BRISTOL WEST HOLDINGS INC
Form 10-Q
November 09, 2006

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

Or

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

For the transition period from to
Commission File No. 001-31984

BRISTOL WEST HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**13-3994449**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
5701 Stirling Road, Davie, Florida	**33314**
(Address of principal executive offices)	*(Zip Code)*

(954) 316-5200
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YesNo
x o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YesNo
o x

At October 31, 2006, the registrant had outstanding an aggregate of 29,514,761 shares of its common stock.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

BRISTOL WEST HOLDINGS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	September 30, 2006	December 31, 2005
	(in thousands, except share data)	
Assets:		
Investments:		
Fixed maturities available-for-sale (amortized cost $489,242 and $458,175 at September 30, 2006 and December 31, 2005, respectively)	$ 486,503	$ 452,872
Equity securities (cost $2,000 at September 30, 2006 and December 31, 2005)	2,000	2,000
Total investments	488,503	454,872
Cash and cash equivalents	41,422	32,399
Accrued investment income	4,857	5,156
Premiums and other receivables (net of allowance for doubtful accounts of $5,622 and $6,758 at September 30, 2006 and December 31, 2005, respectively)	172,036	164,033
Reinsurance recoverables on paid and unpaid losses and loss adjustment expenses	26,489	31,517
Prepaid reinsurance	2,864	21,470
Ceding commission receivable		8,671
Deferred policy acquisition costs	49,410	46,283
Property, software and equipment - net	18,806	19,145
Goodwill	101,546	101,546
Other assets	8,147	8,264
Total assets	$ 914,080	$ 893,356
Liabilities and Stockholders Equity:		
Liabilities:		
Policy liabilities:		
Reserve for losses and loss adjustment expenses	$ 227,166	$ 221,445
Unearned premiums	190,626	185,360
Total policy liabilities	417,792	406,805
Reinsurance payables	3,094	30,590
Accounts payable and other liabilities	36,379	41,862
Deferred income taxes	8,832	7,219
Long-term debt, including current portion	100,000	69,925
Total liabilities	566,097	556,401
Commitments and contingent liabilities (Note 7)		
Stockholders equity:		
Preferred stock, $0.01 par value (15,000,000 shares authorized; 0 shares outstanding at September 30, 2006 and December 31, 2005, respectively)		
	332	328

Common stock, $0.01 par value (200,000,000 shares authorized; 33,253,839 and 32,819,209 shares issued at September 30, 2006 and December 31, 2005, respectively)		
Additional paid-in capital	233,467	235,308
Retained earnings	169,781	144,609
Deferred compensation on restricted stock		(5,763)
Treasury stock at cost (3,706,573 and 2,551,649 shares held at September 30, 2006 and December 31, 2005, respectively)	(53,814)	(34,078)
Stock subscription receivable	(33)	(59)
Accumulated other comprehensive loss	(1,750)	(3,390)
Total stockholders equity	347,983	336,955
Total liabilities and stockholders equity	$ 914,080	$ 893,356

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

BRISTOL WEST HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
	(in thousands, except per share data)			
Revenues:				
Net earned premium	$ 144,220	$ 142,571	$ 433,788	$ 459,566
Net investment income	5,616	4,435	15,681	12,470
Realized (loss) gain on investments, net	(14)	9	29	(17)
Policy service fee revenue	13,607	14,877	40,877	49,155
Other income	1,217	684	2,701	2,110
Total revenues	164,646	162,576	493,076	523,284
Costs and Expenses:				
Losses and loss adjustment expenses incurred	96,918	93,410	292,853	304,728
Commissions and other underwriting expenses	38,803	37,236	114,765	118,847
Other operating and general expenses	11,122	10,337	32,389	29,146
Interest expense	1,565	1,069	4,052	3,071
Extinguishment of debt	1,311		1,311	
Total costs and expenses	149,719	142,052	445,370	455,792
Income before income taxes	14,927	20,524	47,706	67,492
Income taxes	5,120	7,440	16,363	24,466
Net Income	$ 9,807	$ 13,084	$ 31,343	$ 43,026
Net income per common share - Basic	$ 0.34	$ 0.43	$ 1.07	$ 1.39
Net income per common share - Diluted	$ 0.32	$ 0.41	$ 1.02	$ 1.33
Dividends declared per common share	$ 0.07	$ 0.07	$ 0.21	$ 0.19

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

BRISTOL WEST HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
	(in thousands, except share data)	
STOCKHOLDERS EQUITY:		
Common Stock		
Balance, beginning of period	$ 328	$ 325
Exercise of options and warrants, including tax benefit (127,219 shares--2006; 40,059 shares--2005)	1	
Shares issued for services (9,722 shares--2006; 13,066 shares--2005)		
Issuance of restricted common stock (297,378 shares--2006; 183,413 shares--2005)	3	2
Shares issued in payment of dividend (311 shares--2006; 123 shares--2005)		
Balance, end of period	332	327
Additional Paid-In Capital		
Balance, beginning of period	235,308	231,281
Exercise of options and warrants, including tax benefit (127,219 shares--2006; 40,059 shares--2005)	1,180	348
Shares issued for services (9,722 shares--2006; 13,066 shares--2005)	204	252
Issuance of restricted common stock (297,378 shares - 2006; 183,413 shares--2005)	(3)	3,090
Shares issued in payment of dividend (311 shares--2006; 123 shares--2005)	5	2
Forfeiture of restricted common stock (14,985 shares--2006)	264	
Amortization of deferred compensation on restricted stock	2,281	
Tax deficiency on vesting of restricted stock	(9)	
Reclassification resulting from adoption of accounting principle (SFAS No. 123R)	(5,763)	
Balance, end of period	233,467	234,973
Retained Earnings		
Balance, beginning of period	144,609	97,885
Net income	31,343	43,026
Dividend to common shareholders ($0.21 per share--2006; $0.19 per share--2005)	(6,171)	(5,891)
Balance, end of period	169,781	135,020
Deferred Compensation on Restricted Stock		
Balance, beginning of period	(5,763)	(4,723)
Issuance of restricted common stock (183,413 shares--2005)		(3,092)
Amortization of deferred compensation on restricted stock		1,473
Restricted stock forfeited (3,336 shares--2005)		57
Reclassification resulting from adoption of accounting principle (SFAS No. 123R)	5,763	
Balance, end of period		(6,285)
Treasury Stock		
Balance, beginning of period	(34,078)	(2,965)
Acquisition of treasury stock (1,139,939 shares--2006; 1,808,723 shares--2005)	(19,472)	(30,000)
Restricted stock forfeited (14,985 shares--2006; 3,336 shares--2005)	(264)	(57)

Balance, end of period	(53,814)	(33,022)
Stock Subscription Receivable		
Balance, beginning of period	(59)	(120)
Payment of stock subscriptions receivable	26	52
Balance, end of period	(33)	(68)
Accumulated Other Comprehensive Loss		
Balance, beginning of period	(3,390)	640
Unrealized holdings gains (losses) arising during the period	1,610	(2,977)
Reclassification adjustment	30	(144)
Net unrealized gains (losses) on securities	1,640	(3,121)
Balance, end of period	(1,750)	(2,481)
Total Stockholders Equity	$ 347,983	$ 328,464
COMPREHENSIVE INCOME:		
Net income	$ 31,343	$ 43,026
Net unrealized gains (losses) on securities	1,640	(3,121)
Comprehensive Income	$ 32,983	$ 39,905

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

BRISTOL WEST HOLDINGS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW
(Unaudited)

	Nine Months Ended September 30,	
	2006	**2005**
	(in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 31,343	$ 43,026
Adjustments to reconcile net income to net cash provided by operating activities:		
Accretion of fixed maturity investments	3,112	3,086
Depreciation and amortization	5,488	5,038
Realized loss on disposal of property, software and equipment	58	
Realized investment (gain) loss	(29)	17
Deferred federal and state income taxes	682	220
Stock based compensation	2,470	1,586
Extinguishment of debt	1,311	
Changes in assets and liabilities:		
Accrued investment income	299	(1,772)
Premiums and other receivables	(8,003)	13,491
Reinsurance receivables	13,699	260,447
Prepaid reinsurance premiums	18,606	86,588
Deferred policy acquisition costs	(3,127)	(18,381)
Losses and loss adjustment expenses	5,721	(808)
Unearned premiums	5,266	(18,108)
Reinsurance payables	(27,496)	(136,306)
Other assets and liabilities	(7,665)	3,215
Tax benefit on exercise of stock options		184
Net cash provided by operating activities	41,735	241,523
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of fixed maturity investments - available-for-sale	(85,421)	(180,096)
Sales and maturities of fixed maturity investments - available-for-sale	52,263	10,785
Acquisition of property, software and equipment	(4,615)	(5,680)
Net cash used in investing activities	(37,773)	(174,991)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of stock options	63	164
Tax benefit on exercise of stock options	694	
Acquisition of treasury stock	(19,048)	(30,000)
Principal repayment at time of debt extinguishment	(67,975)	
Principal payments on long-term debt	(1,950)	(2,488)
Proceeds from acquisition of long-term bank debt	100,000	
Payment of fees and expenses related to the refinancing of long-term debt	(583)	
Payment of dividends to stockholders	(6,166)	(5,889)
Other	26	52
Net cash provided by (used in) financing activities	5,061	(38,161)
NET INCREASE IN CASH AND CASH EQUIVALENTS	9,023	28,371
Cash and cash equivalents, January 1	32,399	11,508

Cash and cash equivalents, September 30	$	41,422	$	39,879

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

BRISTOL WEST HOLDINGS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(dollars in thousands, except per share data)

1. Nature of Operations

Bristol West Holdings, Inc. (the Company) is a property and casualty insurer writing and distributing private passenger automobile insurance. Given the homogeneity of the product, the regulatory environments in which the Company operates, the type of customer and the method of distribution, the operations of the Company are one segment. As of September 30, 2006, the Company is licensed in 38 states and the District of Columbia. The Company consists of a holding company, five statutory insurance companies (Bristol West Casualty Insurance Company, Bristol West Insurance Company, Security National Insurance Company, Coast National Insurance Company, and Bristol West Preferred Insurance Company), agencies and claims servicing companies. Bristol West Preferred Insurance Company was incorporated on September 7, 2006. This new company was capitalized with $10,000 and is domiciled in the state of Michigan.

2. Basis of Presentation

The unaudited condensed consolidated financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. These unaudited condensed consolidated financial statements and the notes thereto should be read in conjunction with the Company s audited financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

3. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurements* (SFAS No. 157). This statement defines fair value, establishes a framework for measuring fair value under GAAP, and enhances disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, with earlier application encouraged only in the initial quarter of an entity s fiscal year. The Company is currently evaluating the effect, if any, that this statement will have on its Consolidated Financial Statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides guidance for how errors should be evaluated to assess materiality from a quantitative perspective. SAB 108 permits companies to initially apply its provisions by either restating prior financial statements or recording the cumulative effect of initially applying the approach as adjustments to the carrying values of assets and liabilities as of January 1, 2006 with an offsetting adjustment to retained earnings. SAB No. 108 is effective for the first annual period ending after November 15, 2006. The Company does not expect that the adoption of SAB 108 will have a material effect on its Consolidated Financial Statements.

In June 2006, the FASB issued interpretation of SFAS No. 109, *Accounting for Uncertainty in Income Taxes* (FIN 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes.* FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Adoption of this interpretation is not expected to have a material effect on the Company s Consolidated Financial Statements.

4. Stock-based Compensation

Employee Stock Options

The Company has issued stock options to its employees under two plans: the 1998 Stock Option Plan for Management and Key Employees (the 1998 Plan) of Bristol West Holdings, Inc. and its subsidiaries and the 2004 Stock Incentive Plan (the 2004 Plan) of Bristol West Holdings, Inc. and its subsidiaries. The options issued under these plans vest ratably over periods of two or five years, or earlier if there is an acceleration event. Options expire on and are no longer exercisable after the tenth anniversary of the grant date. The original amount of shares authorized for grant under the 1998 Plan and the 2004 Plan were 2,607,600 and 3,000,000, respectively. In the aggregate, there were 1,231,487 and 1,062,858 options exercisable under these plans at September 30, 2006 and December 31, 2005, respectively. The weighted average remaining contractual life of options outstanding under these plans was 2.51 years as of September 30, 2006.

There were no employee option grants made during the nine months ended September 30, 2006. Employee stock option activity under both the 1998 Plan and the 2004 Plan for the nine months ended September 30, 2006 is detailed below:

Option shares	Number of Shares	Weighted Average Exercise Price
Outstanding December 31, 2005	1,352,818	$ 4.77
Exercised during 2006	(16,396)	3.83
Expired during 2006	(757)	10.75
Outstanding September 30, 2006	1,335,665	$ 4.77

	Options Outstanding			Options Exercisable	
Exercise Price	Shares	Weighted Average Price	Remaining Term (in years)	Shares	Weighted Average Price
$3.83	1,180,599	$ 3.83	1.98	1,125,055	$ 3.83
$7.67 - $20.91	155,066	11.96	6.58	106,432	11.81
	1,335,665	$ 4.77	2.51	1,231,487	$ 4.52

Non-Employee Options and Warrants

On July 24, 2002, the Company granted options to purchase 521,520 shares of the Company s common stock with an exercise price of $3.83 per share to Firemark Partners LLC (Firemark) in exchange for providing development and implementation assistance to the Company with respect to the Company s OneStep® software. These options expire on July 24, 2012. The Company capitalized $256 of costs related to options to purchase 130,380 of these shares. The Company calculated the grant date fair value of the options utilizing the Black-Scholes option pricing model and the following assumptions: dividend yield of 0%, expected volatility of 30%, risk-free interest rate of 4.65% and an average expected life of 10 years. The vesting of the remaining options to purchase 391,140 shares is subject to the satisfaction of certain performance criteria, which have not yet been met by Firemark.

