

DRAGON PHARMACEUTICAL INC  
Form 10-Q  
August 14, 2007

U.S. Securities and Exchange Commission

Washington, D.C. 20549

**Form 10-Q**

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

For the quarterly period ended June 30, 2007

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

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(State or other jurisdiction of (IRS Employer Identification No.)  
incorporation or organization)

650 West Georgia Street, Suite 310

Vancouver, British Columbia

Canada V6B 4N9

(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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerate filer, or a non-accelerated filer. See definition of accelerated filer and large and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerate filer

Accelerated filer

Non-accelerated

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

Number of shares of common stock outstanding as of August 14, 2007: 66,374,507



**PART I. FINANCIAL INFORMATION**

**Item 1.**

**Financial Statements**

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****AS AT JUNE 30, 2007 AND DECEMBER 31, 2006****(UNAUDITED) Expressed in US Dollars****(Basis of Presentation Note 1)**

| <b><u>ASSETS</u></b>                              |       | June 30,             | December 31,         |
|---|-------|----------------------|----------------------|
|   | Notes | 2007                 | 2006                 |
| <b>CURRENT ASSETS</b>                             |       |                      |                      |
| Cash and cash equivalents                         | 17    | \$ 1,190,711         | \$ 1,078,536         |
| Restricted cash                                   | 9,17  | 1,966,709            | -                    |
| Accounts receivable, net of allowances            | 2     | 9,110,102            | 4,252,470            |
| Inventories, net                                  | 3     | 10,344,032           | 11,219,909           |
| Prepaid expenses                                  |       | 1,713,269            | 1,183,442            |
| Due from related companies                        | 10    | 488,405              | 192,300              |
| Total Current Assets                              |       | 24,813,228           | 17,926,657           |
| <b>PROPERTY AND EQUIPMENT, NET</b>                | 4,8   | 65,375,754           | 62,681,205           |
| <b>OTHER ASSETS</b>                               |       |                      |                      |
| Intangible assets, net                            | 5     | 2,351,914            | 2,578,858            |
| Investments -cost                                 |       | 13,115               | 12,792               |
| Goodwill  |       | 965,000              | 965,000              |
| Total Other Assets                                |       | 3,330,029            | 3,556,650            |
| <b><u>TOTAL ASSETS</u></b>                        |       | <b>\$ 93,519,011</b> | <b>\$ 84,164,512</b> |
| <b><u>LIABILITIES AND STOCKHOLDERS EQUITY</u></b> |       |                      |                      |
| <b>CURRENT LIABILITIES</b>                        |       |                      |                      |
| Accounts payable                                  |       | \$ 6,146,726         | \$ 5,709,796         |
| Other payables and accrued liabilities            | 7     | 17,871,060           | 15,337,446           |

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|  |    |               |               |
|--|----|---------------|---------------|
| Loans payable short-term   | 8  | 16,368,499    | 12,799,045    |
| Notes payable  | 9  | 1,966,709     | -             |
| Due to related companies   | 10 | 144,120       | 299,673       |
| Total Current Liabilities  |    | 42,497,114    | 34,145,960    |
| <b>LONG-TERM LIABILITIES</b>                                       |    |               |               |
| Long term accounts payable   | 11 | 1,595,219     | 4,049,862     |
| Loans payable long-term  | 8  | 7,213,304     | 7,035,497     |
| Total Long-Term Liabilities  |    | 8,808,523     | 11,085,359    |
| TOTAL LIABILITIES  |    | 51,305,637    | 45,231,319    |
| <b>COMMITMENTS AND CONTINGENCIES</b>                               |    |               |               |
| (Note 14)  |    |               |               |
| <b>STOCKHOLDERS EQUITY</b>   |    |               |               |
| Authorized: 200,000,000 common shares at par value of \$0.001 each |    |               |               |
| Issued and outstanding: 62,878,004 common shares                   |    |               |               |
|  |    | 62,878        | 62,878        |
| Additional paid-in capital   |    | 34,431,535    | 33,411,788    |
| Retained earnings  |    | 2,158,958     | 855,249       |
| Reserves   |    | 2,693,426     | 2,693,426     |
| Accumulated other comprehensive income                             |    | 2,890,506     | 1,933,781     |
| Due from stockholders  |    | (23,929)      | (23,929)      |
| Total Stockholders Equity  |    | 42,213,374    | 38,933,193    |
| <b><u>TOTAL LIABILITIES AND STOCKHOLDERS EQUITY</u></b>            |    | \$ 93,519,011 | \$ 84,164,512 |

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

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****AND COMPREHENSIVE INCOME****FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

|                                     | Note | Three<br>Months<br>Ended June<br>30,<br>2007 | Three<br>Months<br>Ended June<br>30,<br>2006 | Six Months<br>Ended June 30,<br>2007 | Six Months<br>Ended June<br>30,<br>2006 |
|-------------------------------------|------|--|--|--------------------------------------|---|
| <b>SALES</b>                        | 12   | \$ 20,550,368                                | \$ 13,889,515                                | 37,878,068                           | 27,044,339                              |
| <b>COST OF SALES</b>                |      | 16,572,422                                   | 11,494,794                                   | 29,837,823                           | 22,020,242                              |
| <b>GROSS PROFIT</b>                 |      | 3,977,946                                    | 2,394,721                                    | 8,040,245                            | 5,024,097                               |
| <b>OPERATING EXPENSES</b>           |      |  |  |                                      |   |
| Selling expense                     |      | 624,795                                      | 616,286                                      | 1,108,332                            | 1,494,424                               |
| General and administrative expenses |      | 1,933,233                                    | 1,364,925                                    | 3,467,773                            | 2,658,118                               |
| Depreciation and amortization       |      | 255,230                                      | 236,399                                      | 506,986                              | 474,347                                 |
| Total Operating Expenses            |      | 2,813,258                                    | 2,217,610                                    | 5,083,091                            | 4,626,889                               |
| <b>INCOME FROM OPERATIONS</b>       |      | 1,164,688                                    | 177,111                                      | 2,957,154                            | 397,208                                 |
| <b>OTHER INCOME (EXPENSE)</b>       |      |  |  |                                      |   |
| Interest expense                    |      | (677,919)                                    | (939,059)                                    | (1,442,956)                          | (1,835,639)                             |
| Other income                        | 13   | 248,495                                      | 4,169  | 259,674                              | 1,474,041                               |
| Other expense                       |      | (73,202)                                     | -  | (95,877)                             |   |
| Total other income (expense)        |      | (502,626)                                    | (934,890)                                    | (1,279,159)                          | (361,598)                               |

|  |   |              |              |           |           |
|--|---|--------------|--------------|-----------|-----------|
| <b>INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE TAXES</b> |   | 662,062      | (757,779)    | 1,677,995 | 35,610    |
| <b>INCOME TAX EXPENSE</b>                                    |   | (208,405)    | (109,677)    | (374,286) | (143,320) |
| <b>INCOME (LOSS) FROM CONTINUING OPERATIONS</b>              |   | 453,657      | (867,456)    | 1,303,709 | (107,710) |
| <b>INCOME FROM DISCONTINUED OPERATIONS</b>                   | 6 | -            | 546,459      | -         | 880,227   |
| <b>NET INCOME (LOSS)</b>                                     |   | 453,657      | (320,997)    | 1,303,709 | 772,517   |
| <b>OTHER COMPREHENSIVE INCOME</b>                            |   |              |              |           |           |
| Foreign currency translation                                 |   | 589,044      | 115,433      | 956,725   | 245,553   |
| <b>COMPREHENSIVE INCOME (LOSS)</b>                           |   | \$ 1,042,701 | \$ (205,564) | 2,260,434 | 1,018,070 |

