

Edgar Filing: CITY NETWORK INC - Form 10QSB/A

CITY NETWORK INC  
Form 10QSB/A  
January 27, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-QSB/A  
(Amendment No. 1)

(Mark One)

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

For the quarterly period ended: June 30, 2005

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-31954

CITY NETWORK, INC.  
(Exact name of small business issuer as specified in its charter)

Nevada  
(State or other jurisdiction of  
incorporation or organization)

88-0467944  
(I.R.S. Employer Identification No)

2F-1, No. 16, Jian Ba Road, Jhonghe City  
Taipei County 235, Taiwan, ROC  
(Address of principal executive offices)

011-886-2-8226-5566  
(Issuer's telephone number)

(Former name, former address and former fiscal year,  
if changed since last report)

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

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

The number of shares outstanding of the issuer's common stock, \$0.001 par  
value, as of the close of business on January 23, 2006 was 32,967,183.

Transitional Small Business Disclosure Format (Check One): Yes  No

EXPLANATORY NOTE

## Edgar Filing: CITY NETWORK INC - Form 10QSB/A

The purpose of this Amendment No. 1 to Quarterly Report on Form 10-QSB/A of City Network, Inc. (the "Company," "we" or "our") for the fiscal period ended June 30, 2005, filed with the Securities and Exchange Commission ("SEC") on August 22, 2005, is to (i) re-classify the outstanding obligations and liabilities; (ii) reflect commitments due to a contract between City Construction Co., Ltd and three individuals for the construction of property in Keelung, Taiwan; (iii) reflect complete information on credit facility arrangements; (iv) reflect the settlement with a vendor litigation; (v) reflect the construction contract in Vietnam pursuant to which the Company will procure construction materials for approximately US\$14 million; and (vi) reflect the purchase contract with a company in Samoa for approximately US\$3 million for the purchase of the construction materials.

The Items which are amended and restated herein are:

1. Part I, Item 1 - Financial Statements;
2. Part I, Item 2 - Management's Discussion and Analysis or Plan of Operation (only the Liquidity Section); and
3. Part II, Item 1 - Legal Proceedings.

Except as otherwise expressly noted herein, this Amendment No. 1 to Quarterly Report on Form 10-QSB/A does not reflect events occurring after the August 22, 2005 filing of our Quarterly Report on Form 10-QSB in any way, except as those required to reflect the effects of this restatement of our financial statements for the periods presented, as deemed necessary in connection with the completion of the restated financial statements and the revised notes to the financial statements.

The remaining Items contained within this Amendment No. 1 to our Quarterly Report on Form 10-QSB/A consist of all other Items originally contained in our Quarterly Report on Form 10-QSB for the quarterly period ended June 30, 2005 in the form filed with the SEC on August 22, 2005. These remaining Items are not amended hereby, but are included for the convenience of the reader. In order to preserve the nature and character of the disclosures set forth in such Items as originally filed, except as expressly noted herein, this report continues to speak as of the date of the original filing, and we have not updated the disclosures in this report to speak as of a later date. While this report primarily relates to the historical periods covered, events may have taken place since the original filing that might have been reflected in this report if they had taken place prior to the original filing.

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### PART I. FINANCIAL INFORMATION

#### ITEM 1. FINANCIAL STATEMENTS

RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

|  | June 30, 2005 | December 31, 2004 |
|--|---------------|-------------------|
|  | -----         | -----             |
|  | (Unaudited)   |                   |
| ASSETS                                     |               |                   |
| Current Assets                             |               |                   |
| Cash and cash equivalents                  | \$ 696,789    | \$ 2,010,644      |
| Investment                                 | 72,931        | 0                 |
| Accounts receivable, net                   | 2,622,809     | 3,333,990         |
| Inventory                                  | 783,129       | 732,027           |
| Other receivables                          | 22,816        | 6,863             |
| Prepaid expenses                           | 511,715       | 102,896           |
|  | -----         | -----             |
| Total Current Assets                       | 4,710,189     | 6,186,420         |
|  | -----         | -----             |
| Fixed Assets, net                          | 2,265,830     | 2,586,872         |
|  | -----         | -----             |
| Total Fixed Assets                         | 2,265,830     | 2,586,872         |
|  | -----         | -----             |
| Other Assets                               |               |                   |
| Deposits                                   | 1,791,459     | 1,724,542         |
| Construction in progress                   | 30,316        | 0                 |
| Trademarks                                 | 1,740         | 1,812             |
| Equity in net assets of affiliated company | 818,885       | 829,008           |
| Intangible assets                          | 926,730       | 961,053           |
| Other assets                               | 20,459        | 8,255             |
|  | -----         | -----             |
| Total Other Assets                         | 3,589,589     | 3,524,670         |
|  | -----         | -----             |
| Total Assets                               | \$ 10,565,608 | \$ 12,297,962     |
|  | =====         | =====             |

#### LIABILITIES AND STOCKHOLDERS' EQUITY

|                                       |              |              |
|---------------------------------------|--------------|--------------|
| Current Liabilities                   |              |              |
| Accounts payable and accrued expenses | \$ 1,890,939 | \$ 3,335,286 |
| Due to related party                  | 100,344      | 80,083       |
| Deferred revenue                      | 48,368       | 14,566       |

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|  |               |               |
|--|---------------|---------------|
| Current portion, long-term debt  | 3,263,906     | 3,226,181     |
|  | -----         | -----         |
| Total Current Liabilities  | 5,303,557     | 6,656,116     |
| Long-term debt, net of current portion   | 789,550       | 246,330       |
|  | -----         | -----         |
| Total Liabilities  | 6,093,107     | 6,902,446     |
|  | -----         | -----         |
| Stockholders' Equity   |               |               |
| Common stock, \$.001 par value, 100,000,000 shares authorized, 27,500,000 issued and outstanding | 27,500        | 27,500        |
| Additional paid in capital   | 5,937,946     | 5,937,946     |
| Cumulative foreign-exchange translation adjustment   | 363,044       | 142,453       |
| Retained earnings  | (1,855,989)   | (712,383)     |
|  | -----         | -----         |
| Total Stockholders' Equity   | 4,472,501     | 5,395,516     |
|  | -----         | -----         |
| Total Liabilities and Stockholders' Equity   | \$ 10,565,608 | \$ 12,297,962 |
|  | =====         | =====         |

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

|                                     | Three Months Ended |                  | Six Mo           |
|-------------------------------------|--------------------|------------------|------------------|
|                                     | June 30,<br>2005   | June 30,<br>2004 | June 30,<br>2005 |
|                                     | -----              | -----            | -----            |
| Sales, net                          | \$ 3,599,366       | \$ 5,943,514     | \$ 4,892,716     |
| Cost of sales                       | 3,377,970          | 5,599,690        | 4,633,010        |
|                                     | -----              | -----            | -----            |
| Gross profit                        | 221,396            | 343,824          | 259,706          |
| General and administrative expenses | 376,241            | 467,480          | 699,386          |
|                                     | -----              | -----            | -----            |
| Income (loss) from operations       | (154,845)          | (123,656)        | (439,680)        |
|                                     | -----              | -----            | -----            |
| Other (Income) Expense              |                    |                  |                  |
| Interest income                     | (1,688)            | (890)            | (2,087)          |
| Rental income                       | (47,910)           | (7,900)          | (95,580)         |
| Commission income                   | (31,870)           | (2)              | (35,791)         |
| (Gain) loss on currency exchange    | 4,977              | (3,029)          | 13,235           |
| Other income                        | (20,371)           | (53,710)         | (56,239)         |
| Reserve for bad debt                | 11,154             | 49,688           | 696,154          |
| Equity in earnings of investee      | (531)              | 0                | 10,123           |
| Miscellaneous                       | 10,318             | 51,553           | 12,657           |
| Loss on sale of fixed assets        | (2,280)            | 0                | 79,980           |
| Interest expense                    | 42,898             | 23,312           | 81,296           |
|                                     | -----              | -----            | -----            |
| Total Other (Income) Expense        | (35,303)           | 59,022           | 703,748          |
|                                     | -----              | -----            | -----            |

