

Genesis Pharmaceuticals Enterprises, Inc.  
Form 10-Q  
February 13, 2009

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended: December 31, 2008

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 333-86347

GENESIS PHARMACEUTICALS ENTERPRISES, INC.  
(Exact name of small business issuer as specified in its charter)

Florida  
(State or other jurisdiction of  
incorporation or organization)

65-1130026  
(IRS Employer Identification No.)

Middle Section, Longmao Street, Area A, Laiyang Waixiangxing Industrial Park  
Laiyang City, Yantai, Shandong Province, People's Republic of China 265200  
(Address of principal executive offices)

(0086) 535-7282997  
(issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller 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  (Do not check if smaller reporting company)  
Smaller reporting company

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date. The total shares outstanding at February 12, 2009 were 10,351,448.

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## INDEX

	Page
<b>PART I - FINANCIAL INFORMATION</b>	
Item 1. Financial Statements	3
Consolidated Balance Sheets as of December 31, 2008 (Unaudited) and June 30, 2008	3
Consolidated Statements of Income and Other Comprehensive Income for the six months and three months ended December 31, 2008 and 2007 (Unaudited)	4
Consolidated Statements of Cash Flows for the six months ended December 31, 2008 and 2007 (Unaudited)	5
Notes to Consolidated Financial Statements (Unaudited)	6
Item 2. Management's Discussion and Analysis or Plan of Operation	36
Item 3. Quantitative and Qualitative Disclosure About Market Risk	44
Item 4T. Controls and Procedures	45
<b>PART II - OTHER INFORMATION</b>	
Item 1. Legal Proceedings	46
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	48
Item 3. Defaults upon Senior Securities	48
Item 4. Submission of Matters to a Vote of Securities Holders	48
Item 5. Other Information	48
Item 6. Exhibits	49

## GENESIS PHARMACEUTICALS ENTERPRISES, INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

## A S S E T S

	December 31, 2008 (Unaudited)	June 30, 2008
<b>CURRENT ASSETS:</b>		
Cash	\$ 76,379,860	\$ 48,195,798
Restricted cash	6,580,962	7,839,785
Investments	532,724	2,055,241
Accounts receivable, net of allowance for doubtful accounts of \$ 267,957 and \$155,662, respectively	26,101,618	24,312,077
Accounts receivable - related parties	188,022	673,808
Inventories	4,978,846	3,906,174
Other receivables	2,324,562	152,469
Other receivables-related parties	237,343	-
Advances to suppliers and other assets	124,578	1,718,504
<b>Total current assets</b>	<b>117,448,515</b>	<b>88,853,856</b>
<b>PLANT AND EQUIPMENT, net</b>	<b>11,125,526</b>	<b>11,225,844</b>
<b>OTHER ASSETS:</b>		
Restricted investments	600,075	2,481,413
Financing costs, net	1,576,793	1,916,944
Intangible assets, net	9,823,785	9,916,801
<b>Total other assets</b>	<b>12,000,653</b>	<b>14,315,158</b>
<b>Total assets</b>	<b>\$ 140,574,694</b>	<b>\$ 114,394,858</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable	\$ 2,924,891	\$ 2,341,812
Short term bank loans	2,200,500	2,772,100
Notes payable	6,580,962	5,843,295
Other payables	5,613,441	3,671,703
Other payables - related parties	391,793	324,972
Accrued liabilities	231,715	173,604
Liabilities assumed from reorganization	1,771,650	1,084,427
Taxes payable	14,014,450	166,433
<b>Total current liabilities</b>	<b>33,729,402</b>	<b>16,378,346</b>
<b>CONVERTIBLE DEBT, net of discount \$31,364,174 and \$32,499,957 as of December 31, 2008 and June 30, 2008, respectively</b>	<b>3,986,278</b>	<b>2,500,043</b>
<b>Total liabilities</b>	<b>37,715,680</b>	<b>18,878,389</b>

## COMMITMENTS AND CONTINGENCIES

## SHAREHOLDERS' EQUITY:

Preferred stock Series (\$0.001 par value; 20,000,000 shares authorized; none issued or outstanding )	-	-
Common stock (\$0.001 par value, 22,500,000 and 15,000,000 shares authorized, respectively; 9,791,448 and 9,767,844 shares issued and outstanding, respectively)	9,792	9,770
Paid-in-capital	73,566,519	45,554,513
Capital contribution receivable	(27,845,000)	(11,000)
Retained earnings	46,109,412	39,008,403
Statutory reserves	4,685,539	3,253,878
Accumulated other comprehensive income	6,332,752	7,700,905
Total shareholders' equity	102,859,014	95,516,469
Total liabilities and shareholders' equity	\$ 140,574,694	\$ 114,394,858

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

GENESIS PHARMACEUTICALS ENTERPRISES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME  
(UNAUDITED)

	For the Three Months Ended December 31,		For the Six Months Ended December 31,	
	2008	2007	2008	2007
<b>REVENUES:</b>				
Sales	\$ 32,944,809	\$ 25,154,071	\$ 60,265,493	\$ 40,416,860
Sales- related parties	-	1,394,662	243,909	2,742,757
<b>TOTAL REVENUE</b>	<b>32,944,809</b>	<b>26,548,733</b>	<b>60,509,402</b>	<b>43,159,617</b>
<b>Cost of sales</b>				
Cost of sales	7,138,166	6,524,403	12,851,210	10,730,348
Cost of sales -related parties	-	292,040	54,493	676,209
<b>COST OF SALES</b>	<b>7,138,166</b>	<b>6,816,443</b>	<b>12,905,703</b>	<b>11,406,557</b>
<b>GROSS PROFIT</b>	<b>25,806,643</b>	<b>19,732,290</b>	<b>47,603,699</b>	<b>31,753,060</b>
<b>RESEARCH AND DEVELOPMENT EXPENSE</b>	<b>1,098,525</b>	<b>937,390</b>	<b>2,196,450</b>	<b>1,202,310</b>
<b>SELLING, GENERAL AND ADMINISTRATIVE EXPENSES</b>	<b>13,282,421</b>	<b>10,311,750</b>	<b>26,634,396</b>	<b>17,133,166</b>
<b>INCOME FROM OPERATIONS</b>	<b>11,425,697</b>	<b>8,483,150</b>	<b>18,772,853</b>	<b>13,417,584</b>
<b>OTHER (INCOME) EXPENSE:</b>				
Other (income) expense, net	429,559	(40,185)	1,344,529	(27,507)
Other (income)-related parties	(92,774)	(26,944)	(236,724)	(53,436)
Non-operating (income) expense	(225,558)	(59,606)	(150,937)	297
Interest expense, net	1,549,331	339,484	2,902,125	399,484
Loss from discontinued operations	1,545,607	112,931	1,590,823	112,931
<b>OTHER EXPENSE , NET</b>	<b>3,206,165</b>	<b>325,680</b>	<b>5,449,816</b>	<b>431,769</b>
<b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>	<b>8,219,532</b>	<b>8,157,470</b>	<b>13,323,037</b>	<b>12,985,815</b>
<b>PROVISION FOR INCOME TAXES</b>	<b>2,820,346</b>	<b>3,004,007</b>	<b>4,790,367</b>	<b>4,597,360</b>
<b>NET INCOME</b>	<b>\$ 5,399,186</b>	<b>\$ 5,153,463</b>	<b>\$ 8,532,670</b>	<b>\$ 8,388,455</b>
<b>OTHER COMPREHENSIVE INCOME:</b>				
Unrealized holding (loss) gain	\$ (384,650)	\$ 1,618,203	\$ (1,947,617)	\$ 1,618,203
Foreign currency translation adjustment	248,823	1,050,485	579,464	1,467,831
<b>COMPREHENSIVE INCOME</b>	<b>\$ 5,263,359</b>	<b>\$ 7,822,151</b>	<b>\$ 7,164,517</b>	<b>\$ 11,474,489</b>
	9,771,883	9,641,742	9,770,615	5,907,192

