

DRAGON PHARMACEUTICAL INC
Form 10-Q
May 15, 2009

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 March 31, 2009

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 registrant as specified in its charter)

Florida

65-0142474

(State or other jurisdiction of
incorporation or organization)

(IRS Employer Identification No.)

650 West Georgia Street, Suite 310

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Vancouver, British Columbia

Canada V6B 4N9

(Address of principal executive offices)

(604) 669-8817

(Issuer's telephone number)

Not applicable

(Former address if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No []

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock, \$0.001 Par Value - 67,066,418 shares as of May 15, 2009.

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PART I**ITEM 1.****FINANCIAL STATEMENTS**

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS AT MARCH 31, 2009 AND DECEMBER 31, 2008 (UNAUDITED)
Expressed in Thousands (\$ '000) of US Dollars Except Share Data
(Basis of Presentation Note 1)

| <u>ASSETS</u> | Notes | March 31, 2009 | December 31, 2008 |
|--|-------|----------------|-------------------|
| CURRENT ASSETS | | | |
| Cash | 19 | 2,120 | 2,011 |
| Restricted cash | 10,19 | 735 | 2,923 |
| Accounts receivable, net of allowances | 2 | 13,039 | 10,499 |
| Inventories, net | 3 | 21,137 | 25,760 |
| Prepaid expenses | | 7,637 | 5,738 |
| Due from related parties | 17 | 858 | 1,139 |
| Deferred income tax assets | 16 | 140 | 176 |
| Total Current Assets | | 45,666 | 48,246 |
| PROPERTY AND EQUIPMENT, NET | | | |
| | 4,9 | 92,301 | 94,565 |
| OTHER ASSETS | | | |
| Intangible assets, net | 5 | 1,462 | 1,503 |
| Investments cost | | 15 | 15 |
| Other assets | 6 | 8,327 | 3,751 |
| Deferred income tax assets | 16 | 300 | 295 |
| Total Other Assets | | 10,104 | 5,564 |
| TOTAL ASSETS | | 148,071 | 148,375 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | | |
| CURRENT LIABILITIES | | | |
| Accounts payable | | 17,480 | 17,142 |

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| | | | |
|--|----|--------|--------|
| Other payables and accrued liabilities | 8 | 26,518 | 26,280 |
| Loans payable short-term | 9 | 23,573 | 20,870 |
| Notes payable | 10 | 735 | 5,836 |
| Due to related parties | 17 | 21 | 66 |
| Total Current Liabilities | | 68,327 | 70,194 |

LONG-TERM LIABILITIES

| | | | |
|-----------------------------|----|---------------|---------------|
| Loans payable long-term | 9 | 20,597 | 20,571 |
| Deferred revenue | 11 | 383 | 394 |
| Total Long-Term Liabilities | | 20,980 | 20,965 |
| TOTAL LIABILITIES | | 89,307 | 91,159 |

COMMITMENTS AND CONTINGENCIES (Note 14)

STOCKHOLDERS EQUITY

Authorized: 200,000,000 common shares at par value of \$0.001 each,
common shares issued and outstanding 2009: 67,066,418; 2008:
67,066,418

| | | | |
|--|----|----------|----------|
| | | 67 | 67 |
| Additional paid-in capital | | 49,132 | 49,105 |
| Deficit | | (3,141) | (4,588) |
| Reserves | 15 | 4,653 | 4,653 |
| Accumulated other comprehensive income | | 8,053 | 7,979 |
| Total Stockholders Equity | | 58,764 | 57,216 |

| | | | |
|--|--|----------------|----------------|
| TOTAL LIABILITIES AND STOCKHOLDERS EQUITY | | 148,071 | 148,375 |
|--|--|----------------|----------------|

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in Thousands of US Dollars (\$'000) Except Share and Per Share Data

| | Note | 2009 | 2008 |
|---|-------|--------|--------|
| SALES | 12 | 36,963 | 35,869 |
| COST OF SALES | | 30,549 | 29,701 |
| GROSS PROFIT | | 6,414 | 6,168 |
| OPERATING EXPENSES | | | |
| Selling expense | | 1,274 | 1,117 |
| General and administrative expenses | | 1,548 | 1,873 |
| Research and development expenses | | 202 | 434 |
| Depreciation and amortization | | 364 | 178 |
| Total Operating Expenses | | 3,388 | 3,602 |
| INCOME FROM OPERATIONS | | 3,026 | 2,566 |
| OTHER INCOME / (EXPENSE) | | | |
| Interest expense | | (961) | (897) |
| Other income | 11,13 | 12 | 329 |
| Other expenses | | (38) | (1) |
| Total other expenses | | (987) | (569) |
| INCOME FROM CONTINUING OPERATIONS BEFORE TAXES | | 2,039 | 1,997 |
| INCOME TAX EXPENSE | 16 | (592) | (265) |
| INCOME FROM CONTINUING OPERATIONS | | 1,447 | 1,732 |
| INCOME FROM DISCONTINUED OPERATIONS | 7 | - | 229 |
| NET INCOME | | 1,447 | 1,961 |
| OTHER COMPREHENSIVE INCOME | | | |
| Foreign currency translation | | 74 | 1,944 |
| COMPREHENSIVE INCOME | | 1,521 | 3,905 |
| Earnings per share - basic | | | |
| - from continuing operations | | 0.02 | 0.03 |

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| | | |
|---|------------|------------|
| - from discontinued operations | 0.00 | 0.00 |
| - net income | 0.02 | 0.03 |
| Earnings per share - diluted | | |
| - from continuing operations | 0.02 | 0.03 |
| - from discontinued operations | 0.00 | 0.00 |
| - net income | 0.02 | 0.03 |
| Weighted average number of shares outstanding during the period | | |
| - basic | 67,066,418 | 66,374,507 |
| - diluted * | 67,362,462 | 68,170,887 |

* For the three months ended March 31, 2009 and 2008, diluted weighted average number of shares outstanding include the dilutive effect of stock options of 4,690,000 and 8,155,000, respectively, and exclude the antidilutive effect of stock options of 5,070,000 and 1,990,000, respectively.