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



**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**AND COMPREHENSIVE INCOME**

**FOR THE THREE MONTHS AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

Earnings (Loss) per share - basic and diluted

|                                |    |      |    |        |      |      |
|--------------------------------|----|------|----|--------|------|------|
| - from continuing operations   | \$ | 0.01 | \$ | (0.01) | 0.02 | 0.00 |
| - from discontinued operations | \$ | -    | \$ | 0.01   | -    | 0.01 |
| - net income (loss)            | \$ | 0.01 | \$ | 0.00   | 0.02 | 0.01 |

Weighted average number of shares outstanding during the period

|           |            |            |            |            |
|-----------|------------|------------|------------|------------|
| - basic   | 62,878,004 | 62,878,004 | 62,878,004 | 62,878,004 |
| - diluted | 62,878,004 | 62,878,004 | 62,878,004 | 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 SIX MONTHS ENDED JUNE 30, 2007 (UNAUDITED)****Expressed in US Dollars**

|   | Common Stock |           | Additional<br>Paid-In | Retained     |              | Accumulated<br>other<br>compre-<br>hensive<br>income | Due from    |               |
|---|--------------|-----------|-----------------------|--------------|--------------|--|-------------|---------------|
|   | Shares       | Amount    | Capital               | Earnings     | Reserves     |  | Stockholder | Total         |
| <b>Balance,<br/>December 31,<br/>2006</b> | 62,878,004   | \$ 62,878 | \$ 33,411,788         | \$ 855,249   | \$ 2,693,426 | \$ 1,933,781   | (23,929)    | \$ 38,933,193 |
| Comprehensive<br>income                   |              |           |                       |              |              |  |             |               |
| - foreign<br>currency<br>translation      |              |           |                       |              |              | 956,725  |             | 956,725       |
| Stock based<br>compensation               |              |           | 1,019,747             |              |              |  |             | 1,019,747     |
| Net income for<br>the period              |              |           |                       | 1,303,709    |              |  |             | 1,303,709     |
| <b>Balance, June<br/>30, 2007</b>         | 62,878,004   | \$ 62,878 | \$ 34,431,535         | \$ 2,158,958 | \$ 2,693,426 | \$ 2,890,506   | (23,929)    | \$ 42,213,374 |

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

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

|   | 2007         | 2006*       |
|---|--------------|-------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |              |             |
| Income (loss) from continuing operations  | \$ 1,303,709 | (107,710)   |
| Adjustments to reconcile net income to net cash provided by operating activities: |              |             |
| Depreciation and amortization   | 2,934,580    | 2,723,547   |
| Stock compensation expense  | 1,019,747    | 181,036     |
| Accreted interest on long term payable  | 385,534      | 1,036,690   |
| Gain on disposal of cell line (Note 13(A))  | -            | (1,000,000) |
| Loss on disposal of assets  | 41,344       | -           |
| Changes in operating assets and liabilities                                       |              |             |
| Accounts receivable   | (4,703,867)  | (1,121,815) |
| Inventories   | 1,144,695    | (132,484)   |
| Prepaid expenses  | (481,119)    | (49,259)    |
| Accounts payable  | 570,589      | 2,491,422   |
| Amount due from related parties   | (451,658)    | (1,935)     |
| Other payables and accrued expenses   | (296,649)    | 2,313,860   |
| Cash Provided by continuing operations  | 1,466,905    | 6,333,352   |
| Cash Used in discontinued operations  | -            | (897,615)   |
| Net Cash Provided By Operating Activities   | 1,466,905    | 5,435,737   |
| <b>CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES:</b>                            |              |             |
| Purchase of property and equipment  | (3,998,663)  | (2,559,356) |
| Proceeds on disposition of assets   | -            | 514,854     |
| Government grants received in advance   | 1,294,834    | -           |
| Cash Used in continuing operations  | (2,703,829)  | (2,044,502) |
| Cash used in discontinued operations  | -            | (18,054)    |
| Net Cash Used In Investing Activities   | (2,703,829)  | (2,062,556) |

**CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES:**

|   |              |             |
|---|--------------|-------------|
| Due from stockholder  | -            | 5,003       |
| Repayment of long-term account payable  | (2,986,049)  | -           |
| Repayment of non-interest bearing demand loans                                | (173,249)    | -           |
| Proceeds from non-interest bearing demand loans                               | 1,300,000    | -           |
| Proceeds from loans payable   | 6,422,375    | -           |
| Repayment of loans  | (3,217,662)  | (3,764,943) |
| Net Cash Provided by (Used In) Financing Activities                           | 1,345,415    | (3,759,940) |
| <br>  |              |             |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH                                       | 3,684        | 33,371      |
| <br>  |              |             |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                          | 112,175      | (353,388)   |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD                              | 1,078,536    | 1,311,378   |
| <br>  |              |             |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD                                    | \$ 1,190,711 | 957,990     |
| <br>  |              |             |
| Cash paid during the period for interest expense, net of capitalized interest | \$ 854,992   | 852,848     |
| Cash paid during the period for income taxes                                  | \$ 249,402   | 251,481     |

**SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:**

The Company capitalized interest of \$25,877 and \$81,473 during the six months ended June 30, 2007 and 2006, respectively.

\*2006 Q2 Cash flow has been reclassified to reflect the results of discontinued operations. (See Note 6)

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

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

**NOTE 1**

**BASIS OF PRESENTATION**

(A) The accompanying unaudited interim consolidated balance sheets, statements of operations and comprehensive income, stockholders' equity and cash flows reflect 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 June 30, 2007, and the results of operations and cash flows for the interim periods ended June 30, 2007 and 2006.

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 working capital deficiency of \$17,683,886 as at June 30, 2007. 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.

The Company plans to seek additional equity through the conversion of some of its liabilities and expects to raise funds through private placements 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, or that the Company will be able to negotiate and extend the loans. If adequate funds are not available or not available on acceptable terms or the Company is unable to negotiate or extend its loans, 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. However, 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.

Subsequent to June 30, 2007, the Company issued 3,496,503 shares of restricted common stock upon conversion of US\$1,500,000 non-interest bearing demand loans at US\$0.429 per share.

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

**(B)** 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.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

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 three and six months ended June 30, 2007.

In July 2006, FASB issued Interpretation No. 48. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS Statement No. 109, "Accounting for Income Taxes" ( FIN 48 ). This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The company adopted FIN 48 as of January 1, 2007. The adoption of FIN 48 did not have an impact on the Company's consolidated financial statements during the current period.

In September 2006, FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). The objective of SFAS 157 is to increase consistency and comparability in fair value measurements and to expand disclosures about fair value measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The provisions of SFAS 157 are effective for fair value measurements made in fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, that the adoption of SFAS 157 will have on the Company's consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company currently is assessing the impact of SFAS 159 on its consolidated financial position or results of operation.

**NOTE 2**

**ACCOUNTS RECEIVABLE**

Accounts receivable at June 30, 2007 and December 31, 2006 consisted of the following:

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|                                       | June 30, 2007 | December 31,<br>2006 |
|---------------------------------------|---------------|----------------------|
| Trade receivables                     | \$ 9,030,175  | \$ 4,293,212         |
| Other receivables                     | 845,993       | 665,099              |
|                                       | 9,876,168     | 4,958,311            |
| Less: allowance for doubtful accounts | 766,066       | 705,841              |
| Accounts receivable, net              | \$ 9,110,102  | \$ 4,252,470         |



**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

For the three and six months ended June 30, 2007, the Company recorded a provision for doubtful accounts of \$24,168 and \$52,229, respectively, in the Consolidated Statements of Operations compared to (\$53,208) and \$107,615 for the periods three and six months ended June 30, 2006.

