DRAGON PHARMACEUTICAL INC
Form 10QSB
May 15, 2006

U.S. Securities and Exchange Commission
Washington, D.C. 20549

Form 10-QSB

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from _____ to _____

Commission file number 0-27937

DRAGON PHARMACEUTICAL INC.
(Exact name of small business issuer as specified in its charter)

| | |
|---|---|
| Florida | 65-0142474 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

1055 West Hastings Street, Suite 1900
Vancouver, British Columbia
Canada V6E 2E9
(Address of principal executive offices)

(604) 669-8817 (Issuer's telephone number)

(Former address 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 Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

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

Number of shares of common stock outstanding as of March 31, 2006: 62,878,004

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS AT MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars
(Basis of Presentation - Note 1)

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS AT MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars
(Basis of Presentation - Note 1)

ASSETS

| | Notes | Ma |
|---|---|---|
| CURRENT ASSETS | | |
| Cash and cash equivalents | 18 | $ |
| Restricted cash | 11,18 | |
| Accounts receivable, net of allowances | 2 | |
| Inventories, net | 3 | |
| Prepaid expenses | | |
| Total Current Assets | | |
| PROPERTY AND EQUIPMENT, NET | 4,9 | |
| OTHER ASSETS | | |
| Intangible assets, net | 6 | |
| Investments -cost | | |
| Goodwill | | |

| | Note | | |
|---|---|---|---|
| Total Other Assets | | | ---- |
| TOTAL ASSETS | | $ | ==== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | |
| CURRENT LIABILITIES | | | |
| Accounts payable | | $ | |
| Accrued retirement benefits | 7 | | |
| Other payables and accrued liabilities | 8 | | |
| Loans payable - short-term | 9 | | |
| Notes payable | 10 | | |
| Due to related companies | 11 | | ---- |
| Total Current Liabilities | | | ---- |
| LONG-TERM LIABILITIES | | | |
| Long term accounts payable | 12 | | |
| Long term retirement benefits | 7 | | |
| Loans payable - long-term | 9 | | ---- |
| Total Long-Term Liabilities | | | ---- |
| TOTAL LIABILITIES | | | ---- |
| COMMITMENTS AND CONTINGENCIES (Note 15) | | | |
| STOCKHOLDERS' EQUITY | | | |
| Authorized: 200,000,000 common shares at par value of $0.001 each | | | |
| Issued and outstanding: 62,878,004 common shares | | | |
| Additional paid-in capital | | | |
| Retained earnings | | | |
| Reserves | | | |
| Accumulated other comprehensive income | | | |
| Due from stockholders | | | ---- |
| Total Stockholders' Equity | | | ---- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | | $ | ==== |

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005
(UNAUDITED) Expressed in US Dollars

| | Note | 2006 | |
|---|---|---|---|
| NET SALES | 13 | $ 16,637,377 | $ |

| | | |
|---|---|---|
| COST OF SALES | | 12,407,835 |
| GROSS PROFIT | | 4,229,542 |
| OPERATING EXPENSES | | |
| Selling expense | | 1,593,756 |
| General and administrative expenses | | 1,681,840 |
| Depreciation and amortization | | 289,737 |
| Total Operating Expenses | | 3,565,333 |
| INCOME FROM OPERATIONS | | 664,209 |
| OTHER INCOME (EXPENSE) | | |
| Interest expense | 12 | (896,580) |
| Other income | 14(A) | 1,477,180 |
| Funds Released by Chinese Government Liquidator | 14(B) | - |
| Other expense | | (7,260) |
| Total other income | | 573,340 |
| INCOME BEFORE TAXES | | 1,237,549 |
| INCOME TAX EXPENSE | | (144,036) |
| NET INCOME | | 1,093,513 |
| OTHER COMPREHENSIVE INCOME | | |
| Foreign currency translation | | 130,120 |
| COMPREHENSIVE INCOME | | $ 1,223,633 |
| Earnings per share - basic and diluted | | $ 0.02 |
| Weighted average number of shares outstanding during the year - basic and diluted | | 62,878,004 |

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



DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND THE YEAR ENDED DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

| Common Stock | Additional |
|---|---|

| | Shares | Amount | Paid-In Capital | Retained Earnings | Reserves |
|---|---|---|---|---|---|
| Balance, December 31, 2004, adjusted for the effect of recapitalization of reverse acquisition (Note 5) | 44,502,004 | $44,502 | $13,983,002 | $ - | $7,562,432 |
| Reverse acquisition (Note 5) | 18,376,000 | 18,376 | 7,919,370 | - | - |
| Related party debt settled for equity (Note 17) | - | - | 2,415,458 | - | - |
| Notes receivable - stockholders | - | - | - | - | - |
| Comprehensive income (loss) | | | | | |
| - foreign currency translation | - | - | - | - | - |
| Transfer from appropriated earnings - to retained earnings | | | | 5,204,022 | (5,204,022 |
| - to liabilities | - | - | - | - | (17,103 |
| Transfer from retained earnings for reserves (Note 16(B)) | - | - | - | (286,701) | 286,70 |
| Net income for the year ended December 31, 2005 | - | - | - | 182,570 | |
| Balance, December 31, 2005 | 62,878,004 | $ 62,878 | 24,317,830 | 5,099,891 | 2,628,00 |
| Notes receivable - stockholders | - | - | - | - | |
| Comprehensive income (loss) | | | | | |
| - foreign currency translation | - | - | - | - | |
| Stock compensation expense | - | - | 90,518 | - | |
| Net income for the period | - | - | - | 1,093,513 | |
| Balance, March 31, 2006 | 62,878,004 | $ 62,878 | $24,408,348 | $ 6,193,404 | $2,628,00 |

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2006 AND 2005
(UNAUDITED) Expressed in US Dollars

CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES:
Net income
Adjustments to reconcile net income to net cash provided by (used in) operating activities:
Depreciation and amortization
Provision for doubtful accounts
Stock compensation expense
Provision for obsolete inventories
Gain on disposal of cell line (Note 14(A))
Proceed on disposition of assets

Funds Released by Chinese Government Liquidator (Note 14)
Changes in operating assets and liabilities, net of effect of reverse acquisition (Note 5)
Accounts receivable
Inventories
Value added tax receivable
Prepaid expenses
Other receivables
Accounts payable
Other payables and accrued expenses

Net Cash Provided By (Used In) Operating Activities

CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES:
Purchase of property and equipment
Proceeds on disposition of assets
Cash and cash equivalents acquired in connection with reverse acquisition (Note 5

Net Cash Provided By (Used In) Investing Activities

CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES:
Proceeds from loans payable
Due to related companies
Due from stockholder

Net Cash Provided By (Used In) Financing Activities

LOSS ON TRANSLATION OF FOREIGN CURRENCY

NET INCREASE IN CASH AND CASH EQUIVALENTS
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD

CASH AND CASH EQUIVALENTS AT END OF PERIOD

Cash paid during the period for interest expense

Cash paid during the period for income taxes

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:
During March 2005, $2,415,458 of loans payable to an entity related to a director of the Company was converted into equity of the Company (Note 17).

