

CHINA VALVES TECHNOLOGY, INC  
Form 10-Q  
February 09, 2012

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 31, 2011

or

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

For the transition period from \_\_\_\_\_ To \_\_\_\_\_

Commission File Number : 001-34542

**CHINA VALVES TECHNOLOGY, INC.**

(Exact name of registrant as specified in its charter)

Nevada

(State or other jurisdiction of incorporation or organization)

86-0891931

(I.R.S. Employer  
Identification No.)

21F Kineer Plaza, 226 Jinshui Road, Zhengzhou, Henan Province, People's Republic of China

(Address of principal executive offices)

450008

(Zip Code)

(86) 371-8612-7222

(Registrant's telephone number, including area code)

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 Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety (90) days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if

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any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES [X] NO [ ]

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

Large accelerated filer [ ]

Accelerated filer [X]

Non-accelerated filer [ ] (Do not check if a smaller reporting company)

Smaller reporting company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

As of February 6, 2012, there were 36,119,654 shares of common stock of the registrant outstanding. There is only one class of common stock.

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**Part I - Financial Information**

**Item 1. Financial Statements**

The accompanying unaudited consolidated balance sheets, statements of income and other comprehensive income, and statements of cash flows and the related notes thereto, have been prepared in accordance with generally accepted accounting principles ( GAAP ) in the United States of America for interim financial information and in conjunction with the rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. The financial statements reflect all adjustments, consisting only of normal, recurring adjustments, which are, in the opinion of management, necessary for a fair presentation for the interim periods.

The accompanying financial statements should be read in conjunction with the notes to the aforementioned financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended September 30, 2011.

The results of operations for the three-month period ended December 31, 2011 are not necessarily indicative of the results to be expected for the entire fiscal year or any other period.

## CHINA VALVES TECHNOLOGY INC. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

*(Amounts in U.S. dollars)*

| ASSETS  | December 31, 2011<br>(Unaudited) | September 30, 2011<br>(Unaudited) |
|---|----------------------------------|-----------------------------------|
| Current assets:   |                                  |                                   |
| Cash and cash equivalents   | \$ 21,379,092                    | \$ 28,076,692                     |
| Restricted cash   | 2,037,449                        | 2,344,276                         |
| Notes receivable  | 1,870,984                        | 1,465,369                         |
| Accounts receivable, net of allowance for doubtful accounts of \$4,599,966 and \$4,052,398 as of December 31, 2011 and September 30, 2011, respectively | 139,933,486                      | 124,514,274                       |
| Other receivables   | 5,715,772                        | 5,106,572                         |
| Inventories, net of allowance of \$1,945,946 and \$2,394,319 as of December 31, 2011 and September 30, 2011, respectively                               | 24,304,412                       | 23,868,885                        |
| Advances on inventory and equipment purchases   | 1,906,926                        | 2,421,390                         |
| Advances on inventory purchase - related party  | 529,176                          | 1,552,123                         |
| Prepaid expenses and other current assets   | 105,061                          | 79,295                            |
| Total current assets  | 197,782,358                      | 189,428,876                       |
| Property, plant and equipment, net  | 40,356,502                       | 40,192,636                        |
| Accounts receivable - retainage, long term  | 8,872,799                        | 5,724,024                         |
| Goodwill  | 34,171,701                       | 33,976,186                        |
| Intangibles, net  | 22,895,338                       | 22,914,008                        |
| Other investments, cost   | 819,756                          | 815,066                           |
| Other non-current assets  | 15,839                           | 395,514                           |
| Deferred tax assets   | 1,013,941                        | -                                 |
| Total assets  | \$ 305,928,234                   | \$ 293,446,310                    |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                                  |                                   |
| Current liabilities:  |                                  |                                   |
| Accounts payable - trade  | \$ 27,652,827                    | \$ 24,575,461                     |
| Accounts payable - related parties  | -                                | 786,471                           |
| Short-term loans  | 8,124,294                        | 6,513,810                         |
| Other payables  | 4,686,700                        | 5,287,964                         |
| Other payables - related parties  | 274,165                          | 94,226                            |
| Notes payable   | 471,900                          | 469,200                           |
| Accrued liabilities   | 3,353,668                        | 4,091,998                         |
| Customer deposits   | 12,202,929                       | 11,139,936                        |
| Income and other taxes payable  | 7,150,714                        | 8,462,128                         |
| Total current liabilities   | 63,917,197                       | 61,421,194                        |
| Commitments and contingencies   | -                                | -                                 |
| Shareholder's Equity:   |                                  |                                   |
| Common stock, \$0.001 par value; 300,000,000 shares authorized; 35,869,654 and 35,869,654 shares issued and outstanding as of                           | 35,869                           | 35,869                            |

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| December 31, 2011 and September 30, 2011, respectively |    |             |                |
|--|----|-------------|----------------|
| Additional paid-in capital                             |    | 107,055,599 | 106,508,099    |
| Statutory reserves                                     |    | 11,460,305  | 11,224,490     |
| Retained earnings                                      |    | 103,534,944 | 95,571,501     |
| Accumulated other comprehensive income                 |    | 19,924,320  | 18,685,157     |
| Total shareholders' equity                             |    | 242,011,037 | 232,025,116    |
| Total liabilities and shareholders' equity             | \$ | 305,928,234 | \$ 293,446,310 |

The accompanying notes are an integral part of these consolidated financial statements (unaudited).

