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CHINA DIGITAL WIRELESS INC  
Form 10QSB  
May 22, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-QSB

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2006

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

For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_  
0-12536  
(Commission File Number)

CHINA DIGITAL WIRELESS, INC.  
(Exact Name of Small Business Issuer as Specified in Its Charter)

Nevada  
(State or Other jurisdiction of  
Incorporation or Organization)

90-0093373  
(IRS Employer Identification  
No.)

429 Guangdong Road  
Shanghai, People's Republic of China 200001  
(Address of Principal Executive Offices)

Issuer's Telephone Number, Including Area Code: (86 21) 6336-8686

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to the filing requirements for at least the past 90 days. Yes No

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

As of April 24, 2006, there were 17,147,268 shares of \$.001 par value common stock outstanding.

Transitional Small Business Disclosure Format: Yes No

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CHINA DIGITAL WIRELESS INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

|                 | December 31,<br>2005 | March 31,<br>2006 |
|-----------------|----------------------|-------------------|
|                 | -----                | -----             |
| ASSETS          |                      | (Unaudited)       |
| Current assets: |                      |                   |

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|   |               |               |
|---|---------------|---------------|
| Cash and cash equivalents   | \$ 3,578,367  | \$ 1,094,820  |
| Accounts receivable, net of allowance for doubtful accounts of \$44,472 and \$16,750  | 844,977       | 784,958       |
| Inventories   | 62,386        | 42,972        |
| Deferred tax assets   | 12,846        | 3,448         |
| Due from related parties  | 3,094,969     | 5,640,199     |
| Advances and deposits to suppliers  | 19,970        | 35,665        |
|   | -----         | -----         |
| Total current assets  | 7,613,515     | 7,602,062     |
| Property and equipment, net   | 1,105,756     | 1,064,638     |
| Deposit for business acquisition  | 6,257,590     | 6,257,590     |
|   | -----         | -----         |
| Total assets  | \$ 14,976,861 | \$ 14,924,290 |
|   | =====         | =====         |
| LIABILITIES AND SHAREHOLDERS' EQUITY  |               |               |
| Current liabilities:  |               |               |
| Accounts payable  | \$ 881,218    | \$ 782,433    |
| Advance from customer   | 6,399         | 6,441         |
| Deferred revenue  | 31,598        | 18,710        |
| VAT payable   | 92,649        | 60,235        |
| Income tax payable  | 193,586       | 106,121       |
| Due to related parties  | 223,399       | 237,355       |
| Other current liabilities   | 375,960       | 434,814       |
|   | -----         | -----         |
| Total current liabilities   | 1,804,809     | 1,646,109     |
|   | -----         | -----         |
| Shareholders' equity:   |               |               |
| Common stock - \$0.001 par value, 100,000,000 shares authorized, 17,147,268 shares issued and outstanding at December 31, 2005 and March 31, 2006 | 17,148        | 17,148        |
| Additional paid-in capital  | 4,229,845     | 4,229,845     |
| Retained earnings   | 8,084,922     | 8,153,056     |
| Restricted reserves   | 554,466       | 554,466       |
| Accumulated other comprehensive income  | 285,671       | 323,666       |
|   | -----         | -----         |
| Total shareholders' equity  | 13,172,052    | 13,278,181    |
|   | -----         | -----         |
| Total liabilities and shareholders' equity  | \$ 14,976,861 | \$ 14,924,290 |
|   | =====         | =====         |

See accompanying notes to consolidated financial statements.

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(Unaudited)

|   | Three Months ended March 31, |            |
|---|------------------------------|------------|
|   | 2005                         | 2006       |
| Revenues:   |                              |            |
| Product sales                                       | \$ 669,191                   | \$ 349,997 |
| Product sales to related parties                    | 4,060,514                    | 890,744    |
| Information service revenue, net                    | 609,215                      | 261,785    |
| Advertising service revenue, net                    | 459,131                      | 177,159    |
|   | 5,798,051                    | 1,679,685  |
| Total revenues                                      |                              |            |
| Cost of goods sold                                  | 605,888                      | 333,734    |
| Cost of goods sold to related parties               | 3,963,905                    | 777,884    |
| Cost of information service                         | 170,678                      | 189,319    |
| Cost of advertising service                         | 22,819                       | 40,056     |
|   | 4,763,290                    | 1,340,993  |
| Gross profit  | 1,034,761                    | 338,692    |
| Operating expenses:                                 |                              |            |
| Sales and marketing                                 | 43,289                       | 26,967     |
| General and administrative                          | 192,039                      | 207,614    |
|   | 235,328                      | 234,581    |
| Total operating expenses                            |                              |            |
| Income from operations                              | 799,433                      | 104,111    |
| Other revenue                                       | --                           | 204        |
| Interest income, net                                | 465                          | 115        |
|   | 799,898                      | 104,430    |
| Income before income taxes                          |                              |            |
| Income tax provision                                | 133,490                      | 36,296     |
|   | 666,408                      | 68,134     |
| Net income  | \$ 666,408                   | \$ 68,134  |
| Other comprehensive income (loss):                  |                              |            |
| Foreign currency translation adjustment             | \$ (2)                       | \$ 37,995  |
| Comprehensive income                                | \$ 666,406                   | \$ 106,129 |
| Basic and diluted earnings per share                | \$ 0.04                      | \$ 0.00    |
| Weighted average shares of common stock outstanding | 17,018,692                   | 17,147,268 |

See accompanying notes to consolidated financial statements.

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CHINA DIGITAL WIRELESS INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | Three Months ended March |             |
|---|--------------------------|-------------|
|   | 2005                     | 2004        |
| Cash flows from operating activities:   |                          |             |
| Net income  | \$ 666,408               | \$ 666,408  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |             |
| Depreciation and amortization   | 67,684                   | 47,684      |
| Bad debt expenses   | (20,685)                 | (20,685)    |
| Deferred tax assets   | 17,437                   | 17,437      |
| Changes in assets and liabilities:  |                          |             |
| Accounts receivable   | 1,596,154                | 8,154       |
| Inventories   | (793,574)                | 1,574       |
| Due from related parties  | --                       | (5,154)     |
| Advances and deposits to suppliers  | (1,321,604)              | (1,321,604) |
| Accounts payable  | 873,462                  | (9,462)     |
| Advance from customer   | --                       | --          |
| Deferred revenue  | (445,419)                | (1,419)     |
| VAT payable   | (125,617)                | (3,617)     |
| Income tax payable  | (102,186)                | (8,186)     |
| Due to related parties  | (48,910)                 | 1,910       |
| Other current liabilities   | (51,942)                 | 5,942       |
| Net cash flows provided by (used in) operating activities                         | 311,208                  | (1,208)     |
| Cash flows from investing activities:   |                          |             |
| Purchase of property and equipment  | (50,452)                 | (50,452)    |
| Loan to related parties   | (1,432,023)              | (2,49,023)  |
| Net cash flows used in investing activities                                       | (1,482,475)              | (2,49,475)  |
| Cash flows from financing activities:   |                          |             |
| Escrow receivable   | 1,500,000                | 1,500,000   |
| Net cash flows provided by financing activities                                   | 1,500,000                | 1,500,000   |
| Foreign currency translation adjustment   | (2)                      | 3           |
| Net increase (decrease) in cash and cash equivalents                              | 328,731                  | (2,48,731)  |
| Cash and cash equivalents, beginning of the period                                | 75,511                   | 3,57,511    |
| Cash and cash equivalents, end of the period                                      | \$ 404,242               | \$ 1,09,780 |

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Supplemental disclosure of cash flow information:

Cash paid during the period for:

|              |    |         |    |    |
|--------------|----|---------|----|----|
| Interest     | \$ | --      | \$ | 11 |
| Income taxes | \$ | 218,239 | \$ |    |

See accompanying notes to consolidated financial statements.