The Company capitalized interest of $39,163 and $79,012 during the three months ended March 31, 2006 and 2005, respectively.

The Company recognized non-cash imputed interest of $508,292 and $nil the three months ended March 31, 2006 and 2005, respectively.

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

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 1 BASIS OF PRESENTATION

(A) The accompanying unaudited interim consolidated balance sheets, statements of operations, stockholders' equity and cash flows reflected all adjustments, consisting of normal recurring adjustments and other adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position of the Company, at March 31, 2006, and the results of operations and cash flows for the interim periods ended March 31, 2006 and 2005.

The accompanying unaudited interim consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles, which contemplate continuation of the Company as a going concern. The Company has a current liabilities in excess of current assets, however, the Company has developed and is implementing a plan to decrease its debt and increase its working capital which will allow the Company to continue operations.

To meet these objectives, the Company plans to seek additional equity through the conversion of some of its liabilities and expects to raise funds through a private investment in order to support existing operations and expand the range and scope of its business. The Company has also significantly increased production levels to generate additional cash flow under contracted supply agreements. In addition, the Company intends to continue to renegotiate and extend loans, as required, when they become due, as has been done in the past. There is no assurance that such additional funds will be available for the Company on acceptable terms, if at all. If adequate funds are not available or not available on acceptable terms, the Company may be required to scale back or abandon some activities. Management believes that actions presently taken provide the opportunity for the Company to continue as a going concern. The Company's ability to achieve these objectives cannot be determined at this time. These conditions raise substantial doubt about the Company's ability to continue as a going concern. These financial statements do not include any adjustments that might result from this uncertainty.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instruction for Form 10-QSB pursuant to the rules and regulations of Securities and Exchange Commission and, therefore, do not include all information and notes normally provided in audited financial statements and should be read in conjunction with the Company's consolidated financial statements for the year ended December 31, 2005 included in the annual report previously filed on Form 10-KSB.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.



DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005

(UNAUDITED) Expressed in US Dollars

(B) In December 2004, the FASB issued SFAS No. 123(R), "Accounting for Stock-Based Compensation". SFAS 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123(R) requires that the fair value of such equity instruments be recognized as expense in the historical financial statements as services are performed. Prior to SFAS 123(R), only certain pro-forma disclosures of fair value were required.

SFAS 123(R) was adopted by the Company using the modified prospective transition method beginning January 1 2006. Accordingly during the three months ended March 31, 2006 the Company recorded a non-cash stock based compensation expense for awards granted prior to, but not yet vested, as of January 1, 2006, as if the fair value method required for pro forma disclosure under FAS 123 were in effect for expense recognition purposes. This resulted in $90,518 being charged to income during the current period, whereas $1,077,381 was charged on a pro forma basis in the prior period (Note 16(C)). The effect of the adoption of SFAS 123(R) on the Company's consolidated financial statements of the current period is a reduction in the income from continuing operations, income before income taxes and net income of $90,518. The adoption of SFAS123(R) had no effect on the cash flow from operations, cash flow from financing activities and basic and diluted earnings per share.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs--an amendment of ARB No. 43, Chapter 4", which is the result of the FASB's project to reduce differences between U.S. and international accounting standards. SFAS No. 151 requires idle facility costs, abnormal freight, handling costs, and amounts of wasted materials (spoilage) be treated as current-period costs. Under this concept, if the costs associated with the actual level of spoilage or production defects are greater than the costs associated with the range of normal spoilage or defects, the difference would be charged to current-period expense, not included in inventory costs.

SFAS No. 151 was adopted by the Company beginning January 1 2006. The adoption of SFAS No. 151 did not have an impact on the Company's consolidated financial statements during the current period and is not expected to have an effect in the future.

NOTE 2 ACCOUNTS RECEIVABLE

Accounts receivable at March 31, 2006 and December 31, 2005 consisted of the following:

| | March 31, 2006 |
|---|---|
| Trade and other receivables | $ 10,651,810 |
| Less: allowance for doubtful accounts | 665,648 |
| Accounts receivable, net | $ 9,986,162 |

For the period ended March 31, 2006, the Company recorded a provision for doubtful accounts of $160,823 in the Consolidated Statements of Operations compared to $112,610 for the period ended March 31, 2005.



DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 3 INVENTORIES

Inventories at March 31, 2006 and December 31, 2005 consisted of the following:

| | | March 31, 2006 |
|---|---|---|
| Raw materials | $ | 3,132,224 |
| Work-in-progress | | 6,432,757 |
| Finished goods | | 4,792,534 |
| | | 14,357,515 |
| Less: provision for obsolescence | | 249,294 |
| | $ | 14,108,221 |

For the period ended March 31, 2006, the Company disposed of obsolete inventories resulting in a recovery of $507,820 in the Consolidated Statements of Operations compared to a provision for obsolete inventories of $476,583 for the period ended March 31, 2005.

NOTE 4 PROPERTY AND EQUIPMENT

The following is a summary of property and equipment at March 31, 2006 and December 31, 2005:

| | March 31, 2006 | | | | |
|---|---|---|---|---|---|
| | | Cost | | Accumulated Depreciation | |
| Plant and equipment | $ | 46,869,453 | $ | 8,489,255 | $ |
| Land use rights and buildings | | 21,363,673 | | 848,691 | |
| Motor vehicles | | 969,210 | | 150,299 | |
| Furniture and office equipment | | 3,076,960 | | 1,324,011 | |
| Leasehold improvements | | 8,487 | | 2,342 | |
| Construction in progress | | 8,491,668 | | - | |
| | $ | 80,779,451 | $ | 10,814,598 | $ |



DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

| | December 31, 2005 | | N |
|---|---|---|---|
| | Cost | Accumulated Depreciation | |
| Plant and equipment | $ 46,673,710 | $ 7,350,550 | $ |
| Land use rights and buildings | 21,312,872 | 743,593 | |
| Motor vehicles | 752,919 | 218,136 | |
| Furniture and office equipment | 3,066,099 | 1,252,221 | |
| Leasehold improvements | 1,020,949 | 1,018,504 | |
| Construction in progress | 6,984,143 | - | |
| | $ 79,810,692 | $ 10,583,004 | $ |

Depreciation expense for periods ended the March 31, 2006 and 2005 was $1,370,948 and $1,280,960, respectively. Land use rights and equipment with a net book value of $33.1 million are pledged as collateral for $22.3 million in loans payable (Note 9)

NOTE 5 ACQUISITION OF ORIENTAL WAVE HOLDINGS LIMITED

The Company completed the acquisition of Oriental Wave on January 12, 2005 whereby the Company issued 44,502,004 common shares in exchange for all of the issued and outstanding shares of Oriental Wave. The acquisition represented an important strategic step in strengthening the competitive position of the Company. The transaction has been approved by the Company's shareholders and the regulatory authorities, who also approved an increase in the authorized share capital to 200,000,000 common shares.