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|   |              |              |                |
|---|--------------|--------------|----------------|
| Income (loss) before income taxes               | (119,542)    | (182,678)    | (1,143,428)    |
| Provison for income taxes                       | 178          | 19,516       | 178            |
|   | -----        | -----        | -----          |
| Net income (loss)                               | \$ (119,720) | \$ (202,194) | \$ (1,143,606) |
|   | =====        | =====        | =====          |
| Net income (loss) per share (basic and diluted) |              |              |                |
| Basic   | \$ (0.004)   | \$ (0.008)   | \$ (0.042)     |
| Diluted   | \$ (0.004)   | \$ (0.008)   | \$ (0.042)     |
| Weighted average number of shares               |              |              |                |
| Basic   | 27,500,000   | 26,666,667   | 27,500,000     |
| Diluted   | 27,500,000   | 26,666,667   | 27,500,000     |

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|  | Six Months Ended |                  |
|--|------------------|------------------|
|  | June 30,<br>2005 | June 30,<br>2004 |
|  | -----            | -----            |
| CASH FLOWS FROM OPERATING ACTIVITIES   |                  |                  |
| Net Income (loss)  | \$ (1,143,606)   | \$ (9,611)       |
| Adjustments to reconcile net income (loss) to net cash provided by (used) in operating activities: |                  |                  |
| Depreciation and amortization  | 87,730           | 82,441           |
| Equity in earning of investee  | 10,123           |                  |
| Loss on disposal of assets   | 79,980           |                  |
| (Gain) loss on foreign currency exchange   | 13,235           | (20,000)         |
| Translation adjustment   | 192,578          | (13,350)         |
| Decrease (Increase) in receivables   | 711,181          | (739,900)        |
| Decrease (Increase) in inventory   | (51,102)         | (839,990)        |
| Decrease (Increase) in other receivables   | (15,953)         | 1,035,960        |
| Decrease (Increase) in prepaid expenses  | (408,819)        | (246,820)        |
| Decrease (Increase) in deposit   | (66,917)         | 445,820          |
| Decrease (Increase) in other current assets  | (12,204)         | 183,460          |
| (Decrease) Increase in accounts payable and accrued expenses                                       | (164,439)        | 1,232,340        |
| (Decrease) Increase in deferred revenue  | 33,802           | (425,740)        |
| (Decrease) Increase in deposits payable  | 0                |                  |
|  | -----            | -----            |
| Total Adjustments  | 409,195          | 714,010          |
|  | -----            | -----            |
| Net cash (used in) provided by operations  | (734,411)        | 704,390          |
|  | -----            | -----            |
| CASH FLOWS FROM INVESTING ACTIVITIES   |                  |                  |
| Proceeds from sale of fixed assets   | 397,222          |                  |
| Purchase on investment   | (72,931)         |                  |
| Construction in progress   | (30,316)         |                  |
| Purchase of fixed assets   | (194,717)        | (24,250)         |
|  | -----            | -----            |
| Net cash (used in) provided by investing activities  | 99,258           | (24,250)         |
|  | -----            | -----            |

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|  |             |              |
|--|-------------|--------------|
| CASH FLOWS FROM FINANCING ACTIVITIES                 |             |              |
| Payment on notes payable                             | (4,249,488) | (2,554,800)  |
| Payment of loan from related party                   | (6,293)     | (1,524,920)  |
| Loan from related party                              | 26,554      | 248,120      |
| Issuance of short-term debt                          | 3,550,525   | 2,970,240    |
|  | -----       | -----        |
| Net cash (used in) financing activities              | (678,702)   | (861,350)    |
|  | -----       | -----        |
| Net change in cash and cash equivalents              | (1,313,855) | (181,220)    |
|  | -----       | -----        |
| Cash and cash equivalents at beginning of period     | 2,010,644   | 1,148,450    |
|  | -----       | -----        |
| Cash and cash equivalents at end of period           | \$ 696,789  | \$ 967,230   |
|  | =====       | =====        |
| Supplemental cash flows disclosures:                 |             |              |
| Income tax payments                                  | \$ 178      | \$ 21,750    |
|  | -----       | -----        |
| Interest payments                                    | \$ 81,296   | \$ 40,400    |
|  | -----       | -----        |
| Non cash transaction:                                |             |              |
| Conversion of short term liability to long term debt | \$ 789,550  | \$           |
|  | -----       | -----        |
| Conversion of debt to equity                         | \$ 0        | \$ 1,680,320 |
|  | -----       | -----        |

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

|  | June 30, 2005 | December 31, |
|--|---------------|--------------|
|  | -----         | -----        |
|  | (Unaudited)   |              |
| Common stock, number of shares outstanding         |               |              |
| Balance at beginning of period                     | 27,500,000    | 25,000,000   |
| Common stock issued                                | 0             | 2,500,000    |
|  | -----         | -----        |
| Balance at end of period                           | 27,500,000    | 27,500,000   |
|  | -----         | -----        |
| Common stock, par value \$.001                     |               |              |
| Balance at beginning of period                     | \$ 27,500     | \$ 25,000    |
| Common stock issued                                | 0             | 2,500        |
|  | -----         | -----        |
| Balance at end of period                           | 27,500        | 27,500       |
|  | -----         | -----        |
| Additional paid in capital                         |               |              |
| Balance at beginning of period                     | 5,937,946     | 4,260,100    |
| Issuance of stock                                  | 0             | 1,677,800    |
|  | -----         | -----        |
| Balance at end of period                           | 5,937,946     | 5,937,900    |
|  | -----         | -----        |
| Cumulative foreign-exchange translation adjustment |               |              |
| Balance at beginning of period                     | 142,453       | 29,600       |
| Foreign currency translation                       | 220,591       | 112,700      |
|  | -----         | -----        |

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|   |              |            |
|---|--------------|------------|
| Balance at end of period                    | 363,044      | 142,4      |
|   | -----        | -----      |
| Retained (deficits)                         |              |            |
| Balance at beginning of period              | (712,383)    | 252,2      |
| Net income (loss)                           | (1,143,606)  | (964,6     |
|   | -----        | -----      |
| Balance at end of period                    | (1,855,989)  | (712,3     |
|   | -----        | -----      |
| Total stockholders' equity at end of period | \$ 4,472,501 | \$ 5,395,5 |
|   | =====        | =====      |

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

NOTE 1 - NATURE OF OPERATIONS

City Network, Inc., formerly Investment Agents, Inc., was incorporated on August 8, 1996 under the laws of the State of Nevada. City Network Technology, Inc., formerly Gelcrest Investments Limited, was incorporated under the laws of the British Virgin Islands on March 1, 2002. City Network, Inc. - Taiwan, formerly City Engineering, Inc., was incorporated under the laws of Republic of China on September 6, 1994. City Construction was incorporated under the laws of Republic of China on October, 10, 2003. City Network, Inc. owns 100% of the capital stock of City Network Technology, Inc., and City Network Technology, Inc. owns 100% of the capital stock of City Network, Inc. - Taiwan, and City Construction. Collectively, the four corporations are referred to herein as the "Company".