On November 21, 2005, Firemark assigned 78,228 of these options (representing 15% of the total 521,520 option shares) to OneShield, Inc. (OneShield), the developer of the Company s OneStep® software and owner of 15% of the equity interest of Firemark. As of September 30, 2006 and December 31, 2005, OneShield held options to purchase 58,671 shares.

On March 24, 2006, Firemark exercised options to purchase 110,823 shares of the Company s common stock. Firemark used 22,662 of the option shares to settle the exercise price of $424 for these options. The number of option shares used to settle the exercise price was calculated using the per share market price of the Company s common stock on the date of exercise of $18.73. As of September 30, 2006 and December 31, 2005, Firemark held options to purchase 332,469 and 443,292 shares, respectively.

In addition, Inter-Ocean Reinsurance (Ireland) Limited held warrants to purchase 432,613 shares of the Company s common stock at September 30, 2006 and December 31, 2005. These warrants have an exercise price of $3.83 per share and expire on July 1, 2016.

Restricted Shares

The Company began issuing restricted stock awards to employees and directors in 2004 pursuant to the 2004 Plan. The outstanding restricted stock awards were issued as time-based awards, which vest upon the lapse of a period of time, provided that the holder continues to be an employee or director, as appropriate, on the vesting date. These awards typically vest in two or five years, or earlier if there is an acceleration event. The restricted stock awards are expensed pro rata over the vesting period based on the grant date fair value of the awards under SFAS No. 123R.

A summary of all employee and director restricted stock activity for the nine months ended September 30, 2006 follows:

Shares outstanding, December 31, 2005	475,241
Shares granted	297,378
Shares forfeited	(14,985)
Shares vested	(15,218)
Shares outstanding, September 30, 2006	742,416

Recent Accounting Pronouncements

Effective January 1, 2006, the Company adopted FASB SFAS No. 123, *Share-Based Payments (revised 2004)*, (SFAS No. 123R). Among its provisions, SFAS No. 123R requires the Company to recognize compensation expense for equity awards over the vesting period based on their grant-date fair value. Prior to the adoption of SFAS No. 123R, the Company utilized the intrinsic-value based method of accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and related interpretations. Accordingly, compensation cost for the stock options awarded was measured as the excess, if any, of the fair value of the Company s stock at the date of the grant over the amount an employee was required to pay to acquire the stock.

The Company adopted SFAS No. 123R on January 1, 2006 using the modified prospective method. This transition method applies to new awards and awards modified, repurchased, or cancelled after the effective date of this statement. The Company recognized compensation costs of $10 after taxes during the nine months ended September 30, 2006, based on the grant date fair value of its unvested awards and the remaining requisite service period. Results for prior periods have not been restated as provided for under the modified prospective approach. For equity awards granted after the date of adoption, the Company amortizes share-based compensation expense on a straight-line basis over the vesting term.

The Company receives a tax deduction for certain stock option exercises when the options are exercised, generally for the excess of the stock price at the time of exercise over the exercise price of the options. Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the Consolidated Statements of Cash Flows. SFAS No. 123R requires the benefits of tax deductions in excess of the grant-date fair value for those options to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. Accordingly, the Company recognized tax benefits on the exercise of stock options within the Consolidated Statements of Cash Flows as a financing cash inflow of $694 for the nine months ended September 30, 2006 and as an operating cash inflow of $184 for the nine months ended September 30, 2005.

The following table shows the effect on net income and earnings per share for the three and nine months ended September 30, 2005 had compensation expense been recognized based upon the estimated grant date fair value of the awards, in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure:*

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income as reported	$ 13,084	$ 43,026
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(30)	(180)
Pro forma net income	$ 13,054	$ 42,846
Net income per share		
Basic As reported	$ 0.43	$ 1.39
Basic Pro forma	$ 0.43	$ 1.39
Diluted As reported	$ 0.41	$ 1.33
Diluted Pro forma	$ 0.41	$ 1.32

5. Debt

The Company entered into a secured credit facility (Bank Agreement) in February 2004, consisting of: (1) a $50,000 Secured Revolving Credit Facility, which included up to $15,000 of letters of credit maturing in 2009, (2) a $35,000 Term A Loan, maturing in 2010 and (3) a $40,000 Term B Loan, maturing in 2011. The Company s interest rate on borrowings under this bank agreement (Bank Agreement) was London Interbank Offered Rate (LIBOR) plus a margin (1% to 2.25%), based on the Company s consolidated total debt to consolidated total capitalization ratio as defined in the Bank Agreement. The Company also paid certain commitment fees. The Bank Agreement was secured by a pledge of stock of certain of the Company s subsidiaries.

On July 31, 2006, the Company completed a refinancing of the credit facility represented by the Bank Agreement and increased the amount of the term loan facility. The new secured credit facility (Senior Credit Facility) consists of: (1) a $100,000 term loan and (2) a $25,000 revolving credit facility, which includes up to $15,000 of letters of credit. The Senior Credit Facility may be prepaid at any time and is scheduled to expire on July 31, 2011. Borrowings under the Senior Credit Facility bear interest based either upon (1) LIBOR plus an applicable margin ranging from 0.750% to 1.750% based on the then existing ratio of our consolidated total debt to our consolidated total capitalization, as defined in the Senior Credit Facility, or (2) the greater of (a) the applicable prime rate and (b) the Federal funds rate for Federal Reserve System overnight borrowing transactions plus 0.5%, plus an applicable margin ranging from 0.000% to 0.50% based on the then existing ratio of our consolidated total debt to our consolidated total capitalization. The Company also pays a commitment fee on the unused portion of the revolving credit facility. The Senior Credit Facility is secured by guarantees by, and a pledge of stock of, certain of the Company s subsidiaries. The Senior Credit Facility requires compliance with certain financial loan covenants. As of, and for the twelve-month period ended September 30, 2006, we were in compliance with all such covenants.

The amount of debt outstanding at September 30, 2006 and December 31, 2005 was $100,000 and $69,925, respectively. The Company had no borrowings on the revolving credit line at September 30, 2006 and December 31, 2005.

On July 31, 2006, contemporaneously with the execution and delivery of the Senior Credit Facility, the Company terminated the Bank Agreement and paid the principal and all accrued interest and fees. The Company incurred no early termination penalties in connection with the termination of the Bank Agreement. In connection with the prepayment of the refinanced debt, the Company incurred a non-recurring non-cash pre-tax charge of $1,311 during the three months ended September 30, 2006 related to the write-off of the unamortized portion of the deferred financing costs.

6. Net Income per Share

The following table sets forth the computation of basic and diluted earnings per share for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income applicable to common stockholders	$ 9,807	$ 13,084	$ 31,343	$ 43,026
Weighted average common shares - basic	28,928,833	30,314,772	29,319,173	30,930,716
Effect of dilutive securities:				
Options	1,082,830	1,141,633	1,109,958	1,153,642
Restricted stock	178,317	112,580	191,575	75,747
Warrants	210,126	214,995	218,133	214,960
Weighted average common shares - dilutive	30,400,106	31,783,980	30,838,839	32,375,065
Basic Earnings Per Share	$ 0.34	$ 0.43	$ 1.07	$ 1.39
Diluted Earnings Per Share	$ 0.32	$ 0.41	$ 1.02	$ 1.33

7. Commitments and Contingencies

On April 21, 2005, the Company received a subpoena from the Florida Office of Insurance Regulation (FOIR) requesting documents related to all reinsurance agreements to which the Company has been a party since January 1, 1998. On May 2, 2005, the Company received a subpoena from the SEC seeking documents relating to certain loss mitigation insurance products. On June 14, 2005, the Company received a grand jury subpoena from the United States Attorney for the Southern District of New York (the USAO) seeking information relating to the Company s finite reinsurance agreements. The Company has been informed that other insurance industry participants have received similar subpoenas. The Company is cooperating with the FOIR, the SEC and the USAO.

All of the material reinsurance agreements to which the Company has been a party have been terminated and settled, and the reinsurers have been released from all future liabilities under the agreements. Inasmuch as the governmental investigations are ongoing and the various regulatory authorities could reach conclusions different from the Company s concerning the treatment of these transactions that are reflected in the Company s financial statements, it would be premature to reach any conclusions as to the likely outcome of these matters and their potential impact upon the Company.

The Company is named as a defendant in a number of class action and individual lawsuits, the outcomes of which are uncertain at this time. These cases include those plaintiffs who are seeking restitution, damages and other remedies as a result of the Company s alleged failure to properly reimburse claimants for certain expenses and other cases challenging various aspects of the Company s business practices. The Company plans to contest all of the outstanding suits vigorously.

The Company accounts for such activity through the establishment of unpaid claim and claim adjustment expense reserves. The Company believes the current assumptions and other considerations the Company uses to estimate its potential liability for litigation are appropriate. While it is not possible to know with certainty the ultimate outcome of these claims or lawsuits, the Company believes it has adequately reserved for its existing known litigation and that such litigation will not have a material effect on its future financial condition, results of operations, or cash flow. In view of the uncertainties regarding the outcome of these claims or lawsuits, as well as the tax-deductibility of related payments, it is possible that the ultimate cost to the Company of these claims or lawsuits could exceed the reserves established by amounts that would have a material adverse effect on the Company s future financial condition or results of operations in a particular quarter or year.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion and analysis in conjunction with the condensed consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q and in the Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 filed with the SEC on May 10, 2006 (the First Quarter 2006 Form 10-Q), and the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 filed with the SEC on August 9, 2006 (the Second Quarter 2006 Form 10-Q) and our audited consolidated financial statements and notes thereto in our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 filed with the SEC on March 14, 2006 (the Fiscal 2005 Form 10-K), as well as the information under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations, that is part of our Fiscal 2005 Form 10-K, our First Quarter 2006 Form 10-Q and our Second Quarter 2006 Form 10-Q. When this report uses the words we, us, and our, these words refer to Bristol West Holdings, Inc. and its subsidiaries, unless the context otherwise requires.

Overview

General

We provide private passenger automobile insurance and related services in 21 states. Most of the business we write is non-standard automobile insurance. Non-standard automobile insurance provides coverage to drivers who find it difficult to purchase standard automobile insurance as a result of a number of factors, including their driving record, vehicle, age or claims history, or because they have limited financial resources. Many of these drivers purchase state-mandated minimum limits of coverage to comply with financial responsibility laws. Premium rates for non-standard automobile insurance policies are generally higher than for standard or preferred automobile insurance policies for comparable coverage.

The operating results of property and casualty insurance companies are subject to fluctuations from quarter-to-quarter and year-to-year due to a number of factors, including, but not limited to, general economic conditions, the regulatory climate in states where an insurer operates, state regulation of premium rates, changes in pricing and underwriting practices of the insurer and its competitors, the frequency and severity of losses, natural disasters and other factors. Historically, results of property and casualty insurance companies have been cyclical, with periods of high premium rates and strong profitability followed by periods of price competition, falling premium rates and reduced profitability.

We continue to direct our operations in view of the market conditions and anticipated changes to those conditions in each state in which we operate. The non-standard automobile insurance business is highly competitive, and we compete with both large national insurance providers and smaller regional companies. Some of our competitors have more capital, higher ratings and greater resources than we have, and they may offer a broader range of products and lower prices and down payments than we offer.

For a detailed description of our business, see *Item 1. Business* in our Fiscal 2005 Form 10-K.

Products and Services

We continuously monitor the profitability of our business at a highly detailed level. We seek rate changes based on indicated profitability related to our targets. We believe we can continue to improve our product structure by filing class plan changes that lower rates for certain market segments that produce favorable results relative to our average in a given state and raise rates for other poorer performing segments. We have modified rates 47 times thus far in 2006. Thirteen of such modifications were increases, 14 were revenue neutral, 13 were decreases, and 7 were new product introductions. The overall effect of these modifications was to increase our overall rates by 0.7%.

In the aggregate, we utilized point-of-sale underwriting to process over 99% of our new business applications in the first three quarters of 2006. We have fully deployed OneStep®, our browser-based point-of-sale underwriting system, in South Carolina, California, Ohio, Texas, Mississippi, Tennessee, Florida, Indiana, Pennsylvania, and Michigan for both new business and endorsements. Also, we have deployed OneStep for new business in Wisconsin, and we are in the process of deploying it in Arizona. We have deployed OneStep Raptor®, our client-server point-of-sale underwriting system, in all but three of our other states.

We are in the process of rolling out a new more segmented point-of-sale product called Select 2.0. We designed this product to be broadly competitive. We used advanced statistical techniques to create a new rating algorithm for this latest version of our Select product. Additionally, we are employing our own proprietary credit model and vehicle symbol set in the rating process. During the third quarter of 2006, we launched the Select 2.0 product in Florida, South Carolina, and Wisconsin. As of September 30, 2006, we have introduced our Select 2.0 product in six states, and preliminary results indicate it has been well received. In the six states in which we deployed the product, our aggregate written premium for the third quarter of 2006 increased 35% to $49.4 million compared to $36.5 million for the same period of 2005. During October 2006, we launched Select 2.0 in Pennsylvania and Michigan. Additionally, we plan to launch the product in Indiana, Kentucky, Maine, Mississippi, and New Hampshire by year-end. By mid-2007, we expect to have introduced Select 2.0 in 19 of the 21 states in which we operated as of September 30, 2006. We cannot deploy Select 2.0 in California because of regulatory constraints. In Georgia, we believe that it will take longer to obtain regulatory approval. We are satisfied with this product s performance to date. We will continue to closely monitor its performance and take corrective actions, as warranted.

