

Edgar Filing: CITY NETWORK INC - Form 10QSB

CITY NETWORK INC  
Form 10QSB  
November 29, 2006

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

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED: September 30, 2006

COMMISSION FILE NUMBER: 001-31954

CITY NETWORK, INC.  
(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, Chung Ho City  
Taipei County 235, Taiwan, ROC  
(Address of Principal Executive Offices)

011-886-2-8226-5566  
(Telephone Number)

Check whether the Issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to 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 .

As of November 28, 2006, there were 34,967,183 shares of common stock, par value \$0.001 per share, outstanding.

Transitional Small Business Disclosure Format (check one): Yes  No .

TABLE OF CONTENTS

PART I - FINANCIAL INFORMATION.....	3
Item 1. Financial Statements.....	3
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	27
Item 3. Controls and Procedures.....	31
PART II - OTHER INFORMATION.....	32
Item 1. Legal Proceedings.....	32
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds....	32

Edgar Filing: CITY NETWORK INC - Form 10QSB

Item 3. Defaults Upon Senior Securities.....	32
Item 4. Submission of Matters to a Vote of Security Holders.....	33
Item 5. Other Information.....	33
Item 6. Exhibits.....	33
SIGNATURES .....	34

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CITY NETWORK INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2006	December 31, 2005
	----- (Unaudited)	----- (As Adjusted)
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 41,429	\$ 853,964
Accounts receivable, net	851,702	4,341,218
Inventories	645,282	252,608
Other receivables	1,243,939	234,176
Prepayment	1,105,685	3,451,482
Short-term assets - discontinued operation	--	530,073
	-----	-----
TOTAL CURRENT ASSETS	3,888,037	9,663,521
	-----	-----
PROPERTY, PLANT AND EQUIPMENT	4,085,259	2,243,214
	-----	-----
OTHER ASSETS:		
Deposits	123,388	180,915
Cash held for compensating balances	--	1,380,992
Intangible assets	865,679	925,074
Deferred assets	334,585	148,208
Equity in net assets of affiliated company	728,769	790,842
Other assets - discontinued operation	--	322,664
	-----	-----
TOTAL OTHER ASSETS	2,052,421	3,748,695
	-----	-----
TOTAL ASSETS	\$10,025,717	\$15,655,430
	=====	=====

CITY NETWORK INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

Edgar Filing: CITY NETWORK INC - Form 10QSB

	September 30, 2006	December 31, 2005
	----- (Unaudited)	----- (As Adjusted)
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 1,269,906	\$ 1,342,037
Convertible note payable, net	--	250,000
Due to related party	1,199,083	1,131,494
Deferred revenue	8,083	3,027,079
Current portion, long-term debt	2,007,499	4,220,230
Short-term liabilities - discontinued operation	--	301,165
	-----	-----
TOTAL CURRENT LIABILITIES	4,484,571	10,272,005
	-----	-----
NON-CURRENT LIABILITIES:		
Convertible note payable, net	545,000	--
Long-term debt, net of current portion	3,532,466	572,668
	-----	-----
TOTAL NON-CURRENT LIABILITIES	4,077,466	572,668
	-----	-----
TOTAL LIABILITIES	8,562,037	10,844,673
	-----	-----
STOCKHOLDERS' EQUITY:		
Common stock, \$.001 par value, 100,000,000 shares authorized, 32,967,183 shares issued outstanding at June 30, 2006 and December 31, 2005	32,967	32,967
Additional paid in capital	6,282,979	6,157,479
Other comprehensive income	435,265	366,384
Accumulated deficit	(5,287,531)	(1,746,073)
	-----	-----
TOTAL CAPITAL AND RETAINED DEFICIT	1,463,680	4,810,757
Less: cost of treasury stock	--	--
	-----	-----
Total Stockholders' Equity	1,463,680	4,810,757
	-----	-----
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 10,025,717	\$ 15,655,430
	=====	=====

4

CITY NETWORK, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Three Months Ended September 30,		Nine Months
	----- 2006	----- 2005	----- 2006
	----- (As Adjusted)		
Sales, net	\$ 3,916,705	\$ 3,784,392	\$ 7,095,52

Edgar Filing: CITY NETWORK INC - Form 10QSB

Cost of sales	4,369,434	3,427,726	7,222,05
	-----	-----	-----
Gross Profit	(452,729)	356,666	(126,52
General and administrative expenses	1,046,465	483,047	1,892,87
	-----	-----	-----
Income (loss) from operations	(1,499,194)	(126,381)	(2,019,40
	-----	-----	-----
Other (Income) Expense			
Interest income	(19,133)	(3,543)	(20,31
Rental income	340	(46,575)	(61,72
Commission income	544	303	(98,75
(Gain) Loss on currency exchange	(68)	(1,346)	12,40
Other income	(1,601)	(31,938)	(117,61
Reserve for bad debt	1,220,630	(5,900)	1,258,17
Equity in earnings of investee	110,033	15,870	62,07
Loss on physical inventory	(234)	--	42,66
Miscellaneous	204,905	(3,704)	210,19
(Gain) Loss on sale of fixed assets	5	(679)	(71
Interest expense	49,338	22,934	171,29
	-----	-----	-----
Total other (income) expense	1,564,759	(54,578)	1,457,67
	-----	-----	-----
Income (Loss) before income taxes	(3,063,953)	(71,803)	(3,477,08
Provision for income taxes	--	161	--
	-----	-----	-----
Loss from continuing operation	(3,063,953)	(71,964)	(3,477,08
	-----	-----	-----
Income (Loss) from discontinued operation	10,983	(25,313)	31,27
Loss on disposal of discontinued operation	(95,653)	--	(95,65
	-----	-----	-----
Net loss	\$ (3,148,623)	\$ (97,277)	\$ (3,541,45
	=====	=====	=====
Income (Loss) per share - basic and diluted	\$ (0.11)	\$ --	\$ (0.1
	=====	=====	=====
Continuing operations - basic and diluted	\$ (0.11)	\$ --	\$ (0.1
	=====	=====	=====
Discontinued operation - basic and diluted	\$ --	\$ --	\$ --
	=====	=====	=====
Weighted average number of shares			
Basic	28,521,728	27,925,720	28,521,72
Diluted	28,521,728	27,925,720	28,521,72