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### CHINA DIGITAL WIRELESS INC. AND SUBSIDIARY NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 1 - ORGANIZATION AND BUSINESS BACKGROUND

China Digital Wireless, Inc. ("CDW") through its subsidiary sells mobile phones to retailers, distributors, and related parties, provides advertising services and provides information services to users of mobile phones and pagers. Substantially all operations are conducted in Shanghai, People's Republic of China ("PRC").

In order to meet ownership requirements under Chinese law that restrict a foreign company from operating in certain industries such as value-added telecommunication, advertising service and Internet services, CDW's subsidiary has entered into information service and cooperation agreements with two of CDW's affiliates that are incorporated in China: Shanghai Sifang Information Technology Co. ("Sifang Information") and Shanghai Tianci Industry Co. Ltd ("Tianci Industry"). CDW holds no ownership interest in Sifang Information or Tianci Industry. Sifang Information and Tianci Industry contract with China Mobile Communications Corporation ("China Mobile"), and China United Telecommunications Corporation ("China Unicom"), to provide wireless value-added information services to wireless receiver customers in China via China Mobile and China Unicom. Sifang Information transmits those services to customers of China Mobile and China Unicom on behalf of itself and Tianci Industry pursuant to a signed agreement between Sifang Information and Tianci Industry.

#### Business History

CDW's business is primarily conducted through its wholly-owned subsidiary Sifang Holdings and its wholly-owned subsidiary TCH Data Technology Co., Ltd. ("TCH"), that collectively with CDW are referred to as the "Company". Sifang Holdings was established under the laws of the Cayman Islands on February 9, 2004 for the purpose of holding a 100% equity interest in TCH. TCH was established as a foreign investment enterprise in Shanghai under the laws of the PRC on May 25, 2004, with registered capital of \$7.2 million.

CDW's current operations were originally a business division of Sifang Information. Sifang Information is a Shanghai-based privately owned enterprise established under the laws of the PRC on August 14, 1998. Sifang Information is engaged in the business of pager and mobile phone distribution and provides value added information services to the customers in the Shanghai metropolitan area. In March 2004, Sifang Information spun off its mobile phone distribution business and the majority of its value added information services business to TCH. As the acquiring entity under common control, TCH initially recognized all the assets and liabilities transferred at their carrying amounts in the accounts of Sifang Information at the date of transfer under the guidance of Statements of Financial Accounting Standards ("SFAS") No. 141, Appendix D.

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On May 26, 2004, Sifang Information exchanged 100% of the equity interest in TCH for 100% of the equity interest in Sifang Holdings. Since the ultimate owners of the three entities were the same owners and the three entities remained under common control, the ownership exchange transaction was accounted for at historical costs under the guidance of SFAS No. 141, Appendix D. Prior to May 26, 2004, there were no activities in Sifang Holdings. As a result of the exchange of ownership between TCH and Sifang Holdings, TCH's historical financial statements became the historical financial statements of Sifang Holdings.

As a result of the spin-off, the Company engages in the business of mobile phone distribution and provides pager and mobile phone users with access to certain value-added information reformatted by TCH. TCH purchases mobile phones from first tier distributors and sells them to retailers and distributors with a mark-up. In the process of providing value-added information services through entering into monthly subscription agreements with various users, TCH purchases trading activity information from stock exchanges, comments and analysis on PRC stock markets provided by certain reputable security and investment companies, lottery information, weather forecast, and other value-added products and reformats the aforementioned information through decoding and recoding and then has the reformatted information transmitted by Sifang Information, via service contracts, to pager users. The value-added information is constantly saved on TCH's server in order for mobile phone users to dial in via China Mobile or China Unicom. By signing a monthly subscription agreement, wireless receiver users agree to make advance payments for its services for either three or six-month subscription periods.

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### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Basis of Presentation

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S.GAAP") for interim financial information and the instructions to Form 10-QSB and Item 310(b) of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by U.S.GAAP for a complete presentation of financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's financial condition and results of operations for the interim periods presented in this Form 10-QSB have been included. Operating results for the interim periods are not necessarily indicative of financial results for the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2005.

#### Principles of Consolidation

The consolidated financial statements include the accounts of CDW, its wholly-owned subsidiary, Sifang Holdings, and its wholly-owned subsidiary, TCH. Substantially all of CDW's revenues are derived from the operations of TCH, which represents substantially all of CDW's consolidated assets and liabilities as of March 31, 2006. All significant intercompany accounts and transactions have been eliminated.

#### Foreign Currency Translations and Transactions

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The Renminbi ("RMB"), the national currency of the PRC, is the primary currency of the economic environment in which the operations of the Company are conducted. The Company uses the United States dollar ("U.S. dollars") for financial reporting purposes.

The Company translates its financial statements into U.S. dollars in accordance with SFAS No. 52, "Foreign Currency Translation." All asset and liability accounts have been translated using the exchange rate prevailing at the balance sheet date (at March 31, 2006, the prevailing exchange rate of the U.S. dollar against the RMB was 8.0170), and the statement of income is translated at average rate during the reporting period (the average rate of the U.S. dollar against the RMB, during the quarter ended March 31, 2006 were 8.0436). Equity items are translated at historical rates. Adjustments resulting from the translation of the Company's financial statements from RMB into U.S. dollars are recorded in shareholders' equity as part of accumulated other comprehensive income. Gains or losses resulting from transactions in currencies other than RMB are reflected in the statement of income for the reporting periods.

### Revenue Recognition

The Company derives revenues from the sale of mobile phones, advertisement designing service and the provision of wireless information services that are used on mobile phones, pagers and prepaid phone cards. The Company additionally earns commission income ("Agency Income") from the sale of CDMA mobile phones on the behalf of a related party. The Company recognizes its revenues net of related business taxes and value-added taxes.

### Mobile Phone Sales:

Revenues generated from the sale of mobile phones are recognized when the products are shipped to the distributor or retailer and when persuasive evidence of an arrangement exists, delivery of the products has occurred, customer acceptance has been obtained, which means the significant risks and rewards of ownership have been transferred to the customer, the price is fixed or determinable and collectibility is reasonably assured.

### Advertising Servicing Revenue, Net:

Advertising revenues are derived from advertisement designing, masterminding and producing services. The Company recognizes service revenues over the term of the noted agreement at the time of completion of the services. The Company records the revenue from Shanghai Sifang Media Co., Ltd. ("Sifang Media") on a net basis

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in compliance with EITF 99-19, "Reporting Revenue Gross as a Principle versus Net as an Agent" because the Company is not the primary obligor in the arrangement and they receive a fixed fee from Shanghai Sifang Media Co., Ltd. and they have no latitude in determining prices.