Distribution and Marketing

Increasing the number of producers with which we do business is one important aspect of our growth strategy. We attempt to target producers in geographic areas where we are under-represented and where we believe we can write profitable business. During the third quarter of 2006, we increased our total number of producers to 8,701 and our total number of producer locations to 11,674. This compares to 7,281 producers and 9,794 producer locations as of September 30, 2005, and approximately 7,720 producers and 10,360 producer locations as of December 31, 2005. The following table displays our producer representation in our top five states and in all of our other states collectively as of September 30, 2006 and September 30, 2005.

	Producers		**Producer Locations**	
State	**September 30, 2006**	**September 30, 2005**	**September 30, 2006**	**September 30, 2005**
California	1,502	1,051	2,301	1,828
Florida	1,444	1,222	1,752	1,497
Michigan	630	567	912	763
Texas	860	782	1,386	1,238
South Carolina	385	362	434	405
All Other	3,880	3,297	4,889	4,063
Totals	8,701	7,281	11,674	9,794

Policies-in-Force

The number of policies in force is a significant driver of our gross earned premium. The table below shows our average number of policies in force and gross earned premium for the three and nine months ended September 30, 2006 and 2005.

	Three months ended September 30,			**Nine months ended September 30,**		
	2006	**2005**	**% Change**	**2006**	**2005**	**% Change**
	(in thousands)			**(in thousands)**		
Average number of policies in force	400.0	435.4	-8.1%	405.9	456.7	-11.1%
Gross earned premium	$ 146,617	$ 158,388	-7.4%	$ 441,171	$ 494,365	-10.8%

For the third quarter of 2006, the average number of policies in force decreased by 8% compared to the same quarter of 2005, while gross earned premium decreased by 7%. At September 30, 2006, we had approximately 395,000 policies in force, a decrease of 8% compared to approximately 430,000 at September 30, 2005 and a decrease of 3% compared to approximately 406,000 at December 31, 2005.

Average daily new business production in the third quarter of 2006 grew by 3% compared to the third quarter of 2005, driven by an 11% increase in September 2006 compared to September 2005. For the month of October 2006, we continued to see growth in average daily new business production, which increased 21% compared to October 2005 and 16% compared to the nine months ended September 30, 2006. Growth in new business is one component of gross written premium; other components include renewal premium, rewrite premium, and endorsement premium, which increase our written premium, as well as cancellations and non-renewals, which reduce our written premium. The performance of these other components relative to prior periods, known as persistency, has a significant impact on our written and earned premium. In addition, new business production is a policy count metric, and average premium per poli cy also plays a large role in determining gross written premium. As an example, in California, we write predominantly twelve-month policies, which have twice the average premium of a six-month policy. An increase in twelve-month policies, or any higher average premium policy would increase gross written premium, and a move to six-month polices, that we predominantly write in states other than California, would all other things being equal, depress gross written premium.

We continue to emphasize productivity and efficiency by closely managing our staffing levels in relation to volume in our claims and policy service divisions. At September 30, 2006, our staff count was 1,164 compared to 1,203 at September 30, 2005 and 1,213 at December 31, 2005. We employ various metrics to evaluate service performance, so that we may ensure that service levels are meeting or exceeding our benchmarks.

Operating Results Key States

Market conditions in the states in which we operate are competitive to varying degrees. We monitor the rate and underwriting activity of the other market participants in each state in which we do business. During the third quarter of 2006, we tracked 385 rate revisions by companies we monitor as detailed in the table below.

	Three months ended September 30, 2006			
State	**Increases**	**Decreases**	**Revenue-neutral**	**Total**
California	1	1	37	39
Florida	21	7	44	72
Michigan	3	10	11	24
Texas	5	5	5	15
South Carolina			4	4
All Other	43	55	133	231
Total Rate Changes	73	78	234	385

Some companies with which we compete, primarily in California, do not verify certain underwriting information, which has the effect of lowering the premium they charge, and thus attracting more business. In addition, in California and in other states, some companies with which we compete pay incentives to agents and brokers, such as contingent commissions. Also, some competitors spend significant sums on national and local advertising. In all of our markets, we have not relaxed our underwriting standards, we do not pay incentives to agents and brokers, and we do not spend significantly on consumer advertising.

One of our objectives is to increase our geographic diversification over time. Although California continues to be our largest state, our mix of premium writings has become more geographically diverse. For the third quarter of 2006, we derived 38% of our gross written premium from California, down from 44% for the third quarter of 2005. California, Florida and Michigan collectively accounted for 68% of our gross written premium for the third quarter of 2006, down from 74% for the third quarter of 2005. We also look to enter new large non-standard markets with favorable regulatory environments.

Gross written premium by state and in the aggregate before and after the change in the provision for cancellations for the three and nine months ended September 30, 2006 and 2005 is presented below (see *Three Months and Nine Months Ended September 30, 2006 Compared to Three Months and Nine Months Ended September 30, 2005 Revenues Gross Written Premium* below).

State	Three months ended September 30, 2006	Three months ended September 30, 2005	% Change	Nine months ended September 30, 2006	Nine months ended September 30, 2005	% Change
California	$ 55.7	$ 64.1	-13.1%	$ 184.6	$ 219.9	-16.1%
Florida	26.9	21.9	22.8%	74.9	69.9	7.2%
Michigan	17.1	21.1	-19.0%	54.2	63.9	-15.2%
Texas	10.0	5.7	75.4%	22.0	17.5	25.7%
South Carolina	6.7	5.3	26.4%	18.7	15.3	22.2%
Pennsylvania	6.0	4.6	30.4%	19.1	12.1	57.9%
Colorado	3.4	2.2	54.5%	8.2	5.7	43.9%
New Hampshire	3.3	3.8	-13.2%	10.7	11.8	-9.3%
Maine	3.1	3.7	-16.2%	9.4	10.8	-13.0%
Virginia	2.6	2.2	18.2%	8.6	6.9	24.6%
All Other (includes 11 states)	11.2	9.6	16.7%	34.1	30.3	12.5%
Gross written premium, before change in expected policy cancellation provision	$ 146.0	$ 144.2	1.2%	$ 444.5	$ 464.1	-4.2%
Change in expected policy cancellation provision	0.1	3.9	n/m	1.9	12.2	n/m
Gross written premium	$ 146.1	$ 148.1	-1.4%	$ 446.4	$ 476.3	-6.3%

In California, our gross written premium for the three and nine months ended September 30, 2006 declined 13% and 16%, respectively, compared to the same periods of 2005. In our other states, our gross written premium grew by 13% in the aggregate during the three months ended September 30, 2006 and by 6% in the aggregate during the nine months ended September 30, 2006 compared to the same periods of 2005. New business production increased by 3% for the third quarter of 2006 compared to the third quarter of 2005. For the same period, new business production declined 14% in California and grew by an aggregate 14% for all of the other states. Changes in gross written premium, as detailed above, vary significantly by state and are influenced by a variety of factors, including competitive conditions and regulatory environments within each state, our strategies with respect to product pricing, and changes in the number and location of producers.

Our gross written premium in California for the third quarter of 2006 declined by $8.4 million to $55.7 million from $64.1 million in the third quarter of 2005, as a result of continued competitive market conditions in that state. While our competitors rates, as filed, remain stable, some have relaxed underwriting standards by not verifying miles driven, driving experience, or other underwriting information, which can significantly affect policy premiums. This practice has resulted in lower policy premiums for some drivers, making it more difficult for companies not engaging in such practices to attract new customers and retain those that seek alternative quotes at renewal. While some of our competitors have relaxed underwriting standards, we have not observed increased relaxation of such standards during the third quarter of 2006. We have not relaxed our underwriting standards and do not intend to do so in the future.

In Florida, our second largest state, gross written premium for the third quarter of 2006 grew by $5.0 million, or 23%, to $26.9 million compared to $21.9 million for the third quarter of 2005. On August 1, 2006, we launched our Select 2.0 product in Florida (see Overview *Products and Services* above). We attribute much of the premium growth in Florida during the third quarter of 2006 to the introduction of this new product. We experienced a 68% increase in new business in Florida during the first 30 days since the introduction of Select 2.0 compared to the immediately preceding 30 days. Most agents in Florida use third party software that compares rates and, as a result, our new program became available very broadly and very quickly.

We continue to observe signs that the rates in the Florida market are firming. As detailed in the table above, these revisions continue the trend of rate increases outnumbering rate decreases among competitors rate filings that we noted during the fourth quarter of 2005 and the first and second quarters of 2006. The high number of rate filings in the quarter was partially compliance driven, as a result of the Florida Office of Insurance Regulation s recent proposed rules that would make it more difficult for insurers to use credit as a rating variable (see Overview *Regulatory Matters* below).

In Michigan, our third largest state, gross written premium for the third quarter of 2006 declined by $4.0 million to $17.1 million from $21.1 million for the third quarter of 2005. We attribute this decline in volume principally to rate increases that we implemented in January and April 2006 in response to increasing severity of personal injury protection (PIP) claims in Michigan.

In Texas, our gross written premium for the third quarter of 2006 grew by $4.3 million to $10.0 million from $5.7 million for the third quarter of 2005. In June 2006, we introduced our Select 2.0 product in Texas (see Overview *Products and Services* above). The new product has been well received, as evidenced by the premium growth during the third quarter of 2006.

In South Carolina, our gross written premium for the third quarter of 2006 grew by $1.4 million to $6.7 million from $5.3 million for the third quarter of 2005, an increase of 26%. We introduced our Select 2.0 product in South Carolina in September 2006 (see Overview *Products and Services* above). Since we introduced the product, we have seen an increase in the growth rate of our premium writings in the state.

Regulatory Matters

California

Rating Factors Regulations. The California Office of Administrative Law has approved regulations proposed by the California Department of Insurance that require a rate filing and change the weighting of rating factors for private passenger auto insurance. These regulations effectively reduce the influence of territory on premium rates. Specifically, the influence of territory is now required to be less than any of the three mandatory factors (which are driving safety record, annual mileage and years of driving experience) on an individual basis. The new regulations require that all private passenger automobile insurance companies in California submit annual class plan filings to achieve full compliance at any time before mid-July 2008. The regulation requires an initial class plan filing, due during the third quarter of 2006, to correct at least 15% of the rating factor weight non-compliance.

To date, attempts to block the implementation of these regulations have not been successful. A lawsuit was filed challenging the legality of these regulations and seeking a preliminary injunction to prevent their implementation. The trial court denied the request for a preliminary injunction, and therefore the regulations became operative during the third quarter of 2006. The lawsuit challenging the legality of these regulations is still pending.

We and other automobile insurance companies in California submitted the required rate and class plan filings by the end of September or early October 2006. We filed for a 2.6% rate decrease in our Basic program, and a 0.1% rate decrease in our Prima program. Most, but not all, of our significant competitors have rate and class plan filings that are of public record and available on the Department of Insurance s website. The weighted average filed rate change for companies who sell through independent agents and brokers, and whose filings are available on the California Department of Insurance s website, is a 0.1% increase. If the filings are approved, we expect to see our competitive position improve in terms of rates and expect to suffer a modest amount of margin compression.

Policy Cancellation Notice Regulations. In 2004, the California legislature passed and the governor approved legislation, Senate Bill 1500 (SB 1500), that requires insurers to electronically notify the California Department of Motor Vehicles (California DMV) if automobile insurance polices are cancelled. SB 1500 also requires the California DMV to suspend vehicle registrations within a specified period of time after receiving evidence of cancellation. Insurance companies have been required to electronically report insurance status information since January 1, 2006. As of July 1, 2006, law enforcement and court personnel have access to California DMV records to verify current insurance. Effective, October 1, 2006, the California DMV began enforcing the vehicle registration suspension requirements of SB 1500. During October 2006, we saw a modest increase of 8% in new business.

Annual Mileage Verification Regulations. In addition, the California Department of Insurance has proposed a regulation that would require all auto insurers to implement procedures to verify annual mileage driven. Without such a regulation, failure to verify this underwriting information can have the effect of lowering premiums charged.

Florida

The Florida Office of Insurance Regulation (the FOIR) has proposed a rule that makes it more difficult for insurers to use credit as a rating variable. The rule details the information that an insurer must submit to the FOIR regarding their use of credit reports and credit scores. The rule also requires insurers to demonstrate that their use of credit reports and credit scores does not unfairly discriminate against insureds because of their race, color, religion, marital status, age, gender, income, national origin, or place of residence. We are monitoring an administrative challenge to the legality of this proposed rule change. A hearing before an Administrative Law Judge was held in August 2006, but no ruling has been rendered yet.

Michigan

In October 2005, the Michigan governor proposed legislation that would decrease automobile insurance rates by 20% and change existing law to make it easier for claimants to file tort claims. The Michigan legislature has not yet considered the proposed legislation. In addition, in March 2005, the Michigan Office of Financial and Insurance Services (Michigan OFIS) adopted rules eliminating the use of credit as a rating variable and requiring insurers to reduce their base rates by the amount of the rate attributable to credit as a rating variable. In April 2005, a Michigan Circuit Court judge ruled that these Michigan OFIS rules were unenforceable. The Michigan OFIS has appealed the ruling and the case was argued in October 2006 in the Michigan Court of Appeals.