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE THREE MONTHS ENDED MARCH 31, 2009 (UNAUDITED)
Expressed in Thousands (\$'000) of US Dollars Except Share Data

| | Common Stock | | Additional | Deficit | Reserves | Accumulated other compre- hensive income | Total |
|-----------------------------------|--------------|--------|--------------------|----------|----------|---|--------|
| | Shares | Amount | Paid-In Capital | | | | |
| Balance, December 31, 2008 | 67,066,418 | 67 | 49,105 | (4,588) | 4,653 | 7,979 | 57,216 |
| Other comprehensive income | | | | | | | |
| - foreign currency translation | | | | | | 74 | 74 |
| Stock-based compensation | | | 27 | | | | 27 |
| Net income for the period | | | | 1,447 | | | 1,447 |
| Balance, March 31, 2009 | 67,066,418 | 67 | 49,132 | (3,141) | 4,653 \$ | 8,053 | 58,764 |

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in Thousands of US Dollars (\$ '000)

| | 2009 | 2008 |
|---|----------|----------|
| CASH FLOWS FROM (USED IN) OPERATING ACTIVITIES: | | |
| Income from continuing operations | 1,447 | 1,732 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,498 | 1,751 |
| Stock-based compensation expense | 27 | 75 |
| Accreted interest on long term payable | - | 20 |
| loss on disposal of assets | 2 | - |
| Deferred income tax expense | 32 | 383 |
| Deferred revenue | (11) | - |
| Changes in operating assets and liabilities | | |
| Accounts receivable | (3,381) | (563) |
| Inventories | 4,654 | (1,536) |
| Prepaid expenses | (1,892) | (3,363) |
| Accounts payable | 317 | 1,265 |
| Notes payable | (5,108) | 5,574 |
| Restricted cash | 2,194 | (2,787) |
| Amount due from related parties | 237 | 172 |
| Other payables and accrued liabilities | 919 | 1,084 |
| Cash provided by continuing operations | 1,935 | 3,807 |
| Cash provided by discontinued operations | - | 165 |
| Net Cash provided by Operating Activities | 1,935 | 3,972 |
| CASH FLOWS FROM (USED IN) INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (5,922) | (4,111) |
| Proceeds on disposition of assets | - | 976 |
| Government grants received in advance (Note 8) | 95 | - |
| Land deposit received in advance | - | 2,787 |
| Deposit for land and construction | - | (578) |
| Cash used in continuing operations | (5,827) | (926) |
| Cash provided by discontinued operations | - | - |
| Net Cash used in Investing Activities | (5,827) | (926) |
| CASH FLOWS FROM (USED IN) FINANCING ACTIVITIES: | | |
| Due from shareholders | - | 24 |

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| | | |
|---|----------|----------|
| Repayment of non-interest bearing demand loans | (7) | (2,767) |
| Proceeds from non-interest bearing demand loans | 1,329 | 909 |
| Proceeds from loans payable | 4,382 | - |
| Repayment of loans | (1,706) | (4,181) |
| Net Cash provided by (used in) Financing Activities | 3,998 | (6,015) |
| EFFECT OF EXCHANGE RATE CHANGES ON CASH | 3 | 166 |
| NET INCREASE (DECREASE) IN CASH | 109 | (2,803) |
| CASH AT BEGINNING OF THE PERIOD | 2,011 | 4,736 |
| CASH AT END OF THE PERIOD | 2,120 | 1,933 |
| Cash paid during the period for interest expense, net of capitalized interest | 961 | 877 |
| Cash paid during the period for income taxes | 640 | - |

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

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in US Dollars

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND ORGANIZATION

(A) Basis of presentation and accounting policies

The unaudited interim consolidated financial statements have been prepared in conformity with United States generally accepted accounting principles. They include the accounts of Dragon Pharmaceutical Inc., which is incorporated under the laws of the State of Florida, United States, and its wholly-owned or controlled subsidiaries (collectively, the Company). Certain information and footnote disclosures required by United States generally accepted accounting principles for complete annual financial statements have been omitted and, therefore, these consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2008. In the opinion of management, these consolidated financial statements reflect all adjustments, of a normal recurring nature, necessary to present fairly, in all material respects, the Company's consolidated financial position, results of operations, and cash flows for the interim periods presented. The results of operations for the three months ended March 31, 2009 are not necessarily indicative of those for a full fiscal year.

The accompanying unaudited interim consolidated financial statements contemplate continuation of the Company as a going concern. The Company has a working capital deficiency of \$22.66 million as at March 31, 2009. 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 as discussed below.

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 which is expected 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 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. 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.

(B) Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141R). SFAS 141R establishes principles and requirements for how an acquirer recognizes and measures the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after an entity's fiscal year that begins after December 15, 2008. The Company will assess the impact of SFAS 141R if and when a future acquisition occurs.

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
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Expressed in US Dollars

Effective January 1, 2008, the Company adopted, on a prospective basis, SFAS No. 157, Fair Value Measurements (SFAS 157) as amended by FASB Staff Position SFAS 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 (FSP FAS 157-1) and FASB Staff Position SFAS 157-2, Effective Date of FASB Statement No. 157 (FSP FAS 157-2). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and provides for expanded disclosure about fair value measurements. SFAS 157 applies prospectively to all other accounting pronouncements that require or permit fair value measurements. FSP FAS 157-1 amends SFAS 157 to exclude from the scope of SFAS 157 certain leasing transactions accounted for under SFAS No. 13, Accounting for Leases. FSP FAS 157-2 amends SFAS 157 to defer the effective date of SFAS 157 for all non-financial assets and non-financial liabilities except those that are recognized or disclosed at fair value in the financial statements on a recurring basis to fiscal years beginning after November 15, 2008. The adoption of SFAS 157 did not have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, "Disclosures About Derivative Instruments and Hedging Activities, an Amendment of FASB Statement No. 133." SFAS No. 161 amends SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," to amend and expand the disclosure requirements of SFAS No. 133 to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under SFAS No. 133 and its related interpretations, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 was effective for the Company on January 1, 2009. The adoption of SFAS No. 161 did not have a material impact on the Company's consolidated financial statements.

NOTE 2 ACCOUNTS RECEIVABLE

Accounts receivable at March 31, 2009 and December 31, 2008 consisted of the following:

| | March 31, 2009 | December 31, 2008 |
|---------------------------------------|----------------|-------------------|
| | (\$ 000) | (\$ 000) |
| Trade receivables | 12,589 | 9,957 |
| Other receivables | 1,304 | 1,316 |
| Less: allowance for doubtful accounts | (854) | (774) |
| Accounts receivable, net | 13,039 | 10,499 |

For the three months ended March 31, 2009 and 2008, the Company recorded a provision for doubtful accounts of \$79,000 and \$14,000 in the Consolidated Statements of Operations, respectively.

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in US Dollars

NOTE 3 INVENTORIES

Inventories at March 31, 2009 and December 31, 2008 consisted of the following:

| | March 31, 2009 | December 31, 2008 |
|------------------|----------------|-------------------|
| | (\$ 000) | (\$ 000) |
| Raw materials | 6,650 | 8,375 |
| Work-in-progress | 6,113 | 8,049 |
| Finished goods | 8,904 | 9,927 |
| | 21,667 | 26,351 |
| Less: provision | (530) | (591) |
| | 21,137 | 25,760 |

As at March 31, 2009 and 2008, the Company recorded an inventory valuation provision for lower of net realizable value or cost of \$530,000 and \$589,000 in the Consolidated Statements of Operations and Comprehensive Income, respectively.

