

CHINA AUTOMOTIVE SYSTEMS INC
Form 10-Q
May 10, 2006

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

FORM 10-Q

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

For the quarterly period ended March 31, 2006

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

For the transition period from _____ to _____

Commission file number: 000- 33123

China Automotive Systems, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

33-0885775

(IRS employer identification number)

**No. 1 Henglong Road, Yu Qiao Development Zone, Shashi District,
Jing Zhou City, Hubei Province, People's Republic of China**

(Address of principal executive offices)

Issuer's telephone number: (86) 716- 832- 9196

Issuer's fax number: (86) 716- 832-9298

Not Applicable

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

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

YesNo

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

YesNo

As of March 31, 2006, the Company had 23,237,406 shares of common stock issued and outstanding.

CHINA AUTOMOTIVE SYSTEMS, INC.

INDEX

| | <u>Page</u> |
|--|-------------|
| Part I Financial Information | |
| Item 1. <u>Financial Statements</u> | 3 |
| <u>Condensed Consolidated Statements of Operations (Unaudited) for the Three Months Ended March 31, 2006 and 2005</u> | 3 |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited) for the Three Months Ended March 31, 2006 and 2005</u> | 4 |
| <u>Condensed Consolidated Balance Sheets at March 31, 2006 (Unaudited) and December 31, 2005</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the Three Months Ended March 31, 2006 and 2005</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited) for the Three Months Ended March 31, 2006 and 2005</u> | 8 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 27 |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 39 |
| Item 4. <u>Controls and Procedures</u> | 40 |
| Part II Other Information | |
| Item 1. <u>Legal Proceedings</u> | 41 |
| Item 1A. <u>Risk Factors</u> | 41 |
| Item 6. <u>Exhibits</u> | 51 |
| <u>Signatures</u> | 52 |

PART 1 FINANCIAL INFORMATION

Item 1. Financial Statements

China Automotive Systems, Inc.

Condensed Consolidated Statements of Operations (Unaudited)

| | Three Months Ended March 31 | |
|---|--------------------------------|---------------|
| | 2006 | 2005 |
| Net sales from continued operations, including \$583,539 and \$454,925 to related parties at March 31, 2006 and December 31, 2005, respectively | \$ 20,964,452 | \$ 13,976,450 |
| Cost of sales, including \$655,995 and \$405,756 purchased from related parties at March 31, 2006 and December 31, 2005, respectively | 14,019,255 | 8,946,109 |
| Gross profit | 6,945,197 | 5,030,341 |
| Costs and expenses: | | |
| Selling expenses | 909,852 | 674,068 |
| General and administrative expenses (Note 15) | 2,620,174 | 1,770,285 |
| R&D expenses (Note 15) | 189,747 | 357,709 |
| Depreciation and amortization (Note 15) | 688,490 | 614,821 |
| Total costs and expenses | 4,408,263 | 3,416,883 |
| Income from operations | 2,536,934 | 1,613,458 |
| Other income (expenses): | | |
| Other non-operating income | 83,340 | 25,319 |
| Financial expenses | (334,386) | (283,233) |
| Other income (loss), net | (251,046) | (257,914) |
| Income before income taxes | 2,285,888 | 1,355,544 |
| Income taxes | 200,711 | 250,962 |
| Income before minority interests | 2,085,177 | 1,104,582 |
| Minority interests | 990,779 | 238,399 |
| Net income | \$ 1,094,398 | \$ 866,183 |
| Basic | \$ 0.05 | \$ 0.04 |
| Diluted | \$ 0.05 | \$ 0.04 |
| Weighted average number of common shares outstanding - | | |
| Basic | 22,680,813 | 22,574,543 |
| Diluted | 22,704,753 | 22,597,042 |

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

China Automotive Systems, Inc.

Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

| | Three Months Ended March 31, | |
|-----------------------------------|---|-------------------|
| | 2006 | 2005 |
| Net income | \$ 1,094,398 | \$ 866,183 |
| Other comprehensive income: | | |
| Foreign currency translation gain | 601,399 | |
| Comprehensive income | <u>\$ 1,695,797</u> | <u>\$ 866,183</u> |

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

China Automotive Systems, Inc.

Condensed Consolidated Balance Sheets

| | March 31, 2006 | December 31, 2005 |
|---|-----------------------|-----------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,140,596 | \$ 12,374,944 |
| Pledged cash deposits | 3,526,663 | 1,185,660 |
| Accounts and notes receivable, including \$1,815,021 and \$1,829,075 from related parties at March 31, 2006 and December 31, 2005, respectively, net of an allowance for doubtful accounts of \$3,211,064 and \$2,856,025 at March 31, 2006 and December 31, 2005, respectively | 46,331,766 | 41,580,320 |
| Advance payments, including \$982,651 and \$911,765 to related parties at March 31, 2006 and December 31, 2005, respectively | 2,283,186 | 2,126,013 |
| Inventories | 13,594,329 | 12,385,833 |
| Total current assets | 87,876,540 | 69,652,770 |
| Long-term Assets: | | |
| Property, plant and equipment | 52,672,535 | 52,081,669 |
| Less: Accumulated depreciation | (13,584,897) | (12,285,636) |
| | 39,087,638 | 39,796,033 |
| Intangible assets, net | 3,601,327 | 3,503,217 |
| Other receivables, including \$5,813,398 and \$3,966,509 from related parties at March 31, 2006 and December 31, 2005, respectively, net of an allowance for doubtful accounts of \$1,415,475 and \$1,040,169 at March 31, 2006 and December 31, 2005, respectively | 7,489,408 | 6,503,629 |
| Long-term investments | 74,074 | 74,074 |
| Total assets | \$ 138,128,987 | \$ 119,529,723 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Bank loans | \$ 13,732,834 | \$ 14,814,815 |
| Accounts and notes payable, including \$469,391 and \$383,578 to related parties at March 31, 2006 and December 31, 2005, respectively | 41,124,392 | 31,375,599 |
| Customer deposits | 216,636 | 157,919 |
| Accrued payroll and related costs | 1,550,637 | 1,418,093 |
| Accrued expenses and other payables | 6,080,274 | 5,191,617 |
| Accrued pension costs | 2,768,628 | 2,653,064 |
| Taxes payable | 5,047,206 | 4,172,212 |
| Amounts due to shareholders/directors | 680,624 | 766,642 |
| Total current liabilities | 71,201,231 | 60,549,961 |
| Long-term liabilities: | | |
| Special payable | 301,614 | 301,614 |
| Total liabilities | \$ 71,502,845 | \$ 60,851,575 |
| Minority interests | 23,363,240 | 21,751,043 |
| Stockholders equity: | | |
| Preferred stock, \$0.0001 par value- Authorized - 20,000,000 shares Issued and outstanding - None | | |
| Common stock, \$0.0001 par value- Authorized - 80,000,000 shares Issued and outstanding- 23,237,406 shares and 22,574,543 shares at March 31, 2006 and December 31, 2005, respectively | 2,323 | 2,257 |

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| | | |
|--|-----------------------------|-----------------------------|
| Additional paid-in capital | 22,786,655 | 18,146,721 |
| Retained earnings- | | |
| Appropriated | 4,923,262 | 4,923,262 |
| Unappropriated | 13,616,579 | 12,522,181 |
| Accumulated other comprehensive income | 1,934,083 | 1,332,684 |
| | <u> </u> | <u> </u> |
| Total stockholders' equity | 43,262,902 | 36,927,105 |
| | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$ 138,128,987 | \$ 119,529,723 |
| | <u> </u> | <u> </u> |

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

China Automotive Systems, Inc.

Condensed Consolidated Statements of Cash Flows (Unaudited)

| | Three Months Ended March 31, | |
|--|------------------------------|----------------------|
| | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net income | \$ 1,094,398 | \$ 866,183 |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities: | | |
| Minority interests | 990,779 | 238,399 |
| Depreciation and amortization | 1,453,473 | 1,058,241 |
| Allowance for doubtful accounts | 686,568 | 93,561 |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in: | | |
| Pledged deposits | (2,341,003) | (883,917) |
| Accounts and notes receivable | (5,074,395) | 1,924,315 |
| Advance payments | (157,173) | (1,571,473) |
| Inventories | (1,208,496) | 83,856 |
| Increase (decrease) in: | | |
| Accounts and notes payable | 9,748,793 | (854,963) |
| Customer deposits | 58,717 | 55,064 |
| Accrued payroll and related costs | 132,544 | (264) |
| Accrued expenses and other payables | 1,334,919 | (626,918) |
| Accrued pension costs | 115,564 | 251,228 |
| Taxes payable | 874,994 | 265,483 |
| Advances payable | | (156) |
| Net cash (used in) provided by operating activities | 7,709,682 | 898,639 |
| Cash flows from investing activities: | | |
| (Increase) decrease in other receivables | (1,401,564) | (142,253) |
| Cash paid to acquire property, plant and equipment | (652,784) | (552,890) |
| Cash paid to acquire intangible assets | (138,238) | (75,618) |
| Net cash (used in) provided by investing activities | (2,192,586) | (770,761) |
| Cash flows from financing activities: | | |
| Increase (decrease) in proceeds from bank loans | (1,081,981) | 2,409,638 |
| Dividends be paid to the minority interest holders of Joint-venture companies | (124,844) | (787,321) |
| Increase (decrease) in amounts due to shareholders/directors | (86,018) | 57,605 |
| Proceeds from issuance of common stock | 4,940,000 | |
| Net cash provided by (used in) financing activities | 3,647,157 | 1,679,922 |
| Effect of exchange rate fluctuations on cash and cash equivalents | 601,399 | |
| Increase in cash and cash equivalents | 9,765,652 | 1,807,800 |
| Cash and cash equivalents at beginning of period | 12,374,944 | 11,164,639 |
| Cash and cash equivalents at end of period | \$ 22,140,596 | \$ 12,972,439 |

China Automotive Systems, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows (Unaudited) (continued)

| | Three Months Ended March 31, | |
|---|------------------------------|------------|
| | 2006 | 2005 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Cash paid for interest | \$ 193,099 | \$ 281,676 |
| Cash paid for income taxes | \$ 130,715 | \$ 215,500 |
| SUPPLEMENTAL DISCLOSURE OF INVESTING AND FINANCING ACTIVITIES ON A CASHLESS BASIS: | | |
| Issuance of common shares on a cashless basis | \$ 4 | \$ |
| Financing services fee related to issuance of common shares | \$ (4) | \$ |
| Outstanding expenses of issuance of common shares | \$ (300,000) | \$ |
| Dividends declared by Joint-venture for minority shareholder | \$ (300,367) | \$ |
| Increase in capital by minority shareholder of Joint-venture | \$ 921,785 | \$ |

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

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China Automotive Systems, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
Three Months Ended March 31, 2006 and 2005

1. ORGANIZATION AND BASIS OF PRESENTATION

Organization - Effective March 5, 2003, Visions-In-Glass, Inc., a United States company incorporated in the State of Delaware, Visions, entered into a Share Exchange Agreement to acquire 100% of the shareholder interest in Great Genesis Holding Limited, a company incorporated on January 3, 2003 under the Companies Ordinance in Hong Kong as a limited liability company, Great Genesis, as a result of which Great Genesis became a wholly-owned subsidiary of Visions. At the closing, the former directors and officers of Visions resigned, and new directors and officers were appointed. Visions subsequently changed its name to China Automotive Systems, Inc.

China Automotive Systems, Inc., including, when the context so requires, its subsidiaries and the subsidiaries' interests in the Sino-foreign Joint-ventures described below, is referred to herein as the Company. The Company, through its Sino-foreign Joint-ventures described below, is engaged in the manufacture and sale of automotive systems and components in the People's Republic of China, the PRC or China, as described below.

Ji Long Enterprise Investment Limited was incorporated on October 8, 1992 under the Companies Ordinance in Hong Kong as a limited liability company, Ji Long. Ji Long is an investment holding company. Effective March 4, 2003, all of the shareholders of Ji Long exchanged their 100% shareholder interest for a 100% shareholder interest in Great Genesis, as a result of which Ji Long became a wholly-owned subsidiary of Great Genesis.

In exchange for the acquisition of 100% of the shareholder interest in Great Genesis, the shareholders of Great Genesis were issued 20,914,250 shares of common stock of Visions. In addition, the shareholders of Great Genesis paid \$320,000 to the former officer, director and controlling shareholder of Visions in two installments for the cancellation of 17,424,750 shares of common stock.

The acquisition of Great Genesis by the Company was accounted for as a recapitalization of Great Genesis, pursuant to which the accounting basis of Great Genesis remained unchanged subsequent to the transaction date. Accordingly, the pre-transaction financial statements of Great Genesis are the historical financial statements of the Company.

As of March 31, 2006 and 2005, Great Genesis owns the following aggregate net interests in five Sino-foreign Joint-ventures organized in the PRC:

Jingzhou Henglong Fulida Textile Co., Ltd. discussed below was sold in August 2004, hereinafter referred to as Jingzhou.

| Name of Entity | Percentage Interest | |
|---|---------------------------------|-------|
| | Three Months Ended March 31, | |
| | 2006 | 2005 |
| Shashi Jiulong Power Steering Co. Limited, Jiulong | 81.0% | 81.0% |
| Jingzhou Henglong Automotive Parts Co. Limited, Henglong | 44.5% | 44.5% |
| Shenyang Jinbei Henglong Automotive Steering System Co. Limited, Shenyang | 70.0% | 70.0% |
| Zhejiang Henglong & Vie Pump-Manu Co. Limited, Zhejiang | 51.0% | 51.0% |
| Universal Sensor Application, Inc., USAI | 60.0% | |

Jiulong was established in 1993 and mainly engaged in the production of integral power steering gears for heavy-duty vehicles.