### Information Services:

The Company recognizes service revenues over the term of the noted agreement and/or when the services have been provided to the end user.

#### i) Information Services - TCH:

By signing a subscription agreement, wireless receiver users agree to make



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payments for three to six-month subscriptions in advance. TCH records the proceeds as deferred revenue and amortizes the deferred revenue over the subscription period. When customers buy a pre-charged service card, the Company records the proceeds as deferred revenue. When a customer starts to use this card to access the Company's server and starts to use a pager to access the aforementioned information, the Company identifies the subscription period and amortizes the deferred revenue over the subscription period.

### ii) Information Services - Installing Agent:

In response to a retailer's request, the Company has an installing agent who installs the Company's software on mobile phones, which are owned by the retailer. The retailer sells these phones for a premium covering a fee to be paid to the installing agent and pre-charged six-month subscription fees to be paid to the Company. After a customer using such a phone dials into the server to access the desired information, the server records a unique identification number installed on the mobile phone, which indicates that a specific phone user starts his or her subscription period. After the Company receives a detailed list from the installing agent regarding the number of phones that have been installed with the Company's software, the Company matches this information with a detailed list from the retailer setting forth how many such phones have been sold. Based on the number of such phones sold, the Company records accounts receivable and deferred revenue correspondingly. At the date on which a customer starts to dial into the server, the six-month subscription period begins and the Company amortizes deferred revenue accordingly.

### iii) Information Services - China Mobile and/or Unicom:

The Company's affiliates, Sifang Information and Shanghai Tianci Industrial Group Co., Ltd. ("Tianci Group"), contract with China Mobile and/or China Unicom (collectively, "Mobile Operators") for the transmission of the Company's value-added information services. The Mobile Operators bill and collect from customers and then pass those fees (net of billing and collection service fees charged by the Mobile Operators) to Sifang Information and Tianci Group who in turn pass those fees to the Company. The Company recognizes net revenues based on the total amount paid by its customers, for which the Mobile Operators bill and collect on behalf of the Company. There is a time lag ranging from 10 days to 45 days between the end of the service period and the date the Mobile Operators send out their billing statements due to the segregated billing systems of each of the provincial subsidiaries of the Mobile Operators. The Company has not recognized service revenue based on the records provided by its own server but has performed a reconciliation on a monthly basis of the revenues recognized by the Company's server to the Mobile Operator's billing statement. In addition, the Mobile Operators charge a network usage fee based on a fixed per message fee multiplied by the excess of messages sent over messages received. (This type of service is not covered by a monthly service subscription and the Company has no control over whether it will occur or not.) Network usage fees charged by the Mobile Operators are reduced for messages received by the Company because the Mobile Operators separately charge the sender a fee for these transmissions.

The Company records the revenue from the Mobile Operators on a net basis in compliance with EITF 99-19, "Reporting Revenues Gross as a Principle versus Net as an Agent" because the Company:

- o Is not the primary obligor in the arrangement, as it relies on Sifang Information to transmit the information services to the end user,
- o Has limited ability to adjust the cost of services by adjusting the design or marketing of the service,

- o Has limited ability to determine prices, the Company must follow the price policy within ranges prescribed by Mobile Operators, and
- o Has limited ability to assume risk of non-payment by customers.

The Company's dependence on the substance and timing of the billing systems of the mobile telecommunications operators may require the Company to estimate portions of its reported revenue for information services from time to time. As a result, subsequent adjustments may be made to the information service revenue in the Company's consolidated financial statements. As the Company does not bill its information services users directly, the Company depends on the billing systems and records of the mobile telecommunications operators to record the volume of its information services provided, to charge its users through mobile telephone bills, to collect payments from its users, and to pay the Company.

#### Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less to be cash equivalents. The Company maintains its cash accounts at credit worthy financial institutions.

#### Accounts Receivable and Concentration of Credit Risk

During the normal course of business, the Company extends unsecured credit to retailers and distributors who are mainly located in the Shanghai metropolitan area. Typically, for mobile phone distributors, credit terms require payment to be made within 30 days of the sale. The Company does not require collateral from its customers. The Company's policy is to provide for an allowance for doubtful accounts that is based on 5% of total trade accounts receivable less amounts due from related parties and from the installing agent. Total trade accounts receivable due from related parties was nil and \$567,307 as of December 31, 2005 and March 31, 2006, respectively.

The Company regularly evaluates and monitors the creditworthiness of each customer on a case-by-case basis. The Company includes any account balances that are determined to be uncollectible in the overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance. The Company believes that its allowance for doubtful accounts was adequate as of March 31, 2005 and 2006. However, actual write-offs might exceed the recorded allowance.

The following table presents activities in the allowance for doubtful accounts:

|                              | December 31,<br>2005 | March 31,<br>2006 |
|------------------------------|----------------------|-------------------|
|                              | -----                | -----             |
| (Unaudited)                  |                      |                   |
| Beginning balance            | \$ 47,922            | \$ 44,472         |
| Additions charged to expense | --                   | --                |
| Recovered                    | (3,450)              | (27,722)          |
| Actual write off             | --                   | --                |
|                              | -----                | -----             |
| Ending balance               | \$ 44,472            | \$ 16,750         |
|                              | =====                | =====             |

#### Inventories

Inventories consist principally of mobile phones manufactured by name brand manufacturers with various features and are stated at the lower of cost

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(weighted-average) or market.

### Rebates and Credits Receivable

In 2004, the Company's major vendor began providing rebates and credits if the Company meets certain sales volume levels prescribed by the vendor. As a result, the Company is entitled to receive certain rebates and credits for the inventory held and sold by the Company within the specified period of time as defined by its vendor through submitting the necessary application forms. In general, once the vendor approves the applications, the amounts of these rebates and credits will be deducted from the Company's accounts payable to its vendor and decrease the cost of goods sold or inventory held correspondingly.

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### Capitalization of Software Costs

The Company's software is developed by an independent third party to enable pager users to accept certain recoded information which is transmitted by the Company, through affiliates, and enables mobile phone users to dial into the Company's server. The software is developed for internal use and gives the Company the ability to provide value added information services. In accordance with SOP 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," the Company capitalizes the external cost incurred to develop this internal-use software by an engineering company at the application development stage and amortizes that cost over the estimated economic life of the software (two or three years) which is consistent with the expected life of a particular type of mobile phone.

### Property and equipment

Property and equipment are recorded at cost and are stated net of accumulated depreciation. Depreciation expense is determined using the straight-line method over the estimated useful lives of the assets as follows:

|                              |           |
|------------------------------|-----------|
| Buildings                    | 20 years  |
| Software                     | 2-3 years |
| Vehicles and other equipment | 2-5 years |

Maintenance and repairs are charged directly to expense as incurred, whereas betterment and renewals are generally capitalized in their respective property accounts. When an item is retired or otherwise disposed of, the cost and applicable accumulated depreciation are removed and the resulting gain or loss is recognized and reflected as an item before operating income.