NOTE 4 PROPERTY AND EQUIPMENT

The following is a summary of property and equipment at March 31, 2009 and December 31, 2008:

| | March 31, 2009 | | |
|--------------------------------|----------------|-----------------------------|-------------------|
| | Cost | Accumulated Depreciation | Net Book Value |
| | (\$ 000) | (\$ 000) | (\$ 000) |
| Plant and equipment | 86,626 | 25,655 | 60,971 |
| Land use rights and buildings | 19,786 | 1,608 | 18,178 |
| Motor vehicles | 861 | 357 | 504 |
| Furniture and office equipment | 3,517 | 2,283 | 1,234 |
| Construction in progress | 11,414 | - | 11,414 |
| | 122,204 | 29,903 | 92,301 |

| | December 31, 2008 | | |
|--|-------------------|-----------------------------|-------------------|
| | Cost | Accumulated Depreciation | Net Book Value |
| | (\$ 000) | (\$ 000) | (\$ 000) |

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| | | | |
|--------------------------------|---------|--------|--------|
| Plant and equipment | 85,848 | 23,454 | 62,394 |
| Land use rights and buildings | 19,718 | 1,490 | 18,228 |
| Motor vehicles | 860 | 330 | 530 |
| Furniture and office equipment | 3,470 | 2,154 | 1,316 |
| Construction in progress | 12,097 | - | 12,097 |
| | 121,993 | 27,428 | 94,565 |

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in US Dollars

Depreciation expense for the three months ended March 31, 2009 and 2008 was \$ 2,455,000 and \$1,714,000 respectively. Equipment with a net book value of \$43 million is pledged as collateral for \$9.9 million in loans payable (Note 9).

NOTE 5 INTANGIBLE ASSETS

Intangible assets consist of the following as of March 31, 2009 and December 31, 2008:

| | March 31, 2009 | December 31, 2008 |
|--------------------------------|----------------|-------------------|
| | (\$'000) | (\$'000) |
| Product licenses and permits | 1,708 | 1,707 |
| Less: accumulated amortization | (246) | (204) |
| | 1,462 | 1,503 |

Amortization expense for the three months ended March 31, 2009 and 2008 was \$43,000 and \$37,000 respectively.

NOTE 6 OTHER ASSETS

| | March 31, 2009 | December 31, 2008 |
|--|----------------|-------------------|
| | (\$'000) | (\$'000) |
| Prepayment of a formulation facility | 8,327 | - |
| Deposit for land and constructions costs | - | 3,751 |
| | 8,327 | 3,751 |

During 2007 and 2008, the Company was actively exploring additional business opportunities which may involve an investment in a new production campus. In this regard, the Company paid \$3,751,000 refundable deposits to the land bureau and various contractors for possible land and construction costs. During the three months ended March 31, 2009, the Company signed a letter of intent with a third party to acquire a formulation facility which the Company has been leasing since 2008, for a total amount of \$8,327,000 (RMB57 million) with \$4,576,000 in cash and a transfer of \$3,751,000 refundable deposit mentioned above. The Company will continue to lease the formulation facility from the third party until the legal ownership of the fixed assets is transferred to the Company, which is expected to happen prior to December 31, 2009.

NOTE 7 DISCONTINUED OPERATIONS

The Company signed an agreement on November 5, 2007 with a non-affiliated third party to sell the assets of the biotech operation excluding finished goods on hand. According to the agreement, the buyer agreed to pay the Company, before June 2008, a total of US\$ 2.14 million (or RMB15.6 million), in exchange for certain fixed assets and certain net working capital as at October 31, 2007 of the biotech business. The loss on disposal of biotech division was as follows:

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in US Dollars

| | (\$ 000) |
|---|------------|
| Accounts receivable | 567 |
| Inventory -Raw materials & Work-in-progress | 249 |
| Value added tax for sales of inventories | 42 |
| Total Current Assets | 858 |
| Property and equipment | 1,516 |
| Less accounts payables and accrued liabilities | (770) |
| Net assets for sale | 1,604 |
| Selling price | 2,138 |
| Gain on sale of fixed assets and working capital | 534 |
| Less: write off of intangible assets and goodwill | (3,112) |
| Loss on disposal of biotech division | (2,578) |

The operations of the biotech division have been reclassified and are presented in the consolidated financial statements as discontinued operation. A summary of such discontinued operation of the biotech division is as follows:

| | Three months ended March 31, 2009 | Three months ended March 31, 2008 |
|------------------------------------|--------------------------------------|--------------------------------------|
| | (\$'000) | (\$'000) |
| Net sales | - | 534 |
| Cost of sales | - | 180 |
| Gross Profit | - | 354 |
| Operating and other expenses | - | (50) |
| Income before taxes | - | 304 |
| Income tax expense | - | (75) |
| Income from discontinued operation | - | 229 |

NOTE 8 OTHER PAYABLES AND ACCRUED LIABILITIES

Other payables and accrued liabilities at March 31, 2009 and December 31, 2008 consist of the following:

| | March 31, 2009 | December 31, 2008 |
|--|----------------|-------------------|
| | (\$'000) | (\$'000) |
| | | |

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| | | |
|-----------------------------------|--------|--------|
| Machinery and equipment payable | 10,320 | 11,582 |
| Non-interest bearing demand loans | 3,040 | 1,715 |
| Advance of Government grants * | 1,994 | 1,897 |
| Advance of land reservation | 4,821 | 4,814 |
| Accrued expenses | 3,196 | 2,656 |
| Value added tax payables | 583 | 45 |
| Income taxes payable | 308 | 388 |
| Other taxes payable | 1,023 | 1,098 |
| Deposits received from customers | 1,233 | 2,085 |
| | 26,518 | 26,280 |

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DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (UNAUDITED)
Expressed in US Dollars

* The Company received \$95,000 (RMB650,000) during the three months ended March 31, 2009 and \$2,187,000 (RMB16 million) in 2007 of government grants relating to the construction of a water treatment facility. According to an approval of expenditure of the project from the local provincial government in 2008, the Company reclassified \$438,000 (RMB3 million) to deferred revenue and recognized on a straight-line basis as the assets is depreciated over 10 years (Note 11). Upon receipt of final approval of the completed project, the remaining balance of \$1,994,000 (RMB13,650,000) will be reclassified as deferred revenue and recognized on a straight-line basis as the asset is depreciated.