Henglong was established in 1997 and mainly engaged in the production of rack and pinion power steering gears for cars and light duty vehicles.

Shenyang was established in 2002 and focus on power steering parts. As of December 31, 2003, the Company owned 55% equity interest of Shenyang. On April 8, 2004, the board of directors approved an increase in Shenyang's registered capital and total capital from \$5,421,687, equivalent of RMB45,000,000, to \$8,132,530, equivalent of RMB67,500,000, the Chinese investor was changed from Shenyang Jinbei Automotive Industry Co., Ltd. to Shenyang Jinbei Automotive Company Limited. The shareholder transfer and capital increase, together with the newly signed Joint-venture Agreement and Articles of Association, have been approved by the applicable PRC authorities. Accordingly, Shenyang's registered capital is now \$8,132,530, equivalent of RMB67,500,000, including \$5,692,771, equivalent of RMB47,250,000, from the Company, constituting 70% of the total registered capital, and \$2,439,759, equivalent of RMB20,250,000, from Shenyang Jinbei Automotive Company Limited, constituting 30% of the total registered capital. The increase in capital of \$2,710,843, equivalent of RMB22,500,000, has been injected into Shenyang.

Zhejiang was established in 2002 to focus on power steering pumps.

Jingzhou was formed in February 2003 to produce environmental textiles and raw materials, and was owned 51% by Ji Long and 49% by Cixi City Fulida Synthetic Fibre Co., Ltd. Effective September 1, 2004, in order to concentrate on its main products, namely steering and automotive parts, the Company disposed of its 51% interest in Jingzhou by entering into an equity exchange agreement, the Exchange Agreement, with Hubei Wanlong Investment Co., Ltd., Hubei Wanlong, controlled by Mr. Hanlin Chen, the Company's Chairman. Pursuant to the Exchange Agreement, the 51% equity interest in Jingzhou owned by Ji Long was exchanged for 2.5% of Hubei Wanlong's equity interest in Henglong based on their respective fair market values as determined by an independent appraisal firm. The difference between the fair value and the book value resulting from the disposition of the Joint-venture interest in Jingzhou was debited to additional paid-in capital. With respect to consideration paid by the Company in excess of its Chairman's basis for his investment, such excess has been charged to additional paid-in capital as a distribution to the Chairman, resulting in the acquired 2.5% equity interests in Henglong being recorded by the Company at the Chairman's original cost basis. The Company paid approximately \$90,000 to Hubei Wanlong in conjunction with this transaction.

The divested non-core business of Jingzhou has been treated as a discontinued operation under SFAS No. 144. Jingzhou was divested from the Company's operations as of August 31, 2004.

On April 12, 2005, one of the subsidiary companies, Great Genesis entered into a Joint-venture agreement with Shanghai Hongxi Investment Inc., Hongxi, a company controlled by Mr. Hanlin Chen, the Company's Chairman, and Sensor System Solution Inc., Sensor, to establish a joint venture, Universal Sensor Application Inc., USAI, in the Wuhan East Lake development zone. The registered capital of the Joint-venture is \$10 million. Great Genesis and Hongxi will invest \$6 million and \$1 million, respectively, including cash and land and building, which will account for 60% and 10% of the total registered capital, respectively. Sensor invested \$3 million in technology, accounting for 30% of the total registered capital. The registered capital is required to be paid in three installments within one year after signing of the Joint-venture agreement, April 12, 2005. As of March 31, 2006, Great Genesis and Sensor have contributed \$432,100, equivalent of RMB 3,500,000, and \$3,000,000 respectively including cash and technology. Hongxi has not contributed any capital. USAI's main activities in 2005 were to prepare for the technology and manufacturing in production operations and will likely continue to do so in 2006.

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Basis of Presentation - For the three months ended March 31, 2006 and 2005, the accompanying consolidated financial statements include the accounts of the Company and its subsidiaries. The subsidiaries include five Sino-foreign Joint-ventures mentioned in Note 1. Significant inter-company balances and transactions have been eliminated upon consolidation. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America.

Foreign Currencies - The Company maintains its books and records in Renminbi, RMB, the currency of the PRC, its functional currency. Foreign currency transactions in RMB are reflected using the temporal method. Under this method, all monetary items are translated into the functional currency at the rate of exchange prevailing at the balance sheet date. Non-monetary items are translated at historical rates. Income and expenses are translated at the rate in effect on the transaction dates. Transaction gains and losses, if any, are included in the determination of net income (loss) for the period.

In translating the financial statements of the Company from its functional currency into its reporting currency in United States dollars, balance sheet accounts are translated using the closing exchange rate in effect at the balance sheet date and income and expense accounts are translated using an average exchange rate prevailing during the reporting period. Adjustments resulting from the translation, if any, are included in cumulative other comprehensive income (loss) in stockholders' equity.

Exchange rate used in translating the financial statements of the Company from its functional currency, Renminbi, into its reporting currency, US Dollars :

| Reporting Period | Renminbi | US Dollars |
|--|-----------------|-------------------|
| Prior to July 1, 2005 | 1 | 0.1205 |
| From July 1, 2005 to December 31, 2005 | 1 | 0.1233 |
| From January 1, 2006 to March 31, 2006 | 1 | 0.1248 |

Comments - The accompanying interim condensed consolidated financial statements are unaudited, but in the opinion of management of the Company, contain all adjustments, which include normal recurring adjustments, necessary to present fairly the financial position, the results of operations and cash flows for the three months ended March 31, 2006 and 2005.

The consolidated balance sheet as of December 31, 2005 is derived from the Company's audited financial statements.

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Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although the Company's management believes that the disclosures contained in these financial statements are adequate to make the information presented therein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's 2005 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

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

The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2006.

Income Per Share - Basic income per share is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated assuming the issuance of common shares, if dilutive, resulting from the exercise of warrants.

Actual weighted average shares outstanding used in calculating basic and diluted earnings (loss) per share were:

| | Three Months Ended March 31, | |
|-------------------------------------|---|-------------|
| | 2006 | 2005 |
| Weighted average shares outstanding | 22,680,813 | 22,574,543 |
| Effect of dilutive securities | 23,940 | 22,499 |
| Diluted shares outstanding | 22,704,753 | 22,597,042 |

The 156,250 shares underlying warrants issued to Cornell Capital Partners, LP on March 20, 2006 has not been included in the computation of diluted earnings (loss) per share because such inclusion would have had an anti-dilutive effect:

| | Three Months Ended March 31, | |
|--------------------------|---|-------------|
| | 2006 | 2005 |
| Anti-dilutive securities | 67,104 | |

Stock-Based Compensation - The Company may periodically issue shares of common stock for services rendered or for financing costs. Such shares will be valued based on the market price on the transaction date. The Company may periodically issue stock options to employees and stock options or warrants to non-employees in non-capital raising transactions for services and for financing costs.

On July 21, 2004, the Company issued options to purchase 7,500 shares of common stock to each of its three independent directors. Such stock options vest immediately upon grant and are exercisable at \$4.50 per share over a period of two years.

On June 28, 2005, the Company issued additional options to purchase 7,500 shares of common stock to each of its three independent directors. Such stock options vest immediately upon grant and are exercisable at \$6.83 per share over a period of five years.

On March 20, 2006, the Company raised a gross amount of \$5,000,000 in a private placement (PIPE) to Cornell Capital Partners, LP, Investor by issuing 625,000 shares of common stock. As part of the financing cost, the Company issued a warrant to purchase 86,806 shares of common stock, exercisable for three years at an exercise price of \$14.40 per share, and a warrant to purchase 69,444 shares of common stock, exercisable for three years at an exercise price of \$18.00 per share, to Cornell Capital Partners, LP.

On March 20, 2006, the Company issued 37,863 shares of common stock to Cornell Capital Partners, LP and a placement agent, collectively as a commitment fee and a placement agent fee in connection with the establishment of a \$ 15,000,000 equity line of credit under a Standby Equity Distribution Agreement with Cornell Capital Partners, LP.

The Company also paid Cornell Capital Partners, LP's affiliate a structuring fee of \$17,500 in cash and paid Cornell Capital Partners, LP a due diligence fee of \$10,000 in cash.

While the Company has an existing agreement to pay its other placement agents, Sterns, Agree & Leach, Inc. and Trenwith Securities, LLC, \$250,000 (the Commissions) and to issue them warrants to purchase 31,250 shares of common stock (the Warrants), the Company intends to seek to renegotiate to reduce the Commissions and Warrants. The Warrants would have a strike price equal to 120% of the Company's common stock's price on March 20, 2006 and a term of three years.

The Company has adopted Statement of Financial Accounting Standards (SFAS) No. 123R, Accounting for Stock-Based Compensation , which establishes a fair value method of accounting for stock-based compensation plans.

In accordance with SFAS No. 123R, the cost of stock options and warrants issued to non-employees is measured at the grant date based on the fair value of the award. The fair value of the stock-based award is determined using the Black-Scholes option pricing model. The resulting amount is charged to expense on the straight-line basis over the period in which the Company expects to receive benefit, which is generally the vesting period.

We have adopted SFAS No. 123R to calculate cost of stock-based compensation for certain employees beginning the first quarter of 2006, including stock options, restricted stock, award based on performance, stock appreciation rights and stock purchase program for employees.

Comprehensive Income - The Company has adopted the provisions of Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income (SFAS No. 130). SFAS No. 130 establishes standards for the reporting and display of comprehensive income, its components and accumulated balances in a full set of general purpose financial statements. SFAS No. 130 defines comprehensive income to include all changes in equity except those resulting from investments by owners and distributions to owners, including adjustments to minimum pension liabilities, accumulated foreign currency translation, and unrealized gains or losses on marketable securities.

For the three months ended March 31, 2006 and 2005, the Company's only component of other comprehensive income is foreign currency translation gain of \$601,399 and \$0. These amounts have been recorded as a separate component of stockholders' equity.

Reclassifications -- Certain comparative amounts have been reclassified to conform to the current year's presentation. (See Note 15)

2. CERTAIN SIGNIFICANT RISKS AND UNCERTAINTIES

The Company is subject to the realities and risks of operating in the PRC. These include risks associated with the political and economic environment, foreign currency exchange and the legal system in the PRC.

The economy of the PRC differs significantly from the economies of the western industrialized nations in structure, level of development, gross national product, growth rate, capital reinvestment, resource allocation, self-sufficiency, rate of inflation and balance of payments position, among others. Only recently has the PRC government encouraged substantial private economic activities. The Chinese economy has experienced significant growth in the past several years, but such growth has been uneven among various sectors of the economy and geographic regions. Actions by the PRC government to control inflation have significantly restrained economic expansion in the recent past. Similar actions by the PRC government in the future could have a significant adverse effect on economic conditions in the PRC.

Many laws and regulations dealing with economic matters in general and foreign investment in particular have been enacted in the PRC. However, the PRC still does not have a comprehensive system of laws, and enforcement of existing laws may be uncertain and sporadic.

The Company's operating assets and primary sources of income and cash flows are the interests of its subsidiaries in Sino-foreign Joint-ventures in the PRC. The PRC economy has, for many years, been a centrally-planned economy, operating on the basis of annual, five-year and ten-year state plans adopted by central PRC governmental authorities, which set out national production and development targets. The PRC government has been pursuing economic reforms since it first adopted its open-door policy in 1978. There is no assurance that the PRC government will continue to pursue economic reforms or that there will not be any significant change in its economic or other policies, particularly in the event of any change in the political leadership of, or the political, economic or social conditions in the PRC. There is also no assurance that the Company will not be adversely affected by any such change in governmental policies or any unfavorable change in the political, economic or social conditions, the laws or regulations, or the rate or method of taxation in the PRC.

As many of the economic reforms, which have been or are being implemented by the PRC government, are unprecedented or experimental, they may be subject to adjustment or refinement, which may have adverse effects on the Company. Further, through state plans and other economic and fiscal measures such as the level of exchange rate, it remains possible for the PRC government to exert significant influence on the PRC economy.

The Company's financial instruments that are exposed to concentration of credit risk consist primarily of cash and cash equivalents, and accounts receivable from customers. Cash and cash equivalents are maintained with major banks in the PRC. The Company's business activity is with customers in the PRC. The Company periodically performs credit analysis and monitors the financial condition of its clients in order to minimize credit risk.

Any devaluation of the RMB against the United States dollar would have adverse effects on the Company's financial performance and asset values when measured in terms of the United States dollar. Should the RMB significantly devalue against the United States dollar, such devaluation could have a material adverse effect on the Company's earnings and the foreign currency equivalent of such earnings. The Company does not hedge its RMB - United States dollar exchange rate exposure.