### Impairment of Long-Lived Assets

The Company applies the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", issued by the Financial Accounting Standards Board ("FASB"). SFAS No. 144 requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through the estimated undiscounted cash flows expected to result from the use and eventual disposition of the assets. Whenever any such impairment exists, an impairment loss will be recognized for the amount by which the carrying value exceeds the fair value. There was no impairment of long-lived assets during the year ended December 31, 2005 and three months ended March 31, 2006.

### Fair Value of Financial Instruments

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The carrying amount of cash and cash equivalents, accounts receivable, advances and deposits to supplier, accounts payable and other current liabilities are reasonable estimates of their fair value because of the short maturity of these items.

### Stock-Based Compensation

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), "Share-Based Payment". SFAS No. 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense ratably over the requisite service periods. Currently, the Company does not have a stock option plan.

### Value Added Tax

TCH is subject to value added tax ("VAT") imposed by the PRC on TCH's domestic product sales. The output VAT is charged to customers who purchase mobile phones from TCH and the input VAT is paid when TCH purchases mobile phones from its vendors. The VAT rate applied for TCH is 17%. The input VAT can be offset against the output VAT.

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### Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes". SFAS No. 109 requires an entity to recognize deferred tax liabilities and assets. Deferred tax assets and liabilities are recognized for the future tax consequence attributable to the difference between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are measured using the enacted tax rate expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The Company establishes a valuation when it is more likely than not that the assets will not be recovered.

The Company's Chinese subsidiary, TCH, is registered at Pudong District in Shanghai and subject to a favorable income tax rate of 15% compared to a normal income tax rate of 33% (30% for the central government and 3% for the local government) under current PRC tax laws. Sifang Information is registered in the Shanghai downtown and the area has been treated by the Shanghai Municipal Administration of Labor as an enterprise that provides unemployed and handicapped people with jobs. Accordingly, Sifang Information is entitled to a favorable income tax rate of 15% and qualified for an income tax exemption for three years from January 1, 2000 to December 31, 2002, and a 50% income tax reduction for three years from January 1, 2003 to December 31, 2005. The income tax provisions presented in the Company's consolidated financial statements for the three months ended March 31, 2005 and 2006 are based on 15% of income taxable to TCH. The deferred tax assets are determined based on the historical income tax rates applicable at the TCH level.

There is no income tax for companies domiciled in the Cayman Islands. Accordingly, the Company's consolidated financial statements do not present any income tax provisions related to Cayman Islands tax jurisdiction.

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### Use of Estimates

The preparation of consolidated financial statements in conformity with U.S.GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

### Comprehensive Income

The Company adopted SFAS No. 130, "Reporting Comprehensive Income", issued by the FASB. SFAS No. 130 establishes standards for reporting and presentation of comprehensive income and its components in a full set of general-purpose financial statements. The Company has chosen to report comprehensive income in the statements of income and comprehensive income. Comprehensive income is comprised of net income and all changes to shareholders' equity except those due to investments by shareholders and distributions to shareholders.

### Earnings Per Share

The Company computes earnings per share in accordance with the SFAS No. 128, "Earnings per Share". Basic earnings per share includes no dilution and is computed by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period. Diluted earnings per share reflect the potential dilution of securities that could share in the earnings of an entity if they were converted. The Company did not have any potentially dilutive common share equivalents as of March 31, 2005 or 2006.

### Reclassifications

Certain amounts included in the prior period's consolidated financial statements have been reclassified to conform to the current period presentation. Such reclassifications did not have any effect on reported net income and are immaterial to the consolidated financial statements as a whole.

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### NOTE 3 - EQUITY TRANSACTIONS

On August 9, 2005, the Company announced its intent to apply for listing on the American Stock Exchange ("AMEX"). In connection with the AMEX application, certain persons who held more than 200,000 shares of the Company's common stock entered in lockup agreements with the Company where they generally agreed to not offer, sell, assign or otherwise transfer a portion of their shares or other equity securities of the Company without prior written consent of the Company until the earlier of (i) 180 days after the date of the lockup agreements or (ii) the date that AMEX has approved the Company's listing application. The lockup agreements became effective on September 21, 2005, and were executed by ten of the Company's officers and directors and three additional shareholders. Under the lockup agreements with the non-officer/director shareholders, the Company issued an aggregate of 128,576 shares of common stock in consideration thereof.

### NOTE 4 - RELATED PARTY TRANSACTIONS

#### Related Party Relationships

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The following related parties are related through common ownership with the major shareholders of the Company:

|  |                        |
|--|------------------------|
| Shanghai Sifang Information Technology Co.   | ("Sifang Information") |
| Shanghai Tianci Industry Co. Ltd.            | ("Tianci Industry")    |
| Shanghai Tianci Industry Group Co. Ltd.      | ("Tianci Group")       |
| Shanghai Shantian Telecommunication Co. Ltd. | ("Shantian")           |
| Shanghai Sifang Telecommunication Co. Ltd.   | ("Sifang Telecom")     |
| Shanghai Tianci Real Estate Co. Ltd.         | ("Tianci Real Estate") |
| Shanghai Sifang Media Co., Ltd.              | ("Sifang Media")       |

### Merchandise Sold to Related Parties

|          | Three months Ended March 31,<br>2005 | 2006        |
|----------|--------------------------------------|-------------|
|          | -----                                | -----       |
|          | (Unaudited)                          | (Unaudited) |
| Shantian | \$ 4,060,514                         | \$ 890,744  |
|          | -----                                | -----       |

During the three months ended March 31, 2006, TCH sold Samsung GSM mobile phones valued at \$890,744 at a gross profit margin of 12.7% or \$112,860 to Shantian, compared to \$4,060,514 at a gross profit margin of 2.4% or \$96,609 for the same period of the prior year. Accounts receivable includes nil and \$567,307 due from Shantian, as of December 31, 2005 and March 31, 2006, respectively.

### Advertising Services Rendered to Related Party

|                    | Three months Ended March 31,<br>2005 | 2006        |
|--------------------|--------------------------------------|-------------|
|                    | -----                                | -----       |
|                    | (Unaudited)                          | (Unaudited) |
| Tianci Real Estate | \$ 459,131                           | \$ 177,159  |
|                    | -----                                | -----       |

In January 2005, Sifang Media and TCH entered into the "Bank Digital TV's Cooperation Agreement", where TCH will assist in the promotion of TV ads for various customers, including Tianci Real Estate. TCH received a fee of \$177,159 for providing the service during the three months ended March 31, 2006, compared to \$459,131 for the same period of the prior year. There was an "Advertisement Agency Contract" between Tianci Real Estate and Sifang Media, which terminated in November 2005.

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### Service Provided by Related Party

|                    | Three months Ended March 31,<br>2005 | 2006        |
|--------------------|--------------------------------------|-------------|
|                    | -----                                | -----       |
|                    | (Unaudited)                          | (Unaudited) |
| Sifang Information | \$ 121,556                           | \$ 33,966   |
|                    | -----                                | -----       |

In accordance with terms contained in signed service agreements between TCH and Sifang Information giving TCH the right to use Sifang Information's facility

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(which may not be owned by foreign investors at the present time) to transmit the reformatted information, the Company paid service fees of \$90,618 and \$19,898 for the three months ended March 31, 2005 and 2006, respectively. The service agreements are in effect for ten years and became effective on June 1, 2004.