BASIC WEIGHTED AVERAGE NUMBER OF  
SHARES

BASIC EARNINGS PER SHARE	\$	0.55	\$	0.53	\$	0.87	\$	1.42
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DILUTED WEIGHTED AVERAGE NUMBER OF  
SHARES

10,418,317	10,206,553	10,443,463	6,472,003
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DILUTED EARNINGS PER SHARE	\$	0.11	\$	0.02	\$	0.41	\$	0.53
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The accompanying notes are an integral part of these consolidated financial statements.

## GENESIS PHARMACEUTICALS ENTERPRISES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	For the six months ended December 31,	
	2008	2007
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 8,532,670	\$ 8,388,455
Loss from discontinued operations	1,590,823	112,931
Income from continuing operations	10,123,493	8,501,386
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation	289,749	241,282
Amortization of intangible assets	147,120	58,289
Amortization of deferred debt issuance costs	340,151	18,049
Amortization of debt discount	1,646,235	254,630
Bad debt expense	111,237	-
Gain on sale of marketable securities	(115,128)	(64,742)
Unrealized loss (gain) on trading securities	1,459,656	(8,893)
Other non-cash settlement	(20,000)	-
Stock-based compensation	38,028	28,750
Changes in operating assets and liabilities		
Accounts receivable	(1,764,421)	(5,314,103)
Accounts receivable - related parties	488,580	(1,093,483)
Notes receivables	-	58,893
Inventories	(1,049,318)	738,910
Other receivables	(2,175,378)	(84,925)
Other receivables- related parties	(236,724)	-
Advances to suppliers and other assets	1,608,131	(2,129,298)
Accounts payable	569,601	(453,390)
Accrued liabilities	153,587	311,785
Other payables	1,815,563	(879,701)
Other payables - related parties	66,028	13,359
Liabilities assumed from reorganization	(903,600)	(689,022)
Taxes payable	13,821,621	3,363,650
Net cash provided by operating activities	26,414,211	2,871,426
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from sale of marketable securities	117,614	376,205
Prepayment for land use right	-	(2,544,100)
Cash receipt from reverse acquisition	-	534,950
Purchase of equipment	(128,179)	(293,487)
Net cash used in investing activities	(10,565)	(1,926,432)
<b>CASH FLOWS FINANCING ACTIVITIES:</b>		
Decrease in restricted cash	1,292,162	4,270,071
Proceeds from sale of common stock and options exercised	-	180,000
Proceeds from convertible debt	-	5,000,000



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Payments on debt issuance costs	-	(354,408)
Payments for dividends	-	(10,596,800)
Proceeds from short term bank loans	2,196,450	3,183,560
Principal payments on short term bank loans	(2,782,170)	(2,649,200)
Payment to escrow account	-	(325,000)
Increase (Decrease) in notes payable	704,328	(4,270,071)
Net cash provided (used) in financing activities	1,410,770	(5,561,848)
<b>EFFECTS OF EXCHANGE RATE CHANGE IN CASH</b>		
	369,646	513,427
<b>INCREASE (DECREASE) INCREASE IN CASH</b>		
	28,184,062	(4,103,427)
CASH, beginning of the period	48,195,798	17,737,208
CASH, end of the period	\$ 76,379,860	\$ 13,633,781

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

## GENESIS PHARMACEUTICALS ENTERPRISES, INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

(UNAUDITED)

## Note 1 - Organization and business

Genesis Pharmaceuticals Enterprises, Inc. (the “Company” or “Genesis”) was originally incorporated in the state of Florida on August 15, 2001, under the name Genesis Technology Group, Inc. with the principal business objective of operating as a business development and marketing firm that specializes in advising and providing a turnkey solution for small and mid-sized Chinese companies entering Western markets. On October 1, 2007, Genesis executed a Share Acquisition and Exchange Agreement (“Exchange Agreement”) by and among Genesis, Karmoya International Ltd. (“Karmoya”), a British Virgin Islands company, and the shareholders of 100% of Karmoya’s capital stock (the “Karmoya Shareholders”). After the closing of the Exchange Agreement, Karmoya became the Company’s wholly-owned subsidiary, and the Company’s primary operations now consist of the business and operations of Karmoya and its subsidiaries. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of the acquisition:

Cash	\$ 534,950
Prepaid expenses	40,620
Marketable equity securities	370,330
Other assets	7,083
Restricted marketable securities	1,746,809
Restricted marketable securities held for short term loans	3,250,000
Accounts payable and accrued liabilities	(1,085,323)
Loan payable	(515,000)
Other liabilities assumed from acquisition	(452,001)
Minority interest	(121,063)
Net assets acquired	\$ 3,776,405

Contemporaneous with the Exchange Agreement in October 2007, the Company discontinued the business development and marketing segment of the Company, which had been the Company’s principal business objective prior to the reverse merger as described in Note 5 (the business development and marketing segment represented 100% of the Company’s sales prior to October 1, 2007). Liabilities of the business development and marketing segment are reclassified as liabilities assumed from reorganization in the consolidated balance sheets. The results of operations and cash flows of the business development and marketing segment of the Company have been reflected as loss from discontinued operations in the consolidated statements of income and cash flows, respectively. Except for Genesis Pharmaceuticals Enterprises, Inc., all other entities that were consolidated into the Company prior to October 1, 2007, have been administratively dissolved.