## CHINA VALVES TECHNOLOGY INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME  
(Amounts in U.S. dollars) (Unaudited)

|   | <b>Three months ended December 31,</b> |               |
|---|--|---------------|
|   | <b>2011</b>                            | <b>2010</b>   |
| Sales                                       | \$ 55,666,973                          | \$ 51,710,382 |
| Sales related parties                       | 51,949                                 | 618,793       |
| Total sales                                 | 55,718,922                             | 52,329,175    |
| Cost of sales                               | (35,433,899)                           | (33,882,245)  |
| Gross profit                                | 20,285,023                             | 18,446,930    |
| Operating expenses:                         |  |               |
| Selling expenses                            | (3,777,131)                            | (3,763,452)   |
| General and administrative expenses         | (5,870,942)                            | (6,534,031)   |
| Research and development expenses           | (107,060)                              | (46,997)      |
| Total operating expenses                    | (9,755,133)                            | (10,344,480)  |
| Income from operations                      | 10,529,890                             | 8,102,450     |
| Other income (expenses):                    |  |               |
| Other income, net                           | 140,675                                | 178,694       |
| Gain from acquisition                       | -                                      | 2,698,642     |
| Interest and finance expense, net           | (90,641)                               | (18,708)      |
| Change in fair value of warrant liabilities | -                                      | (522,717)     |
| Total other income, net                     | 50,034                                 | 2,335,911     |
| Net income before income taxes              | 10,579,924                             | 10,438,361    |
| Provision for income taxes                  | (2,380,666)                            | (4,030,202)   |
| Net income after income taxes               | 8,199,258                              | 6,408,159     |
| Other comprehensive income:                 |  |               |
| Foreign currency translation adjustment     | 1,239,163                              | 2,481,436     |
| Comprehensive income                        | \$ 9,438,421                           | \$ 8,889,595  |
| Basic earnings per share:                   |  |               |
| Weighted average number of shares           | 35,869,654                             | 34,647,847    |
| Earnings per share                          | \$ 0.23                                | \$ 0.18       |
| Diluted earnings per share:                 |  |               |
| Diluted weighted average number of shares   | 35,869,654                             | 34,759,078    |
| Earnings per share                          | \$ 0.23                                | \$ 0.18       |

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



## CHINA VALVES TECHNOLOGY INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | <b>Three months ended December 31,</b> |              |
|---|--|--------------|
|   | <b>2011</b>                            | <b>2010</b>  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |  |              |
| Net income  | \$ 8,199,258                           | \$ 6,408,159 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |              |
| Depreciation and amortization expenses  | 1,470,234                              | 1,762,403    |
| Allowance for doubtful accounts   | 523,583                                | (129,932)    |
| Gain on acquisition   | -                                      | (2,698,642)  |
| Loss on disposal of fixed assets  | 4,080                                  | -            |
| Stock-based compensation  | 547,500                                | 32,171       |
| Change in fair value of warrant liabilities                                       | -                                      | 522,717      |
| Inventory allowance and wrote off   | -                                      | 725,881      |
| Deferred tax assets   | (1,012,651)                            | -            |
| Change in operating assets and liabilities:                                       |  |              |
| Notes receivable  | (396,677)                              | (2,165,230)  |
| Accounts receivable-trade and retainage, short term                               | (15,207,585)                           | (3,830,343)  |
| Accounts receivable - related parties   | -                                      | (207,309)    |
| Other receivables   | (579,586)                              | 2,078,190    |
| Prepaid expenses and other current assets   | (47,791)                               | 2,296,638    |
| Inventories, net  | (297,794)                              | 3,964,342    |
| Advances on inventory purchases   | 527,726                                | (716,691)    |
| Advances on inventory purchases-related party                                     | 1,030,566                              | (917,202)    |
| Accounts receivable - retainage, long term  | (3,111,874)                            | (4,920,724)  |
| Accounts payable-trade  | 2,932,215                              | 6,269,612    |
| Accounts payable-trade- related parties   | (789,991)                              | 2,382,906    |
| Other payables  | (856,429)                              | 3,234,254    |
| Other payables - related parties  | 171,347                                | 193,988      |
| Accrued liabilities   | (754,131)                              | 41,832       |
| Customer deposits   | 997,619                                | (906,877)    |
| Taxes payable   | (1,343,085)                            | 928,057      |
| Net cash provided by(used in) operating activities                                | (7,993,466)                            | 14,348,200   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |  |              |
| Acquisition of intangible assets  | (52,314)                               | (352,492)    |
| Cash proceeds from sale of equipment  | 35,658                                 | -            |
| Purchases of equipment  | (834,817)                              | (506,531)    |
| Net cash used in investing activities   | (851,473)                              | (859,023)    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |  |              |
| Restricted cash   | 319,910                                | 159,331      |
| Net proceeds from short-term loan - banks and others                              | 1,797,224                              | 3,623,061    |
| Repayments of notes payables  | -                                      | (297,700)    |
| Net cash provided by financing activities   | 2,117,134                              | 3,484,692    |