NOTE 9 LOANS PAYABLE

| | March 31, 2009 | December 31, 2008 |
|---|----------------|-------------------|
| | (\$'000) | (\$'000) |
| RMB89.6 million loan payable to an unrelated third party, non-interest bearing and uncollateralized, due on October 1, 2008. RMB77.92 million were repaid in 2008. According to the new loan agreement dated September 28, 2008, the remaining balance of RMB11.68 million is due March 2009, non-interest bearing and uncollateralized | - | 1,704 |
| RMB3.4 million loan payable to a bank, interest rate of 8.568% per annum, guaranteed by an unrelated third party, due April 2009 (Note 14(B)) * | 497 | 496 |
| RMB55.00 million loan payable to a bank, interest rate of 9.36% per annum, guaranteed by an unrelated third party, due September 2009 (Note 14(B)) | 8,034 | 8,024 |
| RMB15 million loan payable to an unrelated third party, interest rate of 9.99% and uncollateralized, due November 2009 ** | 2,191 | 2,189 |
| RMB5.67million loan payable to a bank, interest rate of 6.696% per annum, collateralized by equipment with a net book value of \$3 million due December 2009 | 828 | 827 |
| RMB52.3 million loan payable to a bank, interest rate of 6.903% per annum, collateralized by equipment with a net book value of \$19 million, due December 2009 | 7,640 | 7,630 |
| RMB10 million loan payable to a bank, interest rate of 6.903% per annum, collateralized by property and equipment with a net book value of \$21 million, due January 2010 | 1,461 | - |
| RMB20 million loan payable to a bank, interest rate of 5.841% per annum, guaranteed by a related party , due January 2010 | 2,921 | - |

DRAGON PHARMACEUTICAL INC. AND SUBSIDIARIES
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| | | |
|--|--------|--------|
| RMB20 million loan payable to an unrelated third party, interest rate of 9.828% and uncollateralized, due June 2010 | 2,921 | 2,918 |
| RMB20 million loan payable to an unrelated third party, interest rate of 9.828% and uncollateralized, due June 2010*** | 2,921 | 2,918 |
| RMB65 million loan payable to an unrelated third party, interest rate of 8.316% and uncollateralized, due September 2010 | 9,497 | 9,483 |
| RMB36 million loan payable to a bank, interest rate of 10.458% per annum, guaranteed by an unrelated third party, due October 2010 | 5,259 | 5,252 |
| | 44,170 | 41,441 |
| Less: current maturities | 23,573 | 20,870 |
| | 20,597 | 20,571 |

Maturities are as follows:

| Fiscal year ended December 31, | |
|--------------------------------|--------|
| 2009 (remaining of the year) | 19,190 |
| 2010 | 24,980 |
| | 44,170 |

* The loan payable due in April 2009 was repaid, and a new loan of \$438,000 (RMB3 million) from the same bank at interest rate of 6.804% per annual and a due date of October 16, 2009 was borrowed.

** The Company has guaranteed the third party to obtain a bank loan of \$2,921,000 (RMB20 million) due November 2009, interest on the loan is charged at 9.99%. The third party loaned \$2,191,000 (RMB15 million) to the Company and charged the same interest rate at 9.99%. According to an agreement between the third party and the Company, the Company will pay the loan balance of \$2,191,000 directly to the bank upon maturity (Note 14(B)).

*** The Company has guaranteed the third party to obtain a bank loan of \$2,921,000 (RMB20 million) due June 2010. Interest on the loan is charged at 9.828%. The third party loaned the \$2,921,000 to the Company and charged the same interest rate at 9.828%. According to an agreement between the third party and the Company, the Company will pay the loan balance of \$2,921,000 directly to the bank upon maturity.

NOTE 10 NOTES PAYABLE

The Company has a banking facility whereby the Company has issued several non-interest bearing notes payables to several vendors totalling \$735,000 (RMB5 million) as at March 31, 2009. These notes are due on July 21, 2009, and are collateralized by \$735,000 of bank deposits that may only be used to repay the notes.

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The Company had a banking facility whereby the Company has issued several non-interest bearing notes payables to several vendors totalling \$2,918,000 (RMB20 million) as at December 31, 2008. These notes were due on February 26, 2009, and were collateralized by \$2,918,000 of bank deposits that may only be used to repay the notes. The Company paid the notes payable in February 2009.

The Company also entered into an agreement with a bank providing a facility of up to \$4,272,000 (RMB30 million) pursuant to which the company may issue promissory notes that are guaranteed by the bank and which can be provided to suppliers to guarantee payment for purchases. This facility was for one year and expired on February 2, 2009. The bank charged a fee of 0.05% on the total amount of each promissory notes issued. The facility was collateralized by equipment with a net book value of \$6,982,000. As at December 31, 2008, the Company issued several non-interest bearing notes under this facility to vendors totalling \$2,918,000. The Company paid the notes payable in February 2009.

NOTE 11 DEFERRED REVENUE

Deferred revenue consisted of the following as of March 31, 2009 and December 31, 2008

| | March 31, 2009 | December 31, 2008 |
|--------------------------------|----------------|-------------------|
| | (\$'000) | (\$'000) |
| Deferred revenue | 438 | 438 |
| Less: accumulated amortization | (55) | (44) |
| | 383 | 394 |

The Company received government grants of \$438,000 (RMB3 million) from provincial government relating to the construction of a water treatment facility in 2007. The Company obtained the final approval from the government that the Company has complied with all conditions attached to the grant in 2008. \$438,000 was recorded as deferred revenue and recognized as other income on a straight-line basis as the asset is depreciated over 10 years (Note 13(A)).

NOTE 12 SEGMENTS

The accounting policies of the segments are the same as described in the summary of significant accounting policies. The Company evaluates segment performance based on gross profit. All sales by division were to external customers (Note 19). Sales relating to the cephalosporin division's 7-ACA product represented approximately 29.60% and 37.81% of the total sales for the three months ended March 31, 2009 and 2008, respectively. Substantially all of the Company's assets are located in China. The following is a summary of the Company's segment information for the three months ended March 31, 2009 and 2008 and as of March 31, 2009 and December 31, 2008.