On July 21, 2005, the People's Bank of China changed exchange rate system from its previous fixed exchange rate announced on January 1, 1994 to a unitary and well-managed floating exchange rate based on market supply and demand. No representation is made that the RMB amounts could be freely converted into other foreign currencies. All foreign exchange transactions continue to take place either through the Bank of China or other banks authorized to buy and sell foreign currencies at the exchange rate quoted by the People's Bank of China. Approval of foreign currency payments by the People's Bank of China or other institutions requires submission of a payment application form together with suppliers' invoices, shipping documents and signed contracts.

3. RECENT ACCOUNTING PRONOUNCEMENTS

In 2003, the FASB issued SFAS No. 132R, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (Revised in December 2003) an amendment of FASB Statements No. 87, 88, and 106 (Issued 12/03). This Statement revises employers' disclosures about pension plans and other postretirement benefit plans. It does not change the measurement or recognition of those plans required by FASB Statements No. 87, *Employers' Accounting for Pensions*, No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. SFAS 132R is effective for fiscal years beginning after December 15, 2003. The adoption of SFAS No. 132R did not have a significant effect on the Company's financial statement presentation or disclosures.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs - An Amendment of Accounting Research Bulletin No. 43, Chapter 4* (SFAS 151). SFAS 151 clarifies that abnormal amounts of idle facility expense, freight, handling costs and spoilage should be expensed as incurred and not included in overhead as an inventory cost. The new statement also requires that allocation of fixed production overhead costs to conversion costs should be based on normal capacity of the production facilities. The provisions in SFAS 151 must be applied prospectively and became effective for the Company beginning January 1, 2006. We adopted this statement beginning in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 152 Accounting for Real Estate Time-Sharing Transactions - an amendment of FASB Statements No. 66 and 67 (SFAS 152). This statement amends FASB Statement No. 66 Accounting for Sales of Real Estate to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position 04-2 Accounting for Real Estate Time-Sharing Transactions (SOP 04-2). SFAS 152 also amends FASB Statement No. 67 Accounting for Costs and Initial Rental operations of Real Estate Projects to state that the guidance for incidental operations and costs incurred to sell real estate projects does not apply to real estate time-sharing transactions, with the accounting for those operations and costs being subject to the guidance in SOP 04-2. The provisions of SFAS 152 are effective in fiscal years beginning after June 15, 2005. We adopted this statement beginning in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004), Share-Based Payment (SFAS 123R). This statement requires financial statement recognition of compensation cost related to share-based payment transactions. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective for the first fiscal year beginning after June 15, 2005. However, in April 2005, the SEC deferred the effective date of SFAS 123R for SEC registrants to the first interim period beginning after June 15, 2005. Accordingly, We adopted this statement beginning in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 153 Exchanges of Nonmonetary Assets, an amendment of Accounting Principles Board Opinion No. 29 (SFAS 153). This statement amends Accounting Principles Board Opinion (APB) No. 29, Accounting for Nonmonetary Transactions to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that have no commercial substance. Under SFAS 153, if a nonmonetary exchange of similar productive assets meets a commercial-substance criterion and fair value is determinable, the transaction must be accounted for at fair value resulting in recognition of any gain or loss. SFAS 153 was effective for nonmonetary transactions in fiscal periods beginning after June 15, 2005. We adopted this statement beginning in the first quarter of 2006.

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, an Interpretation of FASB Statement No. 143 (FIN 47). Under FIN 47, we are required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any uncertainty about the amount and/or timing of future settlement should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value. The provisions of FIN 47 were required to be applied no later than the end of fiscal years ending after December 15, 2005. We adopted this statement beginning in the first quarter of 2006.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3 (SFAS 154). This statement changes the requirements for the accounting for and reporting of a change in accounting principle and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. APB No. 20 required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This statement requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The provisions of SFAS 154 are effective for fiscal years beginning after December 15, 2005. We adopted this statement beginning in the first quarter of 2006.

In 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*. This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. This Statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in indicated situations; requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; permits an entity to choose relevant subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities; at its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value; and requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. The adoption of SFAS No. 156 did not have a material impact on our Consolidated Financial Statements.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*. This Statement amends FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. This Statement resolves issues addressed in Statement 133 Implementation Issue No. D1, *Application of Statement 133 to Beneficial Interests in Securitized Financial Assets*. SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement 133, and establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or

that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. It also clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends Statement 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company has not yet determined the impact of the adoption of SFAS No. 155 on its financial statements, if any.

4. ACCOUNTS RECEIVABLE

The Company's accounts receivable at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | March 31, 2006 | December 31, 2005 |
|---------------------------------------|---------------------------|------------------------------|
| Accounts receivable | \$ 37,856,851 | \$ 31,866,156 |
| Bills receivable | 11,685,979 | 12,570,189 |
| | <u>49,542,830</u> | <u>44,436,345</u> |
| Less: allowance for doubtful accounts | (3,211,064) | (2,856,025) |
| | <u>\$ 46,331,766</u> | <u>\$ 41,580,320</u> |

Bills receivable represent accounts receivable in the form of bills of exchange whose acceptances and settlements are handled by banks.

5. OTHER RECEIVABLES

Other receivables consist of amounts advanced to both related and unrelated parties, primarily as unsecured demand loans, with no stated interest rate or due date. At March 31, 2006, other receivables totaled \$7,489,408, including \$5,813,398 to related parties, net of an allowance for doubtful accounts of \$1,415,475. The allowance for doubtful accounts included \$307,884 made to an investee of Jiulong.

At December 31, 2005, other receivables totaled \$6,503,629, including \$4,356,602 to related parties, net of an allowance for doubtful accounts of \$1,040,169. The allowance for doubtful accounts included \$313,550 made to an investee of Jiulong.

In 1997, Jiulong, one of the Company's Sino-foreign Joint-ventures, made an investment to establish an auto sales company named Jingzhou Jiulong Machinery and Electronic Material Co., Ltd. Since JL Material was experiencing financial difficulties, the receivable from JL Material was \$307,884 for the three months ended March 31, 2006, as compared with \$313,550 in 2005, thus requiring a decrease in allowance for doubtful accounts.

With the exception of other receivables from JL Material, the Company believes that all other receivables are collectible, as the related parties are in good financial conditions and are paying their obligations to the Company pursuant to the terms of their respective contracts.

6. INVENTORIES

Inventories at March 31, 2006 (Unaudited) and December 31, 2005 consisted of the following:

| | March 31, 2006 | December 31, 2005 |
|--------------------------|---------------------------|------------------------------|
| Raw materials | \$ 4,035,322 | \$ 3,025,467 |
| Work-in-process | 2,771,527 | 2,559,626 |
| Finished goods | 7,235,713 | 7,295,082 |
| | <u>14,042,562</u> | <u>12,880,175</u> |
| Less: provision for loss | (448,233) | (494,342) |
| | <u>\$ 13,594,329</u> | <u>\$ 12,385,833</u> |

7. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | March 31, 2006 | December 31, 2005 |
|--------------------------------|---------------------------|------------------------------|
| Land use rights and buildings | \$ 17,028,002 | \$ 16,825,598 |
| Machinery and equipment | 31,379,114 | 30,980,053 |
| Electronic equipment | 2,067,083 | 2,023,457 |
| Motor vehicles | 2,119,719 | 2,179,161 |
| Construction in progress | 78,617 | 73,400 |
| | <u>52,672,535</u> | <u>52,081,669</u> |
| Less: Accumulated depreciation | (13,584,897) | (12,285,636) |
| | <u>\$ 39,087,638</u> | <u>\$ 39,796,033</u> |

8. INTANGIBLE ASSETS

The activities in the Company's intangible asset account at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | March 31, 2006 | December 31, 2005 |
|--------------------------------------|---------------------------|------------------------------|
| Balance at beginning of year | \$ 3,503,217 | \$ 392,552 |
| Add: Additions during the period - | | |
| Management software license | 61,798 | 3,147,867 |
| Mapping design software license | 37,078 | 93,827 |
| Foreign currency translation gain | 39,362 | 9,693 |
| | <u>3,641,455</u> | <u>3,643,939</u> |
| Less: Amortization during the period | (40,128) | (140,722) |
| Balance at the end of the period | <u>\$ 3,601,327</u> | <u>\$ 3,503,217</u> |

As for USAI, one of the Joint-ventures of the Company, its main activities in 2005 were to prepare for the technology and manufacturing in production operations and will likely continue to do so in 2006. Accordingly, there was no record from intangible assets amortization of USAI in the consolidated balance sheet at March 31, 2006 and December 31, 2005. The original value of USAI's intangible assets were \$3,000,000, and it is estimated that the USAI's intangible assets will be amortized over the useful live of 15 years.

9. ACCOUNTS PAYABLE

Accounts payable at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | March 31, 2006 | December 31, 2005 |
|------------------|---------------------------|------------------------------|
| Accounts payable | \$ 19,190,574 | \$ 15,615,402 |
| Notes payable | 21,933,818 | 15,760,197 |
| | <u>\$ 41,124,392</u> | <u>\$ 31,375,599</u> |

Notes payable represent accounts payable in the form of bills of exchange whose acceptances and settlements are handled by banks.

The Company has pledged cash deposits, notes receivable and certain plant and machinery to secure trade financing granted by banks.

10. BANK LOANS

At March 31, 2006, the Company through its Sino-foreign Joint-ventures had outstanding fixed-rate short-term bank loans of \$13,732,834. The weighted average interest rate for the three months ended March 31, 2006 was 5.91% per annum. Jiulong, one of the Company's joint ventures, provided Henglong, another of the Company's Joint-ventures, with loan guarantees covering bank loans of \$3,121,099. Henglong provided Jiulong with loan guarantees covering bank loans of \$6,242,197. The remaining balance of the bank loan of \$4,369,538 was mortgaged using some of the plant and equipment of the Company.

At December 31, 2005, the Company through its Sino-foreign Joint-ventures had outstanding fixed-rate short-term bank loans of \$14,814,815. The weighted average interest rate for the year ended December 31, 2005 was 5.92% per annum. Jiulong, one of the Company's Joint-ventures, provided Henglong, another of the Company's Joint-ventures, with loan guarantees covering bank loans of \$3,086,420. Henglong provided Jiulong with loan guarantees covering bank loans of \$4,938,272. The remaining balance of the bank loan of \$6,790,123 was mortgaged using some of the plant and equipment of the Company.

11. AMOUNTS DUE TO SHAREHOLDERS/DIRECTORS

The activities in the amounts due to shareholders/directors at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | |
|---------------------------------|------------|
| Balance, December 31, 2004 | \$ 589,594 |
| Cash advances from shareholders | 177,048 |
| | <hr/> |
| Balance, December 31, 2005 | \$ 766,642 |
| Cash repaid to shareholder | (86,018) |
| | <hr/> |
| Balance, March 31, 2006 | \$ 680,624 |
| | <hr/> |

As of March 31, 2006 and December 31, 2005, the amounts due to shareholders/directors were unsecured, interest-free and repayable on demand.

12. MINORITY INTERESTS

The activities in respect of the amounts of the minority interests' equity at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | |
|---|---------------|
| Balance, December 31, 2004 | \$ 17,571,838 |
| Add: contribution by minority shareholders | 3,066,000 |
| Minority interests' income | 2,680,318 |
| Additional interest to the minority interest holders in connection with disposal of property, plant and equipment | 93,168 |
| Less: dividends declared to the minority stockholders' equity of Joint-venture companies | (1,660,281) |
| | <hr/> |
| Balance, December 31, 2005 | \$ 21,751,043 |
| Add: contribution by minority shareholders | 921,785 |
| Minority interests' income | 990,779 |
| Less: dividends declared to the minority stockholders' equity of Joint-venture companies | (300,367) |
| | <hr/> |
| Balance, March 31, 2006 | \$ 23,363,240 |
| | <hr/> |

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On February 25, 2006, Jiulong, one of the Joint-ventures of the Company, held a meeting of the board and approved an increase in its capital stock of \$1,897,628, equivalent of RMB15,200,000, of which the Company subscribed \$1,537,079, equivalent of RMB12,312,000, and the capital stock of \$360,549, equivalent of RMB2,888,000, subscribed by the minority shareholder was deducted from dividends payable.

On February 25, 2006, Henglong, one of the Joint-ventures of the Company, held a meeting of the board and approved an increase in its capital stock of \$1,011,236, equivalent of RMB8,100,000, of which the Company subscribed \$450,000, equivalent of RMB3,604,500, and the capital stock of \$561,236, equivalent of RMB4,495,500, subscribed by the minority shareholder was deducted from dividends payable.

On February 20, 2006, Shengyang, one of the Joint-ventures of the Company, held a meeting of the board and approved distribution of dividends of \$1,001,223, equivalent of RMB 8,019,803, of which \$700,856, equivalent of RMB4,900,599, was distributed to the Company and \$300,367, equivalent of RMB3,119,204, was distributed to the minority shareholder.