This transaction resulted in the former shareholders of Oriental Wave owning 68.35% of the issued and outstanding shares of the combined entity as of January 12, 2005. Accounting principles applicable to reverse acquisition has been applied to record the acquisition. Under this basis of accounting, Oriental Wave is the acquirer and, accordingly, the consolidated entity is considered to be a continuation of Oriental Wave with the net assets of the Company deemed to have been acquired and recorded at its fair market value of approximately $7.9 million. The Statement of operations includes the results of Oriental Wave for the year ended December 31, 2005 and those of the Company from January 13 to December 31, 2005.

The allocation of the net assets acquired is as follows:

| | |
|---|---|
| Cash and cash equivalents | $ 2,103,481 |
| Accounts receivable | 1,527,554 |
| Inventories | 549,189 |
| Prepaid and deposits | 100,421 |
| Total Current Assets | 4,280,645 |
| Property and equipment | 785,742 |

DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

| | |
|---|---|
| Intangible assets | 3,380,222 |
| In-process research and development | 265,000 |
| Goodwill | 965,000 |
| Total Assets | 9,676,609 |
| Less accounts payables and accrued liabilities | (1,738,863) |
| Net assets acquired | $ 7,937,746 |

The intangible assets consist of the production technology and license and customer base acquired and are being amortized over a period of seven years. The in-process research and development costs of $265,000 were written-off to other expense during the year ended December 31, 2005, subsequent to the acquisition.



DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 6 INTANGIBLE ASSETS

The Company acquired $603,865 in licenses from a company related to a director in 2002 with the balance being recorded pursuant to the reverse acquisition of Oriental Wave (Note 5).

Intangible assets consist of the following as of March 31, 2006 and December 31, 2005:

| | March 31, 2006 |
|---|---|
| Production technology | $ 1,670,223 |
| Product licenses | 1,220,815 |
| Customer base | 1,160,000 |
| | 4,051,038 |
| Less: accumulated amortization | 817,031 |
| | $ 3,234,007 |

Amortization expense for periods ended March 31, 2006 and 2005 was $138,564 and $130,025, respectively.

DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 7 ACCRUED RETIREMENT BENEFITS

During July 2003, the Company acquired Land Use Rights and buildings from a government liquidator. The present value of the accrued retirement benefits assumed is recorded at March 31, 2006 and December 31, 2005 as follows:

| | | March 31, 2006 | |
|---|---|---|---|
| Total liabilities assumed at closing date | $ | 8,897,685 | $ |
| Less: reduction of liability due to re-employment | | (4 ,949,474) | |
| Less: net present value of liabilities initially not expected to be paid | | (615,304) | |
| Present value of expected liabilities at closing date | | 3,332,907 | |
| Less: amounts paid and adjustment for liabilities not expected to be paid | | 2,685,577 | |
| | | 647,330 | |
| Less: current portion | | 84,470 | |
| | $ | 562,860 | $ |

Under the terms of the contract with the liquidator, the Company will remain contingently liable for these liabilities until the date of retirement or re-employment for each employee (See Notes 15(D)

NOTE 8 OTHER PAYABLES AND ACCRUED LIABILITIES

Other payables and accrued liabilities at March 31, 2006 and December 31, 2005 consist of the following:

| | | March 31, 2006 |
|---|---|---|
| Machinery and equipment payable | $ | 5,212,137 |
| Non-interest bearing demand loans | | 1,968,151 |
| Current portion of long term payables | | 6,577,159 |
| Accrued expenses | | 1,021,296 |
| Value added tax payables | | 62,020 |
| Income taxes payable | | 190,406 |
| Other taxes payable | | 206,317 |
| Deposits received from customers | | 4,920,415 |

| | |
|---|---|
| | ------------------ |
| | $ 20,157,901 |
| | ================== |



DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 9 LOANS PAYABLE

The Loans payable, denominated in Renminbi Yuan, at March 31, 2006 and December 31, 2005are as follows:

| | | March 31, 2006 |
|---|---|---|
| RMB 4.8 million Loan payable to a bank, interest rate of 8.874% per annum, guaranteed by an unrelated third party, due April 2006 | $ | 597,386 |
| RMB 15,000,000 Loan payable to a bank, interest rate of 6.138% per annum, secured by property and equipment of $2.950.480, due April 2006 | | 1,866,833 |
| RMB 30 million Loan payable to a bank, interest rate of 6.138% per annum, secured by property and equipment of $5,123,703, due May 2006 | | 3,733,665 |
| RMB 5 million Loan payable to a bank, interest rate of 7.254% per annum, secured by property and equipment of $1,236,067, due September 2006 | | 622,278 |
| RMB 1.6 million Loan payable to a bank, interest rate of 7.254% per annum, secured by property and equipment of $661,798, due September 2006 | | 209,085 |
| RMB 52.3 million Loan payable to a bank, interest rate of 6.92% per annum, secured by property and equipment of $9,281,312, due November 2006 | | 6,509,023 |
| RMB 20 million Loan payable to a bank, interest rate of 6.138% per annum, secured by property and equipment of $10,232,169, due January 2007 | | 2,489,110 |
| RMB 55 million Loan payable to a bank, interest rate of 6.336% per annum, secured by property and equipment of $3,582,780, due April 2007 | | 6,845,053 |



DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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| | | |
|---|---|---|
| RMB 38 million Loan payable to a company, non-interest bearing and unsecured, due June 30, 2007 | | 4,730,158 |
| RMB 10.18 million Loan payable to a company, non-interest bearing and unsecured, due December 31, 2007 | | 1,266,922 |
| | | 28,869,513 |
| Less current maturities | | 16,027,380 |
| | $ | 12,842,133 |

Maturities are as follows:

Fiscal year ended December 31,
2006
2007



DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 10 NOTES PAYABLE

Shanxi Weiqida has in place a banking facility where its bank has issued a number of bon- interest bearing notes payable to vendors of Shanxi Weiqida totaling $1,853,955, due between May and July 2006. These notes, are secured by $1,853,955 in bank deposits of Shanxi Weiqida and the bank deposits may be used only for the purpose of repaying the notes.

NOTE 11 DUE TO RELATED PARTIES

The amounts due to related parties at March 31, 2006 and December 31, 2005 are due to the spouse of a shareholder and director and are unsecured and non-interest bearing.

NOTE 12 LONG TERM ACCOUNTS PAYABLE

| | March 31, 2006 |
|---|---|
| Non interest bearing amounts payable to contractors related to the acquisition of plant and equipment. The amounts have been discounted using a rate of 6.5% as a result of term modifications made in 2005. The discount has been | |

| | | |
|---|---|---|
| applied against the cost of the plant and equipment acquired. Due dates range from April 30, 2007 through December 31, 2008. | $ 10,045,185 | $ |

During the period the Company accreted interest of $508,292 (2005 $Nil).