Karmoya was established on July 18, 2007, under the laws of the British Virgin Islands (“BVI”). Karmoya was established as a “special purpose vehicle” for the foreign capital raising activities of Laiyang Jiangbo Pharmaceuticals Co., Ltd. (“Laiyang Jiangbo”), a limited liability company formed under the laws of the People’s Republic of China (the “PRC” or “China”). China’s State Administration of Foreign Exchange (“SAFE”) requires the shareholders of any Chinese companies to obtain SAFE’s approval before establishing any offshore holding company structure for foreign financing as well as subsequent acquisition matters under an official notice known as “Circular 106” in the PRC. On September 19, 2007, Karmoya was approved by the local Chinese SAFE as a “special purpose vehicle” offshore company.



On September 20, 2007, Karmoya acquired 100% of Union Well International Limited (“Union Well”), a Cayman Islands corporation established on May 9, 2007. On September 17, 2007, Union Well established a wholly-owned subsidiary, Genesis Jiangbo (“Laiyang”) Biotech Technology Co., Ltd. (“GJBT”), in the PRC as a wholly-owned foreign limited liability company (“WFOE”) with an original registered capital of \$12,000,000. GJBT develops, manufactures, and sells health medicines. The Company increased its registered capital in GJBT to \$30,000,000 in June 2008. In August 2008, the PRC government approved GJBT to increase its registered capital from \$30,000,000 to \$59,800,000. The PRC laws require Union Well, the 100% owner of GJBT to contribute at least 20% of the registered capital within 30 days of the approval and the remaining balance is required to be contributed within two years of the approval date. In August 2008, GJBT’s board of directors approved an increase of additional registered capital in the amount of \$29,800,000 of which \$1,966,000 was paid as of December 31, 2008, and the remaining balance of \$27,834,000 was recorded as a capital contribution receivable as of December 31, 2008.

Laiyang Jiangbo was formed under laws of the PRC in August 2003, with registered capital of \$1,210,000 (RMB 10,000,000). On December 1, 2006, Laiyang Jiangbo’s registered capital increased to \$6,664,000 (RMB 50,000,000), and on December 22, 2006, the registered capital was funded by the contribution of certain buildings to the Company. Laiyang Jiangbo produces and sells western pharmaceutical products in China and focuses on developing innovative medicines to address various medical needs for patients worldwide. Laiyang Jiangbo operates in 26 provinces in the PRC, and is headquartered in Laiyang City, Shandong province, China.

On September 21, 2007, GJBT entered into a series of contractual arrangements (“Contractual Arrangements”) with Laiyang Jiangbo and its shareholders. Under the terms of the Contractual Arrangements, GJBT took control over the management of the business activities of Laiyang Jiangbo and holds a 100% variable interest in Laiyang Jiangbo. The Contractual Arrangements are comprised of a series of agreements, including a Consulting Services Agreement and an Operating Agreement, through which GJBT has the right to advise, consult, manage, and operate Laiyang Jiangbo, and collect and own all of their respective net profits. Additionally, Laiyang Jiangbo’s shareholders have granted their voting rights over Laiyang Jiangbo to GJBT. In order to further reinforce GJBT’s rights to control and operate Laiyang Jiangbo, Laiyang Jiangbo and its shareholders have granted GJBT the exclusive right and option to acquire all of their equity interests in Laiyang Jiangbo or, alternatively, all of the assets of Laiyang Jiangbo. Further, Laiyang Jiangbo’s shareholders have pledged all of their rights, titles, and interests in Laiyang Jiangbo to GJBT. As both companies are under common control, this has been accounted for as a reorganization of entities and the accompanying consolidated financial statements have been prepared as if the reorganization occurred retroactively. The Company consolidates Laiyang Jiangbo’s results of operations, assets and liabilities in its financial statements.

Karmoya used the contractual arrangements to gain control of Laiyang Jiangbo, instead of using a complete acquisition of Laiyang Jiangbo’s assets or equity to make Laiyang Jiangbo a wholly-owned subsidiary of Karmoya, due to the following: (i) PRC laws governing share exchanges with foreign entities, which became effective on September 8, 2006, make the consequences of such acquisitions uncertain and (ii) other than by share exchange, PRC’s laws would require Karmoya to acquire Laiyang Jiangbo in cash, and at the time of the acquisition, Karmoya was unable to raise sufficient funds to pay the full appraised cash fair value for Laiyang Jiangbo’s assets or shares as required under PRC laws.

## Note 2 - Summary of significant accounting policies

### Basis of presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“US GAAP”) for interim financial information and pursuant to the requirements for reporting on Form 10-Q. Accordingly, they do not include all the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, the accompanying consolidated balance sheets, and related interim consolidated statements of income, and cash flows include all adjustments, consisting only of normal

recurring items, however, these consolidated financial statements are not indicative of a full year of operations. The information included in this Form 10-Q should be read in conjunction with information included in the 2008 annual report filed on Form 10-K.

## Principles of consolidation

The accompanying consolidated financial statements include the accounts of the following entities, and all significant intercompany transactions and balances have been eliminated in consolidation:

Consolidated entity name:	Percentage of ownership
Karmoya International Ltd.	100%
Union Well International Limited	100%
Genesis Jiangbo (Laiyang) Biotech Technology Co., Ltd.	100%
Laiyang Jiangbo Pharmaceuticals Co., Ltd.	Variable Interest Entity

Financial Accounting Standards Board (“FASB”) Interpretation Number (“FIN”) 46 (revised December 2003), “Consolidation of Variable Interest Entities, an Interpretation of ARB No.51” (“FIN 46R”), addresses whether certain types of entities, referred to as variable interest entities (“VIEs”), should be consolidated in a company’s consolidated financial statements. In accordance with the provisions of FIN 46R, the Company has determined that Laiyang Jiangbo is a VIE and that the Company is the primary beneficiary, and accordingly, the financial statements of Laiyang Jiangbo are consolidated into the financial statements of the Company.

## Reverse stock split

In July 2008, the Company approved a 40-to-1 reverse stock split, effective September 4, 2008, and a new trading symbol “GNPH” also became effective on that day. The accompanying consolidated financial statements have been retroactively adjusted to reflect the reverse stock split. All share representations are on a post-split basis.