13. STOCKHOLDERS EQUITY

The activities in respect of the amounts of the stockholders interests equity at March 31, 2006 (unaudited) and December 31, 2005 are summarized as follows:

| | Common Stock | | Preferred Stock | | Additional Paid-in Capital |
|---|---------------|-----------|-----------------|-----------|----------------------------------|
| | Shares | Par Value | Shares | Par Value | |
| Balance, December 31, 2004 | 22,574,543 | \$ 2,257 | | \$ | \$ 18,003,168 |
| Foreign currency translation gain | | | | | |
| Deemed distribution to shareholders | | | | | 74,704 |
| Issuance of options for independent directors | | | | | 68,850 |
| Net income for the year ended December, 31, 2005 | | | | | |
| Appropriation of retained earnings | | | | | |
| Balance, December 31, 2005 | 22,574,543 | \$ 2,257 | | \$ | \$ 18,146,721 |
| Issuance of common stock | 625,000 | 62 | | | 4,939,938 |
| Issuance of common shares related to financing services | 37,863 | 4 | | | (4) |
| Services fee related to payable from financing | | | | | (300,000) |
| Foreign currency translation gain | | | | | |
| Net income for the period ended March, 31, 2006 | | | | | |
| Balance, March, 31, 2006 | \$ 23,237,406 | \$ 2,323 | | \$ | \$ 22,786,655 |

| | Retained Earnings | | Accumulated | Total |
|---|-------------------|----------------|-----------------------------------|---------------|
| | Appropriated | Unappropriated | Other Comprehensive Income (Loss) | |
| Balance, December 31, 2004 | \$ 4,396,339 | \$ 9,733,626 | \$ 3,060 | \$ 32,138,450 |
| Foreign currency translation gain | | | 1,329,624 | 1,329,624 |
| Deemed distribution to shareholders | | | | 74,704 |
| Issuance of options for independent directors | | | | 68,850 |
| Net income for the year ended December, 31, 2005 | | 3,315,478 | | 3,315,478 |
| Appropriation of retained earnings | 526,923 | (526,923) | | |
| Balance, December 31, 2005 | \$ 4,923,262 | \$ 12,522,180 | \$ 1,332,684 | \$ 36,927,105 |
| Sale of common stock | | | | 4,940,000 |
| Issuance of common shares related to financing services | | | | |
| Services fee related to payable from financing | | | | (300,000) |
| Foreign currency translation gain | | | 601,399 | 601,399 |
| Net income for the period ended March, 31, 2006 | | 1,094,398 | | 1,094,398 |
| Balance, March, 31, 2006 | \$ 4,923,262 | \$ 13,616,579 | \$ 1,934,083 | \$ 43,262,902 |

14. INCOME TAXES

The Company's Sino-foreign Joint-ventures are subject to PRC state and local income taxes at the applicable tax rate on the taxable income as reported in their PRC statutory financial statements in accordance with the relevant income tax laws applicable to foreign invested enterprises. In accordance with the Income Tax Law of the PRC for Enterprises with Foreign Investments and Foreign Enterprises, enterprises with foreign investments and foreign enterprises meeting certain criteria are entitled to full exemption from income tax for the first two years and a 50% reduction for the next three years, commencing from the first profit-making year after offsetting all tax losses carried forward from the previous five years.

Two of the Company's Sino-foreign Joint-ventures, Henglong and Jiulong, were subject to a tax rate of 15% during 2005 and 2006. Shenyang was entitled to and was certified for a two-year tax holiday commencing in 2003, the first profit-making year. Therefore, Shenyang was income tax exempted in 2004 and is subject to a tax rate of 7.5% in 2005 and 2006. The tax rate for Zhejiang has not yet been approved by tax authorities, but in accordance with the relevant income tax laws as mentioned above, Zhejiang is also entitled to two-year tax exemption in 2004 and 2005, and is subject to a tax rate of 16.5% in 2006. USAI did not have any operating income in 2006.

No provision for Hong Kong profits tax has been made as Ji Long and Great Genesis are investment holding companies and did not have any assessable profits in Hong Kong during three months ended March 31, 2006 and 2005.

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At March 31, 2006 and 2005, the Company did not have any transactions, obligations or relationships that could be considered off-balance sheet arrangements.

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19. COMMITMENTS AND CONTINGENCIES:

The Company has the following material contractual obligations and capital expenditure commitments:

| Date | Parties involved | Description of Commitments and Contingencies |
|-------------------------|---|--|
| October 30, 2001 | Henglong & Bishop Steering Technology Limited, Bishop, an Australian company | Ten year license agreement for the design of power steering systems. Henglong is obligated to pay Bishop technical assistance fee of approximately \$200,000 per year during the first two years and \$110,000 per year during the remaining eight years of the agreement. |
| July 21, 2003 | Henglong & Namyang Industrial Co. Ltd., Namyang, a Korean manufacturer of steering assemblies for automobiles | Five year license and technical assistance agreement. Henglong paid Namyang an initial payment of \$100,000 and is further obligated to pay a royalty of 3% of the sales price of products sold, which includes the licensed columns and universal joint technology. |
| March to December, 2004 | Henglong & some equipment manufacturers | Entered into some equipment contracts with total value approximately \$4,719,967. Henglong paid \$1,743,201 and \$2,606,332 during 2004 and 2005. The Company paid \$112,060 as of three months ended March 31, 2006 and \$258,374 remains outstanding. The Company will pay \$164,747 and \$93,627 for the nine months ended December 31, 2006 and in 2007, respectively. |
| March to December 2004 | Jiulong & some equipment manufacturers | Entered into some equipment contracts with total value of approximately \$2,752,479. Jiulong paid \$1,021,021 and \$1,117,318 during 2004 and 2005. The Company paid \$16,663 as of three months ended March 31, 2006 and \$597,478 remains outstanding. The Company will pay \$330,920 and \$266,558 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | Henglong & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$1,163,650. Henglong paid \$1,039,442 and \$7,388 in 2005 and as of three months ended March 31, 2006, respectively, and \$167,420 remains outstanding. The Company will pay \$161,516 and \$5,904 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | Jiulong & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$637,108. Jiulong paid \$350,542 and \$12,048 in 2005 and as of three months ended March 31, 2006, respectively, and \$274,518 remains outstanding. The Company will pay \$247,217 and \$27,301 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | USAI & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$238,577 in 2005. USAI paid \$141,346 and \$45,277 in 2005 and for the three months ended March 31, 2006, respectively, and will pay off the remaining \$51,954 during the nine months ended December 31, 2006. |

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On March 31, 2006, as amended on May 2, 2006, Great Genesis, the wholly-owned subsidiary of the Company, entered into a Joint-venture agreement with Wuhu Chery Technology Co., Ltd., Chery Technology, to establish a Joint-venture, Wuhu Henglong Automotive Steering System Co., Ltd in the Wuhu Technological Development Zone. Chery Technology is a wholly-owned subsidiary of Chery Automobile. The Joint-venture will focus on producing and selling automotive steering system. The registered capital of the joint venture is \$3,745,318, equivalent of RMB30,000,000. Great Genesis and Chery Technology will invest \$2,896,379, equivalent of RMB23,200,000, and \$848,939, equivalent of RMB 6,800,000 respectively, which will account for 77.33% and 22.67% of the total registered capital, respectively. The registered capital is required to be paid within one month after effectiveness of the agreement which was approved by the Chinese government on April 14, 2006.

20. OPERATING INFORMATION OF THE COMPANY'S SINO-FOREIGN JOINT-VENTURES

The Company has no operations independent of those of Great Genesis and its subsidiaries, and its principal assets are its investments in Great Genesis and its subsidiaries. The operation results of Company's Sino-foreign Joint-ventures for the three months ended March 31, 2006 and 2005 were summarized as follows:

| | Parent Company | | Jiulong | |
|---|-----------------------------|-----------|-----------|-----------|
| | Three Months Ended March 31 | | | |
| | 2006 | 2005 | 2006 | 2005 |
| Proportionate ownership interest at end of year | 100.0% | 100.0% | 81.0% | 81.0% |
| Net sales | | | 5,620,847 | 6,463,164 |
| Operating expenses | 249,695 | 153,299 | 5,134,815 | 5,478,227 |
| Operating earnings (losses) | (249,695) | (153,299) | 486,032 | 984,937 |
| Other income (expenses), net | 685,187 | (1,692) | (113,230) | (104,745) |
| Pretax earnings | 435,492 | (154,991) | 372,802 | 880,192 |
| Income tax | | | (179,173) | 163,627 |
| Income (expenses) before minority interest | 435,492 | (154,991) | 551,975 | 716,565 |
| Minority interest income (expenses) | | | 102,031 | 98,853 |
| Net earnings (expenses) | 435,492 | (154,991) | 449,944 | 617,712 |

| | Henglong | | Shenyang | |
|---|-----------------------------|-----------|-----------|-----------|
| | Three Months Ended March 31 | | | |
| | 2006 | 2005 | 2006 | 2005 |
| Proportionate ownership interest at end of year | 44.5% | 44.5% | 70.0% | 70.0% |
| Net sales | 11,514,385 | 7,355,113 | 3,539,541 | 2,537,098 |
| Operating expenses | 9,824,375 | 7,075,342 | 3,282,453 | 2,057,917 |
| Operating earnings (losses) | 1,690,010 | 279,771 | 257,088 | 479,181 |
| Other income (expenses), net | (133,099) | (156,940) | 10,306 | 6,159 |
| Pretax earnings | 1,556,911 | 122,831 | 267,394 | 485,340 |
| Income tax | 278,295 | 50,965 | 39,903 | 36,370 |
| Income (expenses) before minority interest | 1,278,616 | 71,866 | 227,491 | 448,970 |
| Minority interest income (expenses) | 755,821 | 30,390 | 68,247 | 134,691 |

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| | | | | |
|-------------------------|-------------------|-------------------|-------------------|-------------------|
| Net earnings (expenses) | 522,795 | 41,476 | 159,244 | 314,279 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

25

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| | Zhejiang | | USAI | |
|---|------------------------------------|-------------|--------------|-------------|
| | Three Months Ended March 31 | | | |
| | 2006 | 2005 | 2006 | 2005 |
| Proportionate ownership interest at end of year | 51.0% | 51.0% | 60.0% | 0% |
| Net sales | 2,027,689 | 786,995 | 463 | |
| Operating expenses | 1,754,425 | 838,413 | 98,707 | |
| Operating earnings (losses) | 273,264 | (51,418) | (98,244) | |
| Other income (expenses), net | 510 | (696) | 137 | |
| Pretax earnings | 273,774 | (52,114) | (98,107) | |
| Income tax | 61,686 | | | |
| Income (expenses) before minority interest | 212,088 | (52,114) | (98,107) | |
| Minority interest income (expenses) | 103,923 | (25,535) | (39,243) | |
| Net earnings (expenses) | 108,165 | (26,579) | (58,864) | |
| | Elimination | | Total | |
| | Three Months Ended March 31 | | | |
| | 2006 | 2005 | 2006 | 2005 |
| Proportionate ownership interest at end of year | | | | |
| Net sales | 1,738,473 | 3,165,920 | 20,964,452 | 13,976,450 |
| Operating expenses | 1,916,952 | 3,240,206 | 18,427,518 | 12,362,992 |
| Operating earnings (losses) | (178,479) | (74,286) | 2,536,934 | 1,613,458 |
| Other income (expenses), net | 700,857 | | (251,046) | (257,914) |
| Pretax earnings | 522,378 | (74,286) | 2,285,888 | 1,355,544 |
| Income tax | | | 200,711 | 250,962 |
| Income (expenses) before minority interest | 522,378 | (74,286) | 2,085,177 | 1,104,582 |
| Minority interest income (expenses) | | | 990,779 | 238,399 |
| Net earnings (expenses) | 522,378 | (74,286) | 1,094,398 | 866,183 |

21. SUBSEQUENT EVENTS

None

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

Cautionary Statement Pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995:

This Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006 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. Generally, the words believes, anticipates, may, will, should, expect, intend, estimate, continue, and similar expressions or the negative thereof terminology are intended to identify forward-looking statements which include, but are not limited to, statements concerning the Company's expectations regarding its working capital requirements, financing requirements, business prospects, and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. Such statements are subject to certain risks and uncertainties, including the matters set forth in this Quarterly Report or other reports or documents the Company files with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Undue reliance should not be placed on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update these forward-looking statements. In addition, the forward-looking statements in this Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2006 involve known and unknown risks, uncertainties and other factors that could cause the actual results, performance or achievements of the Company to differ materially from those expressed in or implied by the forward-looking statements contained herein. Please see the discussion on risk factors in Item 1A of Part II of this quarterly report on Form 10-Q.

GENERAL OVERVIEW:

Organization - Effective March 5, 2003, Visions-In-Glass, Inc., a United States company incorporated in the State of Delaware, Visions, entered into a Share Exchange Agreement to acquire 100% of the shareholder interest in Great Genesis Holding Limited, a company incorporated on January 3, 2003 under the Companies Ordinance in Hong Kong as a limited liability company, Great Genesis, as a result of which Great Genesis became a wholly-owned subsidiary of Visions. At the closing, the old directors and officers of Visions resigned, and new directors and officers were appointed. Visions subsequently changed its name to China Automotive Systems, Inc.

China Automotive Systems, Inc., including, when the context so requires, its subsidiaries and the subsidiaries' interests in the Sino-foreign Joint-ventures described below, is referred to herein as the Company. The Company, through its Sino-foreign Joint-ventures described below, is engaged in the manufacture and sale of automotive systems and components in the People's Republic of China, the PRC or China, as described below.

Ji Long Enterprise Investment Limited was incorporated on October 8, 1992 under the Companies Ordinance in Hong Kong as a limited liability company, Ji Long. Ji Long is an investment holding company. Effective March 4, 2003, all of the shareholders of Ji Long exchanged their 100% shareholder interest for a 100% shareholder interest in Great Genesis, as a result of which Ji Long became a wholly-owned subsidiary of Great Genesis.