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|   |               |               |
|---|---------------|---------------|
| Effects of foreign currency translation             | 30,205        | 459,092       |
| Net increase(Decrease) in cash and cash equivalents | (6,697,600)   | 17,432,961    |
| Cash and cash equivalents, beginning of period      | 28,076,692    | 8,387,646     |
| Cash and cash equivalents, ending of period         | \$ 21,379,092 | \$ 25,820,607 |

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

|                            |              |              |
|----------------------------|--------------|--------------|
| Cash paid for interest     | \$ 90,641    | \$ 66,451    |
| Cash paid for income taxes | \$ 3,695,100 | \$ 3,780,831 |

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

**Note 1 Description of Business and Basis of Presentation**

China Valves Technology, Inc. (the Company), was incorporated in Nevada in August 1997. Through its direct and indirect subsidiaries, the Company focuses primarily on the development, manufacture and sale of high-quality metal valves for the electricity, petroleum, chemical, water, gas and metal industries in the People's Republic of China (the PRC). The Company's operations are headquartered in Zhengzhou, Henan Province, PRC.

**REPORTING ENTITIES**

The accompanying consolidated financial statements include the following subsidiaries:

| Name of entity   | Place of incorporation | Ownership       | Principle business |
|--|------------------------|-----------------|--------------------|
| China Valves Technology (Changsha) Valve Co., Ltd. (Changsha Valve)                          | PRC                    | 100% Indirectly | Manufacturing      |
| Yangzhou Rock Valve Lock Technology Co., Ltd. (Yangzhou Rock)                                | PRC                    | 100% Indirectly | Manufacturing      |
| Henan Kai Feng High Pressure Valve Co., Ltd. (Kaifeng Valve)                                 | PRC                    | 100% Indirectly | Manufacturing      |
| Zhengzhou City ZD Valve., Ltd. (ZD Valve)  | PRC                    | 100% Indirectly | Manufacturing      |
| Tai Zhou Tai De Valve Co., Ltd. (Taide Valve)  | PRC                    | 100% Indirectly | Manufacturing      |
| Shanghai Pudong Hanwei Valve Co., Ltd. (Hanwei Valve)  | PRC                    | 100% Indirectly | Manufacturing      |
| Henan Tonghai Fluid Equipment Co., Ltd.  | PRC                    | 100% Indirectly | Holding Company    |
| China Valves Technology Holdings Co., Ltd. (formerly China Fluid Equipment Holdings Limited) | Hong Kong              | 100% Directly   | Holding Company    |

**Note 2 Summary of significant accounting policies****RESTATEMENT**

The presentation of certain line items presented on the consolidated financial statements and the relevant notes for the year ended September 30, 2011 have been restated to correct the under accrued Value Added Tax for the year ended September 30, 2011. The restatement made the Company's previously reported cost of sales in the consolidated statements of income for the year ended September 30, 2011 increase \$2,670,688 and the income and other tax payables in the consolidated balance sheet as of September 30, 2011 increased \$2,670,688. The retained earnings in the consolidated balance sheet and consolidated statements of stockholders' equity as of September 30, 2011 decreased \$2,670,688. The restatement has no effect for the cash flow for the year ended September 30, 2011.

**CONSOLIDATION AND BASIS OF PRESENTATION**

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries (collectively referred to herein as the Company). All significant intercompany accounts and transactions have been eliminated during the process of consolidation. The results of companies acquired during the year are included in the consolidated financial statements from the effective date of acquisition. The consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).

**USE OF ESTIMATES**

The preparation of consolidated financial statements in conformity with US GAAP requires the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant items subject to such estimates and assumptions include the useful lives of fixed assets; the allowance for doubtful accounts; the fair value determination of financial and equity instruments, realizability of inventories; the recoverability of goodwill, intangible assets, land use right, plant and equipment; and accruals for income tax uncertainties and other contingencies. The current economic environment has increased the degree of uncertainty inherent in those estimates and assumptions.

#### FOREIGN CURRENCY TRANSLATIONS AND TRANSACTIONS

The Renminbi ( RMB ) of the People s Republic of China has been determined to be the Company s functional currency. The Company uses the U.S. dollar for financial reporting purposes.

For those entities whose currency is other than the US dollar, all assets and liabilities are translated into U.S. dollars at the exchange rate on the balance sheet date; shareholders equity is translated at historical rates and items in the statements of income and of cash flows are translated at the average rate for the period. Because cash flows are translated based on the average translation rate, amounts related to assets and liabilities reported in the statement of cash flows will not necessarily agree with changes in the corresponding balances in the balance sheet. Translation adjustments resulting from this process are included in accumulated other comprehensive income in the statement of shareholders equity. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

## REVENUE RECOGNITION

The Company recognizes revenue in accordance with Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 605, Revenue Recognition, when persuasive evidence of an arrangement exists, the price is fixed or determinable, collection is reasonably assured and delivery of products has occurred or services have been rendered. These criteria are generally satisfied at the time of delivery for domestic sales when risk of loss and title passes to the customer. For international sales, the revenue recognition criteria are generally satisfied under Freight on Board ( FOB ) terms, in which the Company's responsibility ends once the goods clear the port of shipment. Revenues presented on the consolidated statements of operations and comprehensive income is net of a value-added tax ( VAT ) taxes.