**NOTE 3****INVENTORIES**

Inventories at June 30, 2007 and December 31, 2006 consisted of the following:

|                                  | June 30, 2007 | December 31,<br>2006 |
|----------------------------------|---------------|----------------------|
| Raw materials                    | \$ 4,945,289  | \$ 3,735,622         |
| Work-in-progress                 | 3,368,724     | 2,665,054            |
| Finished goods                   | 2,191,279     | 5,055,394            |
|                                  | 10,505,292    | 11,456,070           |
| Less: provision for obsolescence | 161,260       | 236,161              |
|                                  | \$ 10,344,032 | \$ 11,219,909        |

For the three and six months ended June 30, 2007, the Company recorded a provision for obsolete inventory and a recovery of the obsolescence provision of \$1,039 and (\$79,841) respectively, in the Consolidated Statements of Operations compared to a recovery of \$206,517 and \$582,090 for the three and six months ended June 30, 2006.

**NOTE 4****PROPERTY AND EQUIPMENT**

The following is a summary of property and equipment at June 30, 2007 and December 31, 2006:

|                                | Cost          | June 30, 2007<br>Accumulated<br>Depreciation | Net Book<br>Value |
|--------------------------------|---------------|--|-------------------|
| Plant and equipment            | \$ 52,829,507 | \$ 13,210,704                                | \$ 39,618,803     |
| Land use rights and buildings  | 18,415,152    | 1,137,449                                    | 17,277,703        |
| Motor vehicles                 | 715,627       | 169,043                                      | 546,584           |
| Furniture and office equipment | 2,539,725     | 1,238,738                                    | 1,300,987         |
| Leasehold improvements         | 9,355         | 4,725  | 4,630             |
| Construction in progress       | 6,627,047     | -  | 6,627,047         |
|                                | \$ 81,136,413 | \$ 15,760,659                                | \$ 65,375,754     |

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

|                                |               | December 31, 2006           |    |                   |
|--------------------------------|---------------|-----------------------------|----|-------------------|
|                                | Cost          | Accumulated<br>Depreciation |    | Net Book<br>Value |
| Plant and equipment            | \$ 46,994,977 | \$ 10,821,927               | \$ | 36,173,050        |
| Land use rights and buildings  | 17,203,965    | 783,079                     |    | 16,420,886        |
| Motor vehicles                 | 658,523       | 123,647                     |    | 534,876           |
| Furniture and office equipment | 2,287,291     | 1,018,891                   |    | 1,268,400         |
| Leasehold improvements         | 8,496         | 3,616                       |    | 4,880             |
| Construction in progress       | 8,279,113     | -                           |    | 8,279,113         |
|                                | \$ 75,432,365 | \$ 12,751,160               | \$ | 62,681,205        |

Depreciation expense for the six months ended June 30, 2007 and 2006 was \$2,690,193 and \$2,477,177, respectively. Depreciation expense for the three months ended June 30, 2007 and 2006 was \$1,388,588 and \$1,261,644, respectively. Land use rights, building and equipment with a net book value of \$45.9 million are pledged as collateral for \$22.8 million in loans payable (Note 8).

**NOTE 5****INTANGIBLE ASSETS**

Intangible assets consist of the following as of June 30, 2007 and December 31, 2006:

June 30, 2007

December 31, 2006

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|                                |    |           |    |           |
|--------------------------------|----|-----------|----|-----------|
| Production technology          | \$ | 1,670,223 | \$ | 1,670,223 |
| Product licenses               |    | 666,724   |    | 663,847   |
| Customer base                  |    | 1,160,000 |    | 1,160,000 |
|                                |    | 3,496,947 |    | 3,494,070 |
| Less: accumulated amortization |    | 1,145,033 |    | 915,212   |
|                                | \$ | 2,351,914 | \$ | 2,578,858 |

Amortization expense for the six months ended June 30, 2007 and 2006 was \$244,387 and \$246,370, respectively. For the three months ended June 30, 2007 and 2006, amortization expense was \$122,561 and \$123,356, respectively.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

**NOTE 6**

**ASSETS HELD FOR SALE**

The Company signed two agreements on June 29, 2006 agreeing (1) to dispose part of its formulation business ( Sales of Formulation Business ) and (2) to deliver international registration documentation and services on a related product ( Registration Documentation ), to an unrelated party to the Company.

With the Sales of Formulation Business agreement, the Company agreed to dispose of its formulation production facilities located in the Economic Development Zone in Datong, China, 258 drug approvals from the Chinese State Food and Drug Administration ( SFDA ), the entire related hospital direct sales team for the formulation business and related inventories, accounts receivable and accounts payable, (or collectively Net Working Capital ). The Sales of Formulation Business became effective on July 1, 2006. According to the agreement, the buyer did not assume or have any responsibility for any obligation or liability in connection with any of the assets purchased arising prior to the completion of delivery of the assets purchased, including, any environmental liabilities or contamination which arise or result, directly or indirectly, from operation and use of any assets purchased. The proceeds for this agreement was \$ 13.32 million comprising \$8.20 million in cash and the assumption of \$5.12 million in long-term liabilities.

With the Registration Documentation agreement, the Company agreed to provide certain international registration documentation and assistance to complete the registration. On July 28, 2006, the Company amended the Registration Documentation agreement. The proceeds for this agreement, which was completed in September, 2006, was \$1,500,000 in cash which was received in the third quarter of 2006. The amended Agreement expanded the scope and coverage which will allow the Company to provide additional international registration documentation and assistance to complete the registration in other market areas. The fees related to the expanded scope will be negotiated and determined in the future.

The total proceeds for these two agreements in aggregate were approximately \$14 million.

The operations of the formulation business sold have been reclassified and are presented in the consolidated financial statements as discontinued operations. A summary of such discontinued operations of the formulation business is as follows:

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

|                                    |    | Three Months<br>Ended June 30,<br>2006 | Six Months Ended<br>June 30, 2006 |
|------------------------------------|----|--|-----------------------------------|
| Net sales                          | \$ | 4,937,253                              | \$ 8,419,806                      |
| Cost of sales                      |    | 3,295,048                              | 5,177,434                         |
| Gross Profit                       |    | 1,642,205                              | 3,242,372                         |
| Operating and other expenses       |    | 1,040,008                              | 2,196,014                         |
| Income before taxes                |    | 602,197                                | 1,046,358                         |
| Income tax expense                 |    | (55,738)                               | (166,131)                         |
| Income from discontinued operation | \$ | 546,459                                | \$ 880,227                        |

**NOTE 7****OTHER PAYABLES AND ACCRUED LIABILITIES**

Other payables and accrued liabilities at June 30, 2007 and December 31, 2006 consist of the following:

|                                       |    | June 30, 2007 | December 31,<br>2006 |
|---------------------------------------|----|---------------|----------------------|
| Machinery and equipment payable       | \$ | 8,214,624     | \$ 8,299,839         |
| Non-interest bearing demand loans     |    | 3,413,755     | 2,037,736            |
| Current portion of long term payables |    | 1,362,382     | 1,403,915            |
| Advance of Government grants *        |    | 1,311,510     | -                    |
| Accrued expenses                      |    | 1,682,637     | 1,187,937            |
| Value added tax payables              |    | 355,434       | 93,659               |
| Income taxes payable                  |    | 433,256       | 319,250              |
| Other taxes payable                   |    | 751,507       | 986,234              |

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|                                  |               |               |
|----------------------------------|---------------|---------------|
| Deposits received from customers | 345,955       | 1,008,876     |
|                                  | \$ 17,871,060 | \$ 15,337,446 |

\* During the three months ended June 30, 2007, the Company received \$1,311,510 (RMB10 million) of government grants relating to the construction of a water treatment facility. Upon receipt of final approval of the completed project, which is expected to be received prior to December 31, 2007, the amount of \$1,311,510 will be reclassified to reduce the cost of the assets.