On November 14, 2002, City Network Technology, Inc. became a wholly-owned subsidiary of City Network, Inc. through an Exchange Agreement, dated November 14, 2002 and amended on December 4, 2002 whereby City Network, Inc. acquired all of the issued and outstanding capital stock of City Network Technology, Inc. in exchange for 12,000,000 shares of City Network, Inc. to the shareholders of City Network Technology, Inc.

The Company designs, manufactures and markets a comprehensive line of broadband communication and wireless Internet access product and solutions. The Company's product lines are used in residential building and hospitality markets and include the simple DSL bridge/modem for the home and small business user. The Company is also pursuing work in the business construction field.

On December 16, 2004, the Company changed its fiscal year end from February 28 to December 31.

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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Unaudited Interim Financial Information - The accompanying financial statements have been prepared by City Network, Inc. pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for Form 10-QSB and Item 310 of Regulation S-B and generally accepted accounting principles for interim financial reporting. These financial statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair presentation of the statement of financial position, operations, and cash flows for the periods presented. Operating results for the six months ended June 30, 2005 and 2004 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005, or any future period, due to seasonal and other factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting policies have been omitted in accordance with the rules and regulations of the SEC. These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes, included in the Company's Annual Report on Form 10-KSB for the ten months ended December 31, 2004.

Basis of Consolidation - The consolidated financial statements for 2005 and 2004 include the accounts of City Network, Inc. and its wholly owned subsidiaries City Network Technology, Inc., City Network, Inc. - Taiwan and City Construction Co., Ltd. All material intercompany accounts, transactions and profits have been eliminated in consolidation.

Revenue Recognition - Revenue from sales of products to customers is recognized upon shipment or when title passes to customers based on the terms of the sales and is recorded net of returns, discounts, and allowances.

Cash and Cash Equivalents - Cash equivalents are stated at cost. Cash equivalents are highly liquid investments readily convertible into cash with an original maturity of three months or less and consist of time deposits with commercial banks.

Allowance for Doubtful Accounts - The Company establishes an allowance for doubtful accounts on a case-by-case basis when it believes the required payment of specific amounts owed is unlikely to occur after a review of historical collection experience, subsequent collections, and management's evaluation of existing economic conditions.

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fixed Assets - Property and equipment are stated at cost less accumulated depreciation. Expenditures for major additions and improvements are capitalized and minor replacements; maintenance and repairs are expensed as incurred. Whenever an asset is retired or disposed of, its cost and accumulated depreciation or amortization are removed from the respective accounts and the resulting gain or loss is credited or charged to income.

Depreciation is computed using the straight-line and declining-balance methods over the following estimated useful lives:

|                        |         |
|------------------------|---------|
| Furniture and Fixtures | 5 years |
| Equipment              | 5 years |



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|                                |          |
|--------------------------------|----------|
| Computer Hardware and Software | 3 years  |
| Building and Improvements      | 50 years |

Intangible Assets - Effective July 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets." The adoption of SFAS No. 142 required an initial impairment assessment involving a comparison of the fair value of trademarks, patents and other intangible assets to current carrying value. No impairment loss was recognized for the period ended June 30, 2005.

Trademarks and other intangible assets determined to have indefinite useful lives are not amortized. The Company tests such trademarks and other intangible assets with indefinite useful lives for impairment annually, or more frequently if events or circumstances indicate that an asset might be impaired. Trademarks and other intangible assets determined to have definite lives are amortized over their useful lives or the life of the trademark and other intangible asset, whichever is less.

Inventory - Inventory is valued at the lower of cost or market; cost is determined on the weighted average method. As of June 30, 2005, inventory consisted only of finished goods.

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Contingencies - Certain conditions may exist as of the date the financial statements are issued which may result in a loss to the Company but which will only be resolved when one or more future events occur or fail to occur. The Company's management and legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing loss contingencies related to legal proceedings that are pending against the Company or unasserted claims that may result in such proceedings, the Company's legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims, as well as the perceived merits of the amount of relief sought or expected to be sought.

If the assessment of a contingency indicates that it is probable that a material loss has been incurred and the amount of the liability can be estimated, then the estimated liability would be accrued in the Company's financial statements. If the assessment indicates that a potential material loss contingency is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss, if determinable and material, would be disclosed.

Loss contingencies considered to be remote by management are generally not disclosed unless they involve guarantees, in which case the guarantee would be disclosed. As of June 30, 2005, there are no matters that warrant disclosure in the financial statements.

Advertising - Advertising costs are expensed in the period incurred.

Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and

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disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include collectibility of accounts receivable, accounts payable, sales returns, and recoverability of long-term assets.

Concentration of Credit Risk - Financial instruments, which subject the Company to credit risk, consist primarily of cash equivalents and trade accounts receivable arising from its normal business activities. The Company places its cash in what it believes to be credit-worthy financial institutions. Concentration of credit risk with respect to trade accounts receivable is primarily from customers located in Asia. The Company actively evaluates the creditworthiness of the customers with which it conducts business through credit approvals, credit limits and monitoring procedures.

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### RESTATED CITY NETWORK, INC. AND SUBSIDIARIES

#### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004

##### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Impairment of Long-Lived Assets - On January 1, 2002 the Company adopted SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets". The Company evaluates long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. If the estimated future cash flows (undiscounted and without interest charges) from the use of an asset are less than the carrying value, a write-down would be recorded to reduce the related asset to its estimated fair value. There have been no such impairments to date.

Earnings Per Share - Earnings per share are based on the weighted average number of shares of common stock and common stock equivalents outstanding during each period. Earnings per share are computed using the treasury stock method. The options to purchase common shares are considered to be outstanding for all periods presented, but are not calculated as part of the earnings per share.

Income Taxes - Income taxes have been provided based upon the tax laws and rates in the countries in which operations are conducted and income is earned. The income tax rates imposed by the taxing authorities vary. Taxable income may vary from pre-tax income for financial accounting purposes. There is no expected relationship between the provision for income taxes and income before income taxes, because the countries have different taxation rules, which vary not only to nominal rates but also in terms of available deductions, credits and other benefits. Deferred tax assets and liabilities are recognized for the anticipated future tax effects of temporary differences between the financial statement basis and the tax basis of the Company's assets and liabilities using the applicable tax rates in effect at year end as prescribed by SFAS No. 109 "Accounting for Income Taxes".

Exchange Gain (Loss) - As of June 30, 2005 and 2004, the transactions of City Network, Inc. - Taiwan and City Construction Co., Ltd. were denominated in a foreign currency and are recorded in New Taiwan Dollars ("NTD") at the rates of exchange in effect when the transactions occur. Exchange gains and losses are recognized for the different foreign exchange rates applied when the foreign currency assets and liabilities are settled.