Future annual payments are as follows:

| | |
|---|---|
| 2007 | $ 1,604,515 |
| 2008 | 9,969,227 |
| | $ 11,573,742 |

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DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 13 SEGMENTS

The Company operates in three reportable segments, the Pharma Division, Chemical Division and Biotech Division. The Pharma Division produces chemical generic, mainly anti-infectious, drugs. The Chemical Division produces the bulk intermediate or ingredient to sell to other pharmaceutical companies for further processing and formulation into finished products. The Biotech Division produces Erythropoietin or EPO, an injection that stimulates red blood cell. The accounting policies of the segments are the same as described in the summary of significant accounting policies. The Company evaluates segment performance based on gross profit. All sales by division were to external customers (see Note 18 also). As a result, the components of gross profit for one segment may not be comparable to another segment. The following is a summary of the Company's segment information for the three months ended March 31, 2006 and 2005 and as of March 31, 2006 and December 31, 2005.

| | Chemical Division | Pharma Division | Biotech Division |
|---|---|---|---|
| 2006 | | | |
| Sales | $ 11,475,377 | $ 4,564,245 | $ 597, |
| Gross profit | 2,218,876 | 1,578,208 | 432, |
| Depreciation and amortization | 1,167,706 | 173,390 | 168, |
| As at March 31, 2006 | | | |
| Total assets | 77,567,977 | 17,895,309 | 7,452, |
| Additions to long-lived assets | 1,813,213 | 10,267 | 53, |
| Intangible assets | 46,329 | 368,179 | 2,819, |
| 2005 | | | |
| Three months ended March 31, 2005 | | | |
| Sales | $ 5,704,033 | $ 5,320,771 | $ 803, |

| | | | |
|---|---|---|---|
| Gross profit | 34,425 | 2,508,222 | 666, |
| Depreciation and amortization | 1,057,587 | 153,804 | 199, |
| As at December 31, 2005 | | | |
| Total assets | 75, 831,748 | 17,601,551 | 8,133, |
| Additions to long-lived assets | 10,238,939 | 116,961 | 1,800, |
| Intangible assets | 47,336 | 382,072 | 2,937, |

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DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

NOTE 14 OTHER INCOME

(A) Cell Line Development

The Company has contracted with a European Institute of Biotechnology to develop a high yield proprietary cell line and production process technology for the Company. Product from this advanced technology will be used by the Company to enter the European market, once certain competitor's patents expire. The total contracted cost to develop the cell line was $592,000 (EUROS 500,000) of which $355,000 (EUROS 300,000) was unpaid.

In, January 2006, the Company disposed of the cell line, and all applicable obligations relating, thereto, being developed for the Company to enter the European market. The cell line was sold to a Company controlled by a Director of the Company who was also the President of the Company prior to the transaction. The cell line had a carrying value of $0 and was sold for $1 million, resulting in a gain of $1 million.

Government grants

During the three months ended March 31, 2006, the Shanxi Weiqida applied for, and received, grants of $465,864 from the government for bringing in investment and new technology to Datong city, Shanxi Province.

(B) Funds Released by Chinese Government Liquidator

In July 2003, the Company, through Shanxi Weiqida, acquired out of bankruptcy the Land Use Rights of a state-owned enterprise. After entering into this transaction, the Company was approached by an unrelated state agency to administer certain benefits payable to former employees of the agency (the government liquidator) as the Company had already established an infrastructure to make payments to these employees for settlement of liabilities related to the transaction. As a result, during 2004, the Company received $1,751,208 from the government liquidator, for the settlement of human resources related expenses of the bankrupt enterprise. As well, during the first quarter of 2005, a separate municipal agency, the Datong Municipal Government, approved the transfer of a fund with a balance of $140,036 originally reserved for the employee housing welfare as part of the liquidation process of the state-owned enterprise. The two agencies, unrelated to the acquisition, allowed the Company to retain the cash balance of $745,828 as well as the reserve of $140,036 as payment for services provided by the Company. As a result, the Company recorded other income of $885,864 during the three months ended March 31, 2005 year to reflect the above transactions.

NOTE 15 COMMITMENTS AND CONTINGENCIES

(A) Employee Benefits

The full time employees of Shanxi Weiqida are entitled to employee benefits including medical care, worker compensation, unemployment insurance and pension benefits through a Chinese government mandated multi-employer defined contribution plan. The Company is required to accrue for those benefits based on certain percentages of the employees' salaries. The total provision for such employee benefits





was $130,927 and $116,217 for the three months ended March 31, 2006 and 2005, respectively. The Company is required to make contributions to the plans out of the amounts accrued for medical and pension benefits. The Chinese government is responsible for the medical benefits and the pension liability to be paid to these employees.

(B) Loan Guarantee

The Company has guaranteed a bank loan to a supplier in the amount of $2,489,000 (RMB20 million) due on July 16, 2006. Interest on the loan is charged at 7.905% and the bank has the right to seek settlement from the Company for payment should the supplier fail to repay the loan. There is no recourse or possible recovery for the Company should the suppliers default on their bank loans. The maximum potential amount of future payments (undiscounted) that the Company could be required to make is $2,547,000 (RMB20.55 million). The Company provided the guarantees to these suppliers to maintain a good business relationship.

The Company has also issued a guarantee to a bank as security for loans to a third party vendor of $2,489,000 (RMB20 million) due on September 26, 2007 and $3,734,000 (RMB30 million) due on October 27, 2007. Interest is charged at the bank's base rate plus 5.9475 %. The bank has the right to seek settlement from the Company for payment should the third party vendor fail to repay the loan. The maximum potential amount of future payments (undiscounted) that the Company could be required to make is $ 6,793,000 (RMB54.82 million). This vendor has pledged assets totaling $8,743,000 (RMB70.2 million) to the Company for this guarantee.

(C) Capital Commitments

According to the Articles of Association of Shanxi Weiqida, the Company has to fulfil registered capital of $19,704,877 (RMB 159,018,360) within five years from December 16, 2003. As of March 31, 2006, the Company has fulfilled $15,037,562 (RMB 121,353,123) of registered capital requirement and has registered capital commitments of $4,667,316 (See Note 16(A)).

(UNAUDITED) Expressed in US Dollars

(D) Contingent Employment Benefits

During July 2003, the Company acquired land and buildings from a government liquidator in exchange for assuming certain future employment, healthcare and land acquisition costs of the factory and its former employees. Under the terms of the contract with the liquidator, the Company will remain contingently liable for these liabilities until the earliest of date of retirement, re-employment or death for each employee. As of March 31, 2006, the Company has rehired 679 former employees, 246 employees have retired and 129 former employees remain unemployed. If the Company is unable to provide continued employment to these remaining unemployed individuals, it will be liable to pay them each approximately $55 per month until his or her date of retirement, at age 60 or 50, respectively, or death, whichever comes first (See Note 7).