General

At this time, we cannot determine the impact of the regulatory and legal developments in California on the insurance industry and our competitive position. As described above, it is too early to ascertain if the legal initiatives in Florida and Michigan will result in a change in the laws or regulations in those states, and, if so, what impact such changes might have on the insurance industry and our business.

Reinsurance

We have not purchased any voluntary reinsurance for 2006. However, we continue to cede premium to the Michigan Catastrophic Claims Association (MCCA), a mandatory facility that provides excess of loss coverage for personal injury protection in Michigan. Earned premium ceded to the MCCA was $2.4 million for the third quarter of both 2006 and 2005.

Results of Operations

Selected Financial Data

The table below provides summary financial and operating data as of the dates or for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Statement of Operations Data:				
Revenues:				
Net earned premium	$ 144,220	$ 142,571	$ 433,788	$ 459,566
Net investment income	5,616	4,435	15,681	12,470
Realized (loss) gain on investments, net	(14)	9	29	(17)
Policy service fee revenue	13,607	14,877	40,877	49,155
Other income	1,217	684	2,701	2,110
Total revenues	164,646	162,576	493,076	523,284
Cost and Expenses:				
Losses and loss adjustment expenses incurred	96,918	93,410	292,853	304,728
Commissions and other underwriting expenses	38,803	37,236	114,765	118,847
Other operating and general expenses (a)	11,122	10,337	32,389	29,146
Interest expense	1,565	1,069	4,052	3,071
Extinguishment of debt	1,311		1,311	
Total costs and expenses	149,719	142,052	445,370	455,792
Income before income taxes	14,927	20,524	47,706	67,492
Income taxes	5,120	7,440	16,363	24,466
Net income	$ 9,807	$ 13,084	$ 31,343	$ 43,026
Operating Data:				
Gross written premium	$ 146,063	$ 148,127	$ 446,437	$ 476,257
Net written premium	143,801	130,908	457,660	528,045
Gross earned premium	146,617	158,388	441,171	494,365
Per Share Data:				
Earnings per share - basic	$ 0.34	$ 0.43	$ 1.07	$ 1.39
Earnings per share - diluted	$ 0.32	$ 0.41	$ 1.02	$ 1.33
Ratios:				
Loss ratio	67.2%	65.5%	67.5%	66.3%
Expense ratio (a)	24.3%	22.5%	23.9%	21.0%
Combined ratio	91.5%	88.0%	91.4%	87.3%

	September 30, 2006	December 31, 2005
Balance Sheet Data:		

Cash and investments	$	529,925	$	487,271
Total assets		914,080		893,356
Unpaid losses and loss adjustment expenses		227,166		221,445
Long-term debt, including current portion		100,000		69,925
Total liabilities		566,097		556,401
Stockholders equity		347,983		336,955
Book value per share	$	11.78	$	11.13

(a) Per SEC Staff Accounting Bulletin 107, Topic 14.F, Classification of Compensation Expense Associated with Share-Based Payment Arrangements, stock-based compensation expense should be presented in the same lines as cash compensation. As such, stock-based compensation is no longer presented separately, and our expense ratio now includes this expense item. Prior period amounts have been reclassified to conform to the 2006 presentation.

Three Months and Nine Months Ended September 30, 2006 compared to Three Months and Nine Months Ended September 30, 2005

Overview of Operating Results

Net income for the three months ended September 30, 2006 was $9.8 million compared to $13.1 million for the three months ended September 30, 2005, a decrease of 25%. During the most recent quarter, we incurred a non-recurring non-cash pre-tax charge of $1.3 million due to the write-off of the unamortized portion of the deferred financing costs related to the term debt we repaid when we refinanced our credit facility on July 31, 2006. During the quarter ended September 30, 2005, we incurred pre-tax losses of $300,000 related to Hurricanes Katrina and Rita, as well as pre-tax expenses of $1.3 million associated with responding to regulatory inquiries concerning our reinsurance agreements. Net income, excluding the after-tax effect of these items in both periods, was $10.7 million for the quarter ended September 30, 2006 compared to $14.1 million for the quarter ended September 30, 2005.

Net income for the nine months ended September 30, 2006 was $31.3 million compared to $43.0 million for the nine months ended September 30, 2005, a decrease of 27%. During the nine months ended September 30, 2006, we incurred the aforementioned $1.3 million pre-tax charge associated with the refinancing of our credit facility, in addition to pre-tax losses of $430,000 due to an extra-contractual verdict in California, $375,000 from hail storms in the Midwest, and $168,000 of adverse development on Hurricane Wilma losses. During the nine months ended September 30, 2005, we incurred pre-tax losses of $300,000 related to Hurricanes Katrina and Rita, as well as $2.3 million of pre-tax expenses due to the regulatory inquiries concerning our reinsurance agreements. Net income, excluding the after-tax effect of these items in both periods, was $32.8 million for the nine months ended September 30, 2006 compared to $44.7 million for the nine months ended September 30, 2005.

The following table summarizes the after-tax amounts of the items detailed above that impacted our net income for the three and nine months ended September 30, 2006 and 2005.

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
	(in thousands)		(in thousands)	
Refinancing of credit facility, net of related tax effects	$ 861		$ 861	
Loss due to extra-contractual verdict in California, net of related tax effects			283	
Loss due to hail storms in the Midwest, net of related tax effects			246	
Hurricane losses, net of related tax effects		191	110	191
Expenses associated with regulatory inquiries, net of related tax effects		843		1,439
Total, net of related tax effects	$ 861	$ 1,034	$ 1,500	$ 1,630

Revenues

The following table shows gross, ceded, and net written and earned premium for the three and nine months ended September 30, 2006 and 2005.

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
	(dollars in thousands)		(dollars in thousands)	
Gross written premium	$ 146,063	$ 148,127	$ 446,437	$ 476,257
Ceded written premium:				
Other reinsurance	2,262	17,219	7,064	54,522
Effect of reinsurance commutation			(18,287)(1)	(106,310)(2)
Total ceded written premium	2,262	17,219	(11,223)	(51,788)
Net Written Premium	$ 143,801	$ 130,908	$ 457,660	$ 528,045
% Ceded, excluding effect of reinsurance commutation	1.5%	11.6%	1.6%	11.4%
Gross Earned Premium	$ 146,617	$ 158,388	$ 441,171	$ 494,365
Ceded Earned Premium	2,397	15,817	7,383	34,799
Net Earned Premium	$ 144,220	$ 142,571	$ 433,788	$ 459,566
% Ceded	1.6%	10.0%	1.7%	7.0%

(1) Amount represents the unearned premium previously ceded under our 2005 quota share resinsurance agreement, which we received as a result of the termination and commutation of this agreement.

(2) Amount represents the unearned premium previously ceded under our 2002-2004 quota share reinsurance agreement, which we received as a result of the termination and commutation of this agreement.

Gross Written Premium. Gross written premium was $146.1 million for the three months ended September 30, 2006 compared to $148.1 million for the same period of 2005, a decline of 1%. For the nine months ended September 30, 2006, gross written premium was $446.4 million compared to $476.3 million for the same period of 2005, a decline of 6%. The decline in gross written premium emanated primarily from California and Michigan where written premium fell by a combined $12.4 million and $45.0 million, respectively, for the three and nine months ended September 30, 2006 compared to the corresponding periods of 2005. Our gross written premium in the other states in which we do business was higher in the aggregate by 24% for the quarter ended September 30, 2006 compared to the same quarter of 2005. For the nine months ended September 30, 2006, our gross written premiums outside of California and Michigan were 14% higher than in the nine months ended September 30, 2005. For a detailed discussion of market conditions, see Overview - *Operating Results* *Key States*.

We provide for expected policy cancellations in order to adjust written premium to amounts we expect to ultimately collect and earn. Because the cancellation provision adjusts our unearned premium for amounts we expect will not be collected, the changes in the provision are impacted by both the rate of cancellations and the size of the unearned premium reserve. For the three months ended September 30, 2006, we reduced the provision for expected policy cancellations by $0.1 million, which added less than 1% to our reported gross written premium for the quarter. For the same period of 2005, we reduced the provision by $3.9 million, principally because our unearned premium declined during the quarter. The rate of expected cancellation declined to 22.8% as of September 30, 2005 compared to 23.1% as of June 30, 2005, which had a lesser effect on the change in the provision. Cancellation experience has continued to improve. The expected cancellation rate was 20.6% as of

September 30, 2006. For the nine months ended September 30, 2006, we reduced the provision by $1.9 million, which represented less than 1% of our reported gross written premium for the nine-month period. For the nine months ended September 30, 2005, we reduced the provision by $12.2 million, which added 3% to our reported gross written premium for the nine-month period.

Net Written Premium. Net written premium for the three months ended September 30, 2006 was $143.8 million compared to $130.9 million for the same period of 2005, an increase of 10%. Net written premium for the three months ended September 30, 2005 included a reduction of $14.4 million for premium ceded pursuant to a 10% quota share reinsurance agreement we had in place during that time. We had no similar agreement in 2006. We ceded premium to the MCCA in both periods, the amount and impact of which were not material to the change in net written premium for the third quarter of 2006 compared to the third quarter of 2005.

For the nine months ended September 30, 2006, net written premium decreased to $457.7 million compared to $528.0 million for the comparable period of 2005, a decline of $70.3 million. The decrease resulted primarily from the termination of quota share reinsurance agreements during the first quarters of both 2006 and 2005. Upon termination of the reinsurance agreements, we recaptured the previously ceded unearned premium, which added to our net written premium. We recaptured $18.3 million in the first quarter of 2006 compared to $106.3 million in the first quarter of 2005, a decrease of $88.0 million. Our net written premium, exclusive of the effect of these terminations, was $439.4 million for the first nine months of 2006 compared to $421.7 million for the first nine months of 2005. Net written premium for the nine months ended September 30, 2005 was reduced by $46.8 mi llion ceded premium pursuant to a 10% quota share reinsurance agreement in place during that time. We had no similar agreement in 2006.

Net Earned Premium. Net earned premium for the three months ended September 30, 2006 was $144.2 million compared to $142.6 million for the corresponding period of 2005, an increase of $1.6 million. Net earned premium for the three months ended September 30, 2005 included a reduction of $13.4 million for premium ceded pursuant to a 10% quota share reinsurance agreement. We had no similar agreement in 2006. Net earned premium, excluding the effect of the 2005 quota share reinsurance, decreased by $11.8 million, or 8%, for the third quarter of 2006 compared to the third quarter of 2005.

Net earned premium for the nine months ended September 30, 2006 was $433.8 million compared to $459.6 for the same period of 2005, a decrease of $25.8 million, or 6%. Net earned premium for the nine months ended September 30, 2005 included a reduction of $28.0 million for premium ceded pursuant to a 10% quota share reinsurance agreement. We had no similar agreement in 2006. Net earned premium, excluding the effect of the 2005 quota share reinsurance, decreased by $53.8 million, or 11%, for the first nine months of 2006 compared to the first nine months of 2005.

These declines in net earned premium exclusive of the impact of the elimination of the quota share reinsurance resulted from declines in gross earned premium of 7% and 11% for the three and nine months ended September 30, 2006 compared to the corresponding periods of 2005.

Net Investment Income. Net investment income for the three months ended September 30, 2006 increased by 27% to $5.6 million compared to $4.4 million for the same period of 2005. Net investment income for the nine months ended September 30, 2006 increased by 26% to $15.7 million compared to $12.5 million for the same period of 2005. The tax equivalent book yield of our fixed maturity portfolio increased to 4.88% at September 30, 2006 from 4.39% at September 30, 2005. For the three-month period, the increase in net investment income was primarily due to a higher investment portfolio yield. For the nine-month period, approximately $2.0 million of the increase in net investment income was due to the larger size of the investment portfolio, and approximately $1.2 million related to a higher investment portfolio yield.

Policy Service Fee Revenue. Policy service fee revenue was $13.6 million for the three months ended September 30, 2006 compared to $14.9 million for the same period of 2005, a decrease of $1.3 million, or 9%. For the nine months ended September 30, 2006, policy service fee revenue was $40.9 million compared to $49.2 million for the same period of 2005, a decline of $8.3 million, or 17%. Policy fee income generally correlates with gross earned premium. Gross earned premium was lower by 7% and 11% for the three and nine months ended September 30, 2006, respectively. Our fee income as a percentage of gross earned premium has declined to 9.3% for the three and nine months ended September 30, 2006 from 9.4% and 9.9%, respectively, for the three and nine months ended September 30, 2005. The decline is mostly attributable to declines in our California business, where our fees are higher than for the rest of our business on average, and in our installment fees. In the third quarter of 2006, increased business in Texas, where our fees are relatively higher than for our business on average, augmented fee income. A greater percentage of our customers are signing up for electronic funds transfer (EFT) payment plans, on which we charge lower installment fees. The EFT business is more persistent, produces lower losses and is less expensive to administer. The portion of our policyholders who utilize EFT increased to 17% for the third quarter of 2006 compared to 7% for the third quarter of 2005.

Costs and Expenses

Losses and Loss Adjustment Expenses. Net losses and loss adjustment expenses (LAE) incurred for the three months ended September 30, 2006 were $96.9 million compared to $93.4 million for the same period of 2005. Net losses and LAE incurred for the nine months ended September 30, 2006 were $292.9 million compared to $304.7 million for the same period in 2005.