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## RESTATED CITY NETWORK, INC. AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004

#### NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Translation Adjustment - As of June 30, 2005 and 2004, the accounts of City Network, Inc. - Taiwan and City Construction Co., Ltd. were maintained, and their financial statements were expressed, in NTD. Such financial statements were translated into U.S. Dollars (USD) in accordance with SFAS No. 52, "Foreign Currency Translation", with the NTD as the functional currency. According to SFAS No. 52, all assets and liabilities were translated at the current exchange rate, stockholder's equity are translated at the historical rates and income statement items are translated at the weighted average exchange rate for the period. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income".

As of June 30, 2005 and 2004 the exchange rates between NTD and the USD was NTD\$1=USD\$0.03182 and NTD\$1=USD\$0.02995, respectively. The weighted-average rate of exchange between NTD and USD was NTD\$1 = USD\$0.03186 and NTD\$1=USD\$0.02967, respectively. Total translation adjustment recognized for the period ended June 30, 2005 is \$363,044.

New Accounting Pronouncements - In January 2003, FASB issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN46"). This interpretation of Accounting Research Bulletin No. 51, requires companies to consolidate the operations of all variable interest entities ("VIE's") for which they are the primary beneficiary. The term "primary beneficiary" is defined as the entity that will absorb a majority of expected losses, receive a majority of the expected residual returns, or both. This interpretation was later revised by the issuance of Interpretation No. 46R ("FIN 46R"). The revision was issued to address certain implementation issues that had arisen since the issuance of the original interpretation and to provide companies with the ability to defer the adoption of FIN46 to period after March 15, 2004. The implementation of FIN46 and FIN 46R had no material impact on the Company's financial statements.

On July 16, 2004 the FASB ratified the Emerging Issues Task Force ("EITF") consensus of Issue 02-14, "Whether the Equity Method of Accounting Applies when an Investor Does Not Have an Investment in Voting Stock of an Investee but Exercises Significant Influence through Other Means" ("EITF 02-14"). The consensus concluded that an investor should apply the equity method of accounting when it can exercise significant influence over an entity through a means other than holding voting rights. The consensus is effective for reporting periods beginning after September 2004. The adoption of EITF 02-14 did not have a material impact on the Company's financial statements.

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## RESTATED CITY NETWORK, INC. AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004

#### NOTE 3 - CONCENTRATION

The Company had ten major customers during the six months ended June 30, 2005.

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Those customers comprise 91% of the total sales during the six months ended June 30, 2005. Sales to these customers were approximately \$4,449,227. Included in accounts receivable is \$1,863,874 from these customers as of June 30, 2005.

### NOTE 4 - CASH

The Company maintains its cash balances at various banks in Taiwan and Hong Kong. All balances are insured by the Central Deposit Insurance Corporation (CDIC). As of June 30, 2005 and 2004, there were no uninsured portions of the balances held at the bank.

### NOTE 5 - FIXED ASSETS

Fixed assets consist of the following:

|                          | June 30, 2005 | December 31, 2004 |
|--------------------------|---------------|-------------------|
|                          | -----         | -----             |
| Land                     | \$ 1,774,623  | \$ 1,916,328      |
| Building                 | --            | 283,977           |
| Machinery and equipment  | 464,943       | 430,880           |
| Furniture and fixtures   | 198,182       | 143,655           |
|                          | -----         | -----             |
|                          | \$ 2,437,748  | \$ 2,774,840      |
| <br>                     |               |                   |
| Accumulated depreciation | (171,918)     | (187,968)         |
|                          | -----         | -----             |
|                          | \$ 2,265,830  | \$ 2,586,872      |
|                          | =====         | =====             |

### NOTE 6 - INTANGIBLE ASSETS

Intangible assets consist of the following:

|                          | June 30, 2005 | December 31, 2004 |
|--------------------------|---------------|-------------------|
|                          | -----         | -----             |
| Trademarks               | \$ 2,150      | \$ 2,150          |
| Intangible asset         | 1,000,000     | 1,000,000         |
|                          | -----         | -----             |
|                          | \$ 1,002,150  | \$ 1,002,150      |
| <br>                     |               |                   |
| Accumulated depreciation | (73,679)      | (39,285)          |
|                          | -----         | -----             |
|                          | \$ 928,471    | \$ 962,865        |
|                          | =====         | =====             |

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RESTATED  
CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

### NOTE 7 - COMPENSATED ABSENCES

Employees earn annual vacation leave at the rate of seven (7) days per year for the first three years of employment with the Company. Upon completion of the third year of employment, employees earn annual vacation leave at the rate of ten (10) days per year. At termination, employees are paid for any accumulated

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annual vacation leave. As of June 30, 2005 vacation liability exists in the amount of \$1,498.

### NOTE 8 - COMMITMENTS

A Best Information Technology, Inc. - City Network, Inc. - Taiwan, signed an agreement with A Best Information Technology, Inc. in 2002 for the exclusive right to sell A Best Information's products. The rights are perpetual and transferable. The Company paid \$1,000,000 for these rights.

Reseller Agreements - City Network, Inc. - Taiwan has several signed reseller agreements with various customers. These resellers are given special sales prices and are paid commissions for their sales orders.

Co-Construction Agreements - In April 2004, City Construction Co., Ltd. placed a refundable performance bond in the amount of \$227,240 with the court in Taiwan for the rights to complete an unfinished building in Keelung, Taiwan with the owners of the land. The Company is currently in discussion with the land owner regarding the terms of the project.

In March 2005, City Construction Co., Ltd. entered into a Co-Construction Agreement with three individuals which own a tract of land in Keelung, Taiwan. Under the agreement, the Company will finance, construct and own 60% of the completed building project. The Company has agreed to a refundable security deposit totaling approximately \$95,500 dollars payable at various agreed upon phases of the construction. The deposits will be returned within 2 years after the construction is completed. As of June 30, 2005, the Company has paid \$63,310 as part of the refundable security deposit.

Operating Leases - The Company leases office facilities under operating leases that terminate on various dates. Rental expense for these leases consisted of \$12,116 for the three months ended June 31, 2005. The Company has future minimum lease obligations as follows:

|       |          |
|-------|----------|
| 2005  | \$22,910 |
| 2006  | 45,821   |
|       | -----    |
| Total | \$68,731 |
|       | =====    |

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### RESTATED CITY NETWORK, INC. AND SUBSIDIARIES

### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004

### NOTE 9 - LONG-TERM INVESTMENT

On August 31, 2003, the Company purchased approximately twenty-five percent (25%) of Beijing Putain Hexin Network Technology Co., Ltd for \$325,000. On December 4, 2003 the Company purchased an additional fifteen percent (15%) for \$398,500. Beijing Putain Hexin Network Technology Co., Ltd is not publicly traded or listed. The Company is using the complete equity method to record its share of the subsidiary's net income and loss. As of June 30, 2005 the Company recognized a \$10,123 loss from their acquisition.

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CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

## NOTE 10 - DEBT

At of June 30, 2005, the Company had three separate revolving secured lines of credit agreements, renewable annually, with three banks in Taiwan. The lines of credit are secured either by the Company's deposits with the bank and accounts receivable or by an officer of the Company.