Edgar Filing: CITY NETWORK INC - Form 10QSB

	Nine Months End
	-----
	2006
	-----
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net Income (Loss)	\$ (3,541,458)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Depreciation and amortization	143,084
Equity in earnings of investee	62,072
Bad debt	1,258,171
(Gain) Losses on disposal of fixed assets	(720)
Loss on physical inventory	42,660
Loss (Gain) on foreign currency exchange	--
(Income) Loss from discontinued operation	(31,275)
Loss on disposal of discontinued operation	95,653
Decrease (Increase) in receivables	2,273,493
Decrease (Increase) in other receivables	(995,120)
Decrease (Increase) in inventory	(445,297)
Decrease (Increase) in construction in progress	--
Decrease (Increase) in prepayment and other current assets	1,937,705
Increase (Decrease) in accounts payable and accrued expenses	419,506
(Decrease) Increase in deferred revenue	--
(Decrease) Increase in other liabilities	(3,102,747)
Cash provided by (used in) operating activities - discontinued operation	525,788
	-----
Total Adjustments	2,182,973
	-----
Net cash provided by (used in) operating activities	(1,358,485)
	-----
CASH FLOWS FROM INVESTING ACTIVITIES:	
Proceeds from disposal of investment	200,000
Proceeds from disposal of property, plant and equipment	42,608
Purchase on investment	--
Purchases of property, plant and equipment	(1,688,671)
Decrease (Increase) in deposit	57,452
Increase in short-term investments	--
Payment on deferred assets	(150,253)
Decrease in other assets	1,400,047
Cash used in operating activities - discontinued operation	(327,116)
	-----
Net cash provided by (used in) investing activities	(465,933)
	-----

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

Nine Months Ended Sep  
-----  
2006  
-----

Edgar Filing: CITY NETWORK INC - Form 10QSB

CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from short-term borrowings	\$ 3,871,909
Payment on notes payable	(6,101,032)
Payment of loan from related party	--
Loan from related party	406,920
Proceeds from long-term debts	3,025,514
	-----
Net cash provided by (used in) financing activities	1,203,311
	-----
Effect of exchange rate change on cash	(194,011)
Net change in cash and cash equivalents	(815,158)
	-----
Cash and cash equivalents at beginning of year	853,964
Cash and cash equivalents at beginning of year - discontinued operation	2,623
	-----
Cash and cash equivalents at end of year	\$ 41,429
	=====
Components of cash and cash equivalents, end of period	
From discontinued operation	\$ --
From continuing operations	41,429
Supplemental cash flows disclosures:	
Income tax payments	\$ --
	=====
Interest payments	\$ 146,506
	=====

7

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

	September 30, 2006	De
	-----	-----
	(Unaudited)	
Common stock, number of shares		
Balance at beginning of period	32,967,183	
Common stock issued	--	
	-----	
Balance at end of period	32,967,183	
	-----	
Treasury stock, number of shares		
Balance at beginning of period	4,445,455	
Treasury stock acquired	--	
	-----	
Balance at end of period	4,445,455	
	-----	
Common stock, par value \$.001		
Balance at beginning of period	\$ 32,967	

Edgar Filing: CITY NETWORK INC - Form 10QSB

Common stock issued	--
	-----
Balance at end of period	32,967
	-----
Additional paid in capital	
Balance at beginning of period	6,157,479
Issuance of stock	--
Deemed interest due to warrants issued related to convertible notes	125,500
	-----
Balance at end of period	6,282,979
	-----
Other comprehensive income	
Balance at beginning of period	366,384
Foreign currency translation	68,881
	-----
Balance at end of period	435,265
	-----
Retained earnings (deficits)	
Balance at beginning of period	(1,746,073)
Net income (loss)	(3,541,458)
	-----
Balance at end of period	(5,287,531)
	-----
Less: Cost of treasury stock	0
	-----
Total stockholders' equity at end of period	\$ 1,463,680
	=====

8

CITY NETWORK, INC. AND SUBSIDIARIES  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2006  
(UNAUDITED)

NOTE A - ORGANIZATION

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 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. Collectively the three corporations are referred to herein as the "Company".

The Company designs, manufactures and markets a comprehensive line of broadband communication and wireless Internet access products and solutions. Also, the broadband communication product line includes VOIP, GUI-based remote management and routing technology software packages for simplified setup, extensive network management and global network connectivity capabilities, home PNA and xDSL broadband access equipment, ADSL/VDSL ACCESS DEVICES, HPNA ACCESS DEVICES, FTTB (Fiber to the Building)

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

and FTTH (Fiber to the Home), PCMCIA cards and USB adapters. The other wireless Internet access solutions are used in both individual and corporate.

### NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### 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") 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 nine months ended September 30, 2006 and 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2006, 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 year ended December 31, 2005.