The following table displays our net incurred losses and LAE related to the current accident year (losses and LAE occurring in the current fiscal year) and prior accident years (losses and LAE recognized in the current fiscal year related to accidents which took place in a prior fiscal year).

	Three months ended September 30,		Nine months ended September 30,	
	2006	**2005**	**2006**	**2005**
	(dollars in thousands)		**(dollars in thousands)**	
Losses and LAE incurred - current accident year	$ 95,823	$ 93,336	$ 291,003	$ 304,792
Losses and LAE incurred - prior accident years	1,095	74	1,850	(64)
Total losses and LAE incurred	$ 96,918	$ 93,410	$ 292,853	$ 304,728
Loss ratio - current accident year	66.4%	65.5%	67.1%	66.3%
Loss ratio - prior accident years	0.8%	0.0%	0.4%	0.0%
Total loss ratio	67.2%	65.5%	67.5%	66.3%

Our loss ratio was 67.2% for the three months ended September 30, 2006 compared to 65.5% for the comparable quarter of 2005, an increase of 1.7 points. Approximately 0.8 points of this increase resulted from $1.1 million of adverse development on loss and LAE reserves compared to $0.1 million for the same period of 2005. Loss development occurs when reserves for losses and LAE established for prior accident years prove to be redundant or inadequate, and management adjusts those reserves to reflect the updated estimate of the ultimate losses and LAE related to such accident years. We record a charge or benefit to income in the period in which we make the adjustment. In the third quarter of 2006, we increased our estimate of losses for prior years for our Michigan PIP business by $1.0 million, driven by greater than anticipated average claim severity.

Our loss ratio was 67.5% for the nine months ended September 30, 2006 compared to 66.3% for the corresponding period of 2005, an increase of 1.2 points. Adverse development on loss and LAE reserves for the nine months ended September 30, 2006 was $1.9 million, which added 0.4 points to our reported loss ratio. The adverse development was primarily due to the change in Michigan PIP estimates noted above, an increase of $0.2 million for Hurricane Wilma claims, and an increase in one claim involving an extra-contractual obligation in the amount of $0.4 million.

For both the three and nine month periods in 2006, the current accident year loss ratio has increased. This increase is principally attributable to an increase in our claims adjustment expense ratio. The claims adjustment expense ratio has increased as premium volume has declined because a portion of our claims department s costs are fixed or semi-fixed and cannot be adjusted immediately in response to changes in volume.

Commissions and Other Underwriting Expenses. Commissions and other underwriting expenses for the three months ended September 30, 2006 were $38.8 million compared to $37.2 million for the same period of 2005, an increase of 4%. Commissions and other underwriting expenses vary with production. The ratio of gross commission expense to gross earned premium was 15.0% for the three months ended September 30, 2006 compared to 14.8% for the same period of 2005, while the premium tax rate was little changed for the three months ended September 30, 2006 compared to the same period of 2005. Similarly, the ratio of other underwriting expenses to gross earned premium was little changed for the three months ended September 30, 2006 compared to the corresponding period of 2005. For the nine months ended September 30, 2006, commission and other underwriting expenses were $114.8 million compared to $118.8 million for the same period of 2005. Most of this decrease is attributable to the decline in net earned premium for nine months ended September 30, 2006 compared to the corresponding period of 2005.

The following table provides detail of our commissions and other underwriting expenses before and after the impact of our quota share reinsurance agreements.

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
	(in thousands)		(in thousands)	
Gross commissions	$ 21,986	$ 23,460	$ 65,244	$ 73,303
Premium tax expense	3,390	3,379	9,722	10,991
Other underwriting expenses	13,423	14,338	39,729	42,571
Gross expenses	38,799	41,177	114,695	126,865
Ceding commission (expense) income	Common Stock Warrants			

	September 30, 2014 (1)
Stock price	$ 1.94
Exercise price	$ 1.20
Annual dividend yield	0 %
Expected term (years)	1.99
Risk-free interest rate	0.58 %
Expected volatility	121.83 %

(1) As of September 30, 2014, the warrant had not been exercised.

On September 26, 2013, the issue date of the warrant, the Company classified its fair value as a liability of $33,606. The Company recognized a loss of $58,318 and a gain of $27,994 from the change in fair value of the warrant liability for the three and six months ended September 30, 2014, respectively. The Company recognized a loss of $20,012 from the change in fair value of the warrant liability for the three and six months ended September 30, 2013.

Note 18 – STOCKHOLDERS' EQUITY

Stock-based compensation

On September 26, 2013, the Company agreed to grant a total of 350,000 shares of restricted common stock to a financial consulting firm for its financial advisory services. The term of the service agreement is one year. The trading value of the Company's common stock on September 26, 2013 was $0.51. For the three and six months ended

September 30, 2014, $42,547 and $87,049 was recorded as a service compensation expense. For the three months and six months ended September 30, 2013, $2,445 was recorded as service compensation expense.

On January 16, 2012, the Company granted a total of 297,000 shares of restricted common stock under the Plan to a group of 46 employees. These restricted shares will vest on January 16, 2015, provided that the employees are still employed by the Company on such date. $19,612 was charged to general and administrative expense and $4,010 selling expense was reversed due to two employees left the Company before the vesting date for the three months ended September 30, 2014, and $39,011 and $3,632 for the six months ended September 30, 2014, respectively. $19,612 and $7,226 were charged to general and administrative expense and selling expense, respectively, for the three months ended September 30, 2013, and $39,224 and $15,452 for the six months ended September 30, 2013, respectively.

Statutory reserves

Statutory reserves represent restricted retained earnings. Based on their legal formation, the Company is required to set aside 10% of its net income as reported in their statutory accounts on an annual basis to the Statutory Surplus Reserve Fund (the “Reserve Fund”). Once the total amount set aside in the Reserve Fund reaches 50% of the entity’s registered capital, further appropriations become discretionary. The Reserve Fund can be used to increase the entity’s registered capital upon approval by relevant government authorities or eliminate its future losses under PRC GAAP upon a resolution by its board of directors. The Reserve Fund is not distributable to shareholders, as cash dividend or otherwise, except in the event of liquidation.

Appropriations to the Reserve Fund are accounted for as a transfer from unrestricted earnings to statutory reserves. During the three and six months ended September 30, 2014 and 2013, the Company did not make appropriations to the statutory reserves.

There are no legal requirements in the PRC to fund the Reserve Fund by transfer of cash to any restricted accounts, and the Company does not do so.

Note 19 – LOSS PER SHARE

The Company reports earnings per share in accordance with the provisions of the FASB's related accounting standard. This standard requires presentation of basic and diluted earnings per share in conjunction with the disclosure of the methodology used in computing such earnings per share. Basic earnings per share excludes dilution, but includes vested restricted stocks and is computed by dividing income available to common stockholders by the weighted average common shares outstanding during the period. Diluted earnings per share takes into account the potential dilution that could occur if securities or other contracts to issue common stock were exercised and converted into common stock.

The following is a reconciliation of the basic and diluted earnings per share computation:

	Three months ended September 30,		Six months ended September 30,	
	2014	2013	2014	2013
Net loss attributable to controlling interest	$(36,193)	$(546,590)	$(382,930)	$(1,333,578)
Weighted average shares used in basic computation	14,981,637	13,609,003	14,700,375	13,609,003
Diluted effect of purchase options and warrants	-	-	-	-
Diluted effect of restricted shares	-	-	-	-
Weighted average shares used in diluted computation	14,981,637	13,609,003	14,700,375	13,609,003
Loss per share – Basic:				
Net loss before noncontrolling interest	$(0.00)	$(0.04)	$(0.03)	$(0.10)
Add: Net loss attributable to noncontrolling interest	$-	$-	$-	$-
Net loss attributable to controlling interest	$(0.00)	$(0.04)	$(0.03)	$(0.10)
Loss per share – Diluted:				
Net loss before noncontrolling interest	$(0.00)	$(0.04)	$(0.03)	$(0.10)
Add: Net loss attributable to noncontrolling interest	$-	$-	$-	$-
Net loss attributable to controlling interest	$(0.00)	$(0.04)	$(0.03)	$(0.10)

For the three and six months ended September 30, 2014 and 2013, the 105,000 and 150,000 shares, underlying outstanding purchase options and a warrant, respectively, were excluded from the calculation of diluted loss per share as the options and the warrant were anti-dilutive.

Note 20 – SEGMENTS

The Company operates within four main reportable segments: retail drugstores, online pharmacy, drug wholesale and herb farming. Online pharmacy sells OTC drugs, dietary supplement, medical devices and sundry items to customers through Alibaba’s Tmall and its own platform all over China. The retail drugstores segment sells prescription and over-the-counter (“OTC”) medicines, TCM, dietary supplement, medical devices, and sundry items to retail customers. The drug wholesale segment includes supplying the Company’s own retail drugstores with prescription and OTC medicines, TCM, dietary supplement, medical devices and sundry items (which sales have been eliminated as intercompany transactions), and also selling them to other drug vendors and hospitals. The Company’s herb farming segment cultivates selected herbs for sales to other drug vendors. The Company is also involved in online sales and clinic services that do not meet the quantitative thresholds for reportable segments and are included in the retail drugstores segment.

The segments' accounting policies are the same as those described in the summary of significant accounting policies. The Company evaluates performance based on profit or loss from operations before interest and income taxes not including nonrecurring gains and losses.

The Company's reportable business segments are strategic business units that offer different products and services. Each segment is managed separately because they require different operations and markets to distinct classes of customers.

The following table presents summarized information by segment of the continuing operation for the three months ended September 30, 2014:

	Retail drugstores	Online Pharmacy	Drug wholesale	Herb farming	Total
Revenue	$12,406,038	$2,949,391	$3,088,636	$-	$18,444,065
Cost of goods	10,302,519	2,463,352	2,912,937	-	15,678,808
Gross profit	$2,103,519	$486,039	$175,699	$-	$2,765,257
Selling expenses	1,795,108	666	138,006	-	1,933,780
General and administrative expenses	1,412,896	155,861	(911,544)*	88,962	746,175
(Loss) income from operations	$(1,104,485)	$329,512	$949,237	$(88,962)	$85,302
Depreciation and amortization	$222,829	$1,376	$24,022	$80,081	$328,308
Total capital expenditures	$107,573	$3,210	$6,106	$-	$116,889

* include the accounts receivable and advance to suppliers allowance reversal of $987,383.

The following table presents summarized information of the continuing operations by segment for the three months ended September 30, 2013:

	Retail drugstores	Online pharmacy	Drug wholesale	Herb farming	Total
Revenue	$9,452,053	$1,600,889	$5,802,479	$-	$16,855,421
Cost of goods	7,161,091	1,383,653	5,362,274	-	13,907,018
Gross profit	$2,290,962	$217,236	$440,205	$-	$2,948,403
Selling expenses	1,573,856	248	1,405,027	-	2,979,131
General and administrative expenses	1,140,589	124,216	(818,103)	45,280	491,981
Loss from operations	$(423,481)	$92,770	$(146,719)	$(45,280)	$(522,709)
Depreciation and amortization	$417,983	$(7,462)	$140,867	$262	$551,650
Total capital expenditures	$1,386,499	$307	$16,088	$-	$1,402,894

The following table presents summarized information of the continuing operation by segment for the six months ended September 30, 2014:

	Retail drugstores	Online pharmacy	Drug wholesale	Herb farming	Total
Revenue	$23,001,797	$5,521,933	$6,379,567	$-	$34,903,297
Cost of goods	18,982,408	4,630,716	6,014,297	-	29,627,421
Gross profit	$4,019,389	$891,217	$365,270	$-	$5,275,876

Selling expenses	3,465,497	666	236,194		3,702,357
General and administrative expenses	2,676,192	299,560	(1,323,439)	175,063	1,827,376
Loss from operations	$(2,122,300)	$590,991	$1,452,515	$(175,063)	$(253,857)
Depreciation and amortization	$492,846	$3,538	$175,581	$160,605	$832,570
Total capital expenditures	$141,800	$3,513	$76,258	$-	$221,571

* include the accounts receivable and advance to suppliers allowance reversal of $1,634,886.