In exchange for the acquisition of 100% of the shareholder interest in Great Genesis, the shareholders of Great Genesis were issued 20,914,250 shares of common stock of Visions. In addition, the shareholders of Great Genesis paid \$320,000 to the former officer, director and controlling shareholder of Visions in two installments for the cancellation of 17,424,750 shares of common stock.

The acquisition of Great Genesis by the Company was accounted for as a recapitalization of Great Genesis, pursuant to which the accounting basis of Great Genesis continued unchanged subsequent to the transaction date. Accordingly, the pre-transaction financial statements of Great Genesis are the historical financial statements of the Company.

As of March 31, 2006 and 2005, Great Genesis owns the following aggregate net interests in five Sino-foreign Joint-ventures organized in the PRC:

Jingzhou Henglong Fulida Textile Co., Ltd. discussed below was sold in August 2004, hereinafter referred to as Jingzhou.

| Name of Entity | Percentage Interest | |
|--|------------------------------|-------|
| | Three Months Ended March 31, | |
| | 2006 | 2005 |
| Shashi Jiulong Power Steering Co. Limited (Jiulong) | 81.0% | 81.0% |
| Jingzhou Henglong Automotive Parts Co. Limited (Henglong) | 44.5% | 44.5% |
| Shenyang Jinbei Henglong Automotive Steering System Co. Limited (Shenyang) | 70.0% | 70.0% |
| Zhejiang Henglong & Vie Pump-Manu Co. Limited (Zhejiang) | 51.0% | 51.0% |
| Universal Sensor Application, Inc. (USAI) | 60.0% | |

Jiulong was established in 1993 and mainly engaged in the production of integral power steering gears for heavy-duty vehicles.

Henglong was established in 1997 and mainly engaged in the production of rack and pinion power steering gears for cars, light duty vehicles.

Shenyang was established in 2002 and focus on power steering parts. As of December 31, 2003, the Company owned 55% equity interest of Shenyang. On April 8, 2004, the board of directors approved an increase in Shenyang's registered capital and total capital from \$5,421,687, equivalent of RMB45,000,000, to \$8,132,530, equivalent of RMB67,500,000, the Chinese investor was changed from Shenyang Jinbei Automotive Industry Co., Ltd. to Shenyang Jinbei Automotive Company Limited. The shareholder transfer and capital increase, together with the newly signed Joint-venture Agreement and Articles of Association, have been approved by the applicable PRC authorities. Accordingly, Shenyang's registered capital is now \$8,132,530, equivalent of RMB67,500,000, including \$5,692,771, equivalent of RMB47,250,000, from the Company, constituting 70% of the total registered capital, and \$2,439,759, equivalent of RMB20,250,000, from Shenyang Jinbei Automotive Company Limited, constituting 30% of the total registered capital. The increase in capital of \$2,710,843, equivalent of RMB22,500,000, has been injected into Shenyang.

Zhejiang was established in 2002 to focus on power steering pumps.

Jingzhou was formed in February 2003 to produce environmental textiles and raw materials, and was owned 51% by Ji Long and 49% by Cixi City Fulida Synthetic Fibre Co., Ltd. Effective September 1, 2004, in order to concentrate on its main products, namely steering and automotive parts, the Company disposed of its 51% interest in Jingzhou by entering into an equity exchange agreement, the Exchange Agreement, with Hubei Wanlong Investment Co., Ltd. Hubei Wanlong, controlled by Mr. Hanlin Chen, the Company's Chairman. Pursuant to the Exchange Agreement, the 51% equity interest in Jingzhou owned by Ji Long was exchanged for 2.5% of Hubei Wanlong's equity interest in Henglong based on their respective fair market values as determined by an independent appraisal firm. The difference between the fair value and the book value resulting from the disposition of the Joint-venture interest in Jingzhou was debited to additional paid-in capital. With respect to consideration paid by the Company in excess of its Chairman's basis for his investment, such excess has been charged to additional paid-in capital as a distribution to the Chairman, resulting in the acquired 2.5% equity interests in Henglong being recorded by the Company at the Chairman's original cost basis. The Company paid approximately \$90,000 to Hubei Wanlong in conjunction with this transaction.

The divested non-core business of Jingzhou has been treated as a discontinued operation under SFAS No. 144. Jingzhou was divested from the Company's operations as of August 31, 2004.

On April 12, 2005, one of the subsidiary companies, Great Genesis entered into a Joint-venture agreement with Shanghai Hongxi Investment Inc., Hongxi, a company controlled by Mr. Hanlin Chen, the Company's Chairman, and Sensor System Solution Inc., Sensor, to establish a Joint-venture, Universal Sensor Application Inc., USAI, in the Wuhan East Lake development zone. The registered capital of the Joint-venture is \$10 million. Great Genesis and Hongxi will invest \$6 million and \$1 million, respectively, including cash and land and building, which will account for 60% and 10% of the total registered capital, respectively. Sensor invested \$3 million in technology, accounting for 30% of the total registered capital. The registered capital is required to be paid in three installments within one year after signing of the Joint-venture agreement, April 12, 2005. As of March 31, 2006, Great Genesis and Sensor have contributed \$432,100, equivalent of RMB 3,500,000 and \$3,000,000 respectively including cash and technology. Hongxi has not contributed any capital. USAI's main activities in 2005 were to prepare for the technology and manufacturing in production operations and will likely continue to do so in 2006.

CRITICAL ACCOUNTING POLICIES

The Company prepares its condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Management periodically evaluates the estimates and judgments made. Management bases its estimates and judgments on historical experience and on various factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates as a result of different assumptions or conditions. The following critical accounting policies affect the more significant judgments and estimates used in the preparation of the Company's condensed consolidated financial statements.

MINORITY INTERESTS:

Minority interests refer to the percentage of the owner's equity of a subsidiary owned by those investors other than the parent company. Minority interests in the condensed consolidated financial statements means the percentage of the Company's net assets owned by shareholders of the Company's Sino-foreign Joint-ventures other than the Company, according to their respective investment ratios.

REVENUES:

The Company recognizes revenue when the significant risks and rewards of ownership have been transferred to the customer pursuant to PRC law, including factors such as when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, sales and value added tax laws have been complied with, and collectibility is probable. The Company recognizes product sales generally at the time the product is shipped. Concurrent with the recognition of revenue, the Company reduces revenue for estimated product returns. Shipping and handling costs are included in cost of goods sold. Revenue is presented net of any sales tax and value added tax.

ACCOUNTS RECEIVABLE:

In order to determine the value of the Company's accounts receivable, the Company records an allowance for doubtful accounts to cover estimated credit losses. Management reviews and adjusts this allowance periodically based on historical experience and its evaluation of the collectibility of outstanding accounts receivable. The Company evaluates the credit risk of its customers utilizing historical data and estimates of future performance.

INVENTORIES:

Inventories are stated at the lower of cost or net realizable value. Cost is calculated on the moving-average basis and includes all costs to acquire and other costs incurred in bringing the inventories to their present location and condition. The Company evaluates the net realizable value of its inventories on a regular basis and records a provision for loss to reduce the computed moving-average cost if it exceeds the net realizable value.

INCOME TAXES:

The Company records a tax provision to reflect the expected tax payable on taxable income for the period, using tax rates enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous periods.

IMPAIRMENT OF LONG-LIVED ASSETS:

The Company's long-lived assets consist of property and equipment and certain intangible assets. In assessing the impairment of such assets, the Company periodically makes assumptions regarding the estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or the related assumptions indicate that the carrying amount may not be recoverable, the Company records impairment charges for these assets at such time.

RESULTS OF OPERATIONS THREE MONTHS ENDED MARCH 31, 2006 AND 2005:

NET SALES:

Net sales were \$20,964,452 for the three months ended March 31, 2006, as compared to \$13,976,450 for the three months ended March 31, 2005, an increase of \$6,988,002 or 50.0%. The increase in net sales in 2006 as compared to 2005 was a result of the following factors:

(1) Primarily, the increase in sales was due to an increase in sales of passenger vehicles. As of March 31, 2006, the unfavorable conditions of declined prices and sales downturn for passenger vehicles that commenced in 2004 have been reversed. The Company has adjusted its marketing strategies accordingly and concentrated on manufacturing and selling steering gears for passenger vehicles and steering pumps, which led to sales from steering gears and pumps for the three months ended March 31, 2006 increasing 191.8% and 228.9% over the same period of 2005, respectively.

(2) In the first quarter of 2006, sales of steering gear and accessories for commercial vehicles decreased by 38.3% as compared to the same period of 2005, as a result of the adjustment of the real estate and coal markets by the Chinese Government, which resulted in a significant slowdown in growth in demand for commercial vehicles. Accordingly, the Company as a supplier of steering gears for commercial vehicles was also affected.

GROSS PROFIT

For the three months ended March 31, 2006, the gross profit was \$6,945,197, as compared to \$5,030,341 for the three months ended March 31, 2005, an increase of \$1,914,856 or 38.1%. The increase in sales contributed to an increase of \$2,508,395 in gross profit, a decrease in unit cost resulted in an increase of \$304,039 in gross profit, which was partially offset by a decrease in selling prices which resulted in a decrease of \$897,578 in gross profit.

Gross margin was 33.1% for the three months ended March 31, 2006, a decrease of 2.9% from 36.0% for the same period of 2005. The decrease reflects a decrease in selling prices which was partially offset by a cost decrease during the first quarter of 2006. The decrease in gross profit was consistent with the Company's anticipation that the sales price of automotive parts would fall approximately by 8%-10% during 2006. The Company plans to take the following measures in the remaining nine months of 2006 to reduce costs and to meet its yearly gross margin target of not less than 30%:

(1) Reduce labor costs. The Company has purchased certain advanced production equipment, which optimizes manufacturing cycles, and further improves productivity capacity and efficiency. The Company estimates that its labor costs will be reduced by 3% as compared to 2005 as a result of the advantage of its optimized manufacturing cycles and reduced standard labor hours.

(2) Reduce the cost of raw materials. In 2006, the Company plans to continue to control the costs of raw materials by two means: Firstly, volume purchases of major raw materials will be made through a bidding process, and for purchases of other smaller quantities of non major materials, target prices will be set to guide such purchases. Secondly, technical personnel have been encouraged to reevaluate the product structure and production techniques so as to optimize product design, reduce the weight of parts and wastage in the production process, and thus reduce the cost of raw materials. The Company estimates that its material cost will be reduced by 2% as a result of these measures.

(3) Reduce manufacturing expenses. In 2006, the Company will reexamine the standard material consumption rates, and regulate the program of approval and usage for supplementary materials, such as oil, cutting tools, dies and other supplies. It is estimated that its manufacturing expenses would be reduced by 1% through these measures.

SELLING EXPENSES:

Selling expenses were \$909,852 for the three months ended March 31, 2006, as compared to \$674,068 for the same period of 2005, an increase of 235,784 or 35.0%. The increased selling expenses in the first quarter of 2006 were mainly due to the following factors:

(1) Increased after-sales expenses. The Company recorded \$331,874 of after-sales expenses for the three months ended March 31, 2006, as compared to \$111,123 for the same period of 2005, an increase of \$220,752 or 198.7%. Mainly due to all automobile manufacturers introduced a policy requiring automotive parts suppliers to pay a 3-R Guarantees service charge for repair, replacement and refund of supplied automotive parts in an amount equal to one percent of the total amount of parts supplied during 2006 and 2005. The substantial increase in after-sales service expenses require the Company's management to strengthen its control both on manufacturing cost as well as after-sales service cost.

(2) Increased transportation expenses. The Company recorded \$293,177 of transportation expenses for the three months ended March 31, 2006, as compared to \$179,066 for the same period of 2005, an increase of \$114,111 or 63.7%, as a result of increased sales.

(3) Decreased provision for market development: At the beginning of 2005, the Company began to strengthen its market development and instituted a policy on the establishment of a fund for market development expenditures. The Company recorded \$198,000 of provision for market development expenses during the three months ended March 31, 2005, and during the three months ended March 31, 2006, the Company recorded \$90,000 of provision for market development expenses based on its past experiences.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses were \$2,620,174 for the three months ended March 31, 2006, as compared to \$1,770,285 for the same period of 2005, an increase of \$849,889 or 48.0%.

Material expense items that had increased on a comparable basis were salaries and wages, provision for doubtful accounts and warranty. Material expense items that had decreased on a comparable basis were supplies, labor insurance. They are explained as follows:

(1) Salaries and wages was \$612,287 in the first quarter of 2006, as compared to \$273,113 for the same period of 2005, an increase of \$339,174 or 124.2%. Mainly due to increased production in 2006, which led to increased workload for management.

(2) Provision for doubtful accounts was \$684,517 in the first quarter of 2006, as compared to \$117,737 for the same period of 2005, an increase of \$566,780 or 481.4%. Our accounts receivable increased during the three months ended March 31, 2006 as a result of increased sales volume. Management believes that the Company shall record a higher provision for doubtful accounts to cover estimated credit losses.

(3) Warranty provision was \$582,636 in the first quarter of 2006 as compared to \$125,788 for the same period of 2005, an increase of \$456,848 or 363.2%. Managements believe that the Company should record more reserve for warranty expense to provide for risk of product claims as we gain more market share. As compared to 0.9% for the same period of 2005, the Company increased the rate of warranty provision to 2.78% of the net sales in the first quarter of 2006.