9

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

#### DISCONTINUED OPERATION

On August 31, 2006, the Company sold its 100% interest in City Construction, Inc by entered into an agreement with two individuals (the Buyer). The Company sold its 100% interest in City Construction to the buyer for \$200,000. The assets sold consisted primarily of cash, trade accounts receivable, short-term investments, construction-in-progress, and other current assets. The buyer also assumed all the outstanding debts of City Construction. The control of City Construction has been officially taken over by the Buyer based on the fact that the full amount of consideration of \$200,000 has been received by the Company, the application of changing ownership signed by both parties has been filed with a relevant government agency, and the share certificate of City Construction has been surrendered to the Buyer.

Under the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (FAS 144), the financial results of City Construction are classified as discontinued operations in the accompanying Consolidated Statements of Earnings for all periods presented.

Operating results of the discontinued operations which excluded loss on disposal were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net sales	\$ 269,408	\$ --	\$1,042,642	\$ --



Edgar Filing: CITY NETWORK INC - Form 10QSB

Total revenues	269,408	--	1,042,642	--
Pretax income	10,983	(25,313)	31,275	(75,938)

As of December 31, 2005, assets and liabilities of the Company's discontinued operations were classified as held for sales in the accompanying Consolidated Balance Sheet under the following captions: Short-term assets- discontinued operation, Long-term assets- discontinued operation, short-term liabilities- discontinued operation, and Long-term liabilities- discontinued operation. The discontinued assets and liabilities at December 31, 2005 were composed of as follows:

10

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

DISCONTINUED OPERATION (Continued)

	December 31, 2005
Short-term assets -- discontinued operation	-----
Cash	\$ 2,623
Trade receivables	29,892
Other receivables	7,128
Construction in progress	441,891
Prepayment	48,539
	-----
Total	530,073
Other assets -- discontinued operation	
Deposits	322,664
	-----
Total assets -- discontinued operation	\$852,737
	=====
Short-term liabilities -- discontinued operation	
Accounts payable and accrued expense	\$129,830
Deferred revenue	171,335
	-----
Total liabilities	\$301,165
	=====
The Company assessed the loss on disposal of discontinued operation as follows:	
Carrying value of investment in City Construction at August 30, 2006	\$295,653
Proceeds expected to receive	200,000
	-----
Disposal expense	0
	-----
Loss on disposal of discontinued operation	\$ 95,653
	=====

11

NOTE B - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

REVENUE RECOGNITION

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

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. Service income is recognized as the related services are provided pursuant to the terms of the service agreement.

### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of City Network, Inc., and its wholly owned subsidiaries City Network Technology, Inc. and its wholly owned subsidiaries, City Network, Inc. - Taiwan, collectively referred to within as the Company. All material intercompany accounts, transactions and profits have been eliminated in consolidation.

### FINANCIAL STATEMENT PRESENTATION

Certain changes to the 2005 financial statements have been made to conform to the 2006 financial statement format.

### RISKS AND UNCERTAINTIES

The Company is subject to substantial risks from, among other things, intense competition from the providers of broadband products, services and the telecommunication industry in general, other risks associated with financing, liquidity requirements, rapidly changing customer requirements, limited operating history, and the volatility of public markets.

### 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.

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

### USE OF ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make certain

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

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

### ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company has made an allowance for doubtful accounts for trade receivables based on a combination of write-off history, aging analysis, and any specific known troubled accounts.

### 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 charged to expense as incurred. Depreciation is provided on the straight-line method over the estimated useful lives of the assets, or the remaining term of the lease, as follows:

Furniture and Fixtures	5 years
Equipment	5 years
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 nine months period ended September 30, 2006. 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.

### EXCHANGE GAIN (LOSS)

As of September 30, 2006 and 2005, the transactions of City Network, Inc. - Taiwan and City Construction 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.

13

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

### TRANSLATION ADJUSTMENT

The accounts of City Network, Inc.- Taiwan was maintained, and its financial statements were expressed, in New Taiwan Dollars (NTD). Such financial statements were translated into U.S. Dollars (USD) in accordance SFAS No. 52, "Foreign Currency Translation", with the NTD as the functional

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

currency. According to the Statement, 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 a component of shareholders' equity.

As of September 30, 2006 and December 31, 2005 the exchange rates between NTD and the USD were NTD\$1=USD\$0.03023 and NTD\$1=USD\$0.03044, respectively. The weighted-average rates of exchange between NTD and USD were NTD\$1=USD\$0.03086 and NTD\$1=USD\$0.03117 for the period (year) ended September 30, 2006 and December 31, 2005, respectively. Total translation adjustment recognized as of September 30, 2006 and December 31, 2005 is \$435,265 and \$366,384, respectively.

### FAIR VALUE OF FINANCIAL INSTRUMENTS

Our Company measures its financial assets and liabilities in accordance with generally accepted accounting principles. For certain of the Company's financial instruments, including accounts receivable (trade and related party), notes receivable and accounts payable (trade and related party), and accrued expenses, the carrying amounts approximate fair value due to their short maturities. The amounts owed for long-term debt and revolving credit facility also approximate fair value because interest rates and terms offered to the Company are at current market rates.

### STATEMENT OF CASH FLOWS

In accordance with SFAS No. 95, "Statement of Cash Flows", cash flows from the Company's operations are based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows will not necessarily agree with changes in the corresponding balances on the balance sheet.

### CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk are accounts receivable and other receivables arising from its normal business activities. The Company has a diversified customer base. The Company controls credit risk related to accounts receivable through credit approvals, credit limits and monitoring procedures. The Company routinely assesses the financial strength of its customers and, based upon factors surrounding the credit risk, establishes an allowance, if required, for un-collectible accounts and, as a consequence, believes that its accounts receivable credit risk exposure beyond such allowance is limited.

