

May 19, 2009

China Sky Confusion: Pricewaterhouse Engaged as Non-Auditor and Management's Circular Answers.

Today China Sky One Medical, Inc. (NASDAQ: CSKI) issued a press release stating that it had engaged Pricewaterhouse Coopers to assist the company in complying with the financial reporting and control requirements of the Sarbanes-Oxley Act. Pricewaterhouse will not become the company's auditor. China Sky is only engaging the firm as a consultant.

If China Sky wanted to truly improve its financial reporting, why would it not just retain Pricewaterhouse as its external auditor? Does this mean that the company is admitting faults in its financial control?

Oddly, on May 15 China Sky's management stated that they would not retain a Big 4 firm as auditor. This statement was made in China Sky's first quarter earnings conference call. One analyst on the call asked specifically whether the company would consider hiring one of the Big Four accounting firms to conduct its audit, along with hiring more experienced directors. China Sky management stated in response that the company's chairman "doesn't think it's appropriate to change auditing firms that often," and that the company will not be changing anytime soon.

Reports previously issued by asensio.com pointed out that China Sky had four auditors at different times in the past three years, with each auditor having a history of deficiencies, and that the company had appointed a 25 year-old graduate student to serve on its board and audit committee as a "financial expert."

Apparently the issue of appropriateness did not occur to CSKI management when it changed auditors three times in three years. Crocker Coulson, China Sky's outside investor relations representative, thereafter stated on the call that in his experience smaller auditing firms provided better "service" to companies like China Sky. Mr. Coulson did not specify what services CSKI's current auditor provides that are better than what could be done by a more reputable firm.

In the conference call China Sky management responded to many other questions on issues raised in asensio.com's reports on China Sky, including irregularities in inventory and gross margins. Though China Sky's management answered questions, their responses did not provide much clarity on the serious issues facing the company.

A report issued by asensio.com on May 15 pointed out the continuing inconsistency in China Sky's gross margins evident in the first quarter earnings. China Sky's sales of contract products, manufactured by other companies, decreased to 0% of sales in the first quarter of 2009 from more than 20% in the same period of 2008, while gross margin remained nearly constant. An analyst asked China Sky management about this directly. The company's explanation was that contract sales had gross margins that were only 2% lower than the company's own products.

Several people on the call asked China Sky management about the company's low inventory levels, what is perhaps the most clearly problematic issue in China Sky's financial disclosures.

China Sky's management provided some long-winded, circular responses, but their basic claim was that China Sky

can push its inventory off onto customers and suppliers. If the process of pushing inventory off onto customers and suppliers were indeed the case, it would mean that the company should be reporting deposits from customers and deposits to suppliers as separate line items on the balance sheet. The only comparable entry in CSKI's latest Form 10-Q is for "Prepaid and other current assets," totaling \$77,726. The notes to the financial statements provide no explanation as to what these prepaid and other assets are precisely. However, if it represented prepayments for product, then \$77,726 seems an especially small number for the type of prepayment system that CSKI management alluded to, especially given that the company reported more than \$24 million in sales for the first quarter.

China Sky management made further puzzling statements concerning its customer and distributor relationships. Management referred to two of its three major customers as "sales agents." Sales agents are typically distinct from distributors. It would be highly irregular for a sales agent to maintain the type of relationship where products are pre-purchased, as CSKI management stated was the case in response to questions on inventory.

Trying to find logical explanations to reconcile China Sky's various disclosures and management statements can be like running around in circles. More explanation provided by the company only results in more confusion.