During the three months ended March 31, 2006, Sifang Information also provided other management support and marketing services to TCH for \$14,068, compared to \$30,938 for the three months ended March 31, 2005.

### Due from Related Parties

|                    | December 31, 2005 | March 31, 2006 |
|--------------------|-------------------|----------------|
|                    |                   | (unaudited)    |
| Sifang Information | \$ 2,165,624      | \$ 4,779,528   |
| Sifang Media       | 929,345           | 860,671        |
|                    | \$ 3,094,969      | \$ 5,640,199   |

In order to develop the Company's mobile phone distribution business, the Company applied to become a distributor of Nokia mobile phones (on the provincial level). On March 20, 2005, TCH signed an agreement with Sifang Information with respect to the distribution of Nokia mobile phones and under which TCH will act as an agent to sell Nokia phones on Sifang Information's behalf. In May 2005, Sifang Information obtained the final approval from Nokia.

In order to develop the Company's advertising service business, in January 2006, the Company entered into an agreement with Sifang Information for the establishment of a new joint cooperation entity with a third party. The joint cooperation entity will act as the sole advertising agent of TCH. The Company has advanced RMB20,000,000 (equivalent to \$2,494,699) to Sifang Information to contribute to the joint cooperation entity. The remaining outstanding advances of \$2,284,829 to Sifang Information was for the mobile phone and information services business. These advances will be repaid by December 31, 2006.

As of March 31, 2006, Sifang Media has collected \$929,345 from TCH's advertising customers on its behalf and settled \$68,674 to TCH.

### Deposit for Business Acquisition

In December 2005, TCH entered into a series of agreements to purchase (i) 95% of the equity interests of Shanghai Kena Energy Saving Electric Co Ltd ("Kena") for an aggregate purchase price of RMB 28,500,000 (approximately \$3,532,000); (ii) a related patent from one of the shareholders of Kena for RMB 11,000,000 (approximately \$1,363,000); and (iii) related rights to make a patent application from one of the shareholders of Kena for RMB 11,000,000 (approximately \$1,363,000). The purchase price for both the equity interests in Kena and the consideration for purchase of the patent and the right to apply for registration of the patent shall be paid by Sifang Information on behalf of TCH.

On February 10, 2006, these agreements were amended to impose an additional condition on Mr. Zhang Naiyao, the transferor of the patent and holder of the right to make the patent application, that if he fails to provide the necessary technical assistance services to enable TCH to use the patented technology in producing products on a large scale that meet the standards set by the Company within one year, TCH shall have the right to demand the return of the relevant

payment received by him in full and to terminate the agreement for the assignment of the patent and the right to apply for registration of the patent. The amendments also set forth the arrangement for payment of the purchase price between TCH and Sifang Information. The purchase price for both the equity interests in Kena and the consideration for purchase of the patent and the right to apply for registration of the patent shall be paid by Sifang Information on behalf of TCH. According to the amended agreements, the amount of the purchase consideration paid by Sifang Information on behalf of TCH will be applied to offset the trade receivables owed to TCH by Sifang Information.

Kena was established on April 26, 2005 and it specializes in the research, development and manufacture of energy-saving products, as well as illumination projects in China. The patent and patent application mentioned above relate to a "three phase transformer" which is used in connection with a power supply system and utilizes technology that allows manufacturers to produce transformers with high energy transfer efficiency at a low costs. This technology is expected to be available for mass production within one year.

The transactions are subject to regulatory approval in the PRC.

Due to Related Parties

|                    | December 31, 2005 | March 31, 2006 |
|--------------------|-------------------|----------------|
|                    | -----             | -----          |
|                    |                   | (unaudited)    |
| Tianci Real Estate | \$ 123,467        | \$ 136,759     |
| Shantian           | 99,932            | 100,596        |
|                    | -----             | -----          |
|                    | \$ 223,399        | \$ 237,355     |
|                    | =====             | =====          |

The balance owed to Tianci Real Estate represented rental payments since 2004 and the expenses paid by Tianci Real Estate on behalf of the Company during the three months ended March 31, 2006 and the year ended December 31, 2005, respectively. The balance owed to Shantian represents the advances received from Shantian for mobile phone sales. All of the above amounts due to related parties are unsecured, non-interest bearing and due on demand.

#### NOTE 5 - SEGMENT REPORTING

The Company currently operates in four principal business segments. Management believes that the following table presents the useful information to the chief operation decision makers for measuring business performance and financing needs and preparing the corporate budget, etc. As most of the Company's customers are located in the Shanghai metropolitan area and the Company's revenues are generated in Shanghai, the PRC, no geographical segment information is presented.

|                    | Advertising<br>Service<br>Revenue | Phone Sales | Mobile Phone<br>Service | Beep Pagers<br>Service | Corpora |
|--------------------|-----------------------------------|-------------|-------------------------|------------------------|---------|
|                    | -----                             | -----       | -----                   | -----                  | -----   |
| Three months ended |                                   |             |                         |                        |         |



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|                                    |    |         |    |           |    |         |    |         |    |       |
|------------------------------------|----|---------|----|-----------|----|---------|----|---------|----|-------|
| March 31, 2005                     |    |         |    |           |    |         |    |         |    |       |
| Revenues                           | \$ | 459,131 | \$ | 4,729,705 | \$ | 401,610 | \$ | 207,605 | \$ |       |
| Gross profit                       |    | 436,312 |    | 159,912   |    | 298,413 |    | 140,124 |    |       |
| Depreciation                       |    | --      |    | --        |    | 53,371  |    | --      |    | 14    |
| Interest income, net               |    | --      |    | --        |    | --      |    | --      |    |       |
| Net income                         |    | 363,499 |    | 75,768    |    | 213,177 |    | 88,588  |    | (74)  |
| Expenditures for long-lived assets |    | --      |    | --        |    | 50,452  |    | --      |    |       |
| Total assets, as at March 31, 2005 |    | --      |    | 8,626,642 |    | 288,170 |    | --      |    | 4,513 |

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|                                    |    |         |    |           |    |         |    |         |    |        |
|------------------------------------|----|---------|----|-----------|----|---------|----|---------|----|--------|
| Three months ended                 |    |         |    |           |    |         |    |         |    |        |
| March 31, 2006                     |    |         |    |           |    |         |    |         |    |        |
| Revenues                           | \$ | 177,159 | \$ | 1,240,741 | \$ | 132,557 | \$ | 129,228 | \$ |        |
| Gross profit                       |    | 137,103 |    | 129,123   |    | 9,842   |    | 62,624  |    |        |
| Depreciation                       |    | --      |    | --        |    | 38,637  |    | --      |    | 9      |
| Interest income, net               |    | --      |    | --        |    | --      |    | --      |    |        |
| Net income                         |    | 73,402  |    | 68,195    |    | (9,628) |    | 24,809  |    | (88)   |
| Expenditures for long-lived assets |    | --      |    | --        |    | --      |    | --      |    |        |
| Total assets, as at March 31, 2006 |    | --      |    | 850,219   |    | 139,055 |    | --      |    | 13,935 |

NOTE 6 -EMPLOYEE WELFARE AND RETIREMENT BENEFITS

The PRC has been undergoing significant reforms with regard to its employee welfare and fringe benefits administration. Any enterprise operating in the PRC is subject to government-mandated employee welfare and retirement benefit contribution. In accordance with PRC laws and regulations, TCH participates in a multi-employer defined contribution plan pursuant to which TCH is required to provide employees with certain retirement, medical and other fringe benefits. PRC regulations require TCH to pay the local labor administration bureau a monthly contribution at a stated contribution rate based on the monthly basic compensation of qualified employees. The local labor administration bureau, which manages various investment funds, will take care of employee retirement, medical and other fringe benefits. TCH has no further commitments beyond its monthly contribution. TCH contributed a total of \$12,782 and \$11,934 to these funds as part of selling, general and administrative expenses for the three months ended March 31, 2005 and 2006, respectively.