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| | Cephalosporin Division (\$'000) | Penicillin Division (\$'000) | Total (\$'000) |
|---|--|-------------------------------------|--------------------|
| Three months ended March 31, 2009 | | | |
| Sales | 24,409 | 12,554 | 36,963 |
| Gross profit | 2,844 | 3,570 | 6,414 |
| Depreciation and amortization | 2,020 | 478 | 2,498 |
| Additions to long-lived assets | 961 | 52 | 1,013 |
| As at March 31, 2009 | | | |
| Intangible assets | 1,462 | - | 1,462 |
| Total assets allocated to reportable segments including intangible assets | 111,573 | 33,643 | 145,216 |
| Cash and restricted cash | | | 2,855 |
| Consolidated total assets | | | 148,071 |
| Three months ended March 31, 2008 | | | |
| Sales | 23,728 | 12,141 | 35,869 |
| Gross profit | 3,682 | 2,486 | 6,168 |
| Depreciation and amortization | 1,363 | 388 | 1,751 |
| Additions to long-lived assets | 2,686 | 1,450 | 4,135 |
| As at December 31, 2008 | | | |
| Intangible assets | 1,503 | - | 1,503 |
| Total assets allocated to reportable segments including intangible assets | 108,298 | 35,143 | 143,441 |
| Cash and restricted cash | | | 4,934 |
| Consolidated total assets | | | 148,375 |

Geographical segments information is as follows:

| | Three months ended March 31, 2009 (\$ 000) | Three months ended March 31, 2008 (\$ 000) |
|---------|--|--|
| Sales | | |
| - China | 30,081 | 30,138 |
| - India | 3,881 | 4,607 |
| - Other | 3,001 | 1,124 |

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| | | |
|--------------|----------------|-------------------|
| | 36,963 | 35,869 |
| | | |
| | March 31, 2009 | December 31, 2008 |
| | (\$ 000) | (\$ 000) |
| Total assets | | |
| - China | 147,982 | 148,208 |
| - Other | 89 | 167 |
| | 148,071 | 148,375 |

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NOTE 13 OTHER INCOME

(A) Government grants

During the three months ended March 31, 2009 and 2008, the Company recognized amortization income of \$11,000 and \$0 of government grants related to the construction of a water treatment facility (Note 11).

(B) Subsidies for employee benefit

During 2007, Shanxi Weiqida received subsidies of \$1,370,000 from the government of China for mandated employee benefit contributions for the period from July 2005 to June 2008. These subsidies were deposited directly into the employee's social benefit and insurance accounts, \$0 and \$241,000 was recognized as other income for the three months ended March 31, 2009 and 2008, respectively.

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 \$234,000 and \$205,000 for the three months ended March 31, 2009 and 2008, 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 Guarantees (Note 9)

The Company has guaranteed a bank loan to a supplier in the amount of \$2,600,000 (RMB17.8 million), due on July 7, 2009. Interest on the loan is charged at 10.46% and the bank has the right to seek settlement from the Company for payment should the supplier fail to repay the loan. There is no recourse or possible recovery for the Company should the supplier default on its bank loan. The maximum potential amount of future payments (undiscounted) that the Company could be required to make is \$2,673,000 (RMB18.30 million). The Company provided the guarantee to the supplier to maintain a good business relationship. This supplier has pledged certain property and equipment to the Company as collateral for this guarantee.

The Company has also issued a guarantee to a bank as collateral for loans to a third party vendor of \$2,776,000 (RMB19 million) due on September 25, 2009 and \$4,163,000 (RMB28.5 million) due on October 26, 2009. Interest is charged at 8.715%. 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 \$7,264,000 (RMB49.73 million). This vendor has pledged certain property and equipment to the Company as collateral for this guarantee. The vendor also provided a guarantee to the Company to obtain a bank loan of \$497,000 (RMB3.4 million) due April 2009 (Note 9).

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The Company has issued a guarantee to a bank as collateral for loans to a third party of \$8,034,000 (RMB55 million) due February 2010. Interest is charged at 8.19%. The bank has the right to seek settlement from the Company for payment should the third party fail to repay the loan. 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 \$8,609,000 (RMB58.64 million). This party provided a guarantee to the Company to obtain a bank loan of \$8,034,000 (RMB55 million) due September 2009 (Note 9).

The Company has guaranteed a third party to obtain bank loans of \$2,921,000 (RMB20 million) due November 2009, interest on these loans is charged at 9.99%. The third party loaned \$2,191,000 (RMB15 million) to the Company and charged the same interest rate at 9.99%. The Company has booked \$2,191,000 (RMB15 million) as a liability as at March 31, 2009 (Note 9). The remaining balance of \$730,000 (RMB5 million) was used by the third party and the maximum potential amount of future payments (undiscounted) that the Company could be required to make is \$774,000 (RMB5.30 million). This third party has pledged certain property and equipment to the Company as collateral for this guarantee.

(C) Capital Commitments

According to the approval of the Business Bureau of Shanxi province on December 12, 2007, the total registered capital to Shanxi Weiqida, increased from \$29,215,000 (RMB200 million) to \$58,432,000 (RMB400 million). The Company is required to contribute the additional registered capital of \$29,215,000 (RMB200 million) by paying cash of \$15,484,000 (RMB106 million) and transferring \$13,731,000 (RMB94 million) of retained earnings of Shanxi Weiqida within three years from November 20, 2007. For the three months ended March 31, 2009 and 2008, the Company transferred \$0 and \$6,104,000 (RMB44 million) of retained earnings of Shanxi Weiqida to registered capital of Shanxi Weiqida, respectively (Note 15(B)). As at March 31, 2009, the Company has capital commitment of \$15,484,000 (Rmb106 million) to Shanxi Weiqida.

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 March 31, 2009, the Company has contributed \$1,099,000 of the registered capital requirement. According to the approval of Business Bureau of Beijing city, Beijing Weixiang was dissolved on January 8, 2009. The net assets of \$648,000 were transferred to Shanxi Weiqida.

(D) Operating Leases

The Company has commitments related to operating leases for property which require the following payments for each year ending December 31:

| | (\$ 000) |
|--------------------------------------|----------|
| 2009 (for the remaining of the year) | 900 |
| 2010 | 148 |
| 2011 | 101 |
| 2012 | 49 |
| | 1,198 |

The rent expense for the three months ended March 31, 2009 and 2008 was \$300,000 and \$467,000 respectively,

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(E) Other Commitments

Capital expenditure contracted for but not yet incurred at March 31, 2009 is \$299,000.

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.

In order to fulfill Shanxi Weiqida's additional registered capital requirement, the Company transferred \$0 and \$6,104,000 of retained earnings of Shanxi Weiqida to registered capital during the three months ended March 31, 2009 and 2008 (Note 14 (C)). As at March 31, 2009 and December 31, 2008, Shanxi Weiqida has paid in capital of \$36,983,000 (RMB294 million) and \$36,983,000 (RMB294 million), respectively.

(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.

The Company granted options on February 17, 2008 to its employees to purchase 170,000 shares at an exercise price of \$0.75 (being the market price at the time) expiring on February 17, 2011. Of this grant, options to purchase 120,000 shares were vested immediately with 25,000 options vesting on each of February 17, 2009, and 2010.

The Company did not grant any options during the three months ended March 31, 2009.