(E) Operating Leases

(a) The Company has entered into an operating lease agreement for their administrative offices in Vancouver for an amount escalating from CDN$73,000 to CDN$78,000 (US$62,600 to US$66,500) per annum until March 31, 2011. The Company has subleased its previous office space which is leased until March 31, 2007. The total minimum payments required under both leases are as follows:

| | |
|---|---|
| 2006, balance of year | $ 195,115 |
| 2007 | $ 111,996 |
| 2008 | $ 64,038 |
| 2009 | $ 65,941 |
| 2010 | $ 66,416 |
| Thereafter | $ 16,604 |
| | $ 520,110 |

The Company anticipates recovering $123,300 and $41,100 during fiscal 2006 and 2007, respectively, under its sublease agreement.





NOTE 16 STOCKHOLDERS' EQUITY

(A) Capital Contribution (See note 15(C))

On January 31, 2005 and on February 22, 2005 Oriental Wave paid Shanxi Weiqida $479,988 and $198,682, respectively, towards its registered capital requirement under Chinese law.

(B) Reserves

Pursuant to PRC regulations, Shanxi Weiqida is required to make appropriations to reserves funds, comprising the reserve fund, staff welfare fund and enterprise expansion fund, based on after-tax net income determined in accordance with generally accepted accounting principles of the People's Republic of China (the "PRC GAAP"). Appropriation to the reserve fund should be at least 10% of the after tax net income determined in accordance with the PRC GAAP until the reserve is equal to 50% of Shanxi Weiqida's registered capital. The reserve fund is established for covering the potential loss. Appropriations to the staff welfare fund are at a percentage, as determined by the Board of Directors, of the after tax net income determined in accordance with the PRC GAAP. The staff welfare fund is established for the purpose of providing employee facilities and other collective benefits to the employees. Appropriations to the enterprise expansion fund are made at the discretion of the Board of Directors. The enterprise expansion fund is established for expanding business operation. The reserve fund and enterprise expansion fund are recorded as part of shareholders' equity but are not available for distribution to shareholders other than in liquidation; while the staff welfare fund is recorded as a liability and is not for distribution to shareholders. The appropriations for reserves are made by the Board of Directors on an annual basis.

(C) Stock Options

The Company has adopted the 2005 Stock Option Plan, effective August 13, 2005, which allows for the granting of options to Directors and Employees for a period of up to ten years. The Company did not grant any options during the three months ended March 31, 2006. During the year ended December 31, 2005, the Company granted options to its directors and employees to purchase 5,920,000 shares at a weighted average price of $0.91 per share, with 2,260,000 shares at exercise price of $1.18 (being the market price at the time) expiring on January 12, 2010 and 3,660,000 shares at exercise price of $0.74 (being the market price at the time) expiring on September 30, 2010. Options to purchase 4,320,000 shares were exercisable immediately with 400,000 options becoming available on January 12, 2006, 400,000 options becoming available on September 30, 2006, 400,000 options becoming available on January 12, 2007 and the balance of 400,000 options vesting on September 30, 2007.

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DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2006 AND DECEMBER 31, 2005
(UNAUDITED) Expressed in US Dollars

The following summarizes stock option information for the year ended March 31, 2006:

---

Shares

| | |
|---|---|
| Options outstanding at December 31, 2004 | 1,749,000 |
| Granted | 5,920,000 |
| Forfeited/cancelled | (1,231,500) |
| Options outstanding at December 31, 2005 | 6,437,500 |
| Cancelled | (675,000) |
| Options outstanding at March 31, 2006 | 5,762,500 |

Options Outstanding

| Range of Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Ex |
|---|---|---|---|---|
| \$0.01 - \$1.00 | 3,435,000 | 4.30 | \$0.74 | |
| \$1.01 - \$2.00 | 2,327,500 | 3.59 | \$1.22 | |
| | 5,762,500 | 4.02 | \$0.93 | |

In December 2004, the FASB issued SFAS No. 123(R), "Accounting for Stock-Based Compensation". SFAS 123(R) establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123(R) requires that the fair value of such equity instruments be recognized as expense in the historical financial statements as services are performed. Prior to SFAS 123(R), only certain pro-forma disclosures of fair value were required. SFAS 123(R) was adopted by the Company effective as of the beginning of fiscal 2006, on a modified prospective basis, whereby the Company records a non-cash stock based compensation based upon the fair value of the options at the time they are granted. This resulted in \$90,518 being charged to income during there current period.

The Company previously accounted for its stock-based compensation plan in accordance with APB Opinion No. 25, under which no compensation is recognized in connection with options granted to employees and directors except if options are granted with a strike price below fair value of the underlying stock. The Company adopted the disclosure requirements SFAS No. 123, Accounting for Stock-Based Compensation. Accordingly, the Company is required to calculate and present the pro forma effect of all awards granted. For disclosure purposes, the fair value of each option granted to an employee has been estimated as of the date of grant using the Black-Scholes option pricing model with

DRAGON PHARMACEUTICAL INC., AND SUBSIDIARIES
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the following assumptions: risk-free interest rate of 5.5%, dividend yield 0%, volatility of 90%, and expected lives of approximately 0 to 5 years. The weighted average fair value of the options granted during the period was $0.69 for the options granted in January 2005 and $0.43 for the options granted in September 2005. Based on the computed option values and the number of the options issued, had the Company recognized compensation expense in the prior period the following would have been its effect on the Company's net income and earnings per share:

| For the three months ended March 31, | 2006 | 2005 |
|---|---|---|
| Net income for the period: | | |
| - as reported | $1,093,513 | $1,240,7 |
| - pro-forma | $1,093,513 | $163,3 |
| Basic and diluted income per share: | | |
| - as reported | $0.02 | $0. |
| - pro-forma | $0.02 | $0. |

NOTE 17 RELATED PARTY TRANSACTIONS

During March 2005, $2,415,458 of loans payable to an entity related to a director of the Company was converted into equity of the Company.

See Notes 6, 11 and 14(A) also.

NOTE 18 CONCENTRATIONS AND RISKS

64% and 85% of the Company's revenues for the three months ended March 31, 20065 and 2005, respectively, were derived from customers located in China. The Company had sales of $4,784,861 in the Chemical Biotech Divisions to a customer in India, representing 29% of the Company's revenues for the three months ended March 31, 2006. 99% of the Company's assets at March 31, 2006 and December 31, 2005 were located in China.

Sales to the Company's five largest customers accounted for approximately 54% and 33% of the Company's sales for the three months ended March 31, 2006 and 2005, respectively; while sales to the Company's largest customer accounted for approximately 29% and 8%, respectively. Amounts owing from one customer represented 9% of the Company's trade and other receivables at March 31, 2006 and 12 % of the Company's trade and other receivables at December 31, 2005.

The Company is exposed to the risk arising from changing interest rates. A detailed analysis of the Company's Loans Payable, together with their respective interest rates and maturity dates, are included in Note 9.