**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars****NOTE 8****LOANS PAYABLE**

The loans payable, denominated in Renminbi Yuan ( RMB ), are as follows:

|  | June 30, 2007 | December 31,<br>2006 |
|--|---------------|----------------------|
| RMB 20 million loan payable to a bank, interest rate of 6.138% per annum, collateralized by property and equipment with a net book value of \$ 9,587,611, due January 2007     | -             | 2,558,363            |
| RMB 4.35 million loan payable to a bank, interest rate of 9.486% per annum, guaranteed by an unrelated third party, due April 2007   | -             | 556,444              |
| RMB 3.78 million loan payable to a bank, interest rate of 7.344% per annum, collateralized by property and equipment with a net book value of \$2,594,853 , due September 2007 | 495,751       | 483,530              |
| RMB 2.9 million loan payable to a bank, interest rate of 7.344% per annum, collateralized by property and equipment with a net book value of \$2,535,006, due September 2007   | 380,338       | 370,963              |

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|   |           |           |
|---|-----------|-----------|
| RMB 15 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$3,066,257, due September 2007     | 1,967,265 | 1,918,772 |
| RMB 52.3 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$ 10,669,512 , due December 2007 | 6,859,195 | 6,690,118 |
| RMB 20 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$ 9,194,767, due January 2008      | 2,623,020 | -         |

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

|   |              |              |
|---|--------------|--------------|
| RMB 25 million loan payable to a bank, interest rate of 6.732% per annum, collateralized by land use right and buildings with a net book value of \$ 7,550,448, due February 2008 | 3,278,775    | -            |
| RMB 4.1 million loan payable to a bank, interest rate of 7.938% per annum, guaranteed by an unrelated third party, due October 2007   | 537,718      | -            |
| RMB 55 million loan payable to a bank, interest rate of 8.19% per annum, collateralized by land use right and building with a net book value of \$10,269,849, due September, 2008 | 7,213,304    | 7,035,497    |
| RMB 1.7 million loan payable to a company, non-interest bearing and uncollateralized, due December 31, 2007   | 226,437      | 220,855      |
|   | 23,581,803   | 19,834,542   |
| Less current maturities   | 16,368,499   | 12,799,045   |
|   | \$ 7,213,304 | \$ 7,035,497 |

Maturities are as follows:

|                  |                                |            |
|------------------|--------------------------------|------------|
|                  | Fiscal year ended December 31, |            |
| 2007 (remainder) | \$                             | 10,466,704 |
| 2008             |                                | 13,115,099 |

\$ 23,581,803

**NOTE 9**

**NOTES PAYABLE**

The Company has a banking facility whereby the bank has issued several non-interest bearing notes payable to a vendor totalling \$1,966,709 (RMB 14,995,760) as at June 30, 2007. These notes are collateralized by \$1,966,709 bank deposits that may only be used to repay the notes.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars****NOTE 10****DUE FROM/TO RELATED PARTIES**

The amounts due from /to related parties at June 30, 2007 and December 31, 2006 are unsecured and non-interest bearing:

|   | June 30, 2007 | December 31,<br>2006 |
|---|---------------|----------------------|
| a. Due from related companies   |               |                      |
| Due from a company whose director is also a stockholder and director of the Company (see Note 16) |               |                      |
|   | \$ 488,405    | \$ 192,300           |
| Less: current maturities  | 488,405       | 192,300              |
|   | \$ -          | \$ -                 |
| b. Due to related companies   |               |                      |
| Due to a company whose director is also a stockholder and director of the Company                 |               |                      |
|   | \$ 144,120    | \$ 299,527           |
| Due to a company owned by a stockholder and director  |               |                      |
|   | -             | 146                  |
|   | 144,120       | 299,673              |
| Less: current maturities  | 144,120       | 299,673              |
|   | \$ -          | \$ -                 |

**NOTE 11****LONG TERM ACCOUNTS PAYABLE**

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June 30, 2007

December 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.

Future annual payments are as follows:

|   |    |           |    |           |
|---|----|-----------|----|-----------|
| 2007 (remainder)  | \$ | 1,377,180 | \$ | 1,458,457 |
| 2008  |    | 1,717,309 |    | 4,509,707 |
|   |    | 3,094,489 |    | 5,968,164 |
| Less: debt discount   |    | 136,888   |    | 514,387   |
|   |    | 2,957,601 |    | 5,453,777 |
| Less current maturities included in other payables and accrued liabilities (note 7) |    | 1,362,382 |    | 1,403,915 |
|   | \$ | 1,595,219 | \$ | 4,049,862 |

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars**

The Company accreted interest of \$88,525 and \$385,534 during the three and six months ended June 30, 2007 compared to \$528,398 and \$1,036,690 during the three and six months ended June 30, 2006.

**NOTE 12****SEGMENTS**

The Company operates in three reportable segments, the Pharma Division, Chemical Division and Biotech Division. The Pharma Division produces generic drugs with a focus on cephalosporin antibiotics and freeze-dry injectables. The Chemical Division produces certain 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 in the Company's consolidated financial statement for the year ended December 31, 2006. The Company evaluates segment performance based on gross profit. All sales by division were to external customers (see Note 17). Sales relating to the Chemical Division's 7-ACA product represented approximately 74% and 73% of the division's sales for the three and six months ended June 30, 2007 respectively (76% and 74% for the three and six months ended June 30, 2006 respectively). Substantially all of the Company's assets are located in China. The following is a summary of the Company's segments information for the three and six months ended June 30, 2007 and 2006 and as of June 30, 2007 and December 31, 2006.

|   | Chemical<br>Division | Pharma<br>Division | Biotech<br>Division | Total         |
|---|----------------------|--------------------|---------------------|---------------|
| <b>Three months ended June 30, 2007</b> |                      |                    |                     |               |
| Sales                                   | \$ 16,311,057        | \$ 3,666,240       | \$ 573,071          | \$ 20,550,368 |
| Gross profit                            | 3,870,928            | (326,211)          | 433,229             | 3,977,946     |
| Depreciation and<br>amortization        | 1,268,197            | 22,033             | 187,919             | 1,478,149     |

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|                                |           |       |         |           |
|--------------------------------|-----------|-------|---------|-----------|
| Additions to long-lived assets | 1,994,589 | 2,555 | 119,100 | 2,116,244 |
|--------------------------------|-----------|-------|---------|-----------|

**Six months ended June 30, 2007**

|                                |               |              |            |               |
|--------------------------------|---------------|--------------|------------|---------------|
| Sales                          | \$ 31,340,334 | \$ 5,539,415 | \$ 998,319 | \$ 37,878,068 |
| Gross profit                   | 7,646,140     | (352,629)    | 746,734    | 8,040,245     |
| Depreciation and amortization  | 2,521,956     | 54,748       | 357,876    | 2,934,580     |
| Additions to long-lived assets | 3,798,737     | 3,055        | 139,128    | 3,940,920     |



**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006****(UNAUDITED) Expressed in US Dollars****As at June 30, 2007**

|                   |    |            |    |            |    |           |    |            |
|-------------------|----|------------|----|------------|----|-----------|----|------------|
| Total assets      | \$ | 70,372,098 | \$ | 13,810,901 | \$ | 9,336,012 | \$ | 93,519,011 |
| Goodwill          |    | -          |    | -          |    | 965,000   |    | 965,000    |
| Intangible assets |    | 104,494    |    | -          |    | 2,247,420 |    | 2,351,914  |

**2006\*****Three months ended June 30, 2006**

|                                |    |            |    |           |    |         |    |            |
|--------------------------------|----|------------|----|-----------|----|---------|----|------------|
| Sales                          | \$ | 11,922,615 | \$ | 1,568,592 | \$ | 398,308 | \$ | 13,889,515 |
| Gross profit                   |    | 2,430,686  |    | (231,165) |    | 195,200 |    | 2,394,721  |
| Depreciation and amortization  |    | 1,205,108  |    | -         |    | 179,892 |    | 1,385,000  |
| Additions to long-lived assets |    | 1,167,706  |    | -         |    | 53,518  |    | 1,221,224  |

**Six months ended June 30, 2006**

|                                |    |            |    |           |    |         |    |            |
|--------------------------------|----|------------|----|-----------|----|---------|----|------------|
| Sales                          | \$ | 23,397,992 | \$ | 2,650,284 | \$ | 996,063 | \$ | 27,044,339 |
| Gross profit                   |    | 4,649,562  |    | (253,124) |    | 627,659 |    | 5,024,097  |
| Depreciation and amortization  |    | 2,372,813  |    | 2,426     |    | 348,308 |    | 2,723,547  |
| Additions to long-lived assets |    | 2,493,185  |    | -         |    | 66,171  |    | 2,559,356  |

**As at December 31, 2006**

|                   |    |            |    |           |    |           |    |            |
|-------------------|----|------------|----|-----------|----|-----------|----|------------|
| Total assets      | \$ | 68,517,389 | \$ | 8,138,858 | \$ | 7,508,265 | \$ | 84,164,512 |
| Goodwill          |    | -          |    | -         |    | 965,000   |    | 965,000    |
| Intangible assets |    | 107,835    |    | -         |    | 2,471,023 |    | 2,578,858  |

\* 2006 segment information has been restated to exclude the results of the discontinued operations. (see Note 6).