The following table presents summarized information of the continuing operation by segment for the six months ended September 30, 2013:

	Retail drugstores	Online pharmacy	Drug wholesale	Herb farming	Total
Revenue	$19,100,271	$2,865,061	$10,226,608	$-	$32,191,940
Cost of goods	14,308,218	2,363,997	8,970,153	-	25,642,368
Gross profit	$4,792,053	$501,064	$1,256,455	$-	$6,549,572
Selling expenses	3,248,103	248	1,411,622		4,659,973
General and administrative expenses	2,610,261	221,586	195,564	105,387	3,132,798
Loss from operations	$(1,066,309)	$279,227	$(350,731)	$(105,387)	$(1,243,200)
Depreciation and amortization	$867,839	$-	$272,225	$522	$1,140,586
Total capital expenditures	$1,503,207	$307	$17,424	$-	$1,520,938

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The Company does not have long-lived assets located outside the PRC. In accordance with the enterprise-wide disclosure requirements of FASB's accounting standard, the Company's net revenue from external customers through its retail stores by main products is as follows:

	Three months ended September 30,		Six months ended September 30,	
	2014	2013	2014	2013
Prescription drugs	$4,957,751	$4,637,114	$9,378,003	$9,924,263
Over-the-counter drugs	4,291,738	3,381,486	8,234,531	6,737,739
Nutritional supplements	547,218	216,609	1,171,143	716,217
Traditional Chinese medicine	1,991,112	907,266	3,186,746	1,428,513
Sundry products	502,724	200,864	859,783	123,053
Medical devices	115,495	108,714	171,591	170,486
Total	$12,406,038	$9,452,053	$23,001,797	$19,100,271

The Company's net revenue from external customers through online pharmacy by main products is as follows:

	Three months ended September 30,		Six months ended September 30,	
	2014	2013	2014	2013
Prescription drugs	$-	$-	$-	$-
Over-the-counter drugs	826,755	708,250	1,519,598	1,277,437
Nutritional supplements	191,953	394,616	341,893	454,843
Traditional Chinese medicine	-	-	-	-
Sundry products	455,521	308,971	775,491	684,076
Medical devices	1,475,162	189,052	2,884,951	448,705
Total	$2,949,391	$1,600,889	$5,521,933	$2,865,061

The Company's net revenue from external customers through wholesale by main products is as follows:

	Three months ended September 30,		Six months ended September 30,	
	2014	2013	2014	2013
Prescription drugs	$2,362,902	$4,276,822	$4,261,984	$7,649,675
Over-the-counter drugs	611,219	96,125	1,948,429	875,345
Nutritional supplements	6,387	875	33,949	261,130
Traditional Chinese medicine	80,905	-	89,268	927
Sundry products	6,583	1,428,657	6,777	1,432,811
Medical devices	20,640	-	39,160	6,720

Total	$3,088,636	$5,802,479	$6,379,567	$10,226,608

Note 21 – COMMITMENTS AND CONTINGENCIES

Operating lease commitments

The Company recognizes lease expense on a straight line basis over the term of its leases in accordance with the relevant accounting standards. The Company has entered into various tenancy agreements for its store premises and for the land leased from a local government to farm herbs.

The Company's commitments for minimum rental payments under its leases for the next five years and thereafter are as follows:

Periods ending September 30,	Retail drugstores	Online pharmacy	Drug wholesale	Herb farming	Total Amount
2015	$3,906,015	$ 108,059	$ 176,379	$ -	$ 4,190,453
2016	2,039,822	121,764	176,695	-	2,338,281
2017	1,410,708	139,159	150,756	-	1,700,623
2018	1,228,290	139,159	150,756	-	1,518,205
2019	745,191	139,159	150,756	-	1,035,106
Thereafter	359,140	208,739	113,067	-	680,946

Total rent expense amounted to $1,215,232 and $923,572 for the three months ended September 30, 2014 and 2013, respectively, and $2,397,776 and $1,889,150 for the six months ended September 30, 2014 and 2013, respectively.

Note 22 – SUBSEQUENT EVENTS

On October 9, 2014, the Company, through Jiuzhou Pharmacy, a pharmacy that the Company controls through contractual arrangements, entered into an acquisition agreement to acquire Sanhao Grand Pharmacy Chain Co., Ltd.("Sanhao Pharmacy"), a local drugstore chain located in Hangzhou, at a total price of $1.56 million (RMB9.6 million). Sanhao Pharmacy presently has eleven stores where customers can use insurance cards issued by Hangzhou government for purchases in eight of those stores. The Company expects to further expand its market shares in Hangzhou City through Sanhao's existing insurance-applicable stores. The Company intends to fund its acquisition through its improved cash flow generated by rising sales from its retail business as well as bank financing. As of the date of the report, the registered shareholder of Sanhao Pharmacy has been listed under Jiuzhou Pharmacy.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following management's discussion and analysis should be read in conjunction with our unaudited condensed consolidated financial statements and the notes thereto and the other financial information appearing elsewhere in this item. In addition to historical information, the following discussion contains certain forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as "may," "will," "could," "expect," "anticipate," "intend," "believe," "estimate," "plan," "predict," and similar terms or terminology, or the negative of such terms or other comparable terminology. Although we believe the expectations expressed in these forward-looking statements are based on reasonable assumptions within the bound of our knowledge of our business, our actual results could differ materially from those discussed in these statements. Factors that could contribute to such differences include, but are not limited to, those discussed in the "Risk Factors" section of our annual report on Form 10-K for the year ended March 31, 2014 and filed with the SEC on June 27, 2014. We undertake no obligation to update publicly any forward-looking statements for any reason even if new information becomes available or other events occur in the future.

Our financial statements are prepared in U.S. Dollars and in accordance with accounting principles generally accepted in the United States. See "Exchange Rates" below for information concerning the exchanges rates at which Renminbi ("RMB") were translated into U.S. Dollars ("USD" or "$") at various pertinent dates and for pertinent periods.

Overview

We currently operate in four business segments in China: (1) retail drugstores, (2) online pharmacy, (3) wholesale of products similar to those that we carry in our pharmacies, and (4) farming and selling herbs used for traditional Chinese medicine ("TCM").

Our drugstores offer customers a wide variety of pharmaceutical products, including prescription and over-the-counter ("OTC") drugs, nutritional supplements, TCM, personal and family care products, and medical devices, as well as convenience products, including consumable, seasonal, and promotional items. Additionally, we have licensed doctors of both western medicine and TCM on site for consultation, examination and treatment of common ailments at scheduled hours. We currently have 51 pharmacies in Hangzhou under the store brand of "Jiuzhou Grand Pharmacy." During the three months ended September 30, 2014, we opened two new pharmacies in Hangzhou.

We operate a wholesale business through Jiuxin Medicine distributing third-party pharmaceutical products (similar to those carried by our pharmacies) primarily to trading companies throughout China. We also farm certain herbs used in TCM that we currently sell to a local vendor. Since May 2010, we have also been selling certain OTC drugs and nutritional supplements online.

Recent Developments

On October 9, 2014, the Company, through Jiuzhou Pharmacy, a pharmacy that the Company controls through contractual arrangements, entered into an acquisition agreement with two individual owners of Sanhao Grand Pharmacy Chain Co., Ltd.("Sanhao Pharmacy"), a local drugstore chain located in Hangzhou, for a total purchase price of $1.56 million (RMB9.6 million).

Sanhao Pharmacy presently has eleven stores where customers can use insurance cards issued by Hangzhou government for their purchases in eight of those stores. The reimbursement from local government insurance program has always been an important source of revenue for drugstores chains. As the government is controlling its budget and tightening up its policy to admit new stores into its insurance system, we expect to further strengthen our market shares in Hangzhou by using Sanhao's existing insurance-applicable stores and its network.

Critical Accounting Policies and Estimates

In preparing our unaudited condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America, we are required to make judgments, estimates and assumptions that affect: (i) the reported amounts of our assets and liabilities; (ii) the disclosure of our contingent assets and liabilities at the end of each reporting period; and (iii) the reported amounts of revenue and expenses during each reporting period. We continually evaluate these estimates based on our own historical experience, knowledge and assessment of current business and other conditions, our expectations regarding the future based on available information and reasonable assumptions, which together form our basis for making judgments about matters that are not readily apparent from other sources. Since the use of estimates is an integral component of the financial reporting process, our actual results could differ materially from those estimates.

We believe that any reasonable deviation from those judgments and estimates would not have a material impact on our financial condition or results of operations. To the extent that the estimates used differ from actual results, however, adjustments to the statement of operations and corresponding balance sheet accounts would be necessary. These adjustments would be made in future financial statements.

When reading our financial statements, you should consider: (i) our critical accounting policies; (ii) the judgment and other uncertainties affecting the application of such policies; and (iii) the sensitivity of reported results to changes in conditions and assumptions. The critical accounting policies and related judgments and estimates used to prepare our financial statements are identified in Note 3 to our unaudited condensed consolidated financial statements accompanying in this report. We have not made any material changes in the methodology used in our accounting policies that are inconsistent with those discussed in our annual report on Form 10-K for the year ended March 31, 2014.

Results of Operations

Comparison of three months ended September 30, 2014 and 2013

The following table summarizes our results of operations for the three months ended September 30, 2014 and 2013:

	Three months ended September 30,			
	2014		2013	
	Amount	Percentage of total revenue	Amount	Percentage of total revenue
Revenue	$18,444,065	100.0 %	$16,855,421	100.0 %
Gross profit	$2,765,257	15.0 %	$2,948,403	17.5 %
Selling expenses	$1,933,780	10.5 %	$2,979,131	17.7 %
General and administrative expenses	$746,175	4.0 %	$491,981	2.9 %
(Loss) from operations	$85,302	0.5 %	$(522,709)	(3.1)%
Other (expense), net	$(52,692)	(0.3)%	$37,021	0.2 %
Change in fair value of purchase option derivative liability	$(47,342)	(0.3)%	$(21,049)	(0.1)%
Income tax expense	$22,680	0.1 %	$39,589	0.2 %
Net loss attributable to controlling interest	$(37,412)	(0.2)%	$(546,590)	(3.2)%
Net loss attributable to noncontrolling interest	$(1,219)	(0.0)%	$(264)	(0.0)%

Revenue

Revenue increased by $1,588,644 or 9.4% for the three months ended September 30, 2014, as compared to the same period in the previous fiscal year, primarily due to an increase in our retail business, especially in online pharmacy, offset by decline in our wholesale business.

Quarterly Revenue by Segment

The following table breaks down the revenue for our four business segments for the three months ended September 30, 2014 and 2013:

	Three months ended September 30,									
	2014			2013						
	Amount	% of total revenue		Amount	% of total revenue		Variance by amount		% of change	
Revenue from retail drugstores	$12,406,038	67.2	%	$9,452,053	56.1	%	$2,953,985		31.3	%
Revenue from online sales	2,949,391	16.1	%	1,600,889	9.5	%	1,348,502		84.2	%
Revenue from wholesale business	3,088,636	16.7	%	5,802,479	34.4	%	(2,713,843	)	(46.8	)%
Revenue from farming business	—	—	%	—	—	%	—		—	%
Total revenue	$18,444,065	100.0	%	$16,855,421	100.0	%	$1,588,644		9.4	%

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Retail sales, which accounted for approximately 83.3% of total revenue for the three months ended September 30, 2014, increased by $4,302,487, or 38.9%, to $15,355,429. Same-store sales increased by approximately $2,602,868, or 28.8%, while our five new stores contributed approximately $300,737 in revenue in the three months ended September 30, 2014. The increase in same-store sales reflects the implementation of key drugstore operational strategies such as promoting sales through our doctors and clinics, stricter internal staff assessments that stimulate sales, increased adaptability to community demand, closer monitor to the operation of local stores in Hangzhou, keeping competitive drug retail price, and modest economic improvements in China. We expect same-store sales will keep growing in the near future. Our online pharmacy sales increased by approximately $1,348,502, or 84.2% for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. We have expanded cooperation with business-to-consumer online vendors, including Taobao, JD and Amazon, by posting our products on their online platforms, which direct customers back to our website. Such arrangements have exposed our online presence to a wider consumer base. In addition, we have spent considerable efforts identifying popular products that can drive sales, while we keep close watch on cost. Online shopping is also experiencing explosive expansion in China. As a result, we have seen steady growth in online sales. On the other hand, we ceased operation of all five stores in Shanghai in February 2014 due to their continuous loss. All Shanghai subsidiaries have canceled their SAIC registration. Although these stores were underperforming, they nevertheless contributed approximately $177,861 in revenue prior to their closures in the three months ended September 30, 2013. Our store count kept 51 as of September 30, 2014 and 2013, as a net effect of closing five stores in Shanghai and opening five stores in Hangzhou. Among the five new stores, two were opened in January 2014, one was opened in May 2014 and the remaining two were opened in the three months ended September 30, 2014.

Wholesale revenue decreased by $2,713,843 or 46.8% primarily as a result of discontinuing aggressive volume-driven sales strategy and slow progress made by new management team in marketing profitable products since August 2013, when a new management and sales team, which has over twenty years of industry experience in wholesale pharmaceutical distribution has been brought into our pharmaceutical distribution operations to expand sales to other drug vendors and develop a chain of supply to local pharmacies and hospitals. However, as local hospitals and pharmacies had strong ties with their existing suppliers, during the six months ended September 30, 2014, the new management had not been able to make significant progress. Until the new sales and management team develops and establishes a new customer base, we do not expect our wholesale business to expand in the immediate future.

Gross Profit

Gross profit decreased by $183,146 or 6.2% period over period primarily as a result of the contraction in wholesale business. At the same time, gross margin decreased from 17.5% to 15.0% due to lower retail profit margins. The average gross margins for each of our three business segments are as follows:

	Three months ended September 30,	
	2014	2013
Average gross margin for retail drugstores	17.0 %	24.2 %
Average gross margin for online sales	16.5 %	13.6 %
Average gross margin for wholesale business	5.7 %	7.6 %
Average gross margin for farming business	N/A	N/A

Retail drugstores gross margin decreased primarily due to lower sale prices caused by strong market competition and the implementation of government subsidies to all drugs sold at public hospitals in Zhejiang Province. The China Food and Drug Administration (the "CFDA") continued to add more drugs into its drug retail price controls list. Although most of our drug prices are below the price limit, we adjust our prices from time to time to be competitive in the market. Furthermore, since April 2014, local public hospitals in Zhejiang Province are required to sell all drugs at cost. In turn, local governments reimburse these hospitals with subsidies. Confronted with low or no profit margin sales and government subsidies, we have to maintain low profit margins in order to attract customers.

Online pharmacy sales gross margins are usually lower than gross margins of drugs sold at physical drugstores and vary from time to time depending on the products we carry. During the three months ended September 31, 2014, we were able to sell certain nutritional supplements with high profit margin. However, in order to keep competitive and drive fast sales growth, we may lower our sales prices in long run.