(4) Supplies expense was \$71,458 in the first quarter of 2006, as compared to \$206,486 for the same period of 2005, a decrease of \$135,028 or 65.4%. The decrease is due to the Company having executed a more economical and effective materials consumption standard for Administrative Department during early 2006. These measures have achieved good results.

(5) Labor insurance was \$50,709 in the first quarter of 2006, as compared to \$311,160 for the same period of 2005, a decrease of \$260,451 or 83.7%. The decrease in labor insurance expenses was due to Henglong and Jiulong, two of the Company's subsidiaries changing their calculation base for endowment insurance expenses set by the local Government policy, which was 20% of the minimum salary ratified by the authority in the first quarter of 2006. In 2005 the endowment insurance expenses were recorded as 20% of the salary actually paid.

DEPRECIATION AND AMORTIZATION EXPENSE.

For the three months ended March 31, 2006, the depreciation and amortization expenses excluding those recorded in cost of sales were \$688,490, as compared to \$614,821 for the three months ended March 31, 2005, an increase of \$73,669 or 12%, as a result of USAI, one of the Joint-ventures of the Company, amortizing organization expenses of \$52,166 for the three months ended March 31, 2006, while there being no such expenses for the same period of 2005.

RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses were \$189,747 for the three months ended March 31, 2006, as compared to \$357,709 for the three months ended March 31, 2005, a decrease of \$167,962 or 47.0%, as a result of the Company's R&D department focusing on applications of prior purchased versus organic technologies.

INCOME FROM OPERATIONS

Income from operations was \$2,536,934 for the three months ended March 31, 2006, as compared to \$1,613,458 for the three months ended March 31, 2005, an increase of \$923,476 or 57.2%, as a result of an increase of \$1,914,856 or 38.1% in gross profit and an increase of \$991,380 or 29.0% in operating expenses.

OTHER NON-OPERATING INCOME

Other non-operating income was \$83,340 for the three months ended March 31, 2006, as compared to \$25,319 for the three months ended March 31, 2005, an increase of \$58,021 or 229.2%, as a result of increased sales of materials in the first quarter of 2006.

FINANCIAL EXPENSES

Financial expenses were \$334,386 for the three months ended March 31, 2006, as compared to \$283,233 for the three months ended March 31, 2005, an increase of \$51,153 or 18.1%, primarily result of an increase in weighted average interest rates from 5.24% for the three months ended March 31, 2005 to 5.91% for the three months ended March 31, 2006.

INCOME BEFORE INCOME TAXES

Income before income taxes was \$2,285,888 for the three months ended March 31, 2006, as compared to \$1,355,544 for the three months ended March 31, 2005, an increase of \$930,344 or 68.6%, as a result of an increase in income from operations of \$923,476 or 57.2%, an increase in other non-operating income of \$58,021 or 229.2%, and an increase in financial expenses of \$51,153 or 18.1%.

INCOME TAXES

Income taxes expense was \$200,711 for the three months ended March 31, 2006, as compared to \$250,962 for the three months ended March 31, 2005, a decrease of \$50,251 or 20.0%, as a result of Henglong and Jiulong, two of the Company's Sino-foreign Joint-ventures, having received an income tax benefit of \$365,793 in the first quarter of 2006 for the purchase of domestic equipment, while there being no such item for the same period of 2005.

INCOME BEFORE MINORITY INTERESTS

Income before minority interests was \$2,085,177 for the three months ended March 31, 2006, as compared to \$1,104,582 for the three months ended March 31, 2005, an increase of \$980,595 or 88.8%, as a result of an increase in income before income taxes of \$930,344 or 68.6%, and a decrease in income taxes of \$50,251 or 20.0%.

MINORITY INTERESTS

Minority interests in the earnings of the Sino-foreign Joint-ventures amount to \$990,779 for the three months ended March 31, 2006, as compared to \$238,399 for the three months ended March 31, 2005, an increase of \$752,380 or 315.6%.

Minority shareholders own varying equity interests in five Sino-foreign Joint-ventures through which it conducts its operations, all of which were consolidated in 2006 and 2005. Since minority shareholders do not own the same equity interest in each Sino-foreign Joint-venture, the minority interests in them for different periods presented as disclosed in Note 20 can be significantly affected by the performance mix of the individual Joint-ventures. The increase of minority interests in the earnings of the Sino-foreign Joint-ventures in 2006 as compared to 2005 is primarily due to an increase in net income from Henglong. The minority shareholders own 55.5% of Henglong's equity for the three months ended March 31, 2006.

NET INCOME

Net income was \$1,094,398 for the three months ended March 31, 2006, as compared to a net income of \$866,183 for the three months ended March 31, 2005, an increase of \$228,215 or 26.3%, as a result of an increase in income before minority interests of \$980,595 or 88.8%, and an increase in minority interests of 752,380 or 315.6%.

LIQUIDITY AND CAPITAL RESOURCES:

The Company has relied primarily on cash flow from operations and bank loans for its capital requirements for the three months ended March 31, 2006.

OPERATIONS

The Company's operations provided cash of \$7,709,682 for the three months ended March 31, 2006, as compared to cash of \$898,639 for the three months ended March 31, 2005, an increase of \$6,811,043, which is primarily the result of the following:

- (1) Net cash from continued operations increased during the period as a result of increased cash flow provided by product sales and service: For the three months ended March 31, 2006, cash flow provided by product sales and service was \$4,225,218, as compared to \$2,256,384 for the same period of 2005, an increase of \$1,968,834 as a result of increased sales in 2006.
- (2) Net cash provided by operating activities decreased during the period as a result of increased net cash used in operating assets: For the three months ended March 31, 2006, net cash used in operating assets was \$8,781,067, as compared to \$447,219 for the same period of 2005, a decrease of \$8,333,848, mainly due to increased operating assets along with the increased sales.
- (3) Net cash from continued operations increased during the period as a result of extending due date for payment in operating liabilities: The operating liabilities were \$12,265,531 for the three months ended March 31, 2006, as compared to a decrease of \$910,526 for the same period of 2005, an increase in net cash of \$13,176,057, mainly due to the suppliers having extended the due date for payment contingent on increased purchase volume and acceptable credit rating of the Company.

As of March 31, 2006, cash and cash equivalents were \$22,140,596, and working capital was \$16,675,309. As of December 31, 2005, cash and cash equivalents were \$12,374,944, and working capital were \$9,102,809, reflecting a current ratio of 1.23:1 and 1.15:1 at March 31, 2006 and December 31, 2005, respectively.

The Company intends to finance its operating costs and expenses for the remaining period of 2006 and next year in the following ways:

(1) The Company has working capital of \$16,675,309 for the three months ended March 31, 2006 and cash flow provided from continued operations activities in the remaining months of 2006.

(2) Equity Line of Credit Financing: On March 20, 2006, we entered into a Standby Equity Distribution Agreement with Cornell Capital Partners, LP entitling us to, from time to time, sell common stock at a slight discount to market price for a total purchase price of up to \$15 million. Under the agreement, Cornell Capital Partners, LP has committed to provide funding to be drawn down over a 24-month period at our discretion, following a registration which was declared effective on April 28, 2006..

(3) Loans by banks: Throughout 2006, the Company had a 364-day revolving credit line in the amount of \$33,707,865 with Chinese banks, including \$12,484,395, equivalent of RMB100,000,000, from Bank of China, \$8,739,076, equivalent of RMB70,000,000, from China Construction Bank, \$2,496,879, equivalent of RMB20,000,000, from CITIC Industrial Bank, \$3,745,318, equivalent of RMB30,000,000, from Shanghai Pudong Development Bank and \$6,242,197, equivalent of RMB50,000,000, from Jingzhou Commercial Bank, respectively.

INVESTING

During the three months ended March 31, 2006, the Company expended net cash of \$2,192,586 in investment activities, as compared to \$770,761 for the same period of 2005, an increase of \$1,421,825 as a result of following factors:

(1) Net cash used in investment activities increased during the period as a result of increased net disbursement in other receivables: The Company expended net cash of \$1,401,564 in other receivables for the three months ended March 31, 2006, as compared to \$142,253 for the three months ended March 31, 2005, an increase of \$1,259,311, mainly due to the account receivable of related parties being \$1,846,889 for the three months ended March 31, 2006, as compared to the \$217,633 for the same period of 2005, an increase of \$1,629,256. These accounts receivable were carrying interest and repayable on demand

(2) Net cash used in investment activities increased during the period as a result of increased net disbursement in purchasing property and equipment: The Company expended net cash of \$652,784 for purchasing property and equipment for the three months ended March 31, 2006, as compared to \$552,890 for the three months ended March 31, 2005, an increase of \$99,894, primarily due to the Renminbi rise against the US dollars.

(3) Net cash used in investment activities increased during the period as a result of increased net disbursement in purchasing intangible assets: The Company expended net cash of \$138,238 for purchasing intangible assets for the three months ended March 31, 2006, as compared to \$75,618 for the three months ended March 31, 2005, an increase of \$62,620, primarily due to the Renminbi rise against the US dollars.

FINANCING

During the three months ended March 31, 2006, the Company expended net cash of \$3,647,157 in financing activities, as compared to \$1,679,922 for the three months ended March 31, 2005, an increase of \$1,967,235 as a result of following factors:

(1) Net cash provided in financing activities decreased during the period as a result of decreased net proceeds from the bank loans: The Company has decreased the net proceeds from the bank loans of \$1,081,981 for the three months ended March 31, 2006, as compared to having an increase of \$2,409,638 for the same period of 2005, a decrease of \$3,491,619, mainly due to net cash provided by operating activities having increased, which led to decreased demand on bank loans.

(2) Net cash provided in financing activities increased during the period as a result of decreased dividends paid to the minority interest holders of Joint-ventures: The company expended \$124,844 of dividends to the minority interest holders of Joint-ventures for the three months ended March 31, 2006, as compared to \$787,321 for the same period of 2005, a decrease of \$662,477, mainly due to extending the due date for payment.

(3) Net cash provided in financing activities decreased during the period as a result of decreased amounts due to shareholders/directors: The Company expended \$86,018 of advances from shareholders/directors for the three months ended March 31, 2006, as compared to \$57,605 of advances from shareholders/directors for the same period of 2005, a decrease of \$143,623, mainly due to the Company repaid shareholders/directors part of their advances at their request for the three months ended March 31, 2006.

(4) Net cash provided in financing activities increased during the period as a result of increased financing from investors: The Company received net cash of \$4,940,000 from financing activities for the three months ended March 31, 2006, while there was no such financing for the same period of 2005.

OFF-BALANCE SHEET ARRANGEMENTS

At March 31, 2006 and 2005, the Company did not have any transactions, obligations or relationships that could be considered off-balance sheet arrangements.

COMMITMENTS AND CONTINGENCIES

The Company has the following material contractual obligations and capital expenditure commitments:

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| Date | Parties involved | Description of Commitments and Contingencies |
|-------------------------|---|--|
| October 30, 2001 | Henglong & Bishop Steering Technology Limited, Bishop, an Australian company | Ten year license agreement for the design of power steering systems. Henglong is obligated to pay Bishop technical assistance fee of approximately \$200,000 per year during the first two years and \$110,000 per year during the remaining eight years of the agreement. |
| July 21, 2003 | Henglong & Namyang Industrial Co. Ltd., Namyang, a Korean manufacturer of steering assemblies for automobiles | Five year license and technical assistance agreement. Henglong paid Namyang an initial payment of \$100,000 and is further obligated to pay a royalty of 3% of the sales price of products sold, which includes the licensed columns and universal joint technology. |
| March to December, 2004 | Henglong & some equipment manufacturers | Entered into some equipment contracts with total value approximately \$4,719,967. Henglong paid \$1,743,201 and \$2,606,332 during 2004 and 2005. The Company paid \$112,060 as of three months ended March 31, 2006 and \$258,374 remains outstanding. The Company will pay \$164,747 and \$93,627 for the nine months ended December 31, 2006 and in 2007, respectively. |
| March to December 2004 | Jiulong & some equipment manufacturers | Entered into some equipment contracts with total value of approximately \$2,752,479. Jiulong paid \$1,021,021 and \$1,117,318 during 2004 and 2005. The Company paid \$16,663 as of three months ended March 31, 2006 and \$597,478 remains outstanding. The Company will pay \$330,920 and \$266,558 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | Henglong & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$1,163,650. Henglong paid \$1,039,442 and \$7,388 in 2005 and as of three months ended March 31, 2006, respectively, and \$167,420 remains outstanding. The Company will pay \$161,561 and \$5,904 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | Jiulong & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$637,108. Jiulong paid \$350,542 and \$12,048 in 2005 and as of three months ended March 31, 2006, respectively, and \$274,518 remains outstanding. The Company will pay \$247,217 and \$27,301 for the nine months ended December 31, 2006 and in 2007, respectively. |
| April to December, 2005 | USAI & some equipment manufacturers | Have entered into some equipment contracts with total value approximately \$238,577 in 2005. USAI paid \$141,346 and \$45,277 in 2005 and for the three months ended March 31, 2006, respectively, and will pay off the remaining \$51,954 during the nine months ended December 31, 2006. |

On March 31, 2006, as amended on May 2, 2006, Great Genesis, the wholly-owned subsidiary of the Company, entered into a Joint-venture agreement with Wuhu Chery Technology Co., Ltd., Chery Technology, to establish a Joint-venture, Wuhu Henglong Automotive Steering System Co., Ltd in the Wuhu Technological Development Zone. Chery Technology is a wholly-owned subsidiary of Chery Automobile. The Joint-venture will focus on producing and selling automotive steering system. The registered capital of the joint venture is \$3,745,318, equivalent of RMB30,000,000. Great Genesis and Chery Technology will invest \$2,896,379, equivalent of RMB23,200,000, and \$848,939, equivalent of RMB 6,800,000 respectively, which will account for 77.33% and 22.67% of the total registered capital, respectively. The registered capital is required to be paid within one month after effectiveness of the agreement which was approved by the Chinese government on April 14, 2006.