## Foreign currency translation

The reporting currency of the Company is the U.S. dollar. The functional currency of the Company is the local currency, the Chinese Renminbi (“RMB”). In accordance with Statement of Financial Accounting Standards (“SFAS”) 52, “Foreign Currency Translation,” results of operations and cash flows are translated at average exchange rates during the period, assets and liabilities are translated at the unified exchange rates as quoted by the People’s Bank of China at the end of the period, and equity is translated at historical exchange rates. As a result, amounts related to assets and liabilities reported on the consolidated statements of cash flows will not necessarily agree with changes in the corresponding balances on the consolidated balance sheets. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

Translation adjustments amounted to approximately \$6,932,000 and \$6,353,000 as of December 31, 2008 and June 30, 2008, respectively. Asset and liability accounts at December 31, 2008 were translated at 6.85 RMB to \$1.00 as compared to 6.87 RMB at June 30, 2008. Equity accounts were stated at their historical rates. The average translation rates applied to statements of income for the six months ended December 31, 2008 and 2007 were 6.83 RMB and 7.49 RMB to \$1.00.

In accordance with SFAS 95, “Statement of Cash Flows,” cash flows from the Company’s operations is calculated based upon the local currencies using the average translation rate. As a result, amounts related to assets and liabilities reported on the consolidated statements of cash flows will not necessarily agree with changes in the corresponding balances on the consolidated balance sheets.

#### Use of estimates

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The significant estimates made in the preparation of the Company's consolidated financial statements relate to the assessment of the carrying values of accounts receivable and related allowance for doubtful accounts, allowance for obsolete inventory, sales returns, fair value of warrants and beneficial conversion features related to the convertible notes, and fair value of stock options granted to employees. Actual results could be materially different from these estimates upon which the carrying values were based.

#### Revenue recognition

Product sales are generally recognized when title to the product has transferred to customers in accordance with the terms of the sale. The Company recognizes revenue in accordance with the Securities and Exchange Commission's ("SEC") Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements" as amended by SAB No. 104 (together, "SAB 104"), and SFAS 48 "Revenue Recognition When Right of Return Exists." SAB 104 states that revenue should not be recognized until it is realized or realizable and earned. In general, the Company records revenue when persuasive evidence of an arrangement exists, services have been rendered or product delivery has occurred, the sales price to the customer is fixed or determinable, and collectability is reasonably assured.

The Company is generally not contractually obligated to accept returns. However, on a case by case negotiated basis, the Company permits customers to return their products. In accordance with SFAS 48, revenue is recorded net of an allowance for estimated returns. Such reserves are based upon management's evaluation of historical experience and estimated costs. The amount of the reserves ultimately required could differ materially in the near term from amounts included in the accompanying consolidated statements of income.

#### Financial instruments

SFAS 107, "Disclosures about Fair Value of Financial Instruments," requires disclosure of the fair value of financial instruments held by the Company. SFAS 107 defines the fair value of financial instruments as the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company considers the carrying values of cash, accounts receivable, notes receivable, other receivables, prepayments, accounts payable, other payables, accrued liabilities, customer deposits, taxes payable, and loans to approximate their fair values because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest.

#### Stock-based compensation

The Company records stock-based compensation expense pursuant to SFAS 123R, "Share Based Payment." SFAS 123R requires companies to measure compensation cost for stock-based employee compensation plans at fair value at the grant date and recognize the expense over the employee's requisite service period. Under SFAS 123R, the Company's expected volatility assumption is based on the historical volatility of Company's stock or the expected volatility of similar entities. The expected life assumption is primarily based on historical exercise patterns and employee post-vesting termination behavior. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

Stock-based compensation expense is recognized based on awards expected to vest, and there were no estimated forfeitures as the Company has a short history of issuing options. SFAS 123R requires forfeitures to be estimated at the time of grant and revised in subsequent periods, if necessary, if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option-pricing model which was developed for use in estimating the fair value of options. Option-pricing models require the input of highly complex and subjective variables including the expected life of options granted and the Company's expected stock price volatility over a period equal to or greater than the expected life of the options. Because changes in the subjective assumptions can materially affect the estimated value of the Company's employee stock options, it is management's opinion that the Black-Scholes option-pricing model may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

#### Comprehensive income

SFAS 130, "Reporting Comprehensive Income," establishes standards for reporting and display of comprehensive income and its components in financial statements. It requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in financial statements that is displayed with the same prominence as other financial statements. The accompanying consolidated financial statements include the provisions of SFAS 130.

#### Cash and cash equivalents

Cash and cash equivalents include cash on hand and demand deposits in accounts maintained with state-owned banks within the PRC. The Company considers all highly liquid instruments with original maturities of three months or less, and money market accounts to be cash and cash equivalents.

The Company maintains cash deposits in financial institutions that exceed the amounts insured by the U.S. government. Balances at financial institutions or state-owned banks within the PRC are not covered by insurance. Non-performance by these institutions could expose the Company to losses for amounts in excess of insured balances. As of December 31, 2008 and June 30, 2008, the Company's bank balances, including restricted cash balances, exceeded government-insured limits by approximately \$82,926,000 and \$55,576,000, respectively.

#### Restricted cash

Restricted cash represent amounts set aside by the Company in accordance with the Company's debt agreements with certain financial institutions. These cash amounts are designated for the purpose of paying down the principal amounts owed to the financial institutions, and these amounts are held at the same financial institutions with which the Company has debt agreements. Due to the short-term nature of the Company's debt obligations to these banks, the corresponding restricted cash balances have been classified as current in the consolidated balance sheets.

As of December 31, 2008 and June 30, 2008, the Company had restricted cash of approximately \$6,581,000 and \$7,840,000, respectively, of which approximately \$6,581,000 and \$5,843,000, respectively, were maintained as security deposits for bank acceptance related to the Company's notes payable.

#### Investment and restricted investments

Investments are comprised primarily of equity securities and are stated fair value. Certain of these investments are classified as trading securities based on the Company's intent to sell them within the year. Further, certain of these securities are classified as available-for-sale and are reflected as restricted, noncurrent investments, based on the



Company's intent to hold them beyond one year. Restricted investments are securities that were acquired through the reverse acquisition which contained certain restrictions on the securities. For trading securities, realized and unrealized gains and losses are included in the accompanying consolidated statements of income. For available-for-sale securities, realized gains and losses are included in the consolidated statements of income. Unrealized gains and losses for these available-for-sale securities are reported in other comprehensive income, net of tax. The Company has no investments that are considered to be held-to-maturity securities.

For the three months ended December 31, 2008 and 2007, realized loss on trading securities amounted to approximately \$5,000 and \$0 respectively, and for the six months ended December 31, 2008 and 2007, realized gains on trading securities amounted to approximately \$115,000 and \$9,000, respectively. Unrealized losses on trading securities amounted to approximately \$416,000 and \$76,000 for the three months ended December 31 2008 and 2007, and amounted to approximately \$1,460,000 and \$76,000 for the six months ended December 31, 2008 and 2007, respectively.