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

**NOTE 13**

**OTHER INCOME**

**(A) Cell Line Development**

The Company had contracted with a European institute of biotechnology to develop a proprietary cell line and production process technology for the Company to enter the European market. 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.

**(B) Government grants**

During the three and six months ended June 30, 2007, Shanxi Weiqida, a wholly-owned subsidiary of the Company, applied for, and received, non refundable grants of \$115,758 from the government of China for bringing in investment and new technology to Datong city, Shanxi, Province, China.

**NOTE 14**

**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 \$ 117,915 and \$65,782 for

the three months ended June 30, 2007 and 2006, respectively, and \$ 226,850 and \$129,681 for the six months ended June 30, 2007 and 2006, 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 \$2,596,789 (RMB19.8 million) due on July 9, 2007. Interest on the loan is charged at 9.945% and the bank has the right to seek settlement from the Company for payment should the supplier fail to repay the loan. The loan was renewed with the principal amount of \$2,465,638 (RMB18.8million), bearing interest at 9.576%. Such loan is due on July 8, 2008. The company agreed to continue to provide the guarantee on the loan. There is no recourse or possible recovery for the Company should the supplier default on its bank loan. The maximum potential amount of future payments (undiscounted) that the Company could be required to make is \$2,603,157 (RMB 19.85million). The Company provided the guarantees to the supplier to maintain a good business relationship.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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The Company has also issued a guarantee to a bank as collateral for loans to a third party vendor of \$2,623,020 (RMB20 million) due on September 26, 2007 and \$3,934,529 (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 \$ 6,671,453 (RMB 52.12 million). This vendor has pledged certain property and equipment to the Company as collateral for this guarantee.

**(C) Capital Commitments**

According to the Articles of Association of Beijing Weixiang, the Company is required to contribute registered capital of \$5,000,000 to Beijing Weixiang within five years from August 1, 2005. As of June 30, 2007, the Company has contributed \$1,098,683 of the registered capital requirement and has registered capital commitments of \$3,901,317.

**(D) Operating Leases**

The Company has entered into an operating lease agreement for its 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 had subleased its previous office space which was leased until March 31, 2007. The total minimum payments required under both leases are as follows:

|                  |           |
|------------------|-----------|
| 2007 (remainder) | \$ 36,037 |
| 2008             | \$ 64,380 |
| 2009             | \$ 66,500 |
| 2010             | \$ 66,500 |
| Thereafter       | \$ 16,570 |

\$ 249,987

The rent expense for the three and six months ended June 30, 2007 was \$16,802 and \$42,950 respectively (net of nil and \$40,965 sublease income respectively). For the three and six months ended June 30, 2006, the rent expenses was \$74,733 and \$124,618 respectively (net of \$128,188 and \$128,188 sublease income respectively).

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

**NOTE 15**

**STOCKHOLDERS' EQUITY**

**(A) 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). Appropriations 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 potential losses. 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 to reserves are made by the Board of Directors on an annual basis.

During the year ended December 31, 2006 the Company appropriated reserves of \$838,762 and staff welfare fund of \$6,989 based upon the year's net income after tax.

**(B) 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.

During the three months ended June 30, 2007, the Company granted options to its directors and employees to purchase 4,760,000 shares at an exercise price of \$0.51 (being the market price at the time) expiring on May 16, 2010. Of this grant, options to purchase 3,960,000 shares vested immediately with 400,000 options vesting on each of May 16, 2008, and May 16, 2009.

The Company did not grant any options during the year ended December 31, 2006.



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The following table summarizes stock option information for the six months ended June 30, 2007:

|  |           |                | Weighted Average |  |
|--|-----------|----------------|------------------|--|
|  | Shares    | Exercise Price |                  |  |
| Options outstanding at December 31, 2006 | 5,312,500 | \$ 0.91        |                  |  |
| Granted                                  | 4,760,000 | \$ 0.51        |                  |  |
| Expired                                  | (97,500)  | \$ 1.17        |                  |  |
| Options outstanding at June 30, 2007     | 9,975,000 | \$ 0.71        |                  |  |

  

| Range of Exercise Prices | Options Outstanding |   |                                 | Options Exercisable |   |                                 |
|--------------------------|---------------------|---|---------------------------------|---------------------|---|---------------------------------|
|                          | Number Outstanding  | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price |
| \$0.68 - \$0.74          | 8,155,000           | 2.95  | \$0.60                          | 7,155,000           | 2.95  | \$0.61                          |
| \$1.18 - \$1.70          | 1,820,000           | 2.54  | \$1.18                          | 1,820,000           | 2.54  | \$1.18                          |
|                          | 9,975,000           | 2.88  | \$0.71                          | 8,975,000           | 2.87  | \$0.73                          |

The Company recorded stock based compensation expense of \$998,291 and \$1,019,747 for the three and six months periods ended June 30, 2007 (\$90,518 and \$181,036 for the three and six months ended June 30, 2006) related to stock options granted to directors and employees, which amounts are included in general and administrative expenses. The estimated fair value of stock options granted during the three months ended June 30, 2007 was determined using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility-67.23%; risk-free rate -4.58%; expected average life of the options 3 years; dividend yield 0%. The Company estimated a 0% forfeiture rate by considering the historical employee turnover rates and expectations about the future, and will subsequently adjust compensation cost for differences between expectations and actual experience. There were no options granted during the three months ended March 31, 2007 or during the six months ended June 30, 2006. The

estimated fair value of the option granted during the three months ended June 30, 2007 was \$0.25 per share. The fair value of the options is being expensed on a straight line basis over the vesting period of the options.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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Aggregate intrinsic value of the Company's stock options is calculated as the difference between the exercise price of the options and the quoted price of the Company's common shares that were in-the-money. As of June 30, 2007 there was no intrinsic value to the Company's stock options exercisable or outstanding as none of the options were in-the-money. The estimated fair value of stock options vested during the period ended June 30, 2007 and 2006 was \$964,656 and \$276,252. As of June 30, 2007, there was approximately \$182,700 of compensation expense to be recognized over the next two years.

**NOTE 16**

**RELATED PARTY TRANSACTIONS**

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, to a Company controlled by a Director of the Company who was also the President of the Company prior to the transaction for \$1 million. (See Note 13)

As discussed in Note 6, on July 1, 2006, the Company disposed its formulation business to an unrelated party (the Party). Subsequent to the transaction, one of the Company's stockholders and directors became a director of the Party. During the three and six months ended June 30, 2007, the Company supplied certain raw materials to the Party for which the Company charged \$250,938 and \$664,855 respectively, and also used the Party as a contract manufacturer of certain Pharma Division products for which the Party charged \$33,225 and \$222,142 respectively. As at June 30, 2007, the Company had a net balance of \$344,285 due from the Party (see Note 10). The transactions are recorded at exchange amounts agreed to by the related parties.