### INVENTORY

Inventory is valued at the lower of cost or market. Cost is determined on the weighted average method. As of September 30, 2006, inventory consisted only of finished goods.

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

### PRODUCT WARRANTIES

The Company estimates its warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products

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

under warranty. Future costs for warranties applicable to revenue recognized in the current period are charged to cost of revenue. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligation based on anticipated expenditures over the balance of the obligation period. Adjustments are made when accrual warranty claim experience differs from estimate.

### LONG-TERM EQUITY INVESTMENTS

Long-term equity investments are accounted for by the equity method when the Company and its subsidiaries owns 20% or more of the investee's voting shares, or less than 20% of investee's voting shares but is able to exercise significant influence over the investee's operation and financial policies, but not more than 50%. All other long-term equity investments are accounted for by either the lower-of-cost-or-market method or cost method.

For long-term equity investments accounted for under the equity method related to investee's that are publicly listed companies, unrealized losses resulting from declines in the market value below cost are recorded as a separate component of stockholders' equity.

For long-term equity investments in non-listed companies accounted for under the cost method, investments are stated at original cost. A write-down of the investment balance to earnings is taken only if it is determined that there is a permanent decline in the investment's value. Stock dividends do not result in the recognition of investment income.

For long-term equity investments accounted for by the equity method, the investment is initially recorded at cost, then reduced by dividends and increased or decreased by investor's proportionate share of the investee's net earnings or loss.

### CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investments purchased with initial maturities of three months or less to be cash equivalents.

### ADVERTISING

Advertising costs are expensed in the year incurred.

15

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

### INCOME TAXES

Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements.

Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in SFAS No. 109, "Accounting for Income Taxes". As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

### DEFERRED OFFERING COSTS AND DISCOUNT TO CONVERTIBLE NOTES

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

The Company accounts for offering cost incurred in the private placements as deferred expense and amortizes it over the economic life of these convertible notes. In accordance with APB No. 14, the Company accounts for the fair value of warrants and beneficial conversion feature resulting from issuing convertible notes as discount to these convertible notes and amortizes the discount over the economic life of these convertible notes.

### EARNINGS PER SHARE

The Company uses SFAS No. 128, "Earnings Per Share", for calculating the basic and diluted earnings (loss) per share. Basic earnings (loss) per share are computed by dividing net income (loss) attributable to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share are computed similar to basic earnings per share except that the denominator is increased to include common stock equivalents, if any, as if the potential common shares had been issued.

### IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF

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 were 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.

### NEW ACCOUNTING PRONOUNCEMENTS

In July 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 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. This

16

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

#### NEW ACCOUNTING PRONOUNCEMENTS (Continued)

Interpretation is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The company is currently evaluating the provisions of FIN 48.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurement, which provides guidance for applying the definition of fair value to various accounting pronouncements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the provisions of SFAS 157.

In September 2006, the FASB also issued SFAS No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS 158 amends SFAS 87, 88, 106, and 132R, and requires employers to recognize the overfunded or underfunded status of defined benefit postretirement plans as an asset or liability in its statement of financial position. SFAS No. 158

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

is effective as of the end of fiscal years ending after December 15, 2006. SFAS 158 is not applicable to the Company, as it does not have a defined benefit pension plan.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin 108 ("SAB 108"), Considering the Effect of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements, that addresses how uncorrected errors in previous years should be considered when quantifying errors in the current year financial statements. SAB 108 is effective for fiscal years ending November 15, 2006 and, upon adoption, companies are allowed to record the effects as a cumulative-effect adjustment to retained earnings. The Company will adopt SAB 108 for its fiscal year ending December 31, 2006 and is assessing what impact, if any, the adoption of SAB 108 will have on its financial position and results of operations.

### NOTE C - CONCENTRATION

The Company had two major customers during the nine months ended September 30, 2006. Sales to these customers were approximately \$4,729,821. Those customers comprise 67% of the total sales during the nine months ended September 30, 2006. Included in accounts receivable is approximately \$1,510,549 from these customers as of September 30, 2006.

### NOTE D - CASH

The Company maintains its cash balances at various banks in Taiwan. The balances are insured by the Central Deposit Insurance Corporation (CDIC) up to approximately \$30,230. As of September 30, 2006, there was \$0 in uninsured balances held at these banks.

17

### NOTE E - FIXED ASSETS

Fixed assets consist of the following:

	September 30, 2006	December 31, 2005
Land	\$ 3,258,939	\$ 1,909,023
Building and improvements	584,180	--
Other equipment	481,374	525,077
	\$ 4,324,493	\$ 2,434,100
Accumulated depreciation	(239,234)	(190,886)
	\$ 4,085,259	\$ 2,243,214

### NOTE F - INTANGIBLE ASSETS

Intangible assets consist of the following:

	September 30, 2006	December 31, 2005
Trademarks	\$ 2,207	\$ 2,222
Intangible asset	1,058,050	1,065,400
	\$ 1,055,843	\$ 1,067,622

Edgar Filing: CITY NETWORK INC - Form 10QSB

Accumulated amortization	(190,164)	(142,548)
	-----	-----
	\$ 865,679	\$ 925,074
	=====	=====

NOTE G - COMMITMENTS

Operating Leases - The Company leases office facilities under operating leases that terminate on various dates. Rental expense for these leases consisted of \$24,815 for the nine months ended September 30, 2006. The Company has future minimum lease obligations as follows:

Twelve-month ended September 30,	Amount
-----	-----
2007	\$27,207
	-----
Total	\$27,207
	=====

18

NOTE H - 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 September 30, 2006, the Company recognized a loss of \$62,072 from their acquisition.