At June 30, 2005, the Company had borrowings outstanding in the aggregate amount of \$4,053,456, of which \$2,662,038 are against these lines of credit. Payable as follows:

|   | June 30, 2005<br>----- |  |
|---|------------------------|--|
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by July 31, 2005      | \$ 25,456              | Note payable to a bank in Taiwan, interest at 3.828% per annum, due by February 13, 2005 |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by August 26, 2005    | 60,458                 | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by February 15, 2005 |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by September 8, 2005  | 41,495                 | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 2, 2005     |
| Note payable to a bank in Taiwan, interest at 3.35% per annum, due by September 15, 2005  | 409,670                | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 8, 2005     |
| Note payable to a bank in Taiwan, interest at 3.35% per annum, due by September 15, 2005  | 69,049                 | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 10, 2005    |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by September 23, 2005 | 56,651                 | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 11, 2005    |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by September 23, 2005 | 352,553                | Note payable to a bank in Taiwan, interest at 3.26% per annum, due by March 11, 2005     |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by September 30, 2005 | 309,782                | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by March 15, 2005    |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by October 12, 2005   | 260,606                | Note payable to a bank in Taiwan, interest at 4.42% per annum, due by March 15, 2005     |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by October 25, 2005   | 418,155                | Note payable to a bank in Taiwan, interest at 4.42% per annum, due by March 29, 2005     |

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CITY NETWORK, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2005 AND 2004

NOTE 10 - DEBT (CONTINUED)

|   |              |   |  |
|---|--------------|---|--|
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by October 26, 2005   | 28,363       | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005  |  |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by October 5, 2005  | 503,840      | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005  |  |
| Note payable to a bank in Taiwan, interest at 3.773% per annum, due by February 13, 2006  | 125,960      | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by April 9, 2005  |  |
| Note payable to a corporation in Taiwan, interest at 6.265% per annum, due by November 20, 2005, personally guaranteed by an officer of the Company | 111,510      | Note payable to a bank in Taiwan, interest at 4.42% per annum, due by April 10, 2005  |  |
| Note payable to a corporation in Taiwan, no interest, due by January 10, 2010   | 1,279,908    | Note payable to a bank in Taiwan, interest at 4.42% per annum, due by April 11, 2005  |  |
|   |              | Note payable to a bank in Taiwan, interest at 3.26% per annum, due by April 22, 2005  |  |
|   |              | Note payable to a bank in Taiwan, interest at 4.42% per annum, due by May 29, 2005  |  |
|   |              | Note payable to a bank in Taiwan, interest at 3.616% per annum, due by October 8, 2005  |  |
|   |              | Note payable to a corporation in Taiwan, interest at 6.265% per annum, due by November 20, 2005, personally guaranteed by an officer of the Company |  |
|   |              | Note payable to a bank in Taiwan, interest at 3.175% per annum, due by May 29, 2016   |  |
|   | -----        |   |  |
| Total   | 4,053,456    | Total   |  |
| Current portion   | \$ 3,263,906 | Current portion   |  |





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or US\$900,000 and the other purchase agreement was for an order City Network Inc.-Taiwan sold to a separate customer of the Company in the amount of approximately NT\$12.9 million or US\$390,909.

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### NOTE 12 - LITIGATION (Continued)

On June 21, 2005, City Network Inc.-Taiwan entered a settlement agreement with Rong-Dian and on June 29, 2005, the district court lifted the lawsuit against us. In the June 2005 settlement agreement, City Network Inc.-Taiwan agreed to pay Rong-Dian a total of approximately NT\$40.2 million or US\$1.2 million, to cover the full amount City Network Inc.-Taiwan owed under the two purchase agreements. In August 2005, City Network Inc.-Taiwan paid Rong-Dian approximately NT\$12.9 million or US\$390,909 of the total amount owed upon receipt of such amount from our customer. City Network Inc.-Taiwan intends to pay the balance of approximately NT\$27.3 million or US\$827,272 to Rong-Dian in 54 separate checks, issued and payable by Tai-Wang Technology Co., Ltd. These checks will be in increments of NT\$500,000 or US\$15,910 and payable for 53 consecutive months, beginning on August 10, 2005 with the last and 54th payment being in the amount of NT\$813,003 or US\$25,870 instead of NT\$500,000 or US\$15,910. To date approximately NT\$2 million. or approximately US\$60,000, has been paid on this liability.

Pursuant to the June 2005 settlement agreement, City Network Inc.-Taiwan agreed to pay Rong-Dian the balance of NT\$27.3 million in monthly payments. However, as a result of its relationship with Tai-Wang and the fact that Tai-Wang is the vendor who introduced City Network Inc.-Taiwan to Rong-Dian, Tai-Wang assumed the responsibility for the payment of NT\$27.3 million or US\$827,272 to Rong-Dian. Tai-Wang wrote each monthly check in advance and thereafter provided all 54 checks to Rong-Dian. Rong-Dian will cash one check each month until it receives payment of the full NT\$27.3 million. However, as Tai-Wang has no written obligation with City Network Inc.-Taiwan to make each monthly payment, beyond an oral promise to do so, there is no assurance that each monthly check will be properly cashed by Rong-Dian. Therefore the Company continues to report the total liability to Rong-Dian. As each payment is successfully paid by Tai-Wang the Company will reduce the liability accordingly and recognize other income as the benefit provided by Tai-Wang.

Additionally, as part of the June 2005 settlement agreement, we secured our obligation that Tai-Wang would pay Rong-Dian the outstanding balance of NT\$27.3 million or US\$827,272 by giving Rong-Dian a first priority mortgage on certain property including lots 701-4 and 701-6 in Jay-hou-xiao-duan, Xi-zhi Duan, Xixhi City, Taipei County, Taiwan. The value of the first priority mortgage on the property is approximately NT\$27.3 million or US\$827,272, the aggregate amount owed to Rong-Dian. City Network Inc.-Taiwan agreed with Rong Dian that this mortgage will expire in 2010.

Shanghai Bank - On January 24, 2005, Shanghai Commercial and Savings Bank ("Shanghai Bank") filed a lawsuit with the Taipei District Court against the Company claiming approximately NT\$12 million or approximately US\$387,000 for the payment of an unpaid purchase price for goods. The Company purchased such goods from Chin Shin and Chin Shin assigned the account receivable to Shanghai Bank. As such, Shanghai Bank sued the Company for the payment of those goods. However, the Company returned the said goods because they were defective. The Company and Shanghai Bank are currently in negotiations for a settlement agreement in this matter. The Company deposited a bond in the amount of approximately NT\$3 million or approximately US\$90,000 with the court at the commencement of the lawsuit.

### NOTE 13 - SUBSEQUENT EVENTS

On July 20, 2005, amended on September 22, 2005, the Company entered into a

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construction contract with a company in Vietnam in which the Company agreed to procure materials and equipment related to the project. The estimated amount of gross revenue from this agreement is approximately \$14,000,000. Based on certain criteria of the contract the Company is to receive a deposit of up to \$3,500,000.

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### RESTATED CITY NETWORK, INC. AND SUBSIDIARIES

#### NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS JUNE 30, 2005 AND 2004

##### NOTE 13 - SUBSEQUENT EVENTS (CONTINUED)

On July 25, 2005 the Company entered into a purchase contract with a company in Samoa for approximately \$3,000,000. The Company agreed to pay a deposit of approximately \$750,000 to this company. Purchases are related to items required by the above construction contract.

On August 10, 2005 the Company entered into a Securities Purchase Agreement (the "Securities Purchase Agreement") with Highgate House Funds, Ltd. ("Highgate House"), a Standby Equity Distribution Agreement with Cornell Capital Partners, L.P. ("Cornell Capital"), an affiliate of Highgate house, and related agreements.