The Company allows its customers to retain 5% to 10% of the contract prices as retainage during the warranty period, usually 12 or 24 months after the products were put into use, to guarantee product quality. Retainage is considered as a payment term included as a part of the contract price, and recognized as revenue based upon delivery of products. Due to nature of the retainage, the Company's policy is to take into revenue the full value of the contract without VAT, including any retainage, as it performs against the contract since the Company has experienced insignificant warranty claims historically resulting in the Company having to repair or exchange a defective product. Due to the infrequency and insignificant amount of warranty claims, the ability to collect retainage is reasonably assured and is recognized at the time of delivery.

The Company also provides services to some of its sales agents and distributors. The Company recognizes revenue on these services once a contract is signed and the services have been rendered.

## WARRANTIES

The Company typically provides warranty for all of its products and provides replacement or credit to its customers who are not satisfied with the products for a period of one year from the date of shipment. The Company has not established reserve funds for potential customer claims because, historically, the Company has not experienced significant customer complaints about its products. The Company believes that its customer support teams, quality assurance team and manufacturing monitoring procedures will continue to keep claims at a level that does not support a need for a reserve. The Company reviews customer claims on a monthly basis and may establish a reserve when necessary.

## VALUE ADDED TAX ( VAT )

All China-based enterprises are subject to a VAT imposed by the PRC government on their domestic product sales. The output VAT is charged to customers who purchase goods from the Company and the input VAT is paid when the Company purchases goods from its vendors. Input VAT rates are 17% for the purchasing activities conducted by the Company. Output VAT rate is 17% for all products. The input VAT can be offset against the output VAT. The VAT payable or recoverable balance presented on the consolidated balance sheets represents either the input VAT less than or larger than the output VAT.

## COST OF GOODS SOLD

Cost of goods sold consists primarily of direct material costs, direct labor costs, direct depreciation and related direct expenses attributable to the production of the products. Inbound shipping and handling costs and purchasing are included in direct material costs. Manufacturing overhead includes expenses such as indirect labor, depreciation as it relates to the cost of production, rent, utilities, receiving costs, and equipment maintenance and repairs.

## SHIPPING AND HANDLING COSTS

Shipping and handling costs incurred for shipping of finished products to customers are included in selling expense and totaled \$ 244,641 and \$385,656 for the three months ended December 31, 2011, and 2010, respectively.

#### ADVERTISING EXPENSES

Advertising costs are expensed when incurred and are included in selling, general and administrative expenses, which amounted to \$58,782 and \$86,748 for the three months ended December 31, 2011 and 2010, respectively.

#### RESEARCH AND DEVELOPMENT COSTS

Research and development costs are expensed as incurred. The costs of material and equipment that are acquired or constructed for research and development activities and which have alternative future uses, either in research and development, marketing, or sales, are classified as property and equipment and depreciated over their estimated useful lives.

## CASH AND CASH EQUIVALENTS

The Company considers all highly-liquid investments with maturity of three months or less to be cash equivalents. The Company maintains its cash accounts at creditworthy financial institutions and closely monitors the movements of its cash positions.

## RESTRICTED CASH

The Company's restricted cash consists of cash in the bank as security for its exported products, security deposits for contract performance, notes payable and cash held in escrow to pay for certain investor relations expenses. For restricted cash held in bank, the restriction is released after the customers have received and inspected the products. The Company has notes payable outstanding with various banks and is required to keep certain amounts on deposit that are subject to withdrawal restrictions. Cash held in escrow is expensed as incurred.

## ACCOUNTS RECEIVABLES

The Company's business operations are conducted in the PRC by selling on various payment terms.

The Company regularly evaluates and monitors the creditworthiness of each of its customers in accordance with the prevailing practice in the valve industry and based on general economic conditions in China. The Company maintains a general policy of providing allowance for doubtful accounts as follows:

| Aging of Accounts Receivables | <u>Allowance Percentage</u> |
|-------------------------------|-----------------------------|
| With 12 months                | -                           |
| 12-24months                   | 5%                          |
| 24-36months                   | 25%                         |
| Above 36months                | 100%                        |

Management reviews its receivables on a quarterly basis to determine if the allowance for doubtful accounts is adequate. An estimate for doubtful accounts is recorded when collection of the full amount is no longer probable. Known bad debts are written off against the allowance for doubtful accounts when identified. The Company's existing reserve is consistent with its historical experience and considered adequate by management.

## INVENTORIES

Inventories are stated at the lower of cost or market determined using the weighted average method which approximates cost and estimated net realizable value. Cost of work in progress and finished goods comprise direct material, direct production costs and an allocated portion of production overhead costs based on normal operating capacity.