For the three and six months ended December 31, 2008, unrealized losses on available-for-sales securities amounted to \$385,000 and \$1,948,000, respectively. There was \$1,618,000 and \$1,618,000 in unrealized gains on available-for-sale securities for the three and six months ended December 31, 2007, which has been reflected as a component of accumulated other comprehensive income in shareholders' equity.

#### Accounts receivable

In the normal course of business, the Company extends credit to its customers without requiring collateral or other security interests. Management reviews its accounts receivables at each reporting period to provide for an allowance against accounts receivable for an amount that could become uncollectible. This review process may involve the identification of payment problems with specific customers. The Company estimates this allowance based on the aging of the accounts receivable, historical collection experience, and other relevant factors, such as changes in the economy and the imposition of regulatory requirements that can have an impact on the industry. These factors continuously change, and can have a material impact on collections and the Company's estimation process.

Certain accounts receivable amounts are charged off against allowances after unsuccessful collection efforts. Subsequent cash recoveries are recognized as income in the period when they occur.

#### Inventories

Inventories, consisting of raw materials and finished goods related to the Company's products, are stated at the lower of cost or market utilizing the weighted average method. The Company reviews its inventory periodically for possible obsolete goods or to determine if any reserves are necessary. As of December 31, 2008 and June 30, 2008, the Company has determined that no reserves were necessary.

#### Advances to suppliers

Advances to suppliers represent partial payments or deposits for future inventory and equipment purchases. These advances to suppliers are non-interest bearing and unsecured. From time to time, vendors require a certain amount of monies to be deposited with them as a guarantee that the Company will receive their purchases on a timely basis. As of December 31, 2008 and June 30, 2008, advances to suppliers amounted to approximately \$124,000 and \$1,719,000, respectively.

#### Plant and equipment

Plant and equipment are stated at cost less accumulated depreciation. Additions and improvements to plant and equipment accounts are recorded at cost. When assets are retired or disposed of, the cost and accumulated depreciation are removed from the accounts, and any resulting gains or losses are included in the results of operations in the period of disposition. Maintenance, repairs, and minor renewals are charged directly to operations as incurred. Major additions and betterments to plant and equipment accounts are capitalized. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful lives of the assets are as follows:



	Useful Life
Building and building improvements	5 – 40 Years
Manufacturing equipment	5 – 20 Years
Office equipment and furniture	5 – 10 Years
Vehicles	5 Years

#### Intangible assets

All land in the PRC is owned by the PRC government and cannot be sold to any individual or company. The Company has recorded the amounts paid to the PRC government to acquire long-term interests to utilize land underlying the Company's facilities as land use rights. This type of arrangement is common for the use of land in the PRC. Land use rights are amortized on the straight-line method over the terms of the land use rights, which range from 20 to 50 years. The Company acquired land use rights in August 2004 and October 2007 in the amounts of approximately \$879,000 and \$8,871,000, respectively, which are included in intangible assets.

Patents and licenses include purchased technological know-how, secret formulas, manufacturing processes, technical and procedural manuals, and the certificate of drugs production, and is amortized using the straight-line method over the expected useful economic life of 5 years, which reflects the period over which those formulas, manufacturing processes, technical and procedural manuals are kept secret to the Company as agreed between the Company and the selling parties.

The estimated useful lives of intangible assets are as follows:

	Useful Life
Land use rights	50 Years
Patents	5 Years
Licenses	5 Years

#### Impairment of long-lived assets

Long-lived assets of the Company are reviewed at least annually, more often if circumstances dictate, to determine whether their carrying values have become impaired. The Company considers assets to be impaired if the carrying values exceed the future projected cash flows from related operations. The Company also re-evaluates the periods of depreciation and amortization to determine whether subsequent events and circumstances warrant revised estimates of useful lives. As of December 31, 2008, the Company expects these assets to be fully recoverable.

#### Beneficial conversion feature of convertible notes

The Company accounted for the \$5,000,000 and \$30,000,000 secured convertible notes issued pursuant to the subscription agreements discussed in Note 14 under Emerging Issues Task Force ("EITF") 00-27, "Application of Issue 98-5 to Certain Convertible Instruments." In accordance with EITF 00-27, the Company has determined that the convertible notes contained beneficial conversion feature because on November 6, 2007, the effective conversion price of the \$5,000,000 convertible note was \$5.48 when the market value per share was \$16.00, and on May 30, 2008, the effective conversion price of the \$30,000,000 convertible note was \$4.69 when the market value per share was \$12.00. Total value of beneficial conversion feature of \$2,904,092 for the November 6, 2007 convertible note and \$19,111,323 for the May 30, 2008 convertible debt was discounted from the carrying value of the convertible notes. The beneficial conversion feature is amortized using the effective interest method over the term of the note. As of December 31, 2008 and June 30, 2008, \$19,742,865 and \$20,453,441, respectively, remained unamortized relating to the beneficial conversion features.



## Income taxes

The Company accounts for income taxes in accordance with SFAS 109, "Accounting for Income Taxes." Under the asset and liability method as required by SFAS 109, deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Under SFAS 109, the effect on deferred income taxes of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recognized if it is more likely than not that some portion, or all of, a deferred tax asset will not be realized. Since the Company's operations are domiciled in the PRC, and the taxable income mirrors that of GAAP income, there are no temporary differences that would result in deferred tax assets or liabilities. As such, no valuation allowances were necessary at December 31, 2008 and June 30, 2008.

In July 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109," which clarifies the accounting and disclosure for uncertain tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, and the Company has implemented this interpretation as of July 1, 2007. FIN 48 prescribes a recognition threshold and measurement attribute for recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Under FIN 48, evaluation of a tax position is a two-step process. The first step is to determine whether it is more likely than not that a tax position will be sustained upon examination, including the resolution of any related appeals or litigation based on the technical merits of that position. The second step is to measure a tax position that meets the more-likely-than-not threshold to determine the amount of benefit to be recognized in the financial statements. A tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent period in which the threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not criteria should be de-recognized in the first subsequent financial reporting period in which the threshold is no longer met.

The adoption of FIN 48 at July 1, 2007, did not have a material effect on the Company's consolidated financial statements.

The Company's operations are subject to income and transaction taxes in the United States and in the PRC jurisdictions. Significant estimates and judgments are required in determining the Company's worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations, and as a result the ultimate amount of tax liability may be uncertain. However, the Company does not anticipate any events that would lead to changes to these uncertainties.