The following table summarizes stock options information at March 31, 2009:

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| 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 |
| \$0.51 - \$0.75 | 7,960,000 | 1.29 | \$0.60 | 7,540,000 | 1.29 | \$0.61 |
| \$1.18 | 1,800,000 | 0.79 | \$1.18 | 1,800,000 | 0.79 | \$1.18 |
| | 9,760,000 | 1.20 | \$0.71 | 9,340,000 | 1.20 | \$0.72 |

The Company recorded stock-based compensation expense of \$27,000 for the three months ended March 31, 2009 (\$75,000 for the three months ended March 31, 2008) 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 March 31, 2008 was determined using the Black-Scholes option pricing model with the following weighted average assumptions: expected volatility 81.51%; risk-free rate 4.4%; 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. The estimated fair value of the options granted during the three months ended March 31, 2008 was \$0.41 per share. The fair value of the options is being expensed on a straight-line basis over the vesting period of the options.

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 common shares that were in-the-money. The aggregate intrinsic value of the Company's outstanding stock options as at March 31, 2009 and 2008 was \$281,000 and \$1,161,000, respectively. The estimated fair value of stock options vested during the three months ended March 31, 2009 and 2008 was \$10,000 and \$49,000 respectively. There is approximately \$20,000 of unrecognized compensation expense as of March 31, 2009 that is expected to be recognized over the next 10 months.

NOTE 16 INCOME TAXES

On March 16, 2007, The National People's Congress of China passed The Law of the People's Republic of China on Enterprise Income Tax (the Enterprise Income Tax Law). The Enterprise Income Tax Law became effective on January 1, 2008. This new law eliminated the existing preferential tax treatment that is available to the foreign invested enterprises (FIEs) but provides grandfathering of the preferential tax treatment currently enjoyed by the FIEs. Under the new law, both domestic companies and FIEs are subject to a unified income tax rate of 25% starting from 2008.

During the three months ended March 31, 2008, Shanxi Weiqida applied for and received an income tax credit for reinvestment of \$444,000 from the government of China. This credit was related to reinvestment of retained earnings of 2006 of \$6,704,000 (RMB 49 million) to paid-in capital of 2007. These credits were recorded as a reduction of income taxes for the three months ended March 31, 2008. According to the new China Enterprise Income Tax Law effective on January 1, 2008, the tax refund for reinvestment is no longer applicable to FIEs.

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The effective income tax rate for Shanxi Weiqida for the three months ended March 31, 2009 and 2008 was 25% and 11%, respectively.

The tax effect of temporary differences that give rise to significant components of the deferred tax assets are as follows:

| | March 31, 2009 | December 31, 2008 |
|--------------------------------|----------------|-------------------|
| | (\$,000) | (\$,000) |
| Deferred tax assets | | |
| Inventory | 140 | 176 |
| Deferred revenue | 594 | 573 |
| Property and equipment | 1,889 | 1,935 |
| Losses carried forward | 2,695 | 2,577 |
| Total deferred tax assets | 5,318 | 5,261 |
| Less: Valuation allowance | (4,878) | (4,790) |
| Net deferred tax assets | 440 | 471 |
| Less: deferred tax- short term | 140 | 176 |
| Net deferred tax assets | 300 | 295 |

The valuation allowance is reviewed periodically. When circumstance changes and this causes a change in management's judgment about the realizability of deferred tax assets, the impact of the change on the valuation allowance is generally reflected in current income.

NOTE 17 RELATED PARTY TRANSACTIONS

The Company supplied certain raw materials to a related party, whose director is also a stockholder of the Company, for which the Company charged \$99,000 and \$334,000 for the three months ended March 31, 2009 and 2008, respectively. The Company also used this party as a contract manufacturer of certain cephalosporin products for which the party charged \$13,000 and \$321,000 for the three months ended March 31, 2009 and 2008. The transactions were recorded at the exchange amount.

The balance arising from sales/purchase of goods and services are as follows:

| | March 31, 2009 | December 31, 2008 |
|---|----------------|-------------------|
| | (\$'000) | (\$'000) |
| a. Due from related parties | | |
| Due from a company whose director is also a stockholder and director of the Company | 858 | 1,139 |
| Less: current maturities | 858 | 1,139 |
| | - | - |
| b. Due to related parties | | |
| Due to a company whose director is also a stockholder and director of the Company | 21 | 66 |
| Less: current maturities | 21 | 66 |
| | - | - |

The balances due from/to related parties bear no interest and are under normal trade repayment terms.

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NOTE 18 FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amount of the Company's cash and cash equivalents, accounts receivable, investments, amounts due to related parties and short-term loans and other payables approximates their fair value. The fair value of long-term loans payables and long-term accounts payable are estimated using discounted cash flow analysis, based upon the Company's current borrowing rates, and approximate their carrying value.

NOTE 19 CONCENTRATIONS AND RISKS

81% and 84% of the Company's revenues for the three months ended March 31, 2009 and 2008, respectively, were derived from customers located in China. During the three months ended March 31, 2009 and 2008, the Company had sales of \$3,881,000 and \$4,607,000 respectively to customers in India, representing 10.5% and 12.8% respectively of the Company's revenues for the three months ended March 31, 2009 and 2008. Sales to the Company's largest customer, a Cephalosporin Division customer, accounted for approximately 10.47% and 10% of the Company's sales for the three months ended March 31, 2009 and 2008, respectively. Amounts owing from one customer represented 14% of the Company's trade and other receivables at March 31, 2009.

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

The majority of the Company's assets, liabilities, revenues and expenses are denominated in Renminbi, which was tied to the US Dollar and is now tied to a basket of currencies of China's largest trading partners, is not a freely convertible currency. The appreciation of the Renminbi against the US Dollar would result in an increase in the assets, liabilities, revenues and expenses of the Company and a foreign currency gain included in comprehensive income. Conversely, the devaluation of the Renminbi against the US Dollar would result in a decrease in the assets, liabilities, revenues and expenses of the Company and a foreign currency loss included in comprehensive income. As at March 31, 2009, approximately US\$2,796,000 of the cash and restricted cash (December 31, 2008: US\$4,819,000) were held in Renminbi.

NOTE 20 COMPARATIVE FIGURES

Certain figures for the prior year have been reclassified to conform with the current year's consolidated financial statement presentation.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Except for statements of historical facts, this section contains forward-looking statements involving risks and uncertainties. You can identify these statements by forward-looking words including "believes," "considers," "intends," "expects," "may," "will," "should," "forecast," or "anticipates," or the negative equivalents of those words or comparable terminology, and by discussions of strategies that involve risks and uncertainties. Forward-looking statements are not guarantees of the Company's future performance or results, and the Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factor. This section should be read in conjunction with the Company's unaudited consolidated financial statements.

The following discusses the Company's financial condition and results of operations for the three-month ended March 31, 2009 and 2008 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-K for the fiscal year ended December 31, 2008.

Starting January 1, 2008, the Company has reclassified its business into two segments, consisting of the Penicillin Division and the Cephalosporin Division.