The Company provides a reserve for estimated inventory obsolescence or excess quantities on hand equal to the difference between the cost of the inventory and its estimated realizable value. The future estimated realizable value of inventory is generally based on the historical usage of such inventory. The Company ages its inventory with no recent demand and applies various valuation factors based on the last demand from customers for such material. If future conditions cause a reduction in the Company's current estimate of realizable value, due to a decrease in customer demand, a drop in commodity prices or other market-related factors that may influence demand for particular products, additional provisions may be required. In addition, the Company also reviews most recent quotes from vendors and compares with the carrying value of its inventory. If carrying amount of raw materials exceeds prices available at the balance sheet date, then the excess amount is directly written off and included in cost of the goods sold.

Semi-finished products are work-in-process ( WIP ) inventory at the finishing stages of production. These products that are awaiting final assembly have similar physical shape to finished goods. The Company differentiates these products from WIP for inventory management purposes.

#### PROPERTY, PLANT AND EQUIPMENT

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

|                                | Estimated Useful<br>Economic Life |
|--------------------------------|-----------------------------------|
| Buildings and improvement      | 10-30 years                       |
| Machinery and equipment        | 5-10 years                        |
| Office furniture and equipment | 5 years                           |
| Motor Vehicles                 | 8-10 years                        |



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

Construction in progress represents direct costs of construction as well as acquisition and design fees incurred. Capitalization of these costs ceases and the construction in progress is transferred to property, plant and equipment when substantially all the activities necessary to prepare the assets for their intended use are completed. Interest incurred during the period required to complete the construction is capitalized into construction in progress. All other interest is expensed as incurred. No depreciation is provided until construction is completed and the asset is ready for its intended use. Maintenance, repairs and minor renewals are charged directly to expenses as incurred. Major additions and betterments to property and equipment are capitalized.

#### INTANGIBLE ASSETS

Intangible assets consist of patents, software and land use rights. Patents are being amortized over 5-20 years as management believes those are the estimated useful life of the patents currently owned by the Company. Software is amortized over 10 years, its estimated useful life.

According to the laws of the PRC, the government owns all the land in the PRC. Companies or individuals are authorized to possess and use the land only through the land use rights granted by the government. The land use rights represent cost of the rights to use the land in respect of properties located in the PRC. Land use rights are carried at cost and amortized on a straight-line basis over the period of rights of 46.4 -50 years.

#### IMPAIRMENT OF LONG-LIVED ASSETS

The Company, in accordance with ASC 360, Property, Plant and Equipment, reviews for impairment of long-lived assets and certain identifiable intangibles whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. Recoverability is determined by comparing projected undiscounted cash flows associated with such assets to the related carrying value.

An impairment loss would be recognized when estimated discounted future cash flows expected to result from the use of the asset and its eventual disposition is less than its carrying amount. The Company performed impairment review on its long-lived assets. For the products manufactured by certain equipment that did not meet the customer's needs any more, the Company determined that the equipment was technically obsolete and needed to be replaced with new equipment to meet the customer's current and future needs. \$0 and \$ 1,341,962 impairment losses were recognized for the three month periods ended December 31, 2011 and 2010, respectively.

## RETIREMENT AND OTHER POST RETIREMENT BENEFITS

Full-time employees of the Company in the PRC participate in a government mandated defined contribution plan, pursuant to which certain pension benefits, medical care, employee housing fund and other welfare benefits are provided to employees. Chinese labor regulations require the Company to make contributions to the government for these benefits based on certain percentages of the employees' salaries. The Company accounts for the mandated defined contribution plan under the vested benefit obligations approach based on the guidance of ASC 715, Compensation - Retirement Benefits.

The total amounts for such employee benefits which were expensed were \$552,755 and \$440,142 for the three month periods ended December 31, 2011 and 2010, respectively.

## INCOME TAXES

The Company follows ASC 740, Income Taxes, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates, applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company adopted ASC 740-10-25, which provides criteria for the recognition, measurement, presentation and disclosure of uncertain tax position. The Company must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the benefit that has a greater than 50% likelihood of being realized upon ultimate resolution. The Company did not recognize any additional liabilities for uncertain tax positions as a result of the implementation of ASC 740-10-25.

## COMPREHENSIVE INCOME

The Company adopted ASC 220, Comprehensive Income, which establishes standards for reporting and presentation of comprehensive income) and its components in a full set of general-purpose financial statements. The Company has chosen to report comprehensive income in the statements of operations and comprehensive income. Comprehensive income is comprised of net income and all changes to stockholders' equity except those due to investments by owners and distributions to owners.

## CONCENTRATIONS OF CREDIT RISK AND RISK FACTORS

**Environment** The Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environment in the PRC, and by the general state of the PRC's economy. The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in North America and Western Europe. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, restrictions on currency conversion and remittance abroad, and rates and methods of taxation, among other things.

**Bank Deposits** Certain financial instruments may subject the Company to concentration of credit risk. The Company maintains bank deposits within state-owned banks within the PRC, Hong Kong and the United States. Balances at financial institutions of state owned banks within the PRC are not covered by insurance. As of December 31, 2011 and September 30, 2011, the Company's cash and restricted cash balances, totaling \$23,327,294 and \$29,508,367 respectively were not covered by insurance. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risks on its cash in bank accounts.

**Trade Accounts Receivable** Concentrations of credit risk with respect to accounts receivable are limited due to the large number of customers dispersed across diverse markets and generally short payment terms. Credit is extended based on an evaluation of the customer's financial condition and collateral generally is not required. The Company evaluates the collectability of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, the Company will record a specific allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected.