The majority of the Company's assets, liabilities, revenues and expenses are denominated in Renminbi, which was tied to the US Dollar and is now tied to a basket of currencies of China's largest trading partners, is not a freely convertible currency. The appreciation of the Renminbi against the US Dollar would result in an increase in the assets, liabilities, revenues and expenses of the Company and a foreign currency gain included in comprehensive income. Conversely, the devaluation of the Renminbi against the US Dollar would result in a decrease in the assets, liabilities, revenues and expenses of the Company and a foreign currency loss included in comprehensive income. At March 31, 2006, approximately US$1,393,327 of the cash and cash equivalents (December 31, 2005: US$774,369) and all of the restricted cash are held in Renminbi.



Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

The following discusses the Company's financial condition and results of operations for the three months ended March 31, 2006 based upon the Company's interim unaudited consolidated financial statements which have been prepared in accordance with the United States generally accepted accounting principles. It should be read in conjunction with the Company's audited financial statements and the notes thereto and other financial information included in the Company's Form 10-KSB for the fiscal year ended December 31, 2005.

Incorporated in Florida, USA and headquartered in Vancouver, B.C., Canada, Dragon, prior to the acquisition of Oriental Wave, was formed to develop, market, and sell biologics such as Erythropoietin (EPO) in China and international markets outside of China. Dragon manufactured and sold EPO through its wholly-owned drug manufacturing company Nanjing Huaxin Bio-pharmaceutical Co., Ltd. ("Nanjing Huaxin") located in Nanjing City, China,. Nanjing Huaxin's EPO has been approved and marketed in nine countries including China, India, Egypt, Brazil, Ecuador, the Dominican Republic, Trinidad-Tobago, Peru, and Kosovo. Since August 2005, the Nanjing Huaxin facility was closed and the EPO production facility was relocated to Datong, China. The new EPO production facility is currently located next to the Chemical division facility of Shanxi Weiqida.

On January 12, 2005, the Company completed the acquisition of Oriental Wave in a reverse take-over transaction. Oriental Wave, through its wholly owned subsidiary in China, Shanxi Weiqida Pharmaceutical Ltd. ("Shanxi Weiqida"), currently has five production facilities in China: four Chinese State Food and Drug Administration (SFDA) certified GMP (Good Manufacturing Practice) production facilities consisting of a pharmaceutical facility with a production capacity of 610 million tablets and capsules, 80 million injectables, 47 million sachets, 10 million suppositories and 180 tons of sterilized bulk drugs per year, a chemical plant producing clavulanic acid with an annual capacity of 50 tons, a biotech facility producing EPO and a pharmaceutical facility producing freeze-dry injectables. In addition, Oriental Wave has a fifth facility producing 7-ACA, an intermediate for Cephalosporin antibiotics, by a fermentation process. 7-ACA is an intermediate product and does not require GMP certification for the 7-ACA production facility. Oriental Wave has received approval from the SFDA for 306 drugs, of which 86, mainly anti-infectious drugs, are actively exploited in China. Dragon acquired all of the outstanding shares of Oriental Wave from Mr. Yanlin Han, Mr. Zhanguo Weng, and Ms. Xuemei Liu. As a result of the acquisition, Mr. Han, Mr. Weng, and Ms. Liu collectively owned 68.35% of Dragon's outstanding shares of common stock at the time of the closing of the transaction.

As a result of the acquisition of Oriental Wave, Dragon has transformed into a diversified and growth oriented generic pharmaceutical company with three key business divisions. These divisions consist of a Biotech division for biologics products, such as EPO, a Chemical division for bulk pharmaceutical chemicals and intermediates, such as Clavulanic Acid and 7-ACA, and a Pharma division for formulated drugs, including prescription, over-the-counter drugs and sterilized bulk drugs through two indirect wholly-owned subsidiaries in China, Shanxi Weiqida and Nanjing Huaxin.

The Company, after the acquisition, has significantly increased the size of operations and now has five manufacturing facilities in Datong city, China, approximately 1,800 employees, an additional 1,200 contract sales representatives in China, and 63 key products in 101 different dosages and presentations currently in the Chinese market.

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Pharma Division

The Pharma Division's operations are located in the Datong Economic and Technology Development Zone, Datong City, Shanxi Province, China. Pharma Division produces chemical generic, mainly anti-infectious, drugs. The Pharma Division currently holds approximately 319 product approvals from SFDA, of which only 85 prescription, over-the-counter and sterilized bulk products in different dosages and presentations are currently commercialized in China. At the end of December, 2005, the Company completed a new workshop for the freeze-drying of temperature sensitive pharmaceutical products. Among these products is Levofloxacin, a product marketed by the Company whose production was outsourced to a third party contract manufacturer. The Pharma Division operates its business strategies to focus on the expansion and development of the Chinese market by managing its product portfolio and selecting potential products for commercialization.

Chemical Division

The Chemical Division's facilities are located on Datong Gongnong Road, Datong City, Shanxi Province, China. The Chemical Division produces the bulk pharmaceutical intermediates and API to sell to other pharmaceutical companies for further processing and formulation into finished products. The Chemical Division manages the production of Clavulanic acid and 7-ACA for both Chinese and international markets. The designed production capacity for Clavulanic Potassium and 7-ACA were 30 tons and 400 tons respectively. After the Company's investment in the process optimization and technology improvement, the current production capacity reaches 50 tons and 600 tons for Clavulanic Potassium and 7-ACA respectively. The production for Clavulanic Acid was started in January 2004 and the production of 7-ACA was started in July 2004. One of the key products in Chemical Division is Clavulanic acid, a drug that combines with antibiotics increase the effectiveness of the antibiotics. Dragon is currently the only producer of Clavulanic acid in China. Another key product in the Chemical Division is 7-ACA, an intermediate for Cephalosporin antibiotics. The 600-ton production capacity of 7-ACA positions Dragon among the main producers in the world. The export of 7-ACA to India commenced in 2004. In 2004, Dragon's Chemical Division entered into a 3-year long term supply agreement with a large Indian pharmaceutical company and the Company currently set a target to sell 50% of production to the Indian market. The Chemical Division operates its business strategies to upgrade its technology in order to improve yields and lower production cost, to develop 7-ACA and Clavulanic acid downstream bulk products, and to apply for approvals in the US and EU to enter into European and North American markets.