**NOTE 17**

**CONCENTRATIONS AND RISKS**

67% and 59% of the Company's revenues for the six months ended June 30, 2007 and 2006, respectively, were derived from customers located in China. For the three months ended June 30, 2007 and 2006, 69% and 63% of the Company's

revenues, respectively, were derived from customers located in China. The Company had sales of \$10,830,592 in the Chemical Divisions to customers in India, representing 28.6% of the Company's revenues for the six months ended June 30, 2007; while the Company had sales of \$8,835,704 in the Chemical Division to customers in India, representing 23.33% of the Company's revenues for the six months ended June 30, 2006. Substantially all of the Company's assets at June 30, 2007 and 2006 were located in China.

Sales to the Company's five largest customers accounted for approximately 53.55% and 66% of the Company's sales for the six months ended June 30, 2007 and 2006, respectively; while sales to the Company's largest customer accounted for approximately 23.33% and 31%, respectively. Amounts owing from one customer represented 14.54% of the Company's trade and other receivables at June 30, 2007.

**DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007 AND 2006**

**(UNAUDITED) Expressed in US Dollars**

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 8.

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 June 30, 2007, US\$3,157,420 of the cash and cash equivalents and restricted cash (December 31, 2006: US\$1,014,362) is held in Renminbi.

**NOTE 18**

**COMPARATIVE FIGURES**

Certain of the comparative figures have been reclassified to conform with the presentation adopted in the current period.

**NOTE 19**

**SUBSEQUENT EVENT**

Subsequent to June 30, 2007, the Company issued 3,496,503 shares of restricted common stock upon conversion of US\$1,500,000 non-interest bearing demand loans at US\$0.429 per share.



**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 and six months ended June 30, 2007 based upon the Company's unaudited interim 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 consolidated 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, 2006.

As used in this report, the terms "we", "us", "our", "the Company" and "Dragon" shall mean Dragon Pharmaceutical Inc. and its subsidiaries unless otherwise indicated. Further, unless otherwise indicated, reference to dollars shall mean United States dollars.

**General**

Dragon is a diversified pharmaceutical company with three key business units consisting of a Chemical Division for manufacturing bulk active pharmaceutical ingredient (API) and pharmaceutical intermediates, a Pharma Division for manufacturing formulated generic drugs with a focus on Cephalosporin antibiotics and freeze-dry injectables, and a Biotech Division for manufacturing biologics, currently Erythropoietin or EPO.

The Company currently has four production facilities in Datong, China, including three GMP production facilities certified by Chinese State Food and Drug Administration ("SFDA"): one pharmaceutical facility with a capacity of producing freeze-dry injectables, one biotech facility producing Erythropoietin injectables and one chemical facility producing bulk Clavulanic Acid. The fourth facility produces bulk 7-ACA, an intermediate for Cephalosporin antibiotics by a fermentation process. 7-ACA is an intermediate and no GMP is required for the production facility. The Company now has 47 drugs approved by the Chinese SFDA of which the Pharma division products are sold only in the Chinese markets while products from the Chemical and Biotech divisions are sold in both Chinese and selected international markets.

The Company completed the acquisition of Oriental Wave Holding Ltd. ("Oriental Wave") on January 12, 2005 which transformed us from a single product company into a diversified pharmaceutical company with three key business units consisting of a Biotech Division for biotech products, a Chemical Division for bulk pharmaceutical intermediate and API and a Pharma Division for formulated generic drugs.

The Company's headquarters, located in Vancouver, British Columbia accommodates corporate functions such as financial reporting, SEC compliance, corporate finance, investor relations, and regulatory affairs for international product approval. The Company also has a corporate office in Beijing, China to manage its businesses in China including strategy formulation in the Chinese market, product development, production and sales and marketing management.



## **Business Segments**

The Company operates three key business units consisting of a Chemical Division for bulk pharmaceutical API and intermediates such as Clavulanic acid and 7-ACA, a Pharma Division for formulated drugs with a focus of Cephalosporin antibiotics and freeze-dry injectables, and a Biotech Division for biologics products, currently Erythropoietin or EPO.

### Chemical Division

The Chemical Division's facilities are located on Datong Gongnong Road, Datong City, Shanxi Province, China. The Chemical Division produces 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 acid 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 acid 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. Another key product in the Chemical Division is 7-ACA, an intermediate for Cephalosporin antibiotics. Dragon's 600-ton production facility of 7-ACA positions it as one of the main producers of this product in the world. The export of 7-ACA to India commenced in 2004 and the Company currently has a target to sell 50% of its 7-ACA 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 United States and European Union to enter into European and North American markets.

### Pharma Division

The Company owns 36 drug approvals from the SFDA for the Pharma Division, mostly Cephalosporin powder for injection and API. With this more focused product combination, the Company is able to take advantage of being one of the significant producers of 7-ACA, an intermediate for Cephalosporin antibiotics. The Company uses qualified contract manufacturers to produce the Cephalosporin powder for injection and key sales agents and distributors to sell

the formulation products in the Chinese market. The Company believes that it will be able to utilize excess production capacity of other formulation producers without having to commit huge capital expenditure in its own production facility.

In addition to the cephalosporin product lines, the Pharma Division also offers freeze-dry injectable products. The Company has a freeze-dry injectable workshop, next to the EPO production facility, 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.

### 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 allows the Company to capitalize on the existing production infrastructure and the efficiency of unified operational management. In the new facility, the capacity for bulk EPO doubled to 120 grams and the capacity for sterile vialing 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 in China and developing countries as the current core markets. Currently, Dragon's EPO is sold only in countries where there is no patent protection. Previously, 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 commitments 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 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.

Significant accounting policies 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, 2006. Certain of these significant accounting policies are considered to be critical accounting policies which include: stock based compensation and impairment of long-lived assets and goodwill and intangible assets.

### Stock-based Compensation

Stock-based compensation expense, which is a non-cash charge, results in part from estimating the fair value of employee stock options granted using the Black-Scholes option pricing model. The exercise price for option grants are based on the market value of the Company's common shares. The Company accounts for employee stock options in accordance with the provisions of Statement of Financial Accounting Standards No. 123(R), Share-based Payment, a revision of SFAS 123. The Black-Scholes option pricing model requires the input of the fair value of the Company's stock at the date of grant of the stock options as well as the input of several subjective assumptions including: the expected life of the option, the expected volatility at the time of the options are granted, and the expected forfeiture rate at the time the options were granted. Changes in the inputs and assumptions can materially affect the measure of the estimated fair value of employee stock options. Also, the accounting estimate of stock-based compensation expense is reasonably likely to change from period to period as further stock options are granted and adjustments are made for stock option forfeitures and cancellations.

### Long-lived Assets

The Company periodically evaluates its long-lived assets for potential impairment under SFAS 144, Accounting for the Impairment of Disposal of Long-lived Assets. The Company performs these evaluations whenever events or changes in circumstances suggest that the carrying amount of an asset or group of assets is not recoverable. If impairment recognition criteria in SFAS 144 have been met, the Company charges impairments of the long-lived assets to operations.

### Impairment of Goodwill and Intangible Assets

In accordance with Statement of Financial Accounting Standard, or SFAS 142, Goodwill and Other Intangibles, the Company is required to perform impairment tests annually or whenever events or changes in circumstances suggest that the carrying value of an asset may not be recoverable. While the Company uses available information to prepare the estimates and to perform impairment evaluations, actual results in the future could differ significantly. Impairment tests in future periods may result in impairment charges which could materially impact the Company's future reported results.

In July 2006, FASB issued Interpretation No. 48. This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS Statement No. 109, "Accounting for Income Taxes". This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FASB issued Interpretation No. 48 was adopted by the Company beginning January 1 2007. The adoption of FASB issued Interpretation No. 48 did not have an impact on the Company's consolidated financial statements during the current period.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. The objective of SFAS 157 is to increase consistency and comparability in fair value measurements and to expand disclosures about fair value measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The provisions of SFAS 157 are effective for fair value measurements made in fiscal years beginning after November 15, 2007. The Company has not determined the effect, if any, that the adoption of SFAS 157 will have on the Company's consolidated financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). SFAS 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company currently is assessing the impact of SFAS 159 on its consolidated financial positions and results of operation.

