ASENSIO.com

April 20, 2009

China Sky's Purported Margins Exhibit Disturbing Inconsistencies.

China Sky One Medical, Inc. (NASDAQ: CSKI) claims to sell primarily over-the counter pharmaceutical products in China, a highly competitive market. Indeed, China Sky states in its 10-K that competition in this field is "intense."

China Sky's main products purport to use traditional Chinese medicine. The best selling products are things like hemorrhoid ointment, a patch meant to help people lose weight, and a patch meant to alleviate hypertension. Beyond this, China Sky sells anti-dandruff shampoo, and kits meant to diagnose conditions such as kidney disease and heart disease.

The immediate question about these products is their effectiveness and value. One might well ask how a patch can be used to aid weight-loss or hypertension, and if those products actually work, why aren't they being mass-marketed in the US or other larger markets? Unfortunately, the disclosures in China Sky's SEC filings do not provide much insight into how effective their products actually are or any justification for their claimed pricing and questionably high profit margins.

If investors dig a little deeper into China Sky's financial statements to find how their reported margins behave over time and how their sales are broken down by product type, they will come across some disturbing inconsistencies.

First, China Sky's gross margins seem suspect. Quarter to quarter and year to year, the company's gross margins stay remarkably constant, around 77%. This is high, even compared to some other companies selling the same types of traditional Chinese medicine products in China, like American Oriental Bioengineering, Inc. (NYSE: AOB), a company that has had its own set of controversies.

What's more, China Sky's product mix has changed significantly over the past two years, in a way that should impact gross margin. They have been selling fewer goods manufactured by other companies and more goods they've manufactured themselves. Products manufactured by other companies should have lower margins, so margins should go up when a company sells less of them and more of their own products, all else being equal. However, with China Sky these "contract sales," sales of products manufactured by others, went from being 26% of sales in the first nine months of 2007 to 10% of sales in the same period of 2008. During the same periods, the company's overall gross margin actually went down slightly, from 77.8% to 76%. No explanation is available in China Sky's disclosures to account for this apparent irregularity.

Stranger still are the changes in Average Selling Prices ("ASP") implied by the breakdown of sales by product type for the past two years, as disclosed in the 10-Q filed November 7, 2008.

Two product types in particular, the "lose weight series" and "antihypertension," have ASPs that vary drastically from one quarter to the next from 2007 to 2008. The ASPs on these products repeatedly swing up and down, by as much as 50% or more.

In nearly every quarter over the past two years, these two product types have been more than 30% of sales. This presents a very important question to investors concerning the credibility of China Sky's implied ASPs and gross margins, particularly in light of China Sky's questionable audit and EPS reporting. (see reports <a href="http://www.asensio.com/Reports/ReportView.aspx?ReportId=932&CompanyId=165&CompanyName=China+Sky+ and <a href="http://www.asensio.com/Reports/ReportView.aspx?ReportId=935&CompanyId=165&CompanyName=China+Sky+

How could the ASP on these products vary so much from one quarter to the next, and take up such a large percentage of sales, while the overall gross margin remains roughly constant from one quarter to the next?

There could be two explanations, and neither makes much sense. Either the material costs on these product types are varying as much as the ASP, or the product mix within each group is changing. The problem with the first explanation is that it just doesn't make much sense for costs to swing 50% and back again in one three-month period. The trouble with the latter explanation is that the company only discloses one product within each of the "Lose weight series" and "Antihypertension" product lines. After all how many different types of weigh loss patches can the company be making and why would their cost vary so widely? The conclusion – there is something highly questionable with China Sky's product sales disclosures and with their disclosures on their margins. In what would be a worst case scenario for investors, this might imply that China Sky's reported earnings are not accurate, or may even be completely overstated.

Excerbating the problem is China Sky's own attempts at an explanation.

The company's explanation from the November 2008 10-Q is as follows: "To maintain our competitiveness in the PRC markets, unit selling prices were moderately reduced in 2008. However, the Company was able to negotiate a lower purchase price from our suppliers which negated the decrease in the selling prices of our products. Overall, the Company was able to maintain our 2007 product gross margins of 77% in the year 2008." As indiciated above, for this statement to be true, China Sky would have had to negotiate an approximately 50% reduction in purchase prices from their suppliers for the weight loss patch and the antihypertension patch from the first quarter of 2008 to the third quarter, in order to exactly offset the decrease in sales prices.

China Sky is already trading at a higher multiple than some of its peers. When you add China Sky's irregular funding transactions, questionable auditing relationships, lack of transparency surrounding insider stock holdings and dealings, and the group of serial China reverse merger promoters involved, it seems very unlikely that things are going to end well for China Sky investors.