Biotech Division

The Biotech Division's facility was relocated to Datong, China from its original production site in Nanjing City, China at the end of December, 2005. The new EPO production site is adjacent to the campus of the Chemical division, which already includes the entire basic infrastructure such as power, steam, purified water supply and water treatment facilities. The relocation of the EPO production site to Datong will allow the Company to capitalize on the existing production infrastructure and the efficiency of unified operational management. In the new facility, it is anticipated that the capacity for bulk EPO will be doubled to 120 grams and the capacity for sterile vialing will be tripled to 5 million vials. The sole product of the Biotech Division is Erythropoietin or EPO, an injectable that stimulates red blood cell development. Dragon's Biotech Division develops, manufactures and markets generic EPO with China and developing countries as the current core markets, and has already been approved and sold in 9 countries: China, India, Egypt, Brazil, Peru, Ecuador, Trinidad-Tobago, Dominican Republic and Kosovo. Currently, Dragon's EPO is sold only in countries where there is no patent protection. In the past, Dragon was preparing to enter the European market with a new EPO product under development in Austria. However, in January 2006, the Company sold the development contract with the Austrian partner to a related party for $1 million cash and assumption of all obligations under the contract.



Critical Accounting Policies and Estimates and Recent Accounting Pronouncements

The accompanying management's discussion and analysis of results of operations and financial condition are based upon the Dragon's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses and related disclosure of contingent assets and liabilities. Management evaluates estimates on an ongoing basis. Management bases its estimates on historical experiences and various other factors and assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ materially from these estimates under different assumptions or conditions.

A summary of significant accounting policies and a description of accounting policies that are considered critical are described in Note 1 to the Consolidated Financial Statements contained in this report and in Note 1 to the Dragon's Annual Report on Form 10-KSB for the year ended December 31, 2005. In addition, a description of Recent Accounting Pronouncements is contained in Note 1(B) to the Consolidated Financial Statements contained in this report and in

Note 1(U) to the Consolidated Financial Statements to the Corporation's Annual Report on Form 10-KSB for the year ended December 31, 2005.

Results of Operations

Results of Operations for the Three Months Ended March 31, 2006 and 2005

Sales. Sales for the first quarter ended March 31, 2006 increased 41% to $16.64 million from $11.83 million for the same period in 2005. $10.66 million, or 64% of the sales for the first quarter in 2006 were generated from the sales of products in the Chinese market, and the remaining 5.98 million or 36% were generated from the sales of products in the international markets. $10.11 million, or 85.5% of the sales for the first quarter in 2005 were generated from the sales of products in the Chinese market, and the remaining $1.72 million or 14.5% were generated from the sales of products in international markets. In the first quarter of 2006, $4.56 million, or 27% of the sales, were from the Pharma Division, $11.48 million, or 69% of sales were from the Chemical Division and $0.60 million, or 4% of sales, were from the Biotech Division. For the same period in 2005, 45% of sales were from the Pharma Division, 48% of sales were from the Chemical Division and 7% of sales were from the Biotech Division. The increase in sales during the three months ended March 31, 2006 as compared to the same period for the prior year was primarily due to increases in sales from the Chemical Division.

Cost of sales for the three months ended March 31, 2006 was $12.41 million compared to $8.62 million for the three months ended March 31, 2005. The cost of sales is attributed to the production costs of Dragon's pharmaceutical products with the increase in the cost of sales related to the growth in products and sales in the Chemical Division. Gross profit and gross margin for the three months ended March 31, 2006 were $4.23 million and 25% compared to $3.21 million and 27% for the same period of 2005. The slight decrease in gross margin was mainly due to the increase in sales of the Chemical Division which carried a slightly lower gross margin than products from the other two divisions.

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Divisional Sales and Gross Margin Analysis

The Company's businesses are organized under three business divisions: the Pharma Division, the Chemical Division and the Biotech Division.

Pharma Division

The Pharma Division's sales for the first quarter of 2006 were $4.56 million, accounting for 27% of the total sales of the Company. Comparatively, the Pharma division's sales were $5.32 million for the same period in 2005, contributing 45% of the total sales of the Company. The lower sales were mainly due to the reduction in the retail price of certain prescription drugs imposed by the Chinese government. The lower contribution from the Pharma division was also due to the tremendous growth of the Chemical division achieved during the first quarter of 2006 compared to 2005. The overall gross margin for the division for the first quarter decreased to 35%, representing a 12 basis point decline from the same period of 2005. The reduction in the retail price resulted in the decrease in profit margin.

Chemical Division

The Chemical Division's sales for the first quarter of 2006 were $11.48 million, representing a 101% increase from the sales of $5.70 million during the same period in 2005. The increase is due to the continued increase in export of

7-ACA outside China.

The Chemical Division's gross margin for the first quarter of 2006 was 19%. The gross margin for the division increased from 1% in the comparative period due to the significant increase in production level especially for 7-ACA during the first quarter of 2006 as compared to the same period of 2005.

Biotech Division

The Biotech Division's sales for the three months ended March 31, 2006 were $0.06 million or 4% of sales compared to $0.80 million, or 7% of sales, for the comparative period. The decrease was due to the Company not having any international sales during the period as the new production facilities in Datong have not yet received international orders outside China.

Other Income. During the three months ended March 31, 2006, Dragon recognized $0.57 million of Other Income. This amount primarily consisted of a $1 million gain on the sale of the European EPO cell line development. During the quarter, Dragon disposed of the European EPO cell line, and all applicable obligations relating, thereto, being developed for Dragon to enter the European market. The European EPO cell line was sold to AS Biotech AG, a Swiss company controlled by Dr. Alexander Wick, a Director of Dragon who was also Dragon's President prior to the transaction. The European EPO cell line had a carrying value of $0 and was sold for $1 million and the assumption of all obligations under the agreement. In addition, during the quarter, the Company received $0.47 in Government grants in China. This other income was offset in part by $0.90 in interest expense.

Expenses. Total operating expenses were $3.57 million for the three months ended March 31, 2006 compared to $2.40 million for the same period in 2005. For the three months ended March 31, 2006, the major category of operating expenses was General and Administration expenses which included $0.62 million for salaries, compensation and benefits (of which $0.09 was non-cash stock compensation as a result of stock options granted in the prior year), $0.17

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million for travel expenses, bad debts expense of $0.16and $0.07 million for rent compared to $0.46 million for salaries, compensation and benefits and $0.13 million for travel expenses for the three months of 2005. Operating expenses also included selling expense of $1.50 million and depreciation and amortization of $0.29 million. The increase in operating expenses of $1.17 million for the three months ended March 31, 2006 as compared to the same period for the prior year reflects the additional overhead costs associated with the increase in production and sales in the Chemical Division.

Net Income. Dragon had net income of $1.09 million for the three months ended March 31, 2006 compared to net income of $1.24 million for the same period in 2005. In addition, net income reflects other income of $1.47 million from the gain on the sale of the European EPO cell line development and the receipt of Government grants in China. Shanxi Weiqida is currently subject to income tax at an incentive tax rate, at half of the normal tax rate, for a period of three years commencing in 2005.

Basic Net Income Per Share. Dragon's net income per share has been computed by dividing the net income for the period by the weighted average number of shares outstanding during the same period. Net income per share for both the three months ended March 31, 2006 and 2005 was $0.02 per share. The weighted average number of shares outstanding during the three months ended March 31, 2006 and 2005 were 62,878,004 and 60,427,871 shares, respectively. The outstanding common stock options have no significant dilutive effect on the weighted average number of shares outstanding.