NOTE 7 - RECENT ACCOUNTING PRONOUNCEMENTS

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments--an amendment of FASB Statements No. 133 and 140," to permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation in accordance with the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event occurring after the beginning of an entity's fiscal year that begins after September 15, 2006. We will adopt SFAS No. 155 in fiscal year beginning January 1, 2007. The adoption of this Statement is not expected to have a material effect on our consolidated financial statements.

In March 2006, FASB issued SFAS No. 156, "Accounting for Servicing of Financial

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Assets--an amendment of FASB Statement No. 140," that provides guidance on accounting for separately recognized servicing assets and servicing liabilities. In accordance with the provisions of SFAS No. 156, separately recognized servicing assets and servicing liabilities must be initially measured at fair value, if applicable. Subsequent to initial recognition, the company may use either the amortization method or the fair value measurement method to account for servicing assets and servicing liabilities within the scope of this Statement. SFAS No. 156 is effective as of the beginning of an entity's fiscal year that begins after September 15, 2006. The Company will adopt SFAS No. 156 in fiscal year beginning January 1, 2007. The adoption of this Statement is not expected to have a material effect on our consolidated financial statements.

In April 2006, the FASB issued FASB Staff Position ("FSP") FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)", that will become effective beginning July 2006. FSP FIN No. 46(R)-6 clarifies that the variability to be considered in applying Interpretation 46(R) shall be based on an analysis of the design of the variable interest entity. The adoption of this FSP is not expected to have a material effect on our consolidated financial statement.

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### ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

This report contains certain forward-looking statements that involve risks and uncertainties. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "could," "expect," "plan," "intend," "anticipate," "believe," "estimate," "predict," "potential," or "continue," or the negative of such terms or other comparable terminology. These statements are only predictions and are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described herein.

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto and the other financial information appearing elsewhere in this document. We do not undertake to publicly update or revise any of its forward-looking statements even if experience or future changes show that the indicated results or events will not be realized. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof.

#### Overview of Business Background

Sifang Holdings was formed under the laws of the Cayman Islands on February 9, 2004 for the purpose of holding a 100% equity interests in TCH. TCH was established as a foreign investment enterprise in Shanghai under the laws of the PRC on May 25, 2004, with a registered capital of \$7.2 million.

Sifang Information is a Shanghai-based privately owned enterprise established under the laws of the PRC on August 14, 1998. Sifang Information is engaged in the business of pager and mobile phone distribution and provides value added information services to the customers in the Shanghai metropolitan area.

Sifang Information operates in a business segment that is subject to certain restrictions imposed by the government of the PRC. For example, paging facilities, radio transmitting stations and transmitting equipment owned by

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Sifang Information are not allowed to be owned by foreign investment enterprises in accordance with PRC government regulations. Therefore, Sifang Information still maintains a small part of its business and paging facilities in order to stay in compliance with relevant regulations and laws in the PRC.

TCH engages in the business of mobile phone distribution and provides access to certain information reformatted by TCH to pager and mobile phone (collectively "wireless receiver") users. TCH purchases mobile phones from the first tier distributors and sells them to retailers with a mark-up. In the process of providing value-added information services through entering into monthly subscription agreements with various users, TCH purchases trading activity information from stock exchanges, comments and analysis on PRC stock markets provided by certain reputable security and investment companies, lottery information, weather forecast, and other value-added products and reformats the aforementioned information through decoding and recoding and then has the reformatted information transmitted by Sifang Information, via service contracts, to pager users. The information is constantly saved in TCH's server in order for mobile phone users to dial in via China Mobile or China Unicom. By signing a monthly subscription agreement, wireless users agree to make advance payments for either three or six-month subscription periods.

We launched a digital media project to move into the media market in China in 2005. In conjunction with charitable organizations, we have installed donation boxes with digital TV incorporated on top of them in the main lobbies of commercial banks, hotels, malls and other public locations to call the public's attention to the charity and broadcast commercial advertisements.

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### Discussion and Analysis of Operating Results

Three months ended March 31, 2006 Compared to Three months Ended March 31, 2005

#### Revenues

##### Total Revenues

Total sales revenues consist of product sales, product sales to related parties, and net information and advertising service revenue. Total sales revenues for the three months ended March 31, 2006 decreased by \$4,118,366, representing a 71.0% decrease, to \$1,679,685 as compared to \$5,798,051 for the same period of the prior year. The decrease was mainly due to the significant decline of the advertising service revenue and mobile phone sales to related parties. The demand for mobile phones in the Chinese telecommunication Market is decreasing as the Market gradually becomes saturated.

In the three months ended March 31, 2006, Samsung and Nokia's mobile phones accounted for about 79.4% and 20.6% of our total product sales, respectively, compared to the same period of the prior year, in which Samsung's mobile phones accounted for 97% of our total product sales and other brands accounted for the balance. During 2006, market competition for mobile phone sales continued to intensify, causing us to reposition ourselves in the marketplace and move away from the low-margin sales. The increase of our overall mark-up ratio to 10.4%, in comparison with a mark-up ratio of 3.4% for the same period of the prior year, primarily resulted from the exceptionally high mark-up for the sales of Samsung mobile phone to a related party during the period.

#### Product Sales

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Revenue for product sales in the three months ended March 31, 2006 decreased by \$319,194, representing a 47.7% decrease, to \$349,997 as compared to \$669,191 for the same period of the prior year. The decrease was mainly due to the market factors described above. We reduced the effort and cost of generating sales from such business throughout the period.

We entered an agreement to distribute selected Nokia mobile phones exclusively in the Shanghai region of China in May 2005 and now have obtained the right to distribute two popular models of Nokia's mobile phones. Initially, we believed that this agreement would enhance both our market share and profitability. The initial margin of Nokia was as high as 8% in mid 2005, however, as a result of the sudden change in the market factors during the latter half of 2005, the sales mark-up of the Nokia mobile phones to our customers dropped significantly to 1% during the 4th quarter of 2005. The mark-up for Nokia phone was 1.5% during the 1st quarter of 2006. The Company's management is currently reviewing the market factors and considering discontinuing the mobile phone distribution business in latter 2006 if the market situation remains soft.

Product sales to a related party

We distributed Samsung mobile phones to our related party, Shantian, in which Sifang Information holds a 51% equity interest, for its retail market channel and facility. During the three months ended March 31, 2006, we sold \$890,744 worth of mobile phones to Shantian, with an average mark-up of approximately 12.7%, (compared to \$4,060,514 at gross profit margin of 2.4% in 2005), which represents a \$3,169,770 or 78.1% decrease compared to the same period of the prior year. The decrease in sales was also attributable to the market factors mentioned above. However, due to the urgent demand of a specific model of Samsung mobile phones from Shantian, we were able to charge a exceptionally high mark-up during the period.