## Results of Operations for the Quarter Ended June 30, 2007 and 2006

### *Revenues*

Sales for the quarter ended June 30, 2007 increased 48% to \$20.55 million from \$13.89 million for the same period in 2006. \$14.27 million or approximately 69% of the sales for the quarter ended June 30, 2007 were generated from the sales of products in the Chinese market, and the remaining \$6.28 million or approximately 31% were generated from the sales of products in the international markets (outside of China). 63% of the sales for the quarter ended June 30, 2006 were generated from the sale of products in the Chinese market while the remaining 37% of the sales were generated in the international market outside of China. In the quarter ended June 30, 2007, \$3.67 million or approximately 18% of the sales were from the Pharma Division, \$16.31 million or 79% of sales were from the Chemical Division, and \$0.57 million or 3% of sales were from the Biotech Division. For the same period in 2006, 11% of sales were from the Pharma Division, 86% of sales were from the Chemical Division, and 3% of sales were from the Biotech Division. The increase in sales for the quarter ended June 30, 2007 as compared to the prior year was due to increase in sales from all 3 divisions. Pharma Division, Chemical Division and Biotech Division experienced a year-over-year growth rate of 134%, 37% and 44% respectively.

Cost of sales for the quarter ended June 30, 2007 was \$16.57 million compared to \$11.49 million for the same period of 2006. The cost of sales is attributed to the production costs of products. The increase in the cost of sales was mainly due to the increase in production and sales of products from the Chemical and Pharma Divisions. Gross profit and gross margin for the quarter ended June 30, 2007 were \$3.98 million and 19.36% compared to \$2.39 million and 17.24% for the same period of 2006. The increase in gross margin was mainly due to an improved margin of all three divisions especially the Chemical Division as a result of an increase in production level and hence, better utilization of the production facilities.

Sales for the six months ended June 30, 2007 increased 40% to \$37.88 million from \$27.04 million for the same period in 2006. \$25.43 million, or 67% of the sales for the first six months of 2007 were generated from the sales of products in the Chinese market, and the remaining \$12.45 million or 33% were generated from the sales of products in the international markets. Comparatively, \$15.97 million, or 59% of the sales for the first half of 2006 were generated from the sales of products in the Chinese market, and the remaining 41% were generated from the sales of products in international markets.

In the first half of 2007, \$5.54 million, or 15% of the sales, were from the Pharma Division, \$31.34 million, or 82% of sales were from the Chemical Division and \$1.00 million, or 3% of sales, were from the Biotech Division. For the same period in 2006, 10% of sales were from the Pharma Division, 87% of sales were from the Chemical Division and 3% of sales were from the Biotech Division. The increase in sales during the six months ended June 30, 2007 as compared to the same period for the prior year was primarily due to increases in sales from the Pharma Division (with

a year-over-year growth rate of 109%) and the Chemical Division, especially 7-ACA in the Chinese market (with a year-over-year growth rate of 68%) and Clavulanic Acid in the international market ( with a year-over-year growth rate of 65%).

Cost of sales for the six months ended June 30, 2007 was \$29.84 million compared to \$22.02 million for the six months ended June 30, 2006. Gross profit and gross margin for the six months ended June 30, 2007 were \$8.04 million and 21.23% compared to \$5.02 million and 18.58% for the same period of 2006. The increase in gross margin was mainly due to an improved margin for the Chemical division especially for 7-ACA products.



*Divisional Revenues and Gross Margin Analysis*

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

*Chemical Division*

The Chemical Division's revenues for the quarter ended June 30, 2007 were \$16.31 million, representing a 37% increase from the revenues of \$11.92 million during the same period in 2006. Such increase in revenues was attributed by both 7-ACA and Clavulanic Acid, which had a year-over-year growth rate of 35% and 44% respectively.

The Division had a year-over-year growth rate of 47% and 23% in the Chinese and international markets respectively, out of which Clavulanic Acid and 7-ACA experienced 42% and 75% year-over-year growth in the Chinese market.

The Chemical Division's gross margin for the quarter ended June 30, 2007 was 23.73% compared to 20.39% for the quarter ended June 30, 2006. The increase in gross margin reflected the lowering of per unit production costs as the production level continued to increase.

*Pharma Division*

The Pharma Division's revenues for the quarter ended June 30, 2007 were \$3.67 million, accounting for 18% of the total revenues of the Company. Comparatively, Pharma Division's revenues were \$1.57 million for the same period in 2006, contributing 11% of the total revenues of the Company. The 134% increase in revenues of the Pharma division during the second quarter of 2007 as compared to the same period in 2006 was mainly due to the continued growth in terms of sales quantity in the Chinese market.

The overall gross margin for the Pharma Division for the quarter ended June 30, 2007 was -8.90% as compared to -14.74% for the same period of 2006. The increase in the gross margins was due to the improvement of per unit production costs.

Biotech Division

The Biotech Division's revenues for the quarter ended June 30, 2007 were \$0.57 million representing 3% of the Company's revenues for the year. Comparatively, Biotech Division's revenues were \$0.40 million for the same period in 2006, contributing 3% of the total revenues of the Company. Gross margin for the quarter ended June 30, 2007 was at 75.60% as compared to 49.01% for the same period of 2006. The increase in revenues and gross margin for the second quarter of 2007 as compared to the same period of 2006 was mainly due to the fact that the Datong production facility for EPO was at the initial phase of production last year which had slightly lower production output for sales as well as slightly higher production cost.

### ***Expenses***

Total operating expenses were \$2.81 million for the quarter ended June 30, 2007. The major category of operating expenses was general and administration expenses of \$1.93 million, selling expense of \$0.62 million, and depreciation and amortization expenses of \$0.25 million. Total operating expenses were \$2.22 million for the quarter ended June 30, 2006 with the major expenses being general and administration expenses of \$1.36 million, selling expense of \$0.62 million, and depreciation and amortization expenses of \$0.24 million. During the second quarter ended June 30, 2007, the general and administration expenses included \$1.00 million for non-cash stock based compensation, \$0.46 million for salaries and benefits, \$0.35 million for accounting and auditing, compared to \$0.09 million for non-cash stock based compensation, \$0.33 million for salaries and benefits, \$0.26 million for accounting and auditing for the same period in 2006. The increase in operating expenses of \$0.60 million for the quarter ended June 30, 2007 as compared to the same period for the prior year was mainly due to an increase in non-cash stock based compensation expenses.

Total operating expenses were \$5.08 million for the six months ended June 30, 2007 compared to \$4.63 million for the same period in 2006. The major category of operating expenses for the six months ended June 30, 2007 was General and Administration expenses which included \$1.02 million for non-cash stock based compensation expenses, \$0.83 million for salaries and benefits, \$0.58 million for accounting and auditing expenses, \$0.20 million for travel expenses, \$0.16 million office expenses and \$0.15 million for consulting expenses compared to \$0.18 million for non-cash stock based compensation expenses, \$0.80 million for salaries and benefits, \$0.31 million for accounting and auditing expenses, \$0.23 million for travel expenses, \$0.31 million for office expenses and \$0.14 million for consulting expenses for the first six months of 2006. Operating expenses for the six month ended June 30, 2007 also included selling expense of \$1.11 million and depreciation and amortization of \$0.51 million. The increase in operating expenses of \$0.46 million for the six months ended June 30, 2007 as compared to the same period for the prior year reflected mainly the increase in non-cash stock based compensation and accounting and audit expenses.

### ***Other Income / Expense***

During the second quarter ended June 30, 2007, the Company recognized a net other expense of \$0.50 million which represented primarily interest expense, including \$0.59 million cash interest expense and \$0.09 million non-cash accreted interest expense on the long term payable.