NOTE I - COMPENSATED ABSENCES

Employees earn annual vacation leave at the rate of seven (7) days per year for the first three years. Upon completion of the third year of employment, employees earn annual vacation leave at the rate of ten (10) days per year for years four through five. Upon completion of the fifth year of employment, employees earn annual vacation leave at the rate of fourteen (14) days per year for years six through ten. Upon completion of the tenth year of employment, one (1) additional day for each additional year, until it reaches thirty (30) days per year. At termination, employees are paid for any accumulated annual vacation leave. As of September 30, 2006 vacation liability existed in the amount of \$0.

NOTE J - INCOME TAXES

Total Federal and State income tax expense for the nine months ended September 30, 2006 and 2005 were both amounted to \$0. For the nine months ended September 30, 2006 and 2005, there is no difference between the federal statutory tax rate and the effective tax rate.

The following is a reconciliation of income tax expense:

09/30/06	U.S.	State	International	Total
-----	-----	-----	-----	-----
Current	\$ 0	\$ 0	\$ 0	\$ 0
Deferred	0	0	0	0
	-----	-----	-----	-----



Edgar Filing: CITY NETWORK INC - Form 10QSB

Total	\$ 0	\$ 0	\$ 0	\$ 0
	=====	=====	=====	=====
09/30/05	U.S.	State	International	Total
-----	-----	-----	-----	-----
Current	\$ 0	\$ 0	\$ 178	\$ 178
Deferred	0	0	0	0
-----	-----	-----	-----	-----
Total	\$ 0	\$ 0	\$ 178	\$ 178
	=====	=====	=====	=====

19

NOTE J - INCOME TAXES (Continued)

Reconciliation of the differences between the statutory U.S. Federal income tax rate and the effective rate is as follows:

	09/30/06	09/30/05
	-----	-----
Federal statutory tax rate	34%	34%
State, net of federal benefit	0%	0%
	-----	-----
Effective tax rate	34%	34%
	=====	=====

NOTE K - OTHER COMPREHENSIVE INCOME

Balances of related after-tax components comprising accumulated other comprehensive income (loss), included in stockholders' equity, at September 30, 2006 and December 31, 2005 are as follows:

	Foreign Currency Translation Adjustment	Accumulated Other Comprehensive Income
	-----	-----
Balance at December 31, 2004	\$142,453	\$142,453
Change for 2005	\$223,931	\$223,931
	-----	-----
Balance at December 31, 2005	\$366,384	\$366,384
Change for 2006	\$ 68,881	\$ 68,881
	-----	-----
Balance at September 30, 2006	\$435,265	\$435,265
	=====	=====

NOTE L - CONVERTIBLE NOTES

On June 30, 2006, the Company sold a \$400,000 convertible promissory note to Cornell Capital Partners, LP. The notes bears interest at 7% per annum and will mature two years after issuance. A 20% redemption premium on the principal amount of the Notes is due when they are redeemed, if the closing bid price of the common stock is less than the Fixed Conversion Price. The notes are convertible into Common Stock based on at the lower of (a) \$0.268 per share or (b) ninety-five percent (95%) of the lowest volume weighted average price of the Common Stock, as reported by Bloomberg, LP, for the thirty (30) trading days preceding the conversion. The Company bears \$247,550 of selling expenses. For the nine months ended September 30, 2006, the amortization of deferred offering cost was \$30,944.

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

In connection with this transaction, the Company issued to Cornell Capital Partners, LP a five-year warrant to purchase 1,000,000 shares of Common Stock at an exercises price of \$0.001 per share. The Company estimated the fair value of the warrants attached to the promissory note at \$120,000 by using Black-Scholes option pricing model. In accordance with EITF 00-27, the Company allocated the fair value of \$120,000 to the warrants issued and the fair value of \$280,000 to the convertible notes in accordance with relative fair value method. Based on the fair value of \$280,000, the Company recognized the beneficial conversion feature of \$0 in accordance

20

### NOTE L - CONVERTIBLE NOTES (Continued)

with the market price of the Company's common stock on each issuing date. Consequently, the convertible note of \$400,000 had a total discount of \$120,000. As of September 30, 2006, \$15,000 of the discount related to warrant and \$0 of discount related to beneficial conversion feature have been amortized.

On June 30, 2006, the Company amended and reissued the convertible notes (Original Notes) originally issued to Highgate House Funds, Ltd on August 17, 2005 and December 16, 2005 in the aggregate principal amount of \$250,000. Each note bears interest at 7% per annum and will mature two years after issuance.

The above notes are secured by substantially all of the assets of the Company and its direct and indirect wholly-owned subsidiaries, City Technology, Inc., City Network, Inc.--Taiwan and City Construction Co., Ltd. The Company is currently in default of this security agreement (see Note M).

### NOTE M - CONVERTIBLE NOTES SECURITY AGREEMENT DEFAULT

On June 30, 2006, the Company sold a \$400,000 convertible promissory note to Cornell Capital Partners, LP, and amended and reissued the convertible notes originally issued to Highgate House Funds, Ltd on August 17, 2005 and December 16, 2005 in the aggregate principal amount of \$250,000 (Note L). These notes are secured by substantially all of the assets of the Company and its direct and indirect wholly-owned subsidiaries, City Technology, Inc., City Network, Inc.--Taiwan and City Construction Co., Ltd. However, on August 31, 2006, the Company sold its 100% interest in City Construction, Inc. without consent of the note holders. Based on the security agreement in connection with the above convertible notes, the note holders are entitled to receive all distribution with respect to the pledged property. As of September 30, 2006, and the date of this report, no such demand has been made.