The Penicillin Division currently operates the production and sales of clavulanic acid, cefalexin and cefadroxil. Cefalexin and cefadroxil were launched and included in the Company's product portfolio only at the beginning of 2008. Clavulanic acid is a drug that combines with penicillin group antibiotics to increase the effectiveness against bacterial resistance. Cefalexin and cefadroxil are Penicillin G downstream products that are widely used to treat urinary tract infections, respiratory tract, skin and soft tissue infections.

The Cephalosporin Division operates the production and sales of 7-ACA, crude bulk drugs and formulation drugs. In addition to 7-ACA, an intermediate for cephalosporin antibiotics, the Company's current product offering in the Division also includes crude bulk drug, such as ceftazidime crude powder, and formulation drugs including powder for injection for ceftriaxone, ceftazolin, cefotaxime, cefoperazone, ceftazidime, cefuroxime, cefonicid and cefminox.

Results of Operations for the Three-month Period Ended March 31, 2009 and 2008

Sales and Gross Margin Analysis

Sales for the quarter ended March 31, 2009 increased to \$36.96 million from \$35.87 million for the same period in 2008. \$30.08 million or approximately 81% of the sales were generated from the sales of products in the Chinese market, and the remaining \$6.88 million or approximately 19% were generated from the markets outside of China compared to 84% and 16% respectively during the quarter ended March 31, 2008. Sales generated from the international market outside of China increased 20% from \$5.73 million for the first quarter of 2008 to \$6.88 million for the same period in 2009 reflecting the Company's stronger market acceptance and position in the targeted emerging market.

For the quarter ended March 31, 2009, \$12.55 million or 34% of sales were from the Penicillin Division and \$24.41 million or approximately 66% of the sales were from the Cephalosporin Division. For the same period in 2008, 34% of sales were from the Penicillin Division and 66% of sales were from the Cephalosporin Division. The slight increase in sales for the three-month period ended March 31, 2009 as compared to the same period of prior year was primarily due to an increase in sales in clavulanic acid (34% year-over-year growth), cephalosporin crude bulk drug (562% year-over-year growth) and cephalosporin formulation drugs (11.5% year-over-year growth), which were partially offset by the decrease of sales in cefalexin & cefadroxil and 7-ACA which was mainly due to an increase in internal use for producing downstream products.

Cost of sales for the quarter ended March 31, 2009 was \$30.55 million compared to \$29.70 million for the same period in 2008. The increase in the cost of sales was mainly due to the increase in production and sales of products from both Penicillin and Cephalosporin Divisions as mentioned above.

Overall gross profit for the quarter ended March 31, 2009 increased 4% to \$6.41 million from \$6.17 million for the same period in 2008. The overall gross margin for the quarter ended March 31, 2009 was 17.4% as compared to 17.2% for the same period in 2008. The improvement in the overall gross margin was mainly contributed by the improvement of the gross margin for the Company's core products such as clavulanic acid (43% gross margin for the first quarter of 2009 as compared to 34% for the same period in 2008) and 7-ACA (31% gross margin for the first quarter of 2009 as compared to 27% for the same period in 2008) even though it is partially offset by the decrease in gross margins in cephalosporin crude bulk drugs, cephalosporin formulation drugs as well as cefalexin and cefadroxil

Divisional Revenues and Gross Margin Analysis

The Company's businesses are currently organized under two business Divisions: the Penicillin Division and the Cephalosporin Division.

Penicillin Division

The Penicillin Division's sales for the quarter ended March 31, 2009 were \$12.55 million, accounting for 34% of the total sales of the Company. By comparison, Penicillin Division's sales were \$12.14 million for the same period in 2008, contributing 34% of the total sales of the Company. Overall gross margin for the Penicillin Division was 28% for the first quarter of 2009, an improvement from 20% gross margin for the same period in 2008.

The key products for the Penicillin Division are clavulanic acid and cefalexin & cefadroxil. Clavulanic acid achieved an overall growth rate of 34% in sales for the first quarter of 2009 as compared to the same period in 2008, resulting primarily from a 97% increase in sales volumes but partially offset by a decrease in the average price due to a change in sales product mix. Clavulanic acid products continued to show strong momentum in both the Chinese and international market outside of China with a 12% and 75% year-over-year growth rates respectively. The gross margin for clavulanic acid further improved to 43% for the first quarter of 2009 as compared to 34% in the same period of 2008 due to the continuing effort to improve the production yield and lower the production cost,

Cefalexin and cefadroxil were launched at the beginning of 2008. Sales of these two new products for the first quarter of 2009 was approximately 4% lower than the same period in 2008, because of a 25% decrease in selling price while the sales volume increased by 29% year over year. The overall gross margin for these two products was -0.4% during

the first quarter of 2009 as compared to 1.3% for the same period of 2008.

Cephalosporin Division

Sales for the Cephalosporin Division for the quarter ended March 31, 2009 were \$24.41 million, an increase from \$23.73 million during the same period in 2008. The slight increase in sales was mainly due to higher sales of the cephalosporin crude bulk drug (562% year-over-year growth rate) as well as formulation drugs (11.5% year-over-year growth rate). Sales of 7-ACA for the quarter ended March 31, 2009 decreased 19% from the same period of 2008 due to lower market price and sales volume as the Company used more of its production to produce downstream products.

Overall gross margin for the Cephalosporin Division was 11.7% for the first quarter of 2009 as compared to 15.5% for the same period in 2008. As a result of the Company's continuing effort to improve production yield, 7-ACA's gross margin further improved to 31% during the first quarter of 2009 from 27% for the same period in 2008. Gross margin for the crude bulk drugs and formulation drugs were 1% and -4.9%, respectively, for the first quarter of 2009, as compared to 5% and -0.3% for the same period of 2008.

Operating Expenses

Total operating expenses were \$3.39 million for the quarter ended March 31, 2009. The major category of operating expenses were general and administration expenses of \$1.55 million, and research and development expenses of \$0.20 million, selling expense of \$1.27 million, and depreciation and amortization expenses of \$0.36 million. Total operating expenses were \$3.60 million for the quarter ended March 31, 2008 including general and administration expenses of \$1.87 million, selling expense of \$1.12 million, research and development expenses of \$0.43 million and depreciation and amortization expenses of \$0.18 million.

The decrease of \$0.21 million in operating expenses for the quarter ended March 31, 2009 as compared to the same period of 2008 mainly reflects the continuing effort of the management to lower the operating expenses.

Income from Operations

During the first quarter of 2009, the Company realized \$3.03 million income from operations, an 18% increase from \$2.57 million for the same period in 2008. Such an increase in the income from operations was mainly due to the combined effect of an increase in gross profit and a lowering of operating expenses as described above.