SUBSEQUENT EVENTS

None

Item 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

CREDIT RISK: The Company's financial instruments that are exposed to concentration of credit risk consist primarily of cash and cash equivalents, and accounts receivable from customers. Cash and cash equivalents are maintained with major state-owned banks in the PRC. The Management has not evaluated the credit risk from banks based on its notion that state-owned banks command considerable funds with good reputation. The Company's business activity is primarily with customers in the PRC. The Company periodically performs credit analysis and monitors the financial condition of its clients in order to minimize credit risk. Because of the increase of activities and business, and the increase of customers' accounts receivable, there is no assurance that foresaid measures will be completely effective. We have approximately \$38,000,000 of accounts receivable as of March 31, 2006, the Company's revenues and/or operating cash flow would be materially and adversely affected if there is a 3% allowance for doubtful accounts which led to approximately \$1,100,000 to the Company.

CURRENCY EXCHANGE RATE RISK: The Company's currency exchange rate risks consist primarily of currency from financing. The Company's financing activities were settled in US dollars and deposited in its bank account in US dollars, while the Company conducts virtually all of its business and investment activity in China and the value of our business is effectively denominated in Renminbi. The Company will convert US dollars into RMB to conduct its investment activities and business. The Company does not hedge its RMB-US dollar exchange rate exposure. The Company has dollar holdings of approximately \$5,000,000 as for March 31, 2006, if the exchange rate between US dollars and RMB were to increase by 10%, we would potentially suffer loss by approximately \$500,000. Therefore, we will choose to reduce our exposures through financial instruments (hedges) that provide offsets or limits to our exposures when considered appropriate.

MARKET INTEREST RATE RISK: The Company has \$30,000,000 of short-term revolving credit line with annual interest expenses of \$1,770,000 based on fully used. As result of the bank loan rate of China may be volatile and rising recently, therefore if the market interest rate increased by 10%, such increases could result in increased loan interest on the Company.

RISK OF INVENTORY PRICES: The risk of inventory prices of the Company comes from the upward movement in prices of raw materials and downward movement of selling price. Management believes the latter one is more material. For recent years, the price fluctuation on raw materials was not so great, but the price on steering had fluctuated significantly. During the years 2003 to 2005, the price on steering has decreased at approximately 10% each year on an average basis. In the year 2005, the output and sales of domestic commercial vehicles has decreased greatly as compared to 2004, as a result of influence on rectifying the over-sized and over-loaded of the commercial vehicles market, and the adjustment of the real estate and coal markets by the Chinese Government. One of the Joint-ventures of the Company, Jiulong, also suffered from that as a supplier of commercial vehicles. And there is no sign that the market is on the upturn in 2006. As of March 31, 2006, Jiulong's inventory amount was approximately \$6,000,000. If the selling price of steering decreases by 10%, then the income of the Company will decrease by \$600,000. In the year 2006, the Company will take two measures as follows to decrease the inventory at a reasonable level, thus decreasing the potential risk of inventory prices.

- (1) Further develop the market in order to use up the finished good from more sales.
- (2) Better organize all kinds of information, adjust the inventory from various warehouses, and avoid unnecessary production.

But there is no assurance that foresaid measures will be effective.

ITEM 4 CONTROLS AND PROCEDURES

(a) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Company's disclosure controls and procedures are designed to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission (the SEC). The Company's disclosure controls and procedures are also designed to ensure that information required to be disclosed in the reports filed under the Exchange Act of 1934 (the Exchange Act) is accumulated and communicated to management, including its principal executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure.

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including its principal executive and financial officers, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon and as of the date of that evaluation, the Company's principal executive and financial officers concluded that the Company's disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act 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 disclosure.

(b) CHANGES IN INTERNAL CONTROLS

There was no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1 Legal Proceedings

The Company is not currently a party to any threatened or pending legal proceedings, other than incidental litigation arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

ITEM 1A. Risk Factors

The Company's businesses, financial conditions and results of operations could be materially and adversely affected by many risk factors. Because of these risk factors, actual results might differ significantly from those projected in the forward-looking statements. Factors that might cause such differences include, among others, the following:

Risks Related to the Company's Business and Industry

Because the Company is a holding company with substantially all of its operations conducted through its subsidiaries, its performance will be affected by the performance of its subsidiaries.

The Company has no operations independent of those of Great Genesis and its subsidiaries, and its principal assets are its investments in Great Genesis and its subsidiaries. As a result, the Company is dependent upon the performance of Great Genesis and its subsidiaries and will be subject to the financial, business and other factors affecting Great Genesis as well as general economic and financial conditions. As substantially all of the Company's operations are and will be conducted through its subsidiaries, it will be dependent on the cash flow of its subsidiaries to meet its obligations.

Because virtually all of the Company's assets are and will be held by operating subsidiaries, the claims of its stockholders will be structurally subordinate to all existing and future liabilities and obligations, and trade payables of such subsidiaries. In the event of the Company's bankruptcy, liquidation or reorganization, the Company's assets and those of its subsidiaries will be available to satisfy the claims of its stockholders only after all of the Company's and its subsidiaries' liabilities and obligations have been paid in full.

With the automobile parts markets being highly competitive and many of the Company's competitors having greater resources than it does, the Company may not be able to compete successfully.

The automobile parts industry is a highly competitive business. Criteria for the Company's customers include:

- Quality;
- Price/cost competitiveness;
- System and product performance;
- Reliability and timeliness of delivery;
- New product and technology development capability;
- Excellence and flexibility in operations;
- Degree of global and local presence;
- Effectiveness of customer service; and
- Overall management capability.

The Company's competitors include independent suppliers of parts, as well as suppliers formed by spin-offs from its customers, who are becoming more aggressive in selling parts to other vehicle manufacturers. Depending on the particular product, the number of the Company's competitors varies significantly. Many of the Company's competitors have substantially greater revenues and financial resources than it does, as well as stronger brand names, consumer recognition, business relationships with vehicle manufacturers, and geographic presence than it has. The Company may not be able to compete favorably and increased competition may substantially harm its business, business prospects and results of operations.

Internationally, the Company faces different market dynamics and competition. The Company may not be as successful as its competitors in generating revenues in international markets due to the lack of recognition of its products or other factors. Developing product recognition overseas is expensive and time-consuming and the Company's international expansion efforts may be more costly and less profitable than it expects. If the Company is not successful in its target markets, its sales could decline, its margins could be negatively impacted and the Company could lose market share, any of which could materially harm the Company's business, results of operations and profitability.

The cyclical nature of automotive production and sales could result in a reduction in automotive sales, which could adversely affect the Company's business and results of operations.

The Company's business relies on automotive vehicle production and sales by its customers, which are highly cyclical and depend on general economic conditions and other factors, including consumer spending and preferences. They also can be affected by labor relations issues, regulatory requirements, and other factors. In addition, in the last two years, the price of automobiles in China has generally declined. As a result, the volume of automotive production in China has fluctuated from year to year, which give rise to fluctuations in the demand for the Company's products. Any significant economic decline that results in a reduction in automotive production and sales by the Company's customers would have a material adverse effect on its results of operations. Moreover, if the prices of automobiles do not remain low, then demand for automobile parts could fall and result in lower revenues and profitability.

Increasing costs for manufactured components and raw materials may adversely affect the Company's profitability.

The Company uses a broad range of manufactured components and raw materials in its products, including castings, electronic components, finished sub-components, molded plastic parts, fabricated metal, aluminum and steel, and resins. Because it may be difficult to pass increased prices for these items on to the Company's customers, a significant increase in the prices of the Company's components and materials could materially increase its operating costs and adversely affect its profit margins and profitability.

Pricing pressure by automobile manufacturers on their suppliers may adversely affect the Company's business and results of operations.

Recently, pricing pressure from automobile manufacturers has been prevalent in the automotive parts industry in China. Virtually all vehicle manufacturers seek price reductions each year, including requiring suppliers to pay a 3-R Guarantees service charge for repair, replacement and refund in an amount equal to one percent of the total amount of parts supplied. Although the Company has tried to reduce costs and resist price reductions, these reductions have impacted the Company's sales and profit margins. If the Company cannot offset continued price reductions through improved operating efficiencies and reduced expenditures, price reductions will have a material adverse effect on the Company's results of operations.

The Company's business, revenues and profitability would be materially and adversely affected if it loses any of its large customers.

For the three months ended March 31, 2006, approximately 11.9% of the Company's sales were to Brilliance China Automotive Holdings Limited, approximately 11.2% were to Beiqi Foton Motor Co., Ltd., approximately 13.8% were to Cherry Automobile Co., Ltd. and approximately 13.0% were to Zhejiang Geely Holding Co., Ltd., the Company's four largest customers. The loss of, or significant reduction in purchases by, one or more of these major customers could adversely affect the Company's business.

The Company may be subject to product liability and warranty and recall claims, which may increase the costs of doing business and adversely affect the Company's financial condition and liquidity.

The Company may be exposed to product liability and warranty claims if its products actually or allegedly fail to perform as expected or the use of its products results, or is alleged to result, in bodily injury and/or property damage. The Company started to pay to its customers increased after-sales service expenses due to consumer rights protection policies of recall issued by the Chinese Government in 2004, such as the recalling flawed vehicles policy. Beginning in 2004, automobile manufacturers unilaterally required their suppliers to pay a 3-R Guarantees service charge (for repair, replacement and refund) in an amount equal to one percent of the total amount of parts supplied. Accordingly, the Company has experienced and shall continue to experience higher after sales service expenses. Product liability, warranty and recall costs may have a material adverse effect on the Company's financial condition.

The Company is subject to environmental and safety regulations, which may increase the Company's compliance costs and may adversely affect the Company's results of operation.

The Company is subject to the requirements of environmental and occupational safety and health laws and regulations in China. The Company cannot provide assurance that it has been or will be at all times in full compliance with all of these requirements, or that it will not incur material costs or liabilities in connection with these requirements. Additionally, these regulations may change in a manner that could have a material adverse effect on the Company's business, results of operations and financial condition. The capital requirements and other expenditures that may be necessary to comply with environmental requirements could increase and become a material expense of doing business.

Non-performance by the Company's suppliers may adversely affect its operations by delaying delivery or causing delivery failures, which may negatively affect demand, sales and profitability.

The Company purchases various types of equipment, raw materials and manufactured component parts from its suppliers. The Company would be materially and adversely affected by the failure of its suppliers to perform as expected. The Company could experience delivery delays or failures caused by production issues or delivery of non-conforming products if its suppliers failed to perform, and the Company also faces these risks in the event any of its suppliers becomes insolvent or bankrupt.

The Company's business and growth may suffer if it fails to attract and retain key personnel.

The Company's ability to operate its business and implement its strategies effectively depends on the efforts of its executive officers and other key employees. The Company depends on the continued contributions of its senior management and other key personnel. The Company's future success also depends on its ability to identify, attract and retain highly skilled technical, particularly engineers and other employees with electronics expertise, managerial, finance and marketing personnel. The Company does not maintain a key person life insurance policy on Mr. Hanlin Chen. The loss of the services of any of the Company's key employees or the failure to attract or retain other qualified personnel could substantially harm the Company's business.

The Company's management controls approximately 89.7% of its outstanding common stock and may have conflicts of interest with its minority stockholders.

Members of the Company's management beneficially own approximately 89.7% of the outstanding shares of the Company's common stock. As a result, these majority stockholders have control over decisions to enter into any corporate transaction and have the ability to prevent any transaction that requires the approval of stockholders, which could result in the approval of transactions that might not maximize stockholders' value. Additionally, these stockholders control the election of members of the Company's board, have the ability to appoint new members to the Company's management team and control the outcome of matters submitted to a vote of the holders of the Company's common stock. The interests of these majority stockholders may at times conflict with the interests of the Company's other stockholders.

There is a limited public float of the Company's common stock, which can result in its stock price being volatile and prevent the realization of a profit on resale of the Company's common stock

There is a limited public float of the Company's common stock. Of the Company's outstanding common stock, approximately 10% is considered part of the public float. The term "public float" refers to shares freely and actively tradable on the NASDAQ SmallCap Market and not owned by officers, directors or affiliates, as such term is defined under the Securities Act. Due to the common stock. As a result, the market price of the Company's common stock can be volatile. This stock price volatility could prevent a stockholder seeking to sell Company common stock from being able to sell it at or above the price at which the stock was bought.

Provisions in the Company's certificate of incorporation and bylaws and the General Corporation Law of Delaware may discourage a takeover attempt.