### NOTE N - SHARE-BASED PAYMENTS

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R. The Company recognized the share-based compensation cost based on the grant-date fair value estimated in accordance with the new provisions of SFAS No. 123R. As of September 30, 2006, the Company had outstanding warrants totaling 1,025,000 with an exercise price of \$0.001 per share.

The fair value for the share-based awards was estimated using the Black-Scholes option pricing model with the assumptions listed below:

September 30,

-----

Edgar Filing: CITY NETWORK INC - Form 10QSB

	2006 ----	2005 ----
Expected volatility	47.66 - 81.79%	--%
Weighted average volatility	47.66 - 81.79%	--%
Expected life (years)	3.0 - 5.0	--
Risk free interest rate	3.55 - 4.69%	--%

21

NOTE N - SHARE-BASED PAYMENTS (Continued)

A summary of stock warrants for the nine months ended September 30, 2006 is presented as follows:

Stock Warrants -----	Shares -----	Weighted- Average Exercise Price -----	Weighted- Average Remaining Contractual Term (Months) -----	Aggregat Intrinsic (Values) -----
Outstanding at January 1, 2006	25,000	\$ 0.001	19.33	
Granted	1,000,000	0.001	60.00	
Exercised	--			
Forfeited or expired	--			
-----	-----	-----	-----	-----
Outstanding at September 30, 2006	1,025,000	0.001	56.00	\$121,975
=====	=====	=====	=====	=====
-----	-----	-----	-----	-----
Exercisable at September 30, 2006	1,025,000	\$ 0.001	56.00	\$121,975
=====	=====	=====	=====	=====

NOTE O - DEBT

At September 30, 2006 and December 31, 2005, the Company had notes payable outstanding in the aggregate amount of \$5,539,965 and \$ 4,792,898, respectively. The notes are secured by the Company real properties and time deposits. Payable as follows:

September 30, 2006 -----	December 31, 2005 -----
Note payable to a bank in Taiwan, interest at 4.022% per annum, due on demand.	Note payable to a bank in Taiwan interest at 3.838% per annum, due by October 8, 2006
\$ 2,007,499	
Note payable to a bank in Taiwan, interest at 3.30% per annum, due by April 4, 2021	Note payable to a bank in Taiwan interest at 3.838% per annum, due by August 31, 2006
1,541,730	
Note payable to a bank in Taiwan, interest at 4.200% per annum, due by January 24, 2012	Note payable to a bank in Taiwan interest at 5.906% per annum, due by September 28, 2006
1,512,709	
Note payable to a corporation in Taiwan, no interest, due by February 10, 2010	Note payable to a bank in Taiwan interest at 3.838% per annum, due by January 27, 2006
478,027	

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by February 3, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by February 3, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by February 17, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by February 21, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by February 25, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by March 3, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by March 24, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by April 1, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by April 21, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by April 28, 2006

Note payable to a bank in Taiwan  
interest at 3.838% per annum, du  
by January 17, 2006

Note payable to a corporation i  
Taiwan, no interest, due b  
February 10, 2010

Total	----- \$ 5,539,965
Current portion	\$ 2,007,499 -----
Long-term portion	\$ 3,532,466 =====

NOTE P - RELATED PARTY TRANSACTIONS

Throughout the history of the Company, certain members of the Board of Directors and general management have made loans to the Company to cover operating expenses or operating deficiencies:

Alice Chen - As of September 30, 2006, the Company has a non interest-bearing loan from Alice Chen, a shareholder of the Company, in the amount of \$232,769.

Stella Tseng - As of September 30, 2006, the Company has a non interest-bearing loan from Stella Tseng, a shareholder of the Company, in the amount of \$966,314.

NOTE Q - FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash and cash equivalents, accounts receivable, deposits and accounts payable approximate their fair value because of the short maturity of those instruments.

The carrying amounts of the Company's long-term debt approximate their fair value because of the short maturity and/or interest rates which are comparable to those currently available to the Company on obligations with similar terms.

NOTE R - LEGAL PROCEEDINGS

The Company is party to certain litigation that has arisen in the normal course of its business and that of its subsidiary.

Hwa-Ching - In August 2004, a customer closed business and did not pay the remaining balance due to City Network - Taiwan on outstanding receivables in the amount of NT\$27,313,003 or US\$837,690. City Network - Taiwan has filed criminal and civil litigation against the customer for fraud. The Company has recorded a reserve against this account in the amount of \$660,538. This case is currently ongoing.

In August 2004, City Network Inc.-Taiwan filed a lawsuit against the owner of Hwa-Ching Co., as well as the following eight individuals in 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\$830,000. In January 27 2006, the court reached a verdict and found three individuals guilty of fraud and another two individual not guilty. In connection to the litigation against the other three individuals, the court has not yet reached a verdict.

In December 2004, the Company filed a lawsuit against Tain-Kang Co., a customer of Hwa-Ching Co. in Taipei District Court claiming damages owed to Hwa-Ching from Tain-Kang in the amount of approximately NT\$5,796,000 or US\$178,169 to cover the outstanding account payable owed by Hwa-Ching to the Company. In November 2005, Taipei District Court reached the judgment in favor of defendant. The Company filed appeal to Taiwan High Court. During the appeal, the Company reduced the claimed amount to NT\$3,796,000 or US\$116,689 due to Tain-Kang has provided the proof of payments of NT\$2,000,000 in the court. To date, the court has not yet reached a verdict on this case.