Other Expense

During the quarter ended March 31, 2009, the Company recognized a net other expense of \$0.99 million. This amount primarily consisted of \$0.96 million of interest expense and other expense of \$0.04 which was partly offset by a \$0.01 million other income in form of government grant. Total other expenses for the quarter ended March 31, 2008 were \$0.57 million. The increase in the net other expense for the first quarter of 2009 as compared to the same period of 2008 was due to the fact that the Company received \$0.24 million less in government subsidies.

Income Tax Expense

The Company had \$0.59 million income tax expense for the first quarter of 2009 as compared to \$0.27 million for the same period of 2008. Such an increase in income tax expense was due to the fact that the Company received a tax credit of \$0.44 million for the first quarter of 2008 as compared to \$nil during the same period of 2009.

After-tax Income from Continuing Operations

The Company realized an after-tax income from continuing operations of \$1.45 million for the quarter ended March 31, 2009 as compared to \$1.73 million for the same period of 2008. The decrease of \$0.28 million after-tax income from continuing operations was mainly due to the combined impact of a lowering government subsidies and tax credit

received by the Company during the first quarter of 2009 as described above.

After-tax Income from Discontinued Operations

The Company realized an after-tax income from discontinued operations of \$nil million for the quarter ended March 31, 2009 as compared to an after-tax income from discontinued operations of \$0.23 million for the same period of 2008.

Net Income

For the quarter ended March 31, 2009, the Company had a net income of \$1.45 million compared to \$1.96 million for the same period in 2008. However, year-over-year comparison needs to take into consideration that net income for the first quarter of 2008 benefited from \$0.24 million government subsidies, \$0.44 million tax credit and \$0.23 million after-tax income from discontinued operation. The decrease in the net income for the first quarter of 2009 compared to the same period of 2008 was significantly impacted by the lowering of such government subsidies, tax credit and after-tax income from discontinued operations.

Comprehensive Income

Including a gain on foreign currency translation of \$0.07 million, the Company had a comprehensive income of \$1.52 million for the first quarter of 2009, compared to a comprehensive income of \$3.91 million for the same period of 2008. However, year-over-year comparison needs to take into consideration that net income for the first quarter 2008 benefited from a \$1.94 million gain on foreign currency translation. Foreign currency translation gain results from the translation of the financial statements expressed in Chinese Renminbi (RMB) to United States Dollars. The increase reflects the appreciation of the RMB relative to the United States dollar.

Net Income per Share Basic

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. The weighted average number of shares outstanding was 67,066,418 and 66,374,507 for the first quarter of 2009 and 2008 respectively.

Net Income per share from continuing operations was \$0.02 for the first quarter of 2009 as compared to \$0.03 for the same period of 2008.

Net Income per share from discontinued operations was \$nil for the first quarter of 2009 as compared to \$0.00 for the same period of 2008.

Net Income per share was \$0.02 for the first quarter of 2009 as compared to a net income of \$0.03 per share for the same period of 2008. The decrease of the net income per share for the first quarter of 2009 as compared to the same period of 2008 mainly reflected the lowering of government subsidies, tax credit and after-tax income from discontinued operations during the first quarter of 2009.

Net Income per Share Diluted

During the first quarter of 2009, some of the stock options outstanding had a dilutive impact of the Company's net income. The weighted average number of shares on a diluted basis was 67,362,462 and 68,170,887 for the first quarter of 2009 and 2008 respectively.

Net Income per share from continuing operations on a diluted basis was \$0.02 for the first quarter of 2009 as compared to \$0.03 for the same period of 2008.

Net Income per share from discontinued operations on a diluted basis was \$0.00 for the first quarter of 2009 as compared to \$0.00 for the same period of 2008.

Net Income per share on a diluted basis was \$0.02 for the first quarter of 2009 compared to \$0.03 per share for the same period of 2008. The decrease of the net income per share on a diluted basis for the first quarter of 2009 as compared to the same period of 2008 mainly reflected the lowering of government subsidies, tax credit and after-tax income from discontinued operations during the first quarter of 2009.

Liquidity and Capital Resources

As of March 31, 2009, Dragon Pharma had current liabilities of \$68.33 million and current assets of \$45.67 million, including cash of \$2.12 million, restricted cash of \$0.74 million and accounts receivables of \$13.04 million. The deficiency in working capital was mainly due to the use of short-term loans to finance the increase in working capital requirements as the business grows.

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 exchange 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. 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. 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.

As of March 31, 2009, the Company had current liabilities of \$68.33 million as follows:

| | |
|-------------------------------------|------------------------|
| Accounts Payable | \$17.48 million |
| Other Payables and Accrued Expenses | \$26.52 million |
| Loans Payable - Short Term | \$23.57 million |
| Note Payable | \$0.74 million |
| Due to related companies | \$0.02 million |
| Total Current Liabilities | \$68.33 million |

As of March 31, 2009, the Company had outstanding short-term loans (less than one year term) totaling \$23.57 million. The Company believes that it will be successful in renegotiating loans 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:

At March 31, 2009, the Company had long-term loan payable of \$20.60 million. During the quarter ended March 31, 2009, the Company financed its operations and increased production level at its Penicillin and Cephalosporin Divisions through operating revenues, accounts payables and short-term loans. The Company intends to seek additional funding through equity financing to improve its financial position.

Item 3.

Quantitative and Qualitative Disclosure about Market Risk

Not applicable since the Company is a smaller reporting company.

Item 4.

Controls and Procedures

Item 4T. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

As of March 31, 2009, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed in the Company's periodic reports filed under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified by the Securities and Exchange Commission's rules and regulations.

Changes in internal control over financial reporting.

There has been no change in the Company's internal control over financial reporting that occurred during the Company's first quarter ended March 31, 2009, that has materially affected, or is reasonably likely to affect, the Company's 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-K for the year ended December 31, 2008, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K 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: May 15, 2009

/s/ Yanlin Han
Yanlin Han
Chief Executive Officer

Date: May 15, 2009

/s/ Garry Wong
Garry Wong
Chief Financial Officer

EXHIBIT 31.1

Section 302 Certification of Principal Executive Officer

I, Yanlin Han, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of Dragon Pharmaceutical Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a.

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b.

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c.

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonable likely to materially affect, the registrant's internal control over financial reporting; and

5.

The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a.

All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b.

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: May 15, 2009

/s/ Yanlin Han
Yanlin Han
Chief Executive Officer

EXHIBIT 31.2

Section 302 Certification of Principal Financial Officer

I, Garry Wong, certify that:

1.

I have reviewed this quarterly report on Form 10-Q of Dragon Pharmaceutical Inc.;

2.

Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3.

Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4.

The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a.

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b.

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c.

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonable likely to materially affect, the registrant's internal control over financial reporting; and

5.

The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

a.

All significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b.

Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: May 15, 2009

/s/ Garry Wong
Garry Wong
Chief Financial Officer