Wholesale gross margin decreased primarily due to competitive prices offered by the new wholesale management team in order to retain and develop customers. We have been transitioning in a new sales and management team for Jiuxin Medicine since the third quarter of fiscal 2014. However, the departure of the old salespersons took away certain business. In order to make up the lost business and actively explore the new customers, the new team decided to keep low prices for the majority of our products. As a result, our gross margin became relatively low in the three months ended September 30, 2014.

During the three months ended September 30, 2014, we continued to plant and grow Ginkgo trees based on our best estimate as to future market demands. Due to the prolonged life cycle, we were unable to harvest those herbs in the three months ended September 30, 2014. We expect to continue planting Ginkgo trees and other herbs in the near future. We plan to harvest and sell Ginkgo trees based on our best estimation of the market but do not expect within a year. Revenue from the herbs will be generated when they are harvested.

Selling and Marketing Expenses

Sales and marketing expenses decreased by $1,045,351 or 35.1% period over period. The difference in absolute dollars is primarily attributable to approximately $1.3 million membership rewards to commemorate Jiuzhou Pharmacy's ten-year anniversary in August and September 2013, which were distributed during the three months ended September 30, 2013 and therefore increased the expenses during the same period last year. Excluding the membership rewards, our selling and marketing expenses increased by approximately $0.25 million or 13% mainly due to rental increases and higher labor cost. As a result, such expenses as a percentage of our revenue decreased to 10.5%, from 17.7% for the same period a year ago. We expect future sales and marketing expenses to not deviate significantly from its current levels.

General and Administrative Expenses

General and administrative expenses increased by $254,194 or 51.7% period over period. Such expenses as a percentage of revenue increased to 4.0% from 2.9% for the same period a year ago. The increase in absolute dollars is partly attributable to a decrease of $973,696 in allowance for accounts receivable and advance to suppliers in the three months ended September 30, 2014, as compared to $1,111,689 in the three months ended September 30, 2013. Excluding such allowance effects, general and administrative expense increased by $116,201 or 23.6%. The increase in absolute dollars primarily reflects modest increase in labor cost. We expect future general and administrative expenses to remain at its current levels.

Income (Loss) from Operations

As a result of decreased gross margin, we had income from operations of $85,302, as compared to loss from operations of $522,709 a year ago. Our operating margin for the three months ended September 30, 2014 and 2013 was 0.5% and (3.1)%, respectively.

Income Taxes

Our income tax expense decreased by $16,909 period over period due to decline in Jiuzhou Pharmacy's profit.

Net Loss

As a result of the foregoing, net loss decreased by $508,914 period over period.

Comparison of six months ended September 30, 2014 and 2013

The following table summarizes our results of operations for the six months ended September 30, 2014 and 2013:

	Six months ended September 30,			
	2014		2013	
	Amount	Percentage of total revenue	**Amount**	Percentage of total revenue
Revenue	$34,903,297	100.0 %	$32,191,940	100.0 %
Gross profit	$5,275,876	15.1 %	$6,549,572	20.3 %
Selling expenses	$3,702,357	10.6 %	$4,659,973	14.5 %
General and administrative expenses	$1,827,376	5.2 %	$3,132,799	9.7 %
(Loss) from operations	$(253,857)	(0.7)%	$(1,243,200)	(3.9)%
Other (expense), net	$(168,528)	(0.5)%	$(90,332)	(0.3)%
Change in fair value of purchase option derivative liability	$76,357	0.2 %	$8,384	(0.1)%
Income tax expense	$38,821	0.1 %	$79,109	0.2 %
Net loss attributable to controlling interest	$(384,849)	(1.1)%	$(1,333,578)	(4.1)%
Net loss attributable to noncontrolling interest	$(1,919)	(0.0)%	$(507)	(0.0)%

Revenue

Due to the expansion of our retail business, revenue increased by $2,711,357 or 8.4% for the six months ended September 30, 2014, as compared to the same period in the previous fiscal year, primarily due to an increase in our retail business, especially online pharmacy, offset by decline in our wholesale business.

Quarterly Revenue by Segment

The following table breaks down the revenue for our four business segments for the six months ended September 30, 2014 and 2013:

	Six months ended September 30,								
	2014			2013					
	Amount	% of total revenue		Amount	% of total revenue		Variance by amount	% of change	
Revenue from retail drugstores	$23,001,797	65.9	%	$19,100,271	59.3	%	3,901,526	20.4	%
Revenue from online sales	5,521,933	15.8	%	2,865,061	0.9	%	2,656,872	92.7	%
Revenue from wholesale business	6,379,567	18.3	%	10,226,608	31.8	%	(3,847,041)	(37.6	)%
Revenue from farming business	—	—	%	—	—	%	—	—	%
Total revenue	$34,903,297	100.0	%	$32,191,940	100	%	$2,711,357	8.4	%

Retail sales, which accounted for approximately 81.7% of total revenue for the six months ended September 30, 2014, increased by $6,558,398, or 29.9%, to $28,523,730. Same-store sales increased by approximately $3,245,750, or 18.1%, while five new stores contributed approximately $434,564 in revenue in the six months ended September 30, 2014. The increase in same-store sales reflects the implementation of key drugstore operational strategies such as promoting sales through our doctors and clinics, stricter internal staff assessments that stimulate sales, increased adaptability to community demand, closer monitor to the operation of local stores in Hangzhou and modest economic improvements in China. We expect same-store sales will keep growing in the near future. Our online pharmacy sales increased by approximately $2,646,954, or 92.1% for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. We have expanded cooperation with business-to-consumer online vendors, including Taobao, JD and Amazon, by posting our products on their online platforms, which direct customers back to our website. Such arrangements have exposed our online presence to a wider consumer base. In addition, we have spent considerable efforts identifying popular products that can drive sales, while we keep close watch on cost. Online shopping is also experiencing explosive expansion in China. As a result, we have seen steady growth in online sales. On the other hand, we ceased operation of all five stores in Shanghai in February 2014 due to their continuous loss. All Shanghai subsidiaries have canceled their SAIC registration. Although these stores were underperforming, they nevertheless contributed approximately $369,430 in revenue prior to their closures in the three months ended September 30, 2013. Our store count kept 51 as of September 30, 2014 and 2013, as a net effect of closing five stores in Shanghai and opening five stores in Hangzhou. Among the five new stores, two were opened in January 2014, one was opened in May 2014 and the remaining two were opened in the three months ended September 30, 2014.

Wholesale revenue decreased by $3,847,041 or 37.6% primarily as a result of discontinuing aggressive volume-driven sales strategy and slow progress made by new management team in marketing profitable products since August 2013 as mentioned above. Until the new sales and management team develops and establishes a new customer base, we do not expect our wholesale business to expand in the immediate future.

Gross Profit

Gross profit decreased by $1,273,696 or 19.4% period over period primarily as a result of the contraction in wholesale business. At the same time, gross margin decreased from 20.3% to 15.1% due to lower retail profit margins. The average gross margins for each of our three business segments are as follows:

	Six months ended September 30,	
	2014	2013
Average gross margin for retail drugstores	17.4 %	25.1 %
Average gross margin for online sales	16.1 %	17.5 %
Average gross margin for wholesale business	5.7 %	12.3 %
Average gross margin for farming business	N/A	N/A

Retail gross margin decreased primarily due to lower sale prices caused by strong market competition and the implementation of government subsidies to all drugs sold at public hospitals in Zhejiang Province. The CFDA continue to add more drugs into its drug retail price controls list. Although most of our drug prices are below the price limit, we adjust our prices from time to time to be competitive in the market. Furthermore, since April 2014, local public hospitals in Zhejiang Province are required to sell all drugs at cost. In turn, local governments reimburse these hospitals with subsidies. Confronted with low or no profit margin sales and government subsidies, we have to maintain low profit margins in order to attract customers.

Online pharmacy sales gross margins are usually lower than gross margins of drugs sold at physical drugstores and vary from time to time depending on the products we carry. In order to keep competitive and drive fast sales growth, we may lower our sales prices in long run.

Wholesale gross margin decreased primarily due to competitive prices offered by the new wholesale management team in order to retain and develop customers. We have been transitioning in a new sales and management team for Jiuxin Medicine since the third quarter of fiscal 2014. However, the departure of the old salespersons took away certain business. In order to make up the lost business and actively explore the new customers, the new team decided

to keep low prices for the majority of our products. As a result, our gross margin became relatively low in the six months ended September 30, 2014.

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During the six months ended September 30, 2014, we continued to plant and grow Ginkgo trees based on our best estimate as to future market demands. Due to the prolonged life cycle, we were unable to harvest those herbs in the six months ended September 30, 2014. We expect to continue planting Ginkgo trees and other herbs in the near future based on our best estimation of the market. We plan to harvest and sell Ginkgo trees based on our best estimation of the market but do not expect within a year. Revenue from the herbs will be generated when they are harvested.

Selling and Marketing Expenses

Sales and marketing expenses decreased by $957,616 or 20.5% period over period. The difference in absolute dollars is primarily attributable to approximately $1.3 million membership rewards to commemorate Jiuzhou Pharmacy's ten-year anniversary in August and September 2013, which were distributed during the three months ended September 30, 2013 and therefore increased the expenses during the same period last year. Excluding the membership rewards, our selling and marketing expenses increased by approximately $0.35 million or 7.6%, which is mainly due to rental increases and higher labor cost. Such expenses as a percentage of our revenue decreased to 10.6%, from 14.5% for the same period a year ago as a result of significantly lower wholesale revenue. We expect future sales and marketing expenses to not deviate significantly from its current levels.

General and Administrative Expenses

General and administrative expenses decreased by $1,305,423 or 41.7% period over period. Such expenses as a percentage of revenue decreased to 5.2% from 9.7% for the same period a year ago. The decrease in absolute dollars is primarily attributable to a decrease of $1,647,605 in allowance for accounts receivable and advance to suppliers in the six months ended September 30, 2014, as compared to $489,071 in the six months ended September 30, 2013. Excluding such allowance effects, general and administrative expense decreased by $146,889 or 4.7%. We expect future general and administrative expenses to remain at its current levels.

Loss from Operations

As a result of lower operational expense, we had loss from operations of $253,857, as compared to loss from operations of $1,243,200 a year ago. Our operating margin for the three months ended September 30, 2014 and 2013 was (0.7)% and (3.9)%, respectively.

Income Taxes

Our income tax expense decreased by $40,288 period over period due to decline in Jiuzhou Pharmacy's profit.

Net Loss

As a result of the foregoing, net loss decreased by $950,648 period over period.

Accounts receivable

Accounts receivable, which are unsecured, are stated at the amount we expect to collect. We continuously monitor collections and payments from our customers (our distributors) and maintain a provision for estimated credit losses. To prepare for potential loss in such accounts, we made corresponding reserves.

Our accounts receivable aging was as follows for the periods described below:

From date of invoice to customer	Retail drugstores	Online Pharmacy	Drug wholesale	Herb farming	Total amount
1- 3 months	$4,533,477	$166,569	$2,054,931	$-	$6,754,977
4- 6 months	158,839	-	481,952	-	640,791
7- 9 months	58,778	-	145,512	-	204,290
10 - 12 months	111	-	329,822	-	329,933
Over one year	267,665	-	2,107,815	630,448	3,005,928
Allowance for doubtful accounts	(633,138)	-	(2,939,116)	(630,448)	(4,202,702)
Total accounts receivable	$4,385,732	$ 166,569	$2,180,916	$-	$6,733,217

Accounts receivable from our retail business mainly consist of reimbursements from government health insurance bureaus and commercial health insurance programs. In the six months ended September 30, 2014, we wrote off an approximately $129,494 collectible from provincial and Hangzhou City government insurance, as such amount has been determined by the health insurance bureaus to be unqualified for reimbursement.

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Accounts receivable from our drug wholesale business and herb farming business consist of receivables from our customers such as drug distributors. In the six months ended September 30, 2014, we reversed bad debt provision for $932,628. Our drug wholesale business transitioned away from focusing on sales volume beginning in the second half of fiscal 2013, and it tightened its customer credit policy and strengthened monitoring of uncollected receivables. In addition, the new management team came on board and started implemented a stricter credit policy in August 2013. Furthermore, the new management team expensed significant efforts in clearing outstanding balances with certain customers and suppliers. During the six months ended September 30, 2014, we were able to continually collect certain aged accounts. As a result, we reversed approximately $1,068,630 in allowance.

Subsequent to September 30, 2014 and through October 30, 2014, we collected approximately $3.4 million in receivables relating to our drugstore business, $0.5 million relating to our wholesale business, and $0 relating to our herb farming business.

Advances to suppliers

Advances to suppliers are mainly prepayments to secure certain products or services and favorable pricing. The aging of our advances to suppliers is as follows for the periods described below:

From date of cash prepayment to suppliers	Retail drugstores	Online Pharmacy	Drug wholesale	Herb farming	Total amount
1- 3 months	$ -	$ -	$1,893,884	$ -	$1,893,884
4- 6 months	-	-	979,154	-	979,154
7- 9 months	-	-	1,166,950	-	1,166,950
10 - 12 months	-	-	319,542	-	319,542
Over one year	-	-	3,605,947	-	3,605,947
Allowance for doubtful accounts	-	-	(5,883,314)	-	(5,883,314)
Total advances to suppliers	$ -	$ -	$2,082,163	$ -	$2,082,163

Since the acquisition of Jiuxin Medicine, we have gradually transferred almost all logistics services of our retail drugstores to Jiuxin Medicine. Jiuzhou Pharmacy only purchases certain non-medical products such as sundry. As a result, our retail chain had little advances to suppliers as of September 30, 2014.