Under the terms of the Securities Purchase Agreement, the Company will issue secured convertible debentures (the "Notes") in the aggregate principal amount of \$250,000 to Highgate House. \$125,000 in principal amount of the Notes were issued on August 17, 2005 (the "First Closing Date"). \$125,000 in principal amount of the Notes will be issued at a later closing date.

Simultaneously with the Company's entry into the Securities Purchase Agreement, the Company entered into the Standby Equity Distribution Agreement (the "SEDA") whereby the Company may, over twenty four months after the date of the agreement, issue and sell its common stock to Cornell Capital in \$300,000 installments (each an "Advance") totaling up to \$15,000,000, subject to the terms of the SEDA. The Company's ability to issue and sell common stock pursuant to the SEDA remains subject to, and the Company intend to obtain, (1) the effectiveness of a registration statement covering such shares of common stock, (2) stockholder approval of the issuance of such shares of common stock, and (3) approval by the American Stock Exchange for the additional listing of such shares of common stock. Additionally, any availability under the SEDA will be subject to the Company's continued compliance with the terms of SEDA.

##### NOTE 14 - GOING CONCERN

The Company has suffered recurring losses from operations, cash deficiencies and the inability to meet its maturing obligations without selling operating assets or restructuring debts. These issues may raise substantial concern about its ability to continue as a going concern.

Management has prepared the following statement to address these and other concerns:

The Company is currently are engaged in discussions with a number of companies regarding strategic acquisitions or investments. Although these discussions are ongoing, there can be no assurance that any of these discussions will result in actual acquisitions or investment. See Note 13 to the financial statements.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS

FORWARD-LOOKING STATEMENTS

The following discussion should be read in conjunction with the Consolidated Financial Statements and Notes thereto appearing elsewhere in this Form 10-QSB. The information in this discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements involve risks and uncertainties, including statements regarding our capital needs, business strategy and expectations, including but not limited to the following:

- \* our ability to raise funds in the future through public or private financings;
- \* the timing of our introduction of products or product enhancements;
- \* our ability to manage costs associated with our product or technology acquisitions;
- \* our ability to keep pace with rapidly changing technology, evolving industry standards and new product and services in our industry;
- \* customers' acceptance of our product designs;
- \* our ability to integrate businesses, products and technologies and in joint ventures and strategic relationships with other companies;
- \* our business expenses being greater than anticipated due to competitive factors or unanticipated developments;
- \* changes in political and economic conditions in the Asian and European countries where we do business;
- \* our ability to retain management and key personnel;
- \* our ability to protect our developed technologies, know-how, trademarks and related intellectual properties; and
- \* our ability to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

Any statements contained herein that are not statements of historical facts may be deemed to be forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as "may", "will", "should", "expect", "plan", "intend", "anticipate", "believe", "estimate", "predict", "potential" or "continue", the negative of such terms or other comparable terminology. Actual events or results may differ materially. We disclaim any obligation to publicly update these statements, or disclose any difference between its actual results and those reflected in these statements. The information constitutes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

BACKGROUND OF THE COMPANY

City Network, Inc. ("City Network," "we," "our" or "us") was incorporated on August 8, 1996 as Investment Agents, Inc. under the laws of the State of Nevada. City Network Technology, Inc. ("CNT") was incorporated under the laws of

the British Virgin Islands on March 1, 2002. On November 14, 2002, CNT became a wholly owned subsidiary of our company through an Exchange Agreement, dated November 14, 2002 and amended on December 11, 2002, whereby our company acquired all of the issued and outstanding capital stock of CNT in exchange for 12,000,000 shares of common stock of our company, which represented 49% of our issued and outstanding stock at that time. In connection with the exchange and change in control, the name of our company was changed from Investment Agents, Inc. to City Network, Inc. the officers and directors of City Network resigned and new officers and directors were appointed. Upon the effective date of the exchange and change in control, we ceased our relationship with the company for whom we previously acted as referral agent.

CNT owns all of the issued and outstanding common stock of City Network, Inc.-Taiwan, which was incorporated under the laws of the Republic of China on September 6, 1994, and all of the issued and outstanding common stock of company of City Construction Co., Ltd., which was incorporated under the laws of Republic of China on October, 10, 2003.

On December 16, 2004, our board of directors determined to change our fiscal year end from February 28 to December 31.

#### CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial conditions and results of operations is based upon our financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP"). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. See "Summary of Significant Accounting Policies" in the Notes to Consolidated Financial Statements in Item to this Report for our critical accounting policies. No significant changes in our critical accounting policies have occurred since December 31, 2004.

#### RESULTS OF OPERATIONS

##### THREE MONTHS ENDED JUNE 30, 2005 COMPARED WITH THREE MONTHS ENDED JUNE 30, 2004

NET SALES. Net sales for the three months ended June 30, 2005 were \$3,599,366 compared to \$5,943,514 for the three months ended June 30, 2004. The decrease in net sales for the three months ended June 30, 2005 was due to a decrease in demand for our old products. Our new products, introduced in 2004, are in the early stages of selling. During the three months ended June 30, 2005, the sales volume for our new products was low compared to the sales volume for our old products. We have, however, increased net sales in the second quarter of 2005 over net sales in the first quarter of 2005, primarily due to an increase in sales of our new products.

We design, manufacture and market a comprehensive line of broadband communication and wireless Internet access solutions, including home PNA and xDSL broadband access equipment and related accessories, which comprise our older, established products. In 2004 we introduced new products such as VoIP, GSP and wireless Internet access products.

We believe that an increase in competition over the market for our older products has contributed to a decline in the unit price of those products. Additionally, we believe that the introduction of more technologically advanced products to the marketplace have diminished consumer demand for our older products. We intend to continue upgrading our older products to meet customer expectations.

We believe that sales for our new products, such as VoIP and GSP products, can increase with improved brand name recognition and increased sales channels. We had higher sales of the new products in the second quarter of 2005 compared to the first quarter of 2005, but we have not reached our goals in sales volume for the new products. We intend to continue promoting and marketing our new products to improve brand name recognition as well as work on increasing sales channels.

**COST OF SALES.** Cost of sales for the three months ended June 30, 2005 was \$3,377,970 or 93.8% of net sales, as compared to \$5,599,690 or 94.2% of net sales, during the three months ended June 30, 2004. The decrease in cost of sales is associated with the decrease in sales. The decrease in the cost of sales as a percentage of revenue is due to the higher gross margin of new products, as compared to the gross margin on our old products sold in 2004.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses were \$376,241, or 10.5% of net sales, for the three months ended June 30, 2005, as compared to \$467,480 or 7.9% of net sales, for the three months ended June 30, 2004. The decrease was due to the decrease in sales and an associated decrease in related expenses. The increase in general and administrative expenses as a percentage of net sales is attributable to fixed overhead costs which remain constant for all levels of sales.

**LOSS FROM OPERATIONS.** Loss from operations for the three months ended June 30, 2005 was \$(154,845), compared to loss from operations for the three months ended June 30, 2004 of \$(123,656). The increase in loss from operations for the three months ended June 30, 2005 compared with loss from operations for the three months ended June 30, 2004 was due to a decrease in sales without a proportionate decrease in the cost of sales and general and administrative expenses.