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Information service revenue, net

Total information service revenue net of related business tax and service fee for the three months ended March 31, 2006 decreased by \$347,430, representing a decrease of approximately 57.0%, to \$261,785 compared to \$609,215 for the same period of the prior year.

Value-added service revenue from mobile phone users for the three months ended March 31, 2006 decreased by \$269,053 to \$132,557 compared to \$401,610 for the same period of the prior year, representing a 67.0% decrease. During the three months ended March 31, 2006, there is no service revenue from mobile phone users was attributable to prepaid service fees generated by an installing agent, Chengao Industry Co. Ltd, who installed the software on a retailer's (Beijing Jianghe Communication Co., Ltd.) inventories and collected proceeds from the retailer and transferred the proceeds to the Company, representing a \$388,637 decrease compared to the same period of the prior year. The remaining \$12,973 of the service revenue was generated by our SMS service via China Mobile's network, representing a material decrease compared to the same period of the prior year. The decrease was mainly due to the decline of our financial value-added service. The sluggish Chinese stock market along with inactive stock exchanges hindered our growth in this segment of business.

In addition, service revenue from pager users for the three months ended March 31, 2006 decreased by \$78,377 to \$129,228 compared to \$ 207,605 for the same period of the prior year, representing a decrease of approximately

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37.8%. We believe that service revenue from pager users will continue to decrease given the increased popularity of mobile phones over beepers and pagers. We project that the decrease in service revenue from pager users will likely plateau at a certain level as most lower income pager users still like to use pagers to access our information services.

### Advertising service revenue, net

We launched a digital media project to enter into the media market in China in 2005. In conjunction with charitable organizations, we have installed donation boxes with digital TV incorporated on top of them in the main lobbies of commercial banks, hotels, malls and other public locations to call the public's attention to the charity and broadcast commercial advertisements.

We entered into an agreement with China Charity Foundation ("CCF"), a national non-profit charitable organization, which enables the Company to install donation boxes for CCF in banks and other commercial locations throughout China that will also have the Company's out-of-home digital television advertising media platform attached. The completion of this agreement enables us to accelerate the placement of out-of-home digital television platforms, particularly in banks across China. The Company negotiates placement of the donation boxes and digital television media platform with banks and other commercial entities that wish to support the national charity. The China Banking Regulatory Commission ("CBRC") has previously agreed, pending completion of the agreement with CCF, to support and coordinate this effort with respect to approvals of donation box placements in banks throughout China.

This agreement facilitates the continued placement of platforms with little or no direct costs. We believe that such costs may constitute as much as 30% of the direct costs of our competitors based upon an analysis of publicly available information.

We have placed more than 850 multimedia donation boxes in the inbound area of Shanghai and other arranged spots will be rolled out in the public places with high traffic flow. Based on our experience in Shanghai, our strategy is to expand our network to penetrate other large and mid-sized developed cities throughout China. We believe the earnings potential from the advertising service will be a new source of profit in view of the upcoming Special Olympic World Summer Games in 2007 and World Exposition in 2010 to be held in Shanghai.

In addition, during the three months ended March 31, 2006, TCH generated \$177,159 in service income from advertisement designing and producing services, which represents a decrease of \$281,972 or 61.4%, compared to the service revenue of \$459,131 rendered from the advertisement designing and producing services to Tianci Real Estate, a related party, for publicity and promoting its apartment during the three months ended March 31, 2005.

### Cost of goods sold

The cost of goods sold for the three months ended March 31, 2006 decreased by \$3,458,175 to \$1,111,618 compared to \$4,569,793 for the same period of the prior year, representing a 75.7% decrease. The decrease was consistent with the decrease in revenue from product sales.

### Cost of service

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The cost of service for the three months ended March 31, 2006 increased by \$35,878 to \$229,375 compared to \$193,497 for the same period of the prior year, representing a 18.5% increase. The increase was mainly due to the increase of personnel costs for the value-added mobile phone and pager services. The breakdown of our service business has changed and the proportion of pager services that are related to financial information has increased, resulting in an increase in associated costs pertaining to the securities information fee paid. During the three months ended March 31, 2006, we continued to maintain current fee structures and establish collaborative relationships or partnerships with Chinese mobile operators and certain information content providers. Most of the cost of service was fixed costs and thus it cannot be reduced in response to the decrease in information service revenue.

### Gross profit

After taking into account the cost of goods sold and cost of service, our gross profit for the three months ended March 31, 2006 decreased by \$696,069 to \$338,692, representing a 67.3% decrease, compared to gross profit of \$1,034,761 for the same period of the prior year. The decrease in gross profit was primarily attributable to the drop of proceeds generated from the advertising service and phone sales during the three months ended March 31, 2006.

The following table summarizes certain information related to the various components of revenue.

|                                       | Advertising<br>Service<br>Revenue | Phone Sales  | Information<br>Service -<br>Mobile<br>Phone | Information<br>Service -<br>Pager |
|---------------------------------------|-----------------------------------|--------------|---|-----------------------------------|
|                                       | -----                             | -----        | -----                                       | -----                             |
| For three months ended March 31, 2005 |                                   |              |   |                                   |
| Revenue                               | \$ 459,131                        | \$ 4,729,705 | \$ 401,610                                  | \$ 207,605                        |
| Cost                                  | 22,819                            | 4,569,793    | 103,197                                     | 67,481                            |
| Gross profit                          | 436,312                           | 159,912      | 298,413                                     | 140,124                           |
| Gross profit ratio                    | 95.0%                             | 3.4%         | 74.3%                                       | 67.5%                             |
| For three months ended March 31, 2006 |                                   |              |   |                                   |
| Revenue                               | \$ 177,159                        | 1,240,741    | \$ 132,557                                  | \$ 129,228                        |
| Cost                                  | 40,056                            | 1,111,618    | 122,715                                     | 66,604                            |
| Gross profit                          | 137,103                           | 129,123      | 9,842                                       | 62,624                            |
| Gross profit ratio                    | 77.4%                             | 10.4%        | 7.4%  | 48.4%                             |

### Sales and marketing expenses

Sales and marketing expenses for the three months ended March 31, 2006 decreased by \$16,322 to \$26,967 compared to \$43,289 for the same period of the prior year. The decrease was primarily due to the drop of the management fee

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paid for Sifang Information as a result of the declining revenue generated from information services.

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### General and administrative expenses

General and administrative expenses for the three months ended March 31, 2006 increased by \$15,575 to \$207,614 compared to \$192,039 for the same period of the prior year, representing a 8.1% decrease. The increase was mainly due to the increase of audit fee and partially offset by the tightened control of expense incurred in TCH.

General and administrative expenses incurred at the TCH level for the three months ended March 31, 2006 decreased from \$102,002 to \$69,949, representing a 31.4% decrease. The decrease was primarily attributable to the collection of accounts receivable from our clients, resulting in the recovery of provisions for bad debts, and cost control, which lead to the decline of office expenses and professional fees. At the parent level, we incurred an aggregate of \$137,665 of audit fee and other general expenses in the three months ended March 31, 2006, compared to audit fees and service fees for Investor Relations and Public Relations of \$90,037 incurred in the prior year.