**Revenues** Substantially all of the Company's revenues are derived from sales of valves in the PRC. Any significant decline in market acceptance of the Company's products could impair our ability to operate effectively. Five major customers represented approximately 19% and 13% of the Company's total sales for the three -month periods ended December 31, 2011 and 2010, respectively. Sales from the largest customer accounted for 7% and 4% of total sales for the three months periods ended December 31, 2011 and 2010, respectively.

## FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC 820 defines fair value as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

ASC 820 establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. ASC 820 establishes three levels of inputs that may be used to measure fair value:

- Level 1 Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company holds. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2 Valuation based on quoted prices in markets that are not active for which all significant inputs are observable, either directly or indirectly.
- Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The Company adopted ASC 820, Fair Value Measurements and Disclosures, on January 1, 2008 for all financial assets and liabilities and nonfinancial assets and liabilities that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis (at least annually). ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. The Company has not adopted ASC 820 for nonfinancial assets and nonfinancial liabilities, as these items are not recognized at fair value on a recurring basis. The adoption of ASC 820 for all financial assets and liabilities did not have any impact on the Company's consolidated financial statements and the Company does not expect to have any impact on the Company's consolidated financial statements if ASC 820 for nonfinancial assets and liabilities is adopted.

Financial instruments include cash and cash equivalents, restricted cash, accounts receivables, prepayments and other receivables, investments, short term borrowings from banks, accounts payable and accrued expenses and other payables. The carrying amounts of cash and cash equivalents, restricted cash, accounts receivable, prepayments and other receivables, investments, short -term loans, accounts payable and accrued expenses approximate their fair value due to the short-term maturities of these instruments.

## OTHER INVESTMENTS

The Company invested in China Perfect Machinery Industry Co., Ltd. in 1996 and Kaifeng Commercial Bank in 1997. The Company owns approximately 0.0955% of China Perfect Machinery Industry Co. Ltd. and approximately 1.6% of Kaifeng Commercial Bank. The Company does not have the ability to exercise control over the investee companies and the investments have been recorded under the cost method. These long term investments amounted to \$819,756 and \$815,066 as of December 31, 2011 and September 30, 2011, respectively. There has been no change in the carrying value since initial investment, other than the effects of translation difference.

The Company evaluates potential impairment whenever events or changes in circumstances indicate that the carrying amount of the investments may not be recoverable. For investments carried at cost, the Company recognizes impairment in the event that the carrying value of the investment exceeds the Company's proportionate share of the net book value of the investee. As of December 31, 2011, management believes no impairment charge is necessary.

## CUSTOMER DEPOSITS

Customer deposits represent amounts advanced by customers on product orders. The product normally is shipped within six months after receipt of the advance payment and the related sale is recognized in accordance with the Company's revenue recognition policy. As of December 31, 2011 and September 30, 2011, customer deposits amounted to \$ 12,202,929 and \$11,139,936, respectively.

## STOCK COMPENSATION

The Company receives employee and certain non-employee services in exchange for (a) equity instruments of the Company or (b) liabilities that are based on the fair value of the Company's equity instruments or that may be settled by the issuance of such equity instruments. The Company accounts for stock compensation expense under the fair value recognition provisions of the ASC 718, which requires companies to estimate the fair value of share-based payment awards on the date of grant using an option pricing model.

## RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In April 2011, the FASB issued ASU No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements* (ASU 2011-03), intended to improve financial reporting of repurchase agreements and refocus the assessment of effective control on a transferor's contractual rights and obligations rather than practical ability to perform those rights and obligations. The guidance in ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. The Company does not expect the adoption of ASU 2011-03 to have a significant impact on its consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs* (ASU 2011-04). ASU 2011-04 represents the converged guidance of the FASB and the International Accounting Standards Board (IASB) on fair value measurement. A variety of measures are included in the update intended to either clarify existing fair value measurement requirements, change particular principles requirements for measuring fair value or for disclosing information about fair value measurements. For many of requirements, the FASB does not intend to change the application of existing requirements under Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements. ASU 2011-04 is effective for interim and annual periods beginning after December 15, 2011 and early application is not permitted. The Company is evaluating the impact adoption of ASU 2011-04 and does not expect the adoption of ASU 2011-04 will have significant impact on its consolidated financial statements.

In July 2011, the FASB issued accounting guidance on disclosures about the credit quality of financing receivables and the allowance for credit losses. The guidance expands disclosures for the allowance for credit losses and financing

receivables by requiring entities to disclose information at disaggregated levels. It also requires disclosure of credit quality indicators, past due information and modifications of financing receivables. The Company does not expect the adoption of this guidance to have a significant impact on its consolidated financial statements.

In September 2011, the FASB issued Intangibles – Goodwill and Other (Topic 350) – Testing Goodwill for Impairment (ASU No. 2011-08), which amends ASC 350 to first assess qualitative factors before performing the quantitative goodwill impairment testing. The ASU provides the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If the results of the qualitative analysis indicate it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative two-step impairment test, which is required under current U.S. GAAP, would not be necessary. The ASU is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The implementation of the ASU is not expected to have a material impact on the Company's financial statements.