Provisions in the Company's certificate of incorporation and bylaws and the General Corporation Law of Delaware, the state in which the Company is organized, could make it difficult for a third party to acquire the Company, even if doing so might be beneficial to the Company's stockholders. Provisions of the Company's certificate of incorporation and bylaws impose various procedural and other requirements, which could make it difficult for stockholders to effect certain corporate actions and possibly prevent transactions that would maximize stockholders' value.

Risks Related to Doing Business in China and other International Countries

Because the Company's operations are all located outside of the United States and are subject to Chinese laws, any change of Chinese laws may adversely affect the Company's business.

All of the Company's operations are outside the United States and in China, which exposes it to risks, such as exchange controls and currency restrictions, currency fluctuations and devaluations, changes in local economic conditions, changes in Chinese laws and regulations, exposure to possible expropriation or other Chinese government actions, and unsettled political conditions. These factors may have a material adverse effect on the Company's operations or on the Company's business, results of operations and financial condition.

The Company's international expansion plans subject it to risks inherent in doing business internationally.

The Company's long-term business strategy relies on the expansion of the Company's international sales outside China by targeting markets, such as the United States. Risks affecting the Company's international expansion include challenges caused by distance, language and cultural differences, conflicting and changing laws and regulations, foreign laws, international import and export legislation, trading and investment policies, foreign currency fluctuations, the burdens of complying with a wide variety of laws and regulations, protectionist laws and business practices that favor local businesses in some countries, foreign tax consequences, higher costs associated with doing business internationally, restrictions on the export or import of technology, difficulties in staffing and managing international operations, trade and tariff restrictions, and variations in tariffs, quotas, taxes and other market barriers. These risks could harm the Company's international expansion efforts, which could in turn materially and adversely affect the Company's business, operating results and financial condition.

The Company faces risks associated with currency exchange rate fluctuations, any adverse fluctuation may adversely affect the Company's operating margins.

Although the Company is incorporated in the United States, the majority of its current revenues are in Chinese currency. Conducting business in currencies other than US dollars subjects the Company to fluctuations in currency exchange rates that could have a negative impact on the Company's reported operating results. Fluctuations in the value of the US dollar relative to other currencies impact the Company's revenues, cost of revenues and operating margins and result in foreign currency translation gains and losses. Historically, the Company has not engaged in exchange rate hedging activities. Although the Company may implement hedging strategies to mitigate this risk, these strategies may not eliminate the Company's exposure to foreign exchange rate fluctuations and involve costs and risks of their own, such as ongoing management time and expertise, external costs to implement the strategy and potential accounting implications.

If relations between the United States and China worsen, the Company's stock price may decrease and the Company may have difficulty accessing the U.S. capital markets.

At various times during recent years, the United States and China have had disagreements over political and economic issues. Controversies may arise in the future between these two countries. Any political or trade controversies between the United States and China could adversely affect the market price of the Company's common stock and the Company's ability to access US capital markets.

The Chinese Government could change its policies toward private enterprises, which could adversely affect the Company's business.

The Company's business is subject to political and economic uncertainties in China and may be adversely affected by its political, economic and social developments. Over the past several years, the Chinese Government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese Government may not continue to pursue these policies or may alter them to the Company's detriment from time to time. Changes in policies, laws and regulations, or in their interpretation or the imposition of confiscatory taxation, restrictions on currency conversion, restrictions or prohibitions on dividend payments to stockholders, devaluations of currency or the nationalization or other expropriation of private enterprises could have a material adverse effect on the Company's business. Nationalization or expropriation could result in the total loss of the Company's investment in China.

The economic, political and social conditions in China could affect the Company's business.

All of the Company's business, assets and operations are located in China. The economy of China differs from the economies of most developed countries in many respects, including government involvement, level of development, growth rate, control of foreign exchange, and allocation of resources. The economy of China has been transitioning from a planned economy to a more market-oriented economy. Although the Chinese Government has implemented measures recently emphasizing the utilization of market forces for economic reform, the reduction of state ownership of productive assets and the establishment of sound corporate governance in business enterprises, a substantial portion of productive assets in China is still owned by the Chinese Government. In addition, the Chinese Government continues to play a significant role in regulating industry by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, controlling payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. Therefore, the Chinese Government's involvement in the economy could adversely affect the Company's business operations, results of operations and/or the financial condition.

The significant but uneven growth in the economy of China in the past 20 years could have negative effect on the Company's business and results of operations.

The Chinese Government has implemented various measures from time to time to control the rate of economic growth. Some of these measures benefit the overall economy of China, but may have a negative effect on us.

Government control of currency conversion and future movements in exchange rates may adversely affect the Company's operations and financial results.

The Company receives substantially all of its revenues in Renminbi, the currency of China. A portion of such revenues will be converted into other currencies to meet the Company's foreign currency obligations. Foreign exchange transactions under the Company's capital account, including principal payments in respect of foreign currency-denominated obligations, continue to be subject to significant foreign exchange controls and require the approval of the State Administration of Foreign Exchange in China. These limitations could affect the Company's ability to obtain foreign exchange through debt or equity financing, or to obtain foreign exchange for capital expenditures.

The Chinese Government controls its foreign currency reserves through restrictions on imports and conversion of Renminbi into foreign currency. Although the exchange rate of the Renminbi to the US dollar has been stable since January 1, 1994, and the Chinese Government has stated its intention to maintain the stability of the value of Renminbi, there can be no assurance that exchange rates will remain stable. The Renminbi could devalue against the US dollar. The Company's financial condition and results of operations may also be affected by changes in the value of certain currencies other than the Renminbi in which the Company's earnings and obligations are denominated. In particular, a devaluation of the Renminbi is likely to increase the portion of the Company's cash flow required to satisfy the Company's foreign currency-denominated obligations.

Because the Chinese legal system is not fully developed, the Company's legal protections may be limited.

The Chinese legal system is based on written statutes and their interpretation by the Supreme People's Court. Although the Chinese government introduced new laws and regulations to modernize its business, securities and tax systems on January 1, 1994, China does not yet possess a comprehensive body of business law. Because Chinese laws and regulations are relatively new, interpretation, implementation and enforcement of these laws and regulations involve uncertainties and inconsistencies and it may be difficult to enforce contracts. In addition, as the Chinese legal system develops, changes in such laws and regulations, their interpretation or their enforcement may have a material adverse effect on the Company's business operations. Moreover, interpretative case law does not have the same precedential value in China as in the United States, so legal compliance in China may be more difficult or expensive.

It may be difficult to serve the Company with legal process or enforce judgments against the Company's management or the Company.

All of the Company's assets are located in China and three out of the Company's directors and officers are non-residents of the United States, and all or substantial portions of the assets of such non-residents are located outside the United States. As a result, it may not be possible to effect service of process within the United States upon such persons to originate an action in the United States. Moreover, there is uncertainty that the courts of China would enforce judgments of U.S. courts against the Company, its directors or officers based on the civil liability provisions of the securities laws of the United States or any state, or an original action brought in China based upon the securities laws of the United States or any state.

Risks Related to the Standby Equity Distribution Agreement (SEDA)

Future sales by our stockholders may adversely affect our stock price and our ability to raise funds in new stock offerings.

Sales of our common stock in the public market following the SEDA could lower the market price of our common stock. Sales may also make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that our management deems acceptable, or at all. Of the 23,237,406 shares of common stock outstanding as of April 7, 2006, all such shares are, or will be, freely tradable without restriction, unless held by our affiliates. Some of these shares may be resold under Rule 144.

Existing stockholders could experience significant dilution from our sale of shares under the SEDA.

Our financial needs will be partially provided from the SEDA. The issuance of shares of our common stock under the SEDA, at below-market prices, will have a dilutive impact on our other stockholders and the issuance or even potential issuance of such shares could have a negative effect on the market price of our common stock. As a result, our net income per share could decrease in future periods, and the market price of our common stock could decline. In addition, the lower our stock price, the more shares of common stock we will have to issue under the SEDA to draw down the full amount. If our stock price is lower, then our existing stockholders would experience greater dilution.

Under the SEDA, Cornell Capital Partners will pay less than the then-prevailing market price of our common stock.

The common stock to be issued under the SEDA will be issued at a 1.5% discount to the lowest daily VWAP of our common stock during the five consecutive trading day period immediately following the date we notify Cornell Capital Partners that we desire to access the SEDA; provided, that the price per share paid by Cornell Capital Partners will in no event be less than a minimum of 90% of the closing bid price for our common stock on the trading day immediately preceding the date that we deliver an advance request. Further, Cornell Capital Partners will retain 4.5% of each advance under the SEDA. Based on this discount, Cornell Capital Partners will have an incentive to sell immediately to realize the gain on the 1.5% discount. These sales could cause the price of our common stock to decline, based on increased selling of our common stock.

The sale of our stock under the SEDA could encourage short sales by third parties, which could contribute to the future decline of our stock price.

In many circumstances, the provisions of a SEDA have the potential to cause a significant downward pressure on the price of a company's common stock. This is especially the case if the shares being placed into the market exceed the market's ability to take up the increased stock or if we have not performed in such a manner to show that the equity funds raised will be used for growth. Such an event could place further downward pressure on the price of our common stock. We may request numerous drawdowns pursuant to the terms of the SEDA. Even if we use the SEDA to invest in ways that are materially beneficial to us, the opportunity exists for short sellers and others to contribute to the future decline of our stock price. If there are significant short sales of stock, the price decline that would result from this activity in turn may cause long holders of the stock to sell their shares thereby contributing to sales of stock in the market. If there is an imbalance on the sell side of the market for our common stock, the price will decline.

It is not possible to predict those circumstances whereby short sales could materialize or the extent to which the stock price could drop. In some companies that have been subjected to short sales the stock price has dropped significantly. This could happen to our stock price.

Cornell Capital Partners may sell shares of our common stock after we deliver an advance notice during the pricing period, which could cause our stock price to decline.

Cornell Capital Partners is deemed to beneficially own the shares of common stock corresponding to a particular advance on the date that we deliver an advance notice to Cornell Capital Partners, which is prior to the date the stock is delivered to Cornell Capital Partners. Cornell Capital Partners may sell such shares any time after we deliver an advance notice. Accordingly, Cornell Capital Partners may sell such shares during the pricing period. Such sales may cause our stock price to decline and if so would result in a lower VWAP during the pricing period, which would result in us having to issue a larger number of shares of common stock to Cornell Capital Partners in respect of the advance.

We may not be able to obtain a cash advance under the SEDA if Cornell Capital Partners holds more than 9.9% of our common stock.

In the event Cornell Capital Partners holds more than 9.9% of our then-outstanding common stock, we will be unable to obtain a cash advance under the SEDA. A possibility exists that Cornell Capital Partners may own more than 9.9% of our outstanding common stock at a time when we would otherwise plan to request an advance under the SEDA. In that event, if we are unable to obtain additional external funding, we could fail to achieve the corporate objectives that we had hoped to use the cash to achieve.

ITEM 6. EXHIBITS

INDEX TO EXHIBITS

| Exhibit Number | Description of Document |
|----------------|---|
| 3(i).1 | Certificate of Incorporation* |
| 3(i).2 | Certificate of Amendment of Certificate of Incorporation** |
| 3(ii).1 | By - laws*** |
| 10.1 | Standby Equity Distribution Agreement dated March 20, 2006 between us and Cornell Capital Partners, LP**** |
| 10.2 | Placement Agent Agreement dated March 20, 2006 between us and Newbridge Securities Corporation**** |
| 10.3 | Registration Rights Agreement dated March 20, 2006 between us and Cornell Capital Partners, LP**** |
| 10.4 | Securities Purchase Agreement dated March 20, 2006 between us and Cornell Capital Partners, LP**** |
| 10.5 | Investor Registration Rights Agreement dated March 20, 2006 between us and Cornell Capital Partners, LP**** |
| 10.6 | Warrant to purchase 86,806 shares of common stock at \$14.40 per share, issued to Cornell Capital Partners, LP**** |
| 10.7 | Warrant to purchase 69,444 shares of common stock at \$18.00 per share, issued to Cornell Capital Partners, LP**** |
| 10.8 | Joint-venture Agreement, dated March 31, 2006, as amended on May 2, 2006, between Hongkong Great Genesis Group Co., Ltd. and Wuhu Chery Technology Co., Ltd.***** |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification -Hanlin Chen***** |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification -Daming Hu***** |
| 32.1 | Section 1350 Certification -Hanlin Chen***** |
| 32.2 | Section 1350 Certification - Daming Hu***** |

* Incorporated by reference to exhibit 3(i) to our Form 10SB Registration Statement filed on August 27, 2001.

** Incorporated by reference to Appendix A to our Schedule 14C Definitive Information Statement filed on April 21, 2003.

*** Incorporated by reference to exhibit 3(ii) to our Form 10SB Registration Statement filed on August 27, 2001.

**** Incorporated by reference to the exhibit of the same number to our Form S-3 Registration Statement (File No. 333 - 133331) filed on April 17, 2006.

***** Filed herewith

SIGNATURES

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

CHINA AUTOMOTIVE SYSTEMS, INC.

(Registrant)

Date: May 10, 2006

By: /s/ HANLIN CHEN

Hanlin Chen
President and Chief Executive Officer

Date: May 10, 2006

By: /s/ DAMING HU

Daming Hu
Chief Financial Officer