## Value added tax

The Company is subject to value added tax ("VAT") for manufacturing products and business tax for services provided. The applicable VAT rate is 17% for products sold in the PRC. The amount of VAT liability is determined by applying the applicable tax rate to the invoiced amount of goods sold (output VAT) less VAT paid on purchases made with the relevant supporting invoices (input VAT). Under the commercial practice of the PRC, the Company paid VAT based on tax invoices issued. The tax invoices may be issued subsequent to the date on which revenue is recognized, and there may be a considerable delay between the date on which the revenue is recognized and the date on which the tax invoice is issued. In the event that the PRC tax authorities dispute the date on which revenue is recognized for tax purposes, the PRC tax office has the right to assess a penalty, which can range from zero to five times the amount of the taxes which are determined to be late or deficient, and will be charged to operations in the period if and when a

determination is been made by the taxing authorities that a penalty is due.

13

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VAT on sales and VAT on purchases amounted to approximately \$5,603,000 and \$781,000, respectively, for the three months ended December 31, 2008, and approximately \$4,615,000 and \$136,000, respectively, for the three months ended December 31, 2007. VAT on sales and VAT on purchases amounted to approximately \$10,287,000 and \$1,155,000, respectively, for the six months ended December 31, 2008, and approximately \$7,530,000 and \$194,000, respectively, for the six months ended December 31, 2007. Sales and purchases are recorded net of VAT collected and paid as the Company acts as an agent for the government. VAT is not impacted by the income tax holiday.

#### Shipping and handling

Shipping and handling costs related to costs of goods sold are included in selling, general and administrative expenses. Shipping and handling costs amounted to approximately \$130,000 and \$99,000 for the three months ended December 31, 2008, and 2007, respectively. Shipping and handling costs amounted to approximately \$252,000 and \$147,000 for the six months ended December 31, 2008, and 2007, respectively.

#### Advertising

Expenses incurred in the advertisement of the Company and the Company's products are charged to operations currently. Advertising expenses amounted to approximately \$24,000 and \$1,539,000 for the three months ended December 31, 2008 and 2007, respectively. Advertising expenses amounted to approximately \$928,000 and \$4,129,000 for the six months ended December 31, 2008 and 2007, respectively.

#### Research and development

Research and development costs are expensed as incurred. These costs primarily consist of cost of materials used and salaries paid for the development of the Company's products and fees paid to third parties to assist in such efforts. Research and development costs amounted to approximately \$1,099,000 and \$937,000 for the three months ended December 31, 2008 and 2007, respectively. Research and development costs amounted to approximately \$2,196,000 and \$1,202,000 for the six months ended December 31, 2008 and 2007, respectively.

#### Recently adopted accounting pronouncements

On July 1, 2008, the Company adopted SFAS 157, "Fair Value Measurements," for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information

SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date. SFAS 157 establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measures. The carrying amounts reported on the balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of fair value because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels of valuation hierarchy are defined as follows:



- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company analyzes all financial instruments with features of both liabilities and equity under SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and EITF 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

As required by SFAS 157, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Depending on the product and the terms of the transaction, the fair value of notes payable and derivative liabilities were modeled using a series of techniques, including closed-form analytic formula, such as the Black-Scholes option-pricing model, which does not entail material subjectivity because the methodology employed does not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets.

The following table sets forth by level within the fair value hierarchy the financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2008.

	Carrying Value at December 31, 2008	Fair Value Measurements at December 31, 2008 Using		
		Level 1	Level 2	Level 3
\$5M Convertible Debt (November 2007)	\$ 865,276	\$ -	\$ -	\$ 5,021,998
\$30M Convertible Debt (May 2008)	3,121,002	-	-	30,326,363
<b>Total</b>	<b>\$ 3,986,278</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 35,348,361</b>

The Company did not identify any other non-recurring assets and liabilities that are required to be presented on the consolidated balance sheets at fair value in accordance with SFAS 157.

SFAS 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115," became effective for the Company on July 1, 2008. SFAS 159 provides the Company with the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis with the difference between the carrying value before election of the fair value option and the fair value recorded upon election as an adjustment to beginning retained earnings. The Company chose not to elect the fair value option.

### Recent accounting pronouncements

In December 2007, the FASB issued SFAS 141(R), "Business Combinations," which replaces SFAS 141. SFAS 141R retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting as well as requiring the expensing of acquisition-related costs as incurred. Furthermore, SFAS 141R provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is evaluating the impact, if any, that the adoption of this statement will have on its consolidated results of operations or consolidated financial position.

In December 2007, the FASB issued SFAS 160, "Noncontrolling Interests in Consolidated Financial Statements — An Amendment of ARB No. 51." SFAS 160 amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It is intended to eliminate the diversity in practice regarding the accounting for transactions between equity and noncontrolling interests by requiring that they be treated as equity transactions. Further, it requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. SFAS 160 also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation, requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated, requires expanded disclosures in the consolidated financial statements that clearly identify and distinguish between the interests of the parent's owners and the interests of the noncontrolling owners of a subsidiary, among others. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008, with early adoption permitted, and it is to be applied prospectively. SFAS 160 is to be applied prospectively as of the beginning of the fiscal year in which it is initially applied, except for the presentation and disclosure requirements, which must be applied retrospectively for all periods presented. The Company has not yet evaluated the impact that SFAS 160 will have on its consolidated financial position or consolidated results of operations.

In February 2008, the FASB issued FASB Staff Position No. 157-1 ("FSP 157-1"), "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13." FSP 157-1 indicates that it does not apply under SFAS 13, "Accounting for Leases," and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under SFAS 13. This scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under SFAS 141 or SFAS 141R, regardless of whether those assets and liabilities are related to leases.

Also in February 2008, the FASB issued FASB Staff Position No. 157-2 ("FSP 157-2"), "Effective Date of FASB Statement No. 157." With the issuance of FSP 157-2, the FASB agreed to: (a) defer the effective date in SFAS No. 157 for one year for certain nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), and (b) remove certain leasing transactions from the scope of SFAS 157. The deferral is intended to provide the FASB time to consider the effect of certain implementation issues that have arisen from the application of SFAS 157 to these assets and liabilities.

In March 2008, the FASB issued SFAS 161, "Disclosures about Derivative Instruments and Hedging Activities." SFAS 161 is intended to improve financial reporting of derivative instruments and hedging activities by requiring enhanced disclosures to enable financial statement users to better understand the effects of derivatives and hedging on an entity's financial position, financial performance and cash flows. The provisions of SFAS 161 are effective for interim periods and fiscal years beginning after November 15, 2008, with early adoption encouraged. The Company does not anticipate that the adoption of SFAS 161 will have a material impact on its consolidated results of operations

or consolidated financial position.

In May 2008, the FASB issued SFAS 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP for nongovernmental entities. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board ("PCAOB") amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." The Company does not expect the adoption of SFAS 162 will have a material impact on its consolidated results of operations or consolidated financial position.