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

### NOTE R - LEGAL PROCEEDINGS (Continued)

On October 10, 2004, RPPI International Ltd. (or Rong-Dian), a vendor of the Company, 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 or US\$840,000 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\$396,546.

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\$840,000 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\$15,370 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\$24,992 instead of NT\$500,000 or US\$15,370. As of September 30, 2006, approximately NT\$5 million, or approximately US\$151,150, 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.

### NOTE R - LEGAL PROCEEDINGS (Continued)

Shanghai Bank - On January 24, 2005, Shanghai Commercial and Savings Bank

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

("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.

On November 24, 2005, the Company entered a settlement agreement with Shanghai Bank and the district court lifted the lawsuit against the Company. In the settlement agreement, the City Network Inc.- Taiwan agreed to pay Shanghai Bank a total of NT\$5,100,000 or US\$ 155,244. In December 2005, City Network, Inc.- Taiwan paid Shanghai Bank NT\$1,100,000 or US\$33,484. City Network, Inc.- Taiwan intends to pay the balance of NT\$4,000,000 or US\$121,760 to Shanghai Bank in 4 separate checks. These checks will be payable for each 2 months, beginning on February 25, 2006. As of September 30, 2006, NT\$4,100,000 or US \$123,943 has been paid on this liability.

### NOTE S - GOING CONCERN

The Company has suffered recurring losses from operations, cash deficiencies and the inability to meet its maturing obligations without borrowing from related parties and 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 engaged in discussions with a number of companies regarding strategic acquisitions or potential financings. Although these discussions are ongoing, there can be no assurance that any of these discussions will result in actual acquisitions or a completed financing for the Company.

26

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

### 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;

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

- \* 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.

27

### BACKGROUND OF THE COMPANY

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 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. Collectively, the three corporations are referred to herein as the "Company".

The Company designs, manufactures and markets a comprehensive line of broadband communication and wireless Internet access product and solutions. Also, the broadband communication product line includes VOIP, GUI-based remote management and routing technology software packages for simplified setup, extensive network management and global network connectivity capabilities, Home PNA and xDSL broadband access equipment, ADSL/VDSL ACCESS DEVICES, HPNA ACCESS DEVICES, FTTB (Fiber to the Building) and FTTH (Fiber to the Home), PCMCIA cards and USB adapters. The other wireless internet access solutions are used in both individual and corporate settings.

The Company has also focused on the sales of LCD panels, LCD TVs/ Monitor and other LCD products, and some the LCD TVs/Monitors got the approved from customers, will be start the business next year..

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

We have suffered recurring losses from operations, cash deficiencies and



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

the inability to meet our maturing obligations without borrowing from related parties and restructuring debts. These issues may raise substantial concern about our ability to continue as a going concern.

We are currently engaged in discussions with a number of companies regarding strategic acquisitions or potential financings. Although these discussions are ongoing, there can be no assurance that any of these discussions will result in actual acquisitions or a completed financing for us.

### 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.

28

### RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED WITH THREE MONTHS ENDED SEPTEMBER 30, 2005

**NET SALES.** Net sales for the three months ended September 30, 2006 were \$3,916,705 compared to \$3,784,392 for the three months ended September 30, 2005. The increase in net sales for the three months ended September 30, 2006 was due to an increase in the sales to Vietnam.

**COST OF SALES.** Cost of sales for the three months ended September 30, 2006 was \$4,369,434 or 111.5% of net sales, as compared to \$3,427,726 or 90.6% of net sales, during the three months ended September 30, 2005. The increase was due to the increase of net sales. The increase in the cost of sales as a percentage of revenue was due to decreased sales of higher-margin products.

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses were \$1,046,465 or 26.7% of net sales, for the three months ended September 30, 2006, as compared to \$483,047 or 12.8% of net sales, for the three months ended September 30, 2005. The increase was due to an increase in consulting fees for the construction project in Vietnam. The increase in general and administrative expenses as a percentage of net sales is due to the increase in consulting fees for a construction project in Vietnam.

**LOSS FROM OPERATIONS.** Loss from operations for the three months ended September 30, 2006 was \$(1,499,194), compared to loss from operations for the three months ended September 30, 2005 of \$(126,381). The increase in loss from operations for the three months ended September 30, 2006 compared with loss from operations for the three months ended September 30, 2005 resulted primarily from reasons primarily described above.

**OTHER (INCOME) EXPENSE.** Other (income) expense was \$1,564,759 for the three months ended September 30, 2006, as compared to \$(54,578) for the three months ended September 30, 2005. This change was the reserve for bad debt and late payment penalty charged by bank.

**NET LOSS.** Net loss for three months ended September 30, 2006 was \$(3,148,623) compared to net loss of \$(97,277) for the three months ended

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

September 30, 2005. The decrease in net loss was due to the reasons described above.

NINE MONTHS ENDED SEPTEMBER 30, 2006 COMPARED WITH NINE MONTHS ENDED SEPTEMBER 30, 2005

**NET SALES.** Net sales for the nine months ended September 30, 2006 were \$7,095,525 compared to \$8,677,108 for the nine months ended September 30, 2005. The decrease in net sales for the nine months ended September 30, 2006 was due to a decrease in demand for our products.

**COST OF SALES.** Cost of sales for the nine months ended September 30, 2006 was \$7,222,052 or 101.8% of net sales, as compared to \$8,060,736 or 92.9% of net sales, during the nine months ended September 30, 2005. The decrease in cost of sales is associated with the decrease in sales. The increase in the cost of sales as a percentage of revenue was due to decreased sales of higher-margin products.