**Note 3 Accounts receivable, net**

Accounts receivable consists of the following:

|   | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|---|----------------------------------|-----------------------------------|
| Total accounts receivable                             | \$ 153,406,251                   | \$ 134,290,696                    |
| Allowance for bad debts                               | (4,599,966)                      | (4,052,398)                       |
| Accounts receivable, net                              | 148,806,285                      | 130,238,298                       |
| Accounts receivable non-current retainage             | (8,872,799)                      | (5,724,024)                       |
| Accounts receivable (including related party) current | \$ 139,933,486                   | \$ 124,514,274                    |

As of December 31, 2011 and September 30, 2011, retainage held by customers included in the Company's accounts receivable was as follows:

|                 | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|-----------------|----------------------------------|-----------------------------------|
| Retainage       |                                  |                                   |
| Current         | \$ 15,302,545                    | \$ 13,854,814                     |
| Non-current     | 8,872,799                        | 5,724,024                         |
| Total retainage | \$ 24,175,344                    | \$ 19,578,838                     |

The following represents the changes in the allowance for doubtful accounts:

|   | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|---|----------------------------------|-----------------------------------|
| Balance, beginning of the period        | \$ 4,052,398                     | \$ 998,739                        |
| Additions to the reserve                | 523,583                          | 2,974,399                         |
| Foreign currency translation adjustment | 23,985                           | 79,260                            |
| Balance, end of the period              | \$ 4,599,966                     | \$ 4,052,398                      |

**Note 4 Inventories, net**

|                         | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|-------------------------|----------------------------------|-----------------------------------|
| Raw materials           | \$ 7,082,646                     | \$ 5,438,464                      |
| Work-in-progress        | 6,624,996                        | 9,088,975                         |
| Finished goods          | 10,559,396                       | 8,613,573                         |
| Semi-finished products  | 1,355,761                        | 1,417,185                         |
| Inventory in transit    | 627,559                          | 1,705,007                         |
| Total                   | 26,250,358                       | 26,263,204                        |
| Less: Inventory reserve | (1,945,946)                      | (2,394,319)                       |
| Inventories, net        | \$ 24,304,412                    | \$ 23,868,885                     |

As of December 31, 2011 and September 30, 2011, the management of the Company estimated its inventories at the lower of cost or market, determined on a weighted average method, or net realizable value.

Per the estimation, the Company recognized \$1,945,946 and \$2,394,319 inventory allowance for slow moving inventory as of December 31, 2011 and September 30, 2011, respectively, most of which were slow moving commodity valves produced for general usage whose technical specification was obsolete. The Company recognized \$0 and \$706,836 inventory impairment loss as cost of sales for the three months periods ended December 31, 2011 and 2010, respectively. During the three months periods ended December 31, 2011, the Company disposed some of slow moving inventories, which made the inventory allowance decrease \$448,373 as of December 31, 2011.

**Note 5 Property, plant and equipment, net**

Property, plant and equipment consist of the following:

|                                | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|--------------------------------|----------------------------------|-----------------------------------|
| Buildings and improvements     | \$ 23,760,818                    | \$ 23,592,085                     |
| Machinery and equipment        | 28,940,753                       | 27,934,105                        |
| Motor vehicles                 | 2,942,756                        | 2,925,919                         |
| Office equipment               | 1,686,766                        | 1,665,384                         |
| Construction in progress       | 230,471                          | 165,511                           |
| Total                          | 57,561,564                       | 56,283,004                        |
| Less: Accumulated depreciation | (17,205,062)                     | (16,090,368)                      |
| Plant and equipment, net       | \$ 40,356,502                    | \$ 40,192,636                     |

Depreciation expenses were \$1,267,583 and \$1,572,812 for the three months ended December 31, 2011 and 2010, respectively.

Certain buildings with an aggregate carrying value of \$1,516,132 were pledged as collateral for bank loans as of December 31, 2011.

**Note 6 Goodwill**

Goodwill represents the excess of cost of an acquisition business over the fair value of the identifiable tangible and intangible assets acquired and liabilities assumed in a business combination at the date of the acquisition.

Goodwill for impairment has been tested annually, or whenever events or circumstances indicate that it is more likely than not that the fair value of a reporting unit is below its carrying amount. The Company determines the reporting units based on following factors: a. it engages in business activities from which it may earn revenues and incur expenses; b. its operating results are regularly reviewed by the Company's chief operating decision makers to make



decisions about resources to be allocated to the segment and assess its performance; and c. its discrete financial information is available. No impairment loss was incurred for the three months ended December 31, 2011 and 2010 based on the Company's estimation.

A significant amount of judgment is involved in determining if an indicator of impairment has occurred. Such indicators may include current period operating or cash flow losses combined with a historical of operating or cash flow losses, a projection or forecast that demonstrates continuing operating or cash flow losses, a significant adverse change in AR collection and unanticipated technology revolution in valves industry, among others. The Company performs its annual impairment review of goodwill every year at September 30 and when a triggering event occurs between annual impairment tests. The goodwill impairment test is a two-step test. Under the first step, the fair value of the reporting unit is compared with its carrying value (including goodwill). If the fair value of the reporting unit is less than its carrying value, an indication of goodwill impairment exists for the reporting unit, and the Company must perform step two of the impairment test (measurement). Under step two, an impairment loss is recognized for any excess of the carrying amount of the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, and the residual fair value after this allocation is the implied fair value of the reporting unit goodwill. Fair value of the reporting unit is determined using a discounted cash flow analysis. If the fair value of the reporting unit exceeds its carrying value, step two does not need to be performed.