**OTHER (INCOME) EXPENSE.** Other (income) expense was \$(35,303) for the three months ended June 30, 2005, as compared to \$59,022 for the three months ended June 30, 2004. This change was the result of additional income recognized on rent and export sales commissions received in the three months ended June 30, 2005.

**NET LOSS.** Net loss for three months ended June 30, 2005 was \$(119,542) compared to net loss of \$(182,678) for the three months ended June 30, 2004. The decrease in net loss was due to the reasons described above.

**SIX MONTHS ENDED JUNE 30, 2005 COMPARED WITH SIX MONTHS ENDED JUNE 30, 2004**

**NET SALES.** Net sales for the six months ended June 30, 2005 were \$4,892,716 compared to \$12,230,607 for the six months ended June 30, 2004. The decrease in net sales for the six months ended June 30, 2005 was due to a decrease in demand for our old products. Our new products, introduced in 2004, are in the early stages of selling.

**COST OF SALES.** Cost of sales for the six months ended June 30, 2005 was \$4,633,010 or 94.7% of net sales, as compared to \$11,297,569 or 92.4% of net sales, during the six months ended June 30, 2004. The decrease in cost of sales is associated with the decrease in sales. The decrease in our cost of sales as a percentage of net sales is attributable to a decrease in the sale price of our old products, which is due to increased competition in the market for our old products, while the cost of producing such products has remained constant.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses were \$699,386, or 14.3% of net sales, for the six months ended June 30, 2005, as

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compared to \$849,920 or 6.9% of net sales, for the six months ended June 30, 2004. The decrease was due to the decrease in sales and an associated decrease in related expenses. The increase in general and administrative expenses as a

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percentage of net sales is attributable to fixed overhead costs which remain constant for all levels of sales.

**INCOME (LOSS) FROM OPERATIONS.** Loss from operations for the six months ended June 30, 2005 was \$(439,680), compared to income from operations for the six months ended June 30, 2004 of \$83,118. The loss from operations for the six months ended June 30, 2005 compared with income from operations for the six months ended June 30, 2004 was due to a decrease in sales without a proportionate decrease in the cost of sales and general and administrative expenses.

**OTHER EXPENSE.** Other expense was \$703,748 for the six months ended June 30, 2005, as compared to \$73,219 for the six months ended June 30, 2004. This increase in other expense was the result of additional reserves made on accounts receivable and losses we incurred on the sale of fixed assets, offset by additional income recognized on rent and export sales commissions.

**NET LOSS.** Net loss for six months ended June 30, 2005 was \$(1,143,606) compared to income of \$(9,617) for the six months ended June 30, 2004. The net loss for the three months ended June 30, 2005 compared with income for the three months ended June 30, 2004 was due to the reasons described above, including the additional reserves made on accounts receivable.

### LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2005 and December 31, 2004, we had cash and cash equivalents of \$696,789 and \$2,010,644, respectively. Our current assets totaled \$4,710,189 at June 30, 2005 as compared to \$6,186,420 at December 31, 2004. Our total current liabilities were \$5,303,557 at June 30, 2005 as compared to \$6,656,116 at December 31, 2004. Working capital at June 30, 2005 was \$(593,368) and \$(469,696) at December 31, 2004. For the six months ended June 30, 2005, total cash used in operations was \$(734,411) as compared to net cash provided by operations of \$704,397 during the same period in 2004. Net cash used in financing activities was \$(678,702), which consisted of the payment on notes payable and issuance of short-term debt, as compared with net cash used in financing activities of \$(861,358) during the six months ended June 30, 2004.

We deployed a large amount of cash in the six months ended June 30, 2005 for developing new products. Therefore there is a deficiency in working capital at the end of such period. We have, however, increased the sales of our new products in the second quarter of 2005 as compared to the first quarter of 2005.

Our operations and short term financing does not currently meet our cash needs. We believe we will be able to generate revenues from sales and raise capital through private placement offerings of its equity securities to provide the necessary cash flow to meet anticipated working capital requirements. Our actual working capital needs for the long and short term will depend upon numerous factors, including our operating results, competition, and the availability of credit facilities, none of which can be predicted with certainty. Our future expansion will depend on operating results and will be limited by its ability to enter into financings and raise capital.

Our liquidity is currently dependent on our ability to strengthen our accounts receivable collection time period and our ability to continue to raise cash from financing sources to fund our expansion. Our short-term and long-term liquidity may be influenced by uncollected accounts receivables. If the amount

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of bad debt is high, it will severely affect our ability to continue operations. Therefore, we are taking precautions to manage this risk, including diversifying its customer base and controlling credit risk through credit approvals, credit limits and monitoring procedures. There can be no assurance that these measures will prove successful. Our inability to manage this risk will have a material adverse effect upon its business, financial condition and results of operations.

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**CAPITAL EXPENDITURES.** Total capital expenditures during the six months ended June 30, 2005 were \$194,717 compared to \$24,259 for the six months ended June 30, 2004. We currently have no plans or commitments for significant equipment acquisitions or capital expenditures.

### RECENT DEVELOPMENTS

On August 10, 2005, we entered into a Securities Purchase Agreement (the "Securities Purchase Agreement") with Highgate House Funds, Ltd. ("Highgate House"), a Standby Equity Distribution Agreement with Cornell Capital Partners, L.P. ("Cornell Capital"), an affiliate of Highgate House, and related agreements.

Under the terms of the Securities Purchase Agreement, we will issue secured convertible debentures (the "Notes") in the aggregate principal amount of \$250,000 to Highgate House. \$125,000 in principal amount of the Notes were issued on August 17, 2005 (the "First Closing Date"). \$125,000 in principal amount of the Notes will be issued at a later closing date.

Simultaneously with our entry into the Securities Purchase Agreement, we entered into the Standby Equity Distribution Agreement (the "SEDA") whereby we may, over twenty-four months after the date of the agreement, issue and sell our common stock to Cornell Capital in \$300,000 installments (each an "Advance") totaling up to \$15,000,000, subject to the terms of the SEDA. Our ability to issue and sell common stock pursuant to the SEDA remains subject to, and we intend to obtain, (1) the effectiveness of a registration statement covering such shares of common stock, (2) stockholder approval of the issuance of such shares of common stock, and (3) approval by the American Stock Exchange for the additional listing of such shares of common stock. Additionally, any availability under the SEDA will be subject to our continued compliance with the terms of the SEDA.

### OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

### ITEM 3. CONTROLS AND PROCEDURES

We maintain "disclosure controls and procedures," as such term is defined under Exchange Act Rule 13a-15(e), that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and in reaching a reasonable level of assurance our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. We have 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

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effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2005. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2005 our disclosure controls and procedures were effective at the reasonable assurance level in ensuring that material information relating to us, is made known to the Chief Executive Officer and Chief Financial Officer by others within our company during the period in which this report was being prepared.

There were no changes in our internal controls or in other factors during the most recent quarter that has materially affected, or is reasonably likely to materially affect, our internal controls over financial reporting.

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### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

##### HWA-CHING CO. AND RELATED LAWSUITS

In April 2004, Hwa-Ching Co. made purchases from City Network Inc.-Taiwan for products in the aggregate amount of approximately NT\$19 million or US\$575,757. In June 2004, Hwa-Ching Co. wrote a check to City Network Inc.-Taiwan paying for such products and City Network Inc.-Taiwan successfully cashed this check. Also in June 2004, Hwa-Ching Co. made purchases from City Network Inc.-Taiwan for additional products in the aggregate amount of approximately NT\$18 million or US\$545,454 and paid for such products with a check that City Network Inc.-Taiwan also successfully cashed.