In May 2008, the FASB issued SFAS 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60." The scope of SFAS 163 is limited to financial guarantee insurance (and reinsurance) contracts issued by enterprises included within the scope of SFAS 60. Accordingly, SFAS 163 does not apply to financial guarantee contracts issued by enterprises excluded from the scope of SFAS 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). SFAS 163 also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities." The Company does not expect the adoption of SFAS 163 will have a material impact on its consolidated results of operations or consolidated financial position.

On May 9, 2008, the FASB issued FASB Staff Position No. APB 14-1 ("FSP APB 14-1"), "Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)." FSP APB 14-1 clarifies that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of APB Opinion No. 14, "Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants." Additionally, FSP APB 14-1 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The Company is currently evaluating the impact that FSP APB 14-1 will have on its consolidated results of operations or consolidated financial position.

On June 16, 2008, the FASB issued FASB Staff Position No. EITF 03-6-1 ("FSP EITF 03-6-1"), "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities," to address the question of whether instruments granted in share-based payment transactions are participating securities prior to vesting. FSP EITF 03-6-1 indicates that unvested share-based payment awards that contain rights to dividend payments should be included in earnings per share calculations. The guidance will be effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the requirements of FSP EITF 03-6-1 and the impact that its adoption will have on the consolidated results of operations or consolidated financial position.

In June 2008, the FASB issued Emerging Issues Task Force Issue 07-5 ("EITF 07-5"), "Determining whether an Instrument (or Embedded Feature) is indexed to an Entity's Own Stock." EITF 07-5 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. Paragraph 11(a) of SFAS No. 133 "Accounting for Derivatives and Hedging Activities," specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF 07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS 133 paragraph 11(a) scope exception. This standard triggers liability accounting on all options and warrants exercisable at strike prices denominated in any currency other than the functional currency of the operating entity in the PRC (Renminbi). The Company is currently evaluating the impact of the adoption of EITF 07-5 on the accounting for related warrants transactions.

In June 2008, FASB issued EITF 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5." The objective of EITF 08-4 is to provide transition guidance for conforming changes made to EITF 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," that result from EITF 00-27 "Application of Issue No. 98-5 to Certain Convertible Instruments," and SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." EITF 08-4 is effective for financial statements issued for fiscal years ending after December 15, 2008. Early application is permitted. The Company is currently evaluating the impact of adoption of EITF 08-4 on the accounting for the convertible notes and related warrants transactions.



On October 10, 2008, the FASB issued FSP 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active," which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 became effective on October 10, 2008, and its adoption did not have a material impact on the Company's consolidated results of operations or consolidated financial position for the six months ended December 31, 2008.

#### Reclassifications

Certain amounts in the prior period's consolidated financial statements have been reclassified to conform to the current period presentation with no impact on the previously reported net income or cash flows.

#### Note 3 - Earnings per share

The Company reports earnings per share in accordance with the provisions of SFAS 128, "Earnings Per Share." SFAS 128 requires presentation of basic and diluted earnings per share in conjunction with the disclosure of the methodology used in computing such earnings per share. Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted average common shares outstanding during the period. Diluted earnings per share takes into account the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock.

All share and per share amounts used in the Company's financial statements and notes thereto have been retroactively restated to reflect the 40-to-1 reverse stock split, which occurred on September 4, 2008.

The following is a reconciliation of the basic and diluted earnings per share computations for the three months ended December 31, 2008 and 2007:

#### Basic earning per share

	2008	2007
For the three months ended December 31, 2008 and 2007		
Net income for basic earnings per share	\$ 5,399,186	\$ 5,153,463
Weighted average shares used in basic computation	9,771,883	9,641,782
Earnings per share-Basic	\$ 0.55	\$ 0.53

#### Diluted earning per share

	2008	2007
For the three months ended December 31, 2008 and 2007		
Net income for basic earnings per share	\$ 5,399,186	\$ 5,153,463
Add: Interest expense	76,667	46,667
Add: Note discount amortization	178,338	342,392
Subtract: Loan issuance cost	(218,223)	(336,359)
Subtract: Debt discount if converted	(4,313,060)	(5,000,000)
Net income for diluted EPS	1,122,908	206,163
Weighted average shares used in basic computation	9,771,883	9,641,742

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Diluted effect of stock options and warrants	646,434	564,811
Weighted average shares used in diluted computation	10,418,317	10,206,553
Earnings per share-Diluted	\$ 0.11	0.02

18

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The following is a reconciliation of the basic and diluted earnings per share computations for the six months ended December 31, 2008 and 2007:

## Basic earning per share

	2008	2007
For the six months ended December 31, 2008 and 2007		
Net income for basic earnings per share	\$ 8,532,670	\$ 8,388,455
Weighted average shares used in basic computation	9,770,615	5,907,192
Earnings per share – Basic	\$ 0.87	\$ 1.42

## Diluted earnings per share

	2008	2007
For the six months ended December 31, 2008 and 2007		
Net income for basic earnings per share	\$ 8,532,670	\$ 8,388,455
Add: Interest expense	\$ 153,333	46,667
Add: Note discount amortization	319,916	342,392
Subtract: Loan issuance cost	(218,223)	(336,359)
Subtract: Debt discount if converted	(4,454,641)	(5,000,000)
Net income for diluted EPS	4,333,055	3,441,155
Weighted average shares used in basic computation	9,770,615	5,907,192
Diluted effect of stock options and warrants	672,848	564,811
Weighted average shares used in diluted computation	10,443,463	6,472,003
Earnings per share-Diluted	\$ 0.41	\$ 0.53

For the three and six months ended December 31, 2008, 2,000 stock options and 1,875,000 warrants with an average exercise price of \$12.00 and \$10.00, respectively, were not included in the diluted earnings per share calculation because of the anti-dilutive effect. For the three and six months ended December 31, 2007, 74,084 and 250,000 stock options and warrants at an exercise price of \$10.00 and \$12.80, respectively, were not included in the diluted earnings per share calculation because of the anti-dilutive effect.



## Note 4 - Supplemental disclosure of cash flow information

Cash paid for income taxes amounted to \$128,329 and \$3,434,140 for the six months ended December 31, 2008 and 2007, respectively. Cash paid for income taxes amounted to \$65,386 and \$3,351,133 for the three months ended December 31, 2008 and 2007, respectively.

Cash paid for interest amounted to \$1,110,572 and \$205,729 for the six month ended December 31, 2008 and 2007, respectively. Cash paid for interest amounted to \$1,051,922 and \$115,463 for the three month ended December 31, 2008 and 2007, respectively.