Liquidity and Capital Resources

As of March 31, 2006, Dragon had current liabilities of $45.32 million and current assets of $28.74 million, including cash balance of $3.38 million and accounts receivables of $9.99 million. The excess of current liabilities over current assets is mainly due to the Company financiang operations through bank loans and payables and investment in the new EPO and Freeze-dry Injectable workshops.

The Company has developed and is implementing a plan to decrease its debt and increase its working capital which will allow the Company to continue operations.

To meet these objectives, the Company plans to seek additional equity through the conversion of some of its liabilities and expects to raise funds through a private investment in order to support existing operations and expand the range and scope of its business. The Company has also significantly increased production levels to generate additional cash flow under contracted supply agreements. In addition, the Company intends to continue to renegotiate and extend loans, as required, when they become due, as has been done in the past. There is no assurance that such additional funds will be available for the Company on acceptable terms, if at all. If adequate funds are not available or not available on acceptable terms, the Company may be required to scale back or abandon some activities. Management believes that actions presently taken provide the opportunity for the Company to continue as a going concern. The Company's ability to achieve these objectives cannot be determined at this time.

As of March 31, 2006, Dragon had current liabilities of $45,316,802 as follows:

| | | |
|---|---|---|
| Accounts Payable | | |
| Accrued Retirement Benefits - current portion | | |
| Other Payables and Accrued Expenses | | |
| Due to Related Companies | | |
| Notes payable | | |
| Loans Payable-Short Term:<br>Loan payable to a bank, interest rate of 8.874% per annum, guaranteed by a third party, due April 2006 | $597,386 | |
| Loan payable to a bank, interest rate of 6.138% per annum, secured by property and equipment of $2,950,480, due April 2006 | $1,866,833 | |



| | | |
|---|---|---|
| Loan payable to a bank, interest rate of 6.138% per annum, | | |

| | | |
|---|---|---|
| secured property and equipment of $5,123,703, due April 2006 | $3,733,665 | |
| Loan payable to a bank, interest rate of 7.254% per annum, secured by property and equipment of $1,236,067, due September 2006 | $622,278 | |
| Loan payable to a bank, interest rate of 7.254% per annum, secured by property and equipment of $661,798 due September 2006 | $209,085 | |
| Loan payable to a bank, interest rate of 6.92% per annum, secured by property and equipment of $9,281,312, due November 2006 | 6,509,023 | |
| Loan payable to a bank, interest rate of 6.138% per annum, secured by property and equipment of $10,232,169, due January 2007 | 2,489,110 | |
| Loans Payable - Short Term Subtotal | | |
| Total Current Liabilities | | |

The Accounts payable were incurred as part of the normal course of business of Dragon while other payables and accrued expenses were incurred as part of the investment in establishing the Chemical Division.

As of March 31, 2006, Dragon had outstanding short-term loans (less than one year term) totaling $16.03 million. Dragon believes that it will be successful in the renegotiating loans due based on the assumption that the Company has enhanced its ability to generate additional cash flow from its operation since the loans were originally entered into, even though there is no assurance of renewing the loan. Since then, the Company's Chemical Division commenced production and began generating revenues and cash flow. Further, it entered into a three-year long term supply contract with Aurobindo Biopharma to supply specified amounts of Clavulanic Acid and 7-ACA produced from its Chemical Division.

Long-term Liabilities:

At March 31, 2006, Dragon had long-term liabilities of $23,450,178 as follows:

| | | |
|---|---|---|
| Long-term accounts payable | | $1 |
| Long-term retirement benefits | | |
| Loan Payable - Long Term | | |
| Loan payable to a bank, interest rate of 6.336% per annum, secured by property and equipment of $3,582,780, due April 2007 | 6,845,053 | |
| Loan payable to a company, non-interest bearing and unsecured, due June 2007 | 4,730,158 | |
| Loan payable to a company, non-interest bearing and unsecured, due December 2007 | 1,266,922 | |

| | |
|---|---|
| Loan Payable - Long Term | $1 |
| Total Long-term Liabilities | $2 |

As of March 31, 2006, the Company had long-term retirement benefits of $0.56 million, which was incurred in July 2003 when Shanxi Weiqida acquired land and buildings from a government liquidator in exchange for assuming certain future employment, healthcare and land acquisition costs of the factory and its former employees during July 2003. The Company is required to pay certain minimum wages and health care costs until the date of their employment, retirement or death, whichever occurs first. The total amount of the liabilities assumed on the closing date was $8.90 million, which approximated the appraised value of the land. As of March 31, 2006, Shanxi Weiqida had employed 679 former employees, and 246 former employees have retired. Shanxi Weiqida has calculated the related asset value by computing the net present value of the future

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expected payments to the remaining 129 employees assuming an interest rate of 3%. As of March 31, 2006, 129 former employees of Datong Pharmaceutical remained as the obligation of Dragon.

Dragon has long-term loans payables (one to two years) totaling approximately $12.84 million of which $6.85 million will be due April 2007, $4.73 million will be due June 2007and $1.27 million due April 2007, in addition to long-term account payables of $11.57 million which are due to be paid April 2007 through December 2008.

During the three months ended March 31, 2006, Dragon financed its operations, development of its new EPO and freeze-dry injectable facilities, and increased production level at its Chemical Division through operating revenues, accounts payables and short-term loans. The Company had anticipated that it would increase its production level through an equity financing, however, the anticipated financing has taken longer than expected

Item 3. Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined by Exchange Act Rule 13a-15(e)) as of the end of the quarter pursuant to Exchange Act Rule 13a-15(b)), and concluded that Dragon's disclosure controls and procedures are effective to ensure that information required to be disclosed in Dragon's reports filed with the Securities and Exchange Commission pursuant to the Exchange Act is accumulated and communicated to management, including Dragon's Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, as of the end of the period covered by this report, the Chief Executive Officer and Chief Financial Officer concluded that Dragon's disclosure controls and procedures were effective in recording, processing, summarizing and reporting information required to be disclosed by Dragon within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in our internal control over financial reporting that occurred during such quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is not currently involved in any legal proceedings.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None

Item 3. Defaults Upon Senior Securities.

None

Item 4. Submission of Matters to a Vote of Security Holders.

None



Item 5. Other Information.

None

Item 6. Exhibits and Reports on Form 8-K.

Exhibits.

| Exhibit No. | |
|---|---|
| 31.1 | Certification by the Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act. |
| 31.2 | Certification by the Principal Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act. |
| 32 | Certification by the Principal Executive and Financial Officers Pursuant to Section 906 of the Sarbanes-Oxley Act. |



## SIGNATURES

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

DRAGON PHARMACEUTICAL INC.

(registrant)

Date: May 15, 2006

/s/ Yanlin Han
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Yanlin Han

Chief Executive Officer

Dated: May 15, 2006

/s/ Garry Wong
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Garry Wong
Chief Financial Officer