During June to August 2004, Hwa-Ching Co. requested additional products from City Network Inc.-Taiwan in the aggregate amount of approximately NT\$27 million or US\$818,181. City Network Inc.-Taiwan filled these orders with confidence as Hwa-Ching had paid for the prior orders from April 2004 and June 2004. However, the check, in the amount of approximately NT\$27 million or US\$818,181 that Hwa-Ching Co. wrote to City Network, Inc.-Taiwan bounced upon deposit with the bank. Immediately thereafter, Hwa-Ching Co. closed down with this remaining account payable balance of approximately NT\$27 million or US\$818,181 outstanding and payable to City Network Inc.-Taiwan.

In August 2004, City Network Inc.-Taiwan filed a lawsuit against Yune-Chang Tsuo, the owner of Hwa-Ching Co., as well as the following eight individuals including, Yong-Zhang Zhuo, Shu-Tao Lu, Yong-Yi Zhuo, Zhuan-Xuan Dai, Ya-Hui Qiu, Mei-Zhen Huang, Zong-Ya Wu, Yao-Guo Cen in Taiwan Taipei district court of Taiwan, in Taipei, Taiwan, alleging fraud for closing down Hwa-Ching Co. without payment for the delivered merchandise. City Network Inc.-Taiwan sought approximately NT\$27 million or approximately US\$900,000 from Yune-Chang Tsuo to cover the outstanding account payable. To date, the court has not yet reached a verdict on this case.

##### RPPI INTERNATIONAL LTD.

As of June 21, 2005, City Network Inc.-Taiwan settled a litigation with RPPI International Ltd. (or Rong-Dian), a vendor of the Company.

On October 10, 2004, Rong-Dian filed a lawsuit against City Network Inc.-Taiwan in the Taiwan Taipei district court of Taiwan, in Taipei, Taiwan, alleging breach of contract for two different purchase agreements that City Network Inc.-Taiwan entered with them and two third-parties. Rong-Dian sought the aggregate amount of approximately NT\$40.2 million or US\$1.2 million for the alleged breaches. One purchase agreement was for an order that City Network Inc.-Taiwan sold to Hwa-Ching Co. in the amount of approximately NT\$27.3 million



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or US\$900,000 and the other purchase agreement was for an order City Network Inc.-Taiwan sold to a separate customer of the Company in the amount of approximately NT\$12.9 million or US\$390,909.

On June 21, 2005, City Network Inc.-Taiwan entered a settlement agreement with Rong-Dian and on June 29, 2005, the district court lifted the lawsuit against us. In the June 2005 settlement agreement, City Network Inc.-Taiwan agreed to pay Rong-Dian a total of approximately NT\$40.2 million or US\$1.2 million, to cover the full amount City Network Inc.-Taiwan owed under the two purchase agreements. In August 2005, City Network Inc.-Taiwan paid Rong-Dian approximately NT\$12.9 million or US\$390,909 of the total amount owed upon receipt of such amount from our customer. City Network Inc.-Taiwan intends to

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pay the balance of approximately NT\$27.3 million or US\$827,272 to Rong-Dian in 54 separate checks, issued and payable by Tai-Wang Technology Co., Ltd. These checks will be in increments of NT\$500,000 or US\$15,910 and payable for 53 consecutive months, beginning on August 10, 2005 with the last and 54th payment being in the amount of NT\$813,003 or US\$25,870 instead of NT\$500,000 or US\$15,910. To date, approximately NT\$2 million or approximately US\$60,000 was paid.

Pursuant to the June 2005 settlement agreement, City Network Inc.-Taiwan agreed to pay Rong-Dian the balance of NT\$27.3 million in monthly payments. However, as a result of its relationship with Tai-Wang and the fact that Tai-Wang is the vendor who introduced City Network Inc.-Taiwan to Rong-Dian, Tai-Wang assumed the responsibility for the payment of NT\$27.3 million or US\$827,272 to Rong-Dian. Tai-Wang wrote each monthly check in advance and thereafter provided all 54 checks to Rong-Dian. Rong-Dian will cash one check each month until it receives payment of the full NT\$27.3 million. However, as Tai-Wang has no written obligation with City Network Inc.-Taiwan to make each monthly payment, beyond an oral promise to do so, there is no assurance that each monthly check will be properly cashed by Rong-Dian.

Additionally, as part of the June 2005 settlement agreement, we secured our obligation that Tai-Wang would pay Rong-Dian the outstanding balance of NT\$27.3 million or US\$827,272 by giving Rong-Dian a first priority mortgage on certain property including lots 701-4 and 701-6 in Jay-hou-xiao-duan, Xi-zhi Duan, Xixhi City, Taipei County, Taiwan. The value of the first priority mortgage on the property is approximately NT\$27.3 million or US\$827,272, the aggregate amount owed to Rong-Dian. City Network Inc.-Taiwan agreed with Rong Dian that this mortgage will expire in 2010.

### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

### ITEM 5. OTHER INFORMATION

None.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

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(a) Exhibits:

- 10.1 Securities Purchase Agreement, dated as of August 10, 2005, by and between the Company and Highgate House Funds, Ltd. (the "Investor"). (1)
- 10.2 Standby Equity Distribution Agreement, dated as of August 10, 2005, by and between the Company and Cornell Capital Partners, L.P. ("Cornell Capital"). (1)
- 10.3 Investor Registration Rights Agreement, dated as of August 10, 2005, by and between the Company and the Investor. (1)
- 10.4 Security Agreement, dated as of August 10, 2005, by and between the Company and the Investor. (1)

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- 10.5 Security Agreement, dated as of August 10, 2005, by and between City Technology, Inc. ("CTI") and the Investor. (1)
- 10.6 Security Agreement, dated as of August 10, 2005, by and between City Network, Inc. - Taiwan and the Investor. (1)
- 10.7 Security Agreement, dated as of August 10, 2005, by and between City Construction Co. Ltd. and the Investor. (1)
- 10.8 Pledge and Escrow Agreement, dated as of August 10, 2005, by and among the Company, the Investor and David Gonzalez, Esq., as escrow agent. (1)
- 10.9 Secured Convertible Debentures, dated as of August 17, 2005, executed by the Company in favor of the Investor. (1)
- 10.10 Warrant, dated as of August 17, 2005, to purchase up to 25,000 shares of Common Stock, executed by the Company in favor of the Investor. (1)
- 10.11 Registration Rights Agreement, dated as of August 10, 2005, by and between the Company and Cornell Capital. (1)
- 10.12 Placement Agent Agreement, dated as of August 10, 2005 by and between the Company and Monitor Capital, Inc. (1)
- 31.1 Certifications of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
- 31.2 Certifications of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
- 32.1 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)

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(1) Incorporated herein by reference to the Registrant's Form 10-QSB filed with the SEC on August 22, 2005.

(2) Filed herewith.

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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.

CITY NETWORK, INC.

Dated: January 27, 2006

By: /s/ Tiao-Tsan Lai

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Tiao-Tsan Lai  
Chief Executive Officer  
(Principal Executive Officer)

Dated: January 27, 2006

By: /s/ Yun-Yi Tseng

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Yun-Yi Tseng  
Chief Financial Officer  
(Principal Financial Officer)