### ***Income / (Loss) from Continuing Operations***

The Company has an income from continuing operations of \$0.45 million (net of \$1.00 million non-cash stock based compensation expense) for the second quarter of 2007 as compared to a loss from continuing operations of \$0.87 million (net of \$0.09 million non-cash stock based compensation expense) for the same period in 2006.

For the six month period ended June 30, 2007, the Company has an income from continuing operations of \$ 1.30 million (net of \$1.02 million non-cash stock based compensation expense) compared to a loss from continuing operations of \$0.11 million (net of \$0.18 million non-cash stock based compensation expense) for the same period of 2006.

***Net Income***

The Company had a net income of \$0.45 million for the quarter ended June 30, 2007 compared to a net loss of \$0.32 million for the same period in 2006 which included a net loss of \$0.87 million from continuing operations and a \$0.55 million after-tax income from discontinued operations. The net income for the second quarter of 2007 was net of a non-cash stock based compensation expense of \$1.00 million while the net income for the same period in 2006 was net of \$0.09 million as the non-cash stock based compensation expense.

For the six month period ended June 30, 2007, Dragon has a net income of \$ 1.30 million compared to a net income of \$0.77 million for the same period of 2006 which included \$0.11 million net loss from continuing operations and an after-tax income from discontinued operations of \$0.88 million. The net income for the six month period ended June 30, 2007 was net of a non-cash stock based compensation expense of \$1.02 million while the net income for the same period in 2006 was net of \$0.18 million as the non-cash stock based compensation expense.

### ***Comprehensive Income***

The Company had a comprehensive income of \$1.04 million (including a currency translation income of \$0.59 million) and a comprehensive loss of \$0.21 million (net of a currency translation income of \$0.12 million) for the quarters ended June 30, 2007 and 2006, respectively. The foreign currency translation income results from translation of the financial statements expressed in RMB to United States Dollar. The increase reflects the appreciation of the RMB relative to the United States dollar.

### ***Basic Net Income per Share***

Company'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 from continuing operations for the quarter ended June 30, 2007 was \$0.01 per share and (\$0.01) for the quarter ended June 30, 2006. Net income per share for the quarter ended June 30, 2007 was \$0.01 per share as compared to \$0.00 for the quarter ended June 30, 2006 which included \$0.01 per share net income from discontinued operations. The weighted average number of shares outstanding was 62,878,004 for the quarter ended June 30, 2007 and 2006, respectively. The outstanding common stock options have no significant dilutive effect on the weighted average number of shares outstanding.

Dividends of the PRC subsidiary may only be distributed after allowance has been made for i) recovery of losses, if any; ii) appropriations to the reserve fund; iii) appropriations to the staff welfare fund; and iv) appropriations to an enterprise expansion fund if determined by the Board of Directors. Under current regulation, appropriations 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 PRC subsidiary's registered capital; 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; appropriations to the enterprise expansion fund are made at the discretion of the Board of Directors. The reserve fund and enterprise expansion fund are recorded as part of stockholders' 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. As at June 30, 2007, the Company's reserve fund is \$2.69 million, 11.14% of the Company's registered capital.

### ***Liquidity and Capital Resources***

As of June 30, 2007, the Company had current liabilities of \$42.5 million and current assets of \$24.81 million, including cash and cash equivalents of \$1.19 million, restricted cash of \$1.97 million and accounts receivable of \$9.1 million. The working capital deficiency is mainly due to the fact that some long-term accounts payable and bank loans will become due within a year and therefore transferred from long-term liabilities to short-term liabilities.

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 private placements 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, or that the Company will be able to negotiate and extend the loans. If adequate funds are not available or not available on acceptable terms or the Company is unable to negotiate or extend its loans, 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. However, 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. The Company's financial statements do not include any adjustments that might result from this uncertainty. (See below for private placement subsequent to June 30, 2007.)

As of June 30, 2007, Dragon had current liabilities of \$42,497,114 as follows:

|   |              |
|---|--------------|
| Accounts Payable  | \$ 6,146,726 |
| Other Payables and Accrued Expenses   | \$17,871,060 |
| Loans Payable-Short Term:   |              |
| RMB 3.78 million loan payable to a bank, interest rate of 7.344% per annum, collateralized by property and equipment with a net book value of \$2,594,853 , due September 2007  | \$495,751    |
| RMB 2.9 million loan payable to a bank, interest rate of 7.344% per annum, collateralized by property and equipment with a net book value of \$2,535,006, due September 2007    | \$380,338    |
| RMB 15 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$3,066,257, due September 2007     | \$1,967,265  |
| RMB 52.3 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$ 10,669,512 , due December 2007 | \$6,859,195  |
| RMB 20 million loan payable to a bank, interest rate of 7.956% per annum, collateralized by property and equipment with a net book value of \$ 9,194,767, due January 2008      | \$2,623,020  |
| RMB 25 million loan payable to a bank, interest rate of 6.732% per annum,   | \$3,278,775  |

collateralized by land use right and buildings with a net book value of \$ 7,550,448, due February 2008

RMB 4.1 million loan payable to a bank, interest rate of 7.938% per annum, guaranteed by an unrelated third party, due October 2007 \$537,719

RMB 1.7 million loan payable to a company, non-interest bearing and uncollateralized, due December 31, 2007 226,437

Loans Payable Short Term Subtotal \$16,368,499

Note Payable \$1,966,709

Due to related companies \$144,120

Total Current Liabilities \$42,497,114



As of June 30, 2007, the Company had outstanding short-term loans (less than one year term) and note payable totaling \$18.33 million. The Company 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 loans.

Long-term Liabilities:

As of June 30, 2007, the Company had long-term liabilities of \$8,808,523 as follows:

|  |             |
|--|-------------|
| Long-term accounts payable   | \$1,595,219 |
| Loan Payable - Long Term:  |             |
| RMB 55 million loan payable to a bank, interest rate of 8.19% per annum, collateralized by land use right and building with a net book value of \$10,269,849 due September, 2008 | 7,213,304   |
| Total Long-term Liabilities  | \$8,808,523 |

As of June 30, 2007, the Company had a long-term loan payable of \$7.21 million due September 2008, in addition to long-term portion of accounts payable of \$1.60 million which will become due during 2008. The long-term portion of accounts payable, which are non-interest bearing, have been discounted at 6.5% and are carried in the financial statements at \$1.60 million.

During the second quarter ended June 30, 2007, the Company financed its operations and increased production level at its Chemical Division through operating revenues, accounts payables and short-term loans. The Company intends to seek additional funding through equity financing to improve its financial position, which may include conversion of certain payables to certain vendors of Shanxi Weiqida into the Company's common stock.

Subsequent to June 30, 2007, the Company issued 3,496,503 shares of restricted common stock upon conversion of US\$1,500,000 non-interest bearing demand loans at US\$0.429 per share.

**Item 3.**

**Quantitative and Qualitative Disclosure about Market Risk**

Substantially all of our business is transacted in currencies other than the United States dollar. The Company's functional currency is the United States dollar. However, the functional currency of certain subsidiaries is their local currencies. As a result, the Company is subject to exposure from movements in foreign currency exchange rates. The Company does not use derivative financial instruments for speculative trading purposes, nor does the Company hedge its foreign currency exposure to manage its foreign currency fluctuation risk.

The Company has approximately \$7.21 million in long-term debt due in September 2008. In the event that the Company refinances or seeks renewal of this loan, the Company may be subject to interest rate risk. Management does not believe that inflation has had or will have a significant impact on the Company's results of operations. The Company is not exposed to any market risk involving activities in derivative commodity instruments.

**Item 4.**

**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 period covered by this report 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 1.A.**

**Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1 Description of Business in our Annual Report on Form 10-KSB for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-KSB are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and /or operating results.

**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**

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.

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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: August 14, 2007

/s/ Yanlin Han  
Yanlin Han  
Chief Executive Officer

Date: August 14, 2007

/s/ Garry Wong  
Garry Wong  
Chief Financial Officer