## Note 5 - Discontinued operations

In connection with the reverse merger with Karmoya on October 1, 2007, the Company determined to discontinue its operations of business development and marketing, as it no longer supported its core business strategy. The discontinuance of these operations did not involve any sale of assets or assumption of liabilities by another party. In conjunction with the discontinuance of operations, the Company determined that the assets related to the Company's business development and marketing operations were subject to the recognition of impairment. However, since the related assets are continuing to be used by the company and its subsidiaries, the Company determined that there had been no impairment. The remaining liabilities of the discontinued operations are reflected in the consolidated balance sheets under the caption "liabilities assumed from reorganization" which amounted to \$1,771,650 and \$1,084,427 as of December 31, 2008 and June 30, 2008, respectively.

In accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," the results of operations of a component of entity that has been disposed of or is classified as held for sale shall be reported in discontinued operations. Accordingly, the results of operations of the business development and marketing operation segment are reported as discontinued operations in the accompanying consolidated statements of income for the six months ended December 31, 2008. As the accompanying consolidated statements of income for the six months ended December 31, 2008 reflect the results of operations for Karmoya and its subsidiaries, the discontinued operations of the Company did not have any impact on the consolidated statements of income for the period presented.

The following is a summary of the components of the loss from discontinued operations for the six months ended December 31, 2008 and 2007:

	2008	2007
Revenues	\$ -	\$ -
Cost of sales	-	-
Gross profit	-	-
Operating and other non-operating expenses	1,590,823	112,931
Loss from discontinued operations before other expenses and income taxes	1,590,823	112,931
Income tax benefit	-	-
Loss from discontinued operations	\$ 1,590,823	\$ 112,931

The following is a summary of the components of the loss from discontinued operations for the three months ended December 31, 2008 and 2007:

	2008	2007
Revenues	\$ -	\$ -
Cost of sales	-	-
Gross profit	-	-
Operating and other non-operating expenses	1,545,607	112,931

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Loss from discontinued operations before other expenses and income taxes	1,545,607	112,931
Income tax benefit	-	-
Loss from discontinued operations	\$ 1,545,607	\$ 112,931

20

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## Note 6 - Inventories

Inventories consisted of the following:

	December 31, 2008 (Unaudited)	June 30, 2008
Raw materials	\$ 2,295,316	\$ 2,164,138
Work-in-process	-	531,076
Packing materials	611,336	204,763
Finished goods	2,072,194	1,006,197
<b>Total</b>	<b>\$ 4,978,846</b>	<b>\$ 3,906,174</b>

## Note 7 - Plant and equipment

Plant and equipment consisted of the following:

	December 31, 2008 (Unaudited)	June 30, 2008
Buildings and building improvements	\$ 10,986,277	\$ 10,926,369
Manufacturing equipment	1,171,399	1,188,643
Office equipment and furniture	317,806	298,137
Vehicles	475,462	380,485
<b>Total</b>	<b>12,950,944</b>	<b>12,793,634</b>
Less: accumulated depreciation	(1,825,418)	(1,567,790)
<b>Total</b>	<b>\$ 11,125,526</b>	<b>\$ 11,225,844</b>

For the three months ended December 31, 2008 and 2007, depreciation expense amounted to approximately \$147,000 and \$130,000, respectively. For the six months ended December 31, 2008 and 2007, depreciation expense amounted to approximately \$294,000 and \$241,000, respectively.

## Note 8 - Intangible assets

Intangible assets consisted of the following:

	December 31, 2008 (Unaudited)	June 30, 2008
Land use rights	\$ 9,984,606	\$ 9,930,157
Patents	542,790	539,830
Licenses	23,399	23,271
<b>Total</b>	<b>10,550,795</b>	<b>10,493,258</b>
Less: accumulated amortization	(727,010)	(576,457)
<b>Total</b>	<b>\$ 9,823,785</b>	<b>\$ 9,916,801</b>

Total amortization expense for the three months ended December 31, 2008 and 2007 amounted to approximately \$74,000 and \$27,000, respectively. Total amortization expense for the six months ended December 31, 2008 and 2007 amounted to approximately \$147,000 and \$58,000, respectively.

Note 9 - Debt

Short term bank loan

Short term bank loan represents an amount due to a bank that is due within one year. This loan can be renewed with the bank upon maturity. The Company's short term bank loan consisted of the following:

	December 31, 2008 (Unaudited)	June 30, 2008
Loan from Bank of Communication; due December 2009 and September 2008; interest rates of 6.37 and 8.64% per annum; monthly interest payment; guaranteed by related party, Jiangbo Chinese-Western Pharmacy.	\$ 2,200,500	\$ 2,772,100
Total	\$ 2,200,500	\$ 2,772,100

Interest expense related to the short term bank loans amounted to \$58,665 and \$115,463 for six months ended December 31, 2008 and 2007, respectively. Interest expense amounted to \$15 and \$57,190 for the three months ended December 31, 2008 and 2007, respectively.

Notes Payable

Notes payable represent amounts due to a bank which are normally secured and are typically renewed. All notes payable are secured by the Company's restricted cash. The Company's notes payables consist of the following:

	December 31, 2008 (Unaudited)	June 30, 2008
Commercial Bank, various amounts, due from January 2009 to June 2009	\$ 6,580,962	\$ 5,843,295
Total	\$ 6,580,962	\$ 5,843,295

Note 10 - Related party transactions

Accounts receivable - related parties

The Company is engaged in business activities with three related parties, Jiangbo Chinese-Western Pharmacy, Laiyang Jiangbo Medicals, Co., Ltd, and Yantai Jiangbo Pharmaceuticals Co., Ltd. The Company's Chief Executive Officer and other majority shareholders have 100% ownership of these entities. At December 31, 2008 and June 30, 2008, accounts receivable from sales of the Company's products to these related entities were \$188,022 and \$673,808, respectively. Accounts receivable due from related parties are receivable in cash and due within three to six months. For the three months ended December 31, 2008 and 2007, the Company recorded net revenues of \$0 and \$1,394,662, respectively, from sales to these related parties. For the six months ended December 31, 2008 and 2007, the Company recorded net revenues of \$243,909 and \$2,742,757, respectively, from sales to related parties. For the six months ended December 31, 2008 and 2007, the Company recorded sales to related parties as follows:



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Name of Related Party	Relationship	December 31, 2008 (Unaudited)	December 31 , 2007 (Unaudited)
Jiangbo Chinese-Western Pharmacy	90% owned by Chief Executive Officer	\$ 108,124	\$ 773,446
Laiyang Jiangbo Medicals Co., Ltd.	60% owned by Chief Executive Officer	-	483,591
Yantai Jiangbo Pharmaceuticals Co., L			