29

**GENERAL AND ADMINISTRATIVE EXPENSES.** General and administrative expenses were \$1,892,877, or 26.7% of net sales, for the nine months ended September 30, 2006, as compared to \$1,131,776, or 13.0% of net sales, for the nine months ended September 30, 2005. The increase was due to an increase in consulting fee for the construction project in Vietnam. The increase in general and administrative expenses as a percentage of net sales is due to the increase in consulting fee for the construction project in Vietnam.

**LOSS FROM OPERATIONS.** Loss from operations for the nine months ended September 30, 2006 was \$(2,019,404), compared to income from operations for the nine months ended September 30, 2005 of \$(515,404). The loss from operations for the nine months ended September 30, 2006 compared with income from operations for the nine months ended September 30, 2005 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 \$1,457,676 for the nine months ended September 30, 2006, as compared to \$649,202 for the nine months ended September 30, 2005. This change was the result of the reserve for bad debt and late payment penalty charged by bank.

**NET LOSS.** Net loss for nine months ended September 30, 2006 was \$(3,541,458) compared to income of \$(1,240,883) for the nine months ended September 30, 2005. The net loss for the nine months ended September 30, 2006 compared with income for the nine months ended September 30, 2005 was due to the reasons described above.

### LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2006 and December 31, 2005, we had cash and cash equivalents of \$41,429 and \$853,964, respectively. Our current assets totaled \$3,888,037 at September 30, 2006 as compared to \$9,663,521 at December 31, 2005. Our total current liabilities were \$4,484,571 at September 30, 2006 as compared to \$10,272,005 at December 31, 2005. Working capital at September 30, 2006 was \$(596,534) and \$(608,484) at December 31, 2005. For the nine months ended September 30, 2006, total cash used in operations was \$(1,358,485) as compared to net cash used in operations of \$(1,845,454) during the same period in 2005. Net cash provided by financing activities was \$1,203,311, which consisted of loans, as compared with net cash provided by financing activities of \$1,600,914 during the nine months ended September 30, 2005.

### WORKING CAPITAL REQUIREMENTS

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

Our operations and short term financing do not currently meet our cash needs. We 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. Several potential investors have already shown their interest to invest in our company.

### FACTORS THAT INTERRUPT OUR OPERATIONS

Our major risk is incurring a large amount of bad debt. Our short-term and long-term liquidity may be influenced by uncollected account receivables. If the amount of bad debt is high, it will severely affect our ability to continue

30

operations. Therefore, we are taking precautions to manage this risk, such as preparing accounts receivable aging reports each week and collecting the overdue invoices. We will try to diversify our customer base and control credit risk related to accounts receivable through credit approvals, credit limits and monitoring procedures. Although we have already taken these measures, it is still possible to incur a large amount of bad debt.

Financial instruments that potentially subject us to concentrations of credit risk are cash, accounts receivable and other receivables arising from its normal business activities. We place our cash in what we believe to be credit-worthy financial institutions. We have a diversified customer base, most of which are related parties. We control credit risk related to accounts receivable through credit approvals, credit limits and monitoring procedures. We routinely assess the financial strength of its customers and, based upon factors surrounding the credit risk, establish an allowance, if required, for un-collectible accounts and, as a consequence, believe that our accounts receivable credit risk exposure beyond such allowance is limited.

**CAPITAL EXPENDITURES.** Total capital expenditures during the nine months ended September 30, 2006 were \$1,688,671 compared to \$193,310 for the nine months ended September 30, 2005.

### OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

### ITEM 3. CONTROLS AND PROCEDURES

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and the Chief Financial Officer, the Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report (the "Evaluation Date"). Based on this evaluation, our Chief Executive Officer and the Chief Financial Officer concluded as of the Evaluation Date that the Company's disclosure controls and procedures were effective such that the material information required to be included in our SEC reports is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms relating to the Company, including our consolidating subsidiaries, and was made known to them by others within those entities, particularly during the period when this report was being prepared.

31

### PART II - OTHER INFORMATION

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

### 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.

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

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

On June 30, 2006, the Company sold a \$400,000 convertible promissory note to Cornell Capital Partners, LP, and amended and reissued the convertible notes originally issued to Highgate House Funds, Ltd on August 17, 2005 and December 16, 2005 in the aggregate principal amount of \$250,000. These notes are secured by substantially all of the assets of the Company and its direct and indirect wholly-owned subsidiaries, City Technology, Inc., City Network, Inc.--Taiwan and City Construction Co., Ltd. However, on August 31, 2006, the Company sold its 100% interest in City Construction, Inc. without consent of the note holders. Based on the security agreement in connection with the above convertible notes, the note holders are entitled to receive all distribution with respect to the pledged property. As of September 30, 2006, and the date of this report, no such demand has been made.

32

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

None.

### ITEM 5. OTHER INFORMATION

None.

Edgar Filing: CITY NETWORK INC - Form 10QSB

ITEM 6. EXHIBITS

(a) Exhibits:

No. ---	Description -----
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, filed herewith.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350 (Section 906 of the Sarbanes-Oxley Act of 2002), filed herewith.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350 (Section 906 of the Sarbanes-Oxley Act of 2002), filed herewith.

33

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: November 29, 2006

By: /s/ Alice Chen

-----  
Alice Chen  
Chief Executive Officer  
(Principal Executive Officer)

Dated: November 29, 2006

By: /s/ Yun-Yi Tseng

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

34