### Interest income, net

During the three months ended March 31, 2006, the interest income derived from bank deposits increased by \$866 to \$1,331, compared to \$465 for the same period of the prior year.

During the three months ended March 31, 2006, finance expense incurred in discounting bank drafts net of interest income from bank deposits increased by \$1,216 to \$1,216, compared to nil for the same period of the prior year.

### Income taxes

The Company's Chinese subsidiary, TCH is registered at Pudong District in Shanghai and is subject to a favorable income tax rate of 15% compared to a normal income tax rate of 33% (30% for the central government and 3% for the local government) under current PRC tax laws. The income tax provisions presented in the Company's consolidated financial statements are based on the historical actual income tax rates of TCH at 15% for the year ended December 31, 2005. In the three months ended March 31, 2005 and 2006, income tax expense was \$133,490 and \$36,296, respectively, based on pretax income of \$799,898 and \$104,430, respectively.

### Comprehensive income

We recorded comprehensive income of \$106,129 for the three months ended March 31, 2006, a \$560,277 decrease in comprehensive income compared to comprehensive income of \$666,406 for the same period of the prior year, representing a decrease of approximately 84.1%. The decrease in comprehensive income was attributable to (i) the decrease of revenue contribution from our advertising business that was newly initiated in the 2005 fiscal year, and (ii) the significant declines in revenue from sales of mobile phones and information services. These factors offset the appreciation of Chinese RMB to US dollars of \$37,995 in the quarter ended March 31, 2006.

### Earnings per share

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The earnings per share for the three months ended March 31, 2006 was \$0.00 compared to \$0.04 for the same period of the prior year. The decrease was due mainly to the decrease in the net income.

### Liquidity and Capital Resources

Our net cash used during the three months ended March 31, 2006 was \$2,483,547 while we generated cash of \$328,731 during the same period in 2005, which represents a net change of \$2,812,278.

Net cash flows used in operating activities was \$19,665 during the three months ended March 31, 2006 compared to net cash flows provided by operating activities of \$311,208 during the same period of the prior year. The net decrease in cash provided was primarily due to the decrease in collection of accounts receivable, accounts payable and net income which was offset by the decrease in advances and deposits to suppliers and inventories.

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Net cash flows used in investing activities for the three months ended March 31, 2006 increased to \$2,494,699 compared to \$1,482,475 for the same period of the prior year. The change in cash used in investing activities was mainly due to the increase in loan to related parties. As of March 31, 2006, the amounts due from Sifang Media and Sifang Information represent \$860,671 and \$4,779,528 respectively.

Net cash provided by financing activities for the three months ended March 31, 2006 was nil compared to \$1,500,000 for the same period of the prior year. The cash inflow of \$1,500,000 during the three months ended March 31, 2005 related to proceeds for shares that were issued in fiscal 2004 but were held in escrow until we filed a Registration Statement on Form SB-2 with the SEC in 2005. We treated the proceeds held in escrow as a current asset as the entire amount was released from escrow in March 2005 and paid to us.

We believe that current cash balance and cash flows from operations, if any, will be sufficient to meet present growth strategies and related working capital. In regards to the capital expenditures, we have sufficient funds to expand our operations. We plan to utilize a combination of internally generated funds from operations with potential debt and/or equity financings to fund our longer-term growth over a period of two to five years. The availability of future financings will depend on market conditions. There is no assurance that the future funding will be available.

The forecast of the period of time through which our financial resources will be adequate to support operations is a forward-looking statement that involves risks and uncertainties.

### Off-Balance Sheet Arrangements

We have never entered into any off-balance sheet financing arrangements and have not formed any special purpose entities. We have not guaranteed any debt or commitment of other entities or entered into any options or non-financial assets.

### Contractual Obligations and Commitments

The following table summarized our contractual payment obligations and



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commitments as of March 31, 2006:

|                                   | Payment Obligations By Period |                  |                  |                  |                  | Therea        |
|-----------------------------------|-------------------------------|------------------|------------------|------------------|------------------|---------------|
|                                   | 2006 (a)                      | 2007             | 2008             | 2009             | 2010             |               |
| Operating lease obligations       | \$ 37,297                     | \$ --            | \$ --            | \$ --            | \$ --            | \$            |
| Obligations for service agreement | 34,127                        | 45,502           | 45,502           | 45,502           | 45,502           | 155           |
| <b>Total</b>                      | <b>\$ 71,424</b>              | <b>\$ 45,502</b> | <b>\$ 45,502</b> | <b>\$ 45,502</b> | <b>\$ 45,502</b> | <b>\$ 155</b> |

(a) Remaining 9 months in 2006.

### Recent Accounting Pronouncements

In February 2006, the FASB issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140," to permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation in accordance with the provisions of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event occurring

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after the beginning of an entity's fiscal year that begins after September 15, 2006. We will adopt SFAS No. 155 in fiscal year beginning January 1, 2007. The adoption of this statement is not expected to have a material effect on our consolidated financial statements.

In March 2006, FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140," that provides guidance on accounting for separately recognized servicing assets and servicing liabilities. In accordance with the provisions of SFAS No. 156, separately recognized servicing assets and servicing liabilities must be initially measured at fair value, if applicable. Subsequent to initial recognition, the company may use either the amortization method or the fair value measurement method to account for servicing assets and servicing liabilities within the scope of this statement. SFAS No. 156 is effective as of the beginning of an entity's fiscal year that begins after September 15, 2006. The Company will adopt SFAS No. 156 in fiscal year beginning January 1, 2007. The adoption of this statement is not expected to have a material effect on our consolidated financial statements.

In April 2006, the FASB issued FASB Staff Position ("FSP") FIN 46(R)-6, "Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)", that will become effective beginning July 2006. FSP FIN No. 46(R)-6 clarifies that the variability to be considered in applying Interpretation 46(R) shall be based on an analysis of the design of the variable interest entity. The adoption of this FSP is not expected to have a material effect on our consolidated financial statement.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the SEC did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

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ITEM 3. CONTROLS AND PROCEDURES

Prior to the conclusion of the period covered by this report, 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 pursuant to Exchange Act Rule 13(a)-14(c). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to information relating to us (including our consolidated subsidiaries) required to be included in our periodic SEC filings.

There were no changes in our internal controls over financial reporting that materially affected or are reasonably likely to materially affect our internal control over financial reporting during the quarter ended March 31, 2006.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is not currently involved in any material pending legal proceedings.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

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## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

## ITEM 5. OTHER INFORMATION

Not Applicable.

## ITEM 6. EXHIBITS

The following documents are filed as part of this report:

- 31.1 Chief Executive Officer Certification furnished pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Chief Financial Officer Certification furnished pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Chief Executive Officer Certification furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Chief Financial Officer Certification furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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## SIGNATURES

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

CHINA DIGITAL WIRELESS, INC.  
(Registrant)

Date: May 22, 2006

/s/ Fu Sixing

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Fu Sixing, Chief Executive Officer

Date: May 22, 2006

/s/ Qian Fang

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Qian Fang, Chief Financial Officer