Advances to suppliers for our drug wholesale business consist of prepayments to our vendors such as drug manufacturers and other distributors. We typically receive products from vendors within three to six months after making prepayments. We continuously monitor delivery from and payments to our vendors and maintain a provision

for estimated credit losses based upon historical experience and any specific customer collection issues that have been identified. If we are having difficulty receiving products from a vendor, we take the following steps: cease purchasing products from the vendor, ask for return of our prepayment promptly, and if necessary, take legal recourse. If all of these steps are unsuccessful, management then determines whether or not the prepayments should be reserved or written off. To facilitate its initial expansion, Jiuxin Medicine made significant prepayments to certain vendors. Lack of timely supplier account reconciliation caused by several accounting staff rotations delayed the monitoring of such accounts. To accommodate potential loss in advances to suppliers, we made reserve for amounts considered to be uncollectible. As previously discussed, Jiuxin Medicine transitioned away from focusing on sales volume beginning in the second half of fiscal 2013, and since then we have tightened our customer credit policy and strengthened monitoring of uncollected receivables. During the six months ended September 30, 2014, we were able to continually collect and sold goods from certain suppliers which we made advances in the past. As a result, we reversed approximately $709,631 in allowance. In addition, the new management team came on board and started implemented a stricter credit policy in August 2013. As a result, we do not expect a significant increase in bad debts going forward.

Liquidity and Capital Resources

Our cash flows for the periods indicated are as follows:

	Six months ended September 30	
	2014	2013
Net cash provided by operating activities	$1,801,793	$2,579,557
Net cash used in investing activities	$(258,582)	$(1,543,586)
Net cash provided by financing activities	$1,281,070	$492,230

For the six months ended September 30, 2014, cash provided by operating activities amounted to $1,801,793, as compared to $2,579,557 a year ago. The change is primarily attributable to a decrease in cash used in inventory of $1,860,089, a decrease in cash used in customer deposit of $3,334,730, offset by increase in cash used in decrease of accounts payable of $5,880,466, and advances to suppliers of $1,909,915.

For the six months ended September 30, 2014, net cash used in investing activities amounted to $258,582, as compared to $1,543,586 a year ago. The change is attributable to the deposit made in the six months ended September 30, 2013.

For the six months ended September 30, 2014, net cash provided by financing activities amounted to $1,281,070, as compared to $492,230 in net cash used in financing activities a year ago.

As of September 30, 2014, we had cash of approximately $7,352,723. Our total current assets as of September 30, 2014, were $32,406,182 and total current liabilities were $34,158,107, which resulted in a negative net working capital of $1,751,925.

Our ability to continue as a going concern depends upon aligning our sources of funding (debt and equity) with our expenditure requirements and repayment of the short-term debts as and when they become due (See Note 2 – liquidity).

The drug retail business is a highly competitive industry in PRC. Several large drugstore chains and a variety of single stores operate in Hangzhou City and Zhejiang Province. The Company closed unprofitable stores including those in Shanghai in fiscal 2013 and 2014. The Shanghai stores alone contributed a loss of $1.3 million in fiscal 2014. The remaining drugstores have historically been profitable and are not expected to require additional financing.

As reflected in our consolidated financial statements, we had a net loss of $384,849 for the six months ended September 30, 2014. We have taken measures to address some of these challenges, such as accelerating cash or goods collections from suppliers against advances, and attracting talent to improve and enhance our traditional retail pharmacy plus in-store clinic business. We are looking to open additional in-store clinics to attract customer traffic. Moreover, the Company is actively developing its high profit margin product line of Chinese Medicine and high-grade nutritional supplements such as Ginseng under its own trademark of Shouantang. We have collected certain aged accounts from our suppliers and customers and will continue to pursue the collection of certain older accounts receivables. Additionally, we will sublease our healthcare center under Jiuyingtang to cut loss in the near future. By doing so, we hope to utilize the value of leasehold improvement we invested in Jiuyingtang fiscal 2013. We have also adjusted our wholesale strategy to focus on profitability and timely collection of credit sales rather than immediate sales volume growth, even though we anticipate that this will lower our wholesale revenue in the near term. A new management and sales team, whose members have been involved with wholesale pharmaceutical distribution for over twenty years, has been transitioning into the Company’s wholesale business in the third quarter of fiscal 2014. The new team is actively seeking out potential customers, such as local hospitals, which have higher profit margins for sales than sales to other wholesale customers. Additionally, the new team has established an OTC Drug department looking to supply other smaller retails drugstores which, if successful, can increase our sales. The Company plans to fund current operations by continuing to focus on profitability for its wholesale operations and focus on strengthening and expanding its core business model of integrated pharmacy and clinic, which has proven to be a key profit driver.

As of September 30, 2014, our current liabilities exceed current assets by $1.75 million. In assessing its liquidity, management monitors and analyzes the Company's cash balance, its ability to renew bank facilities, and its operating and capital expenditure commitments. Its principal liquidity needs are to meet its working capital requirements, operating expenses and capital expenditure obligations. As of the latest applicable date of this report, the Company has obtained the following financial supports, which are listed below:

Line of bank credit

Banks	Amount of Line of Credit as of September 30, 2014 (in millions)	Unused Amount of Line of Credit as of September 30, 2014 (in millions)	Expiration Date
Hangzhou United Bank	$ 1.38	$ -	November 7, 2014
Hangzhou United Bank	0.81	0.01	April 2, 2014
Hangzhou United Bank	1.17	-	October 23, 2014
Industrial and Commercial Bank of China	1.95	1.95	July, 16, 2015
Bank of Hangzhou	1.82	1.82	June 12, 2015
Bank of Hangzhou	2.86	0.44	June 12, 2015
Total	$ 9.99	$ 4.22	

Our principal sources of liquidity consist of existing cash, bank facilities from local banks as well as personal loans from our principal shareholders if necessary. We have three credit line agreements from three local banks as displayed in detail in Note 12. The three credit lines from HUB, ICBC, and BOH allow us to borrow up to $9.99 million in sum. By putting up the restricted cash of $5.44 million deposited in the bank, the credit line is raised up to $15.43 million in total. As of September 30, 2014, we have approximately $11.21 million bank notes payable, approximately $4.22 million bank credit line has not been used and is still available for further borrowing. Any borrowing therefrom is guaranteed by a third-party guarantor company, and secured by our assets pursuant to a collateral agreement, as well as the personal guarantees of some of its principal shareholders.

We have taken measures to reduce its losses and generate positive cash flow by accelerating cash or goods collections from suppliers against advances, and attracting talent to improve and enhance traditional retail pharmacy plus in-store clinic business. In its retail sector, we have closed five unprofitable pharmacies in Shanghai last year and are looking to open additional in-store clinics to attract customer traffic. The remaining stores are considered profitable and are currently generating positive cash flow. We plan to implement O2O (Online to Offline) business model that allows drugstores to deliver goods to online customers in neighborhood communities. Through O2O model, customers can make orders online and our drugstores will deliver ordered products to them within a few hours. As O2O business model cuts the in-store shelf space need for products exhibition, we expect the model can eventually save rental cost in the future. We are actively negotiating with several large suppliers including Pfizer to obtain more purchase discounts and financial support. Moreover, we are actively developing its high profit margin product line of Chinese Medicine and high-grade nutritional supplements such as Ginseng under its own trademark of Shouantang. As healthcare products have become more popular in China, we anticipate a reasonable positive gross margin driving profitability. The drug wholesale industry is usually marked with low profit margin. However, as we are strengthening its customer and supplier credit policy and ceased extremely low profit margin transactions that cannot cover related overhead, we do not expect a significant loss in the future. Additionally, we will sublease our healthcare center under Jiuyingtang to cut loss.

The retail drugstores have been projected to slightly increase as compared to the prior year with lower profit margins. The online pharmacy sales are expected to grow significantly with similar profit margin. The wholesale business is not expected to contribute a significant gross margin to support overhead for the remaining of fiscal 2015, and sales have been projected to be approximately the same as the prior year. The farming business is not expected to have any sales and may incur limited operating costs.

Our good credit history with local banks may also enable us to obtain additional credit lines from the same banks or seek new loans from other banks if necessary. In addition, our CEO Mr. Lei Liu has agreed to provide the necessary financial support to meet our financial obligations in the event that we require additional liquidity. However, since we have no formal agreement with Mr. Liu contractually obligating him to meet our anticipated cash needs for the near future, we cannot be certain that additional financing will be available through shareholder loans, or even if available, if it will be available on terms acceptable to us.

We believe that the foregoing sources will collectively provide sufficient liquidity for us to meet our liquidity and capital obligations for the next twelve months.

Contractual Obligations and Off-Balance Sheet Arrangements

Contractual Obligations

When we open store locations, we typically enter into lease agreements that are generally between three to ten years. Our commitments for minimum rental payments under our leases for the next five years and thereafter are as follows:

Periods ending September 30,	Retail drugstores	Online pharmacy	Drug wholesale	Herb farming	Total Amount
2015	$3,906,015	$108,059	$176,379	$ -	$4,190,453
2016	2,039,822	121,764	176,695	-	2,338,281
2017	1,410,708	139,159	150,756	-	1,700,623
2018	1,228,290	139,159	150,756	-	1,518,205
2019	745,191	139,159	150,756	-	1,035,106
Thereafter	359,140	208,739	113,067	-	680,946

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Off-balance Sheet Arrangements

We do not have any outstanding financial guarantees or commitments to guarantee the payment obligations of any third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as stockholder's equity or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

Exchange Rates

Our subsidiaries and affiliated companies in the PRC maintain their books and records in RMB, the lawful currency of the PRC. In general, for consolidation purposes, we translate their assets and liabilities into USD using the applicable exchange rates prevailing at the balance sheet date, and the statement of income is translated at average exchange rates during the reporting period. Adjustments resulting from the translation of their financial statements are recorded as accumulated other comprehensive income.

The exchange rates used to translate amounts in RMB into USD for the purposes of preparing the unaudited condensed consolidated financial statements or otherwise disclosed in this report were as follows:

	September 30, 2014	**March 31, 2014**	**September 30, 2013**
Balance sheet items, except for the registered and paid-up capital, as of end of period/year	USD1: RMB 0.1625	USD1: RMB 0.1623	USD1: RMB 0.1630
Amounts included in the statement of Operations and statement of cash flows for the period/ year ended	USD1: RMB 0.1623	USD1: RMB 0.1626	USD1: RMB 0.1618

Inflation

We believe that inflation has not had a material effect on our operations to date.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not applicable.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of September 30, 2014, we carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended. Based upon such evaluation, our chief executive officer and chief financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were ineffective at the reasonable assurance level. Such conclusion is based on the presence of the following material weaknesses in internal control over financial reporting as following:

- the significance of the audit adjustments' impact on the overall financial statements; and
- how adequately we complied with U.S. GAAP on transactions.

Accounting and Finance Personnel Weaknesses - As noted in Item 9A of our annual reports on Form 10-K for the preceding three fiscal years, management concluded that in light of the inexperience of our accounting staff with respect to the requirements of U.S. GAAP-based reporting and SEC rules and regulations, we did not maintain effective controls and did not implement adequate and proper supervisory review to ensure that significant internal control deficiencies can be detected or prevented.

Management anticipates that our disclosure controls and procedures will remain ineffective until such material weakness is remediated.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934) during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II – OTHER INFORMATION

ITEM 5. OTHER INFORMATION.

On October 9, 2014, the Company, through Jiuzhou Pharmacy, a pharmacy that the Company controls through contractual arrangements, entered into an acquisition agreement with two individual owners of Sanhao Grand Pharmacy Chain Co., Ltd.("Sanhao Pharmacy"), a local drugstore chain located in Hangzhou, for a total purchase price of $1.56 million (RMB9.6 million), 20% of which was paid within three business days upon the entry into the agreement; 40% shall be paid upon the completion of the registration of the new business license of Sanhao Pharmacy by the local State Administration of Industrial and Commerce, and the balance shall be paid within one year from the entry into the agreement. The Company intends to fund its acquisition through its improved cash flow generated by rising sales from its retail business as well as bank financing.

Sanhao Pharmacy presently has eleven stores where customers can use insurance cards issued by Hangzhou government for purchases in eight of those stores. The Company expects to further expand its market shares in Hangzhou City through Sanhao's existing insurance-applicable stores. As of the date of the report, the registered shareholder of Sanhao Pharmacy has been listed under Jiuzhou Pharmacy.

ITEM 6. EXHIBITS.

EXHIBIT INDEX

Exhibit Number	Description
10.1	Acquisition Agreement between Jiuzhou Pharmacy and Sanhao Pharmacy dated October 9, 2014 *
31.1	Section 302 Certification by the Corporation's Chief Executive Officer *
31.2	Section 302 Certification by the Corporation's Chief Financial Officer *
32.1	Section 906 Certification by the Corporation's Chief Executive Officer *
32.2	Section 906 Certification by the Corporation's Chief Financial Officer *
101.INS	XBRL Instance Document* **
101.SCH	XBRL Taxonomy Extension Schema Document* **
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document* **
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document* **
101.LAB	XBRL Taxonomy Extension Label Linkbase Document* **
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document* **

* Filed herewith.

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	CHINA JO-JO DRUGSTORES, INC. (Registrant)
Date: November 12, 2014	By: /s/ Lei Liu Lei Liu Chief Executive Officer
Date: November 12, 2014	By: /s/ Ming Zhao Ming Zhao Chief Financial Officer

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