A summary of changes in the Company's goodwill was as follows:

|   | Goodwill      |
|---|---------------|
| Balance, September 30, 2011             | \$ 33,976,186 |
| Foreign currency translation adjustment | 195,515       |
| Balance, December 31, 2011              | \$ 34,171,701 |

The goodwill was generated from the acquisitions of a number of companies engaged in production of valves in China. According to ASC805 Business Combinations, the acquisition of these businesses should be treated as acquisition of a business. Any excess of the purchase prices over the estimated fair values of the net assets acquired is recorded as goodwill.

In 2004, the Company acquired two companies engaged in the production of valves. The Company recognized approximately \$21 million goodwill representing the excess of cost of an acquisition business over the fair value of the identifiable tangible and intangible assets acquired and liabilities assumed in a business combination at the date of the acquisition.

On April 8, 2010, the Company acquired 100% of Hanwei Valve and recognized approximately \$11 million goodwill representing the excess of cost of an acquisition business over the fair value of the identifiable tangible and intangible assets acquired and liabilities assumed in a business combination at the date of the acquisition.

The goodwill recognized in conjunction with the acquisition of Hanwei Valve represents intangible values that Hanwei Valve has built over its more than 16 years of history, which do not qualify for separate recognition. These values include but are not limited to:

- i) Expected synergies from combining operations of the Company's operating subsidiaries and Hanwei Valve;
- ii) The experienced work force;
- iii) Proprietary technologies related to certain products; and
- iv) The proprietary manufacturing processes.

The Company has six operating subsidiaries as reporting units included in continuing operations as of December 31, 2011, among which three reporting units had goodwill. The following table represents goodwill of the three subsidiaries as of December 31, 2011 and September 30, 2011, respectively.

| (in thousands)                          | December 31, 2011<br>(Unaudited) | September 30, 2011<br>(unaudited) |
|---|----------------------------------|-----------------------------------|
| Kaifeng Valve                           | \$ 10,783                        | \$ 10,783                         |
| ZD Valve                                | 10,029                           | 10,029                            |
| Hanwei Valve                            | 11,046                           | 11,046                            |
| Foreign currency translation adjustment | 2,314                            | 2,118                             |
| <b>Total</b>                            | <b>\$ 34,172</b>                 | <b>\$ 33,976</b>                  |

**Note 7 - Intangible assets, net**

Intangible assets consist of the following:

|                                 | December 31, 2011<br>(unaudited) | September 30, 2011<br>(unaudited) |
|---------------------------------|----------------------------------|-----------------------------------|
| Patents                         | \$ 2,781,752                     | \$ 2,765,836                      |
| Software                        | 1,914,014                        | 1,850,982                         |
| Land use rights                 | 20,134,396                       | 20,019,196                        |
| Total                           | 24,830,162                       | 24,636,014                        |
| Less: Accumulated amortization: |                                  |                                   |
| Patents                         | (354,716)                        | (307,061)                         |
| Software                        | (497,028)                        | (442,451)                         |
| Land use rights                 | (1,083,080)                      | (972,494)                         |
| Total accumulated amortization  | (1,934,824)                      | (1,722,006)                       |
| Intangibles, net:               |                                  |                                   |
| Patents                         | 2,427,036                        | 2,458,775                         |
| Software                        | 1,416,986                        | 1,408,531                         |
| Land use rights                 | 19,051,316                       | 19,046,702                        |
| Intangibles, net                | \$ 22,895,338                    | \$ 22,914,008                     |

Amortization expense was \$202,651 and \$189,591 for the three months ended December 31, 2011 and 2010, respectively.

As of December 31, 2011, certain land use rights with an aggregate carrying value of \$5,891,214 were pledged as collateral for short-term bank loans.

**Note 8 Loans****SHORT-TERM LOANS:**

|  | December<br>31, 2011<br>(unaudited) | September 30,<br>2011<br>(unaudited) |
|--|-------------------------------------|--------------------------------------|
| Bank of Communications , Changsha branch, due December 2012, annum interest at 7.872%, pledged by Changsha Valve s land use rights         | \$ 629,200                          | \$ 625,600                           |
| China Everbright Bank, Changsha branch, due June 2012, annum interest at 7.572%, pledged by Changsha Valve s land use rights and buildings | 943,800                             | 938,400                              |
| China Citic Bank, Zhengzhou branch, due December 2012 annum interest at 8.528%, guaranteed by Kaifeng Cast Iron Co., Ltd.                  | 4,719,000                           | 3,128,000                            |
| Unrelated third parties, due on demand, annum interest rate range from 0% to 10.000%, and unsecured  | 988,165                             | 982,511                              |
| Local Bureau of Finance, Kaifeng City, due on demand, non-interest bearing and unsecured   | 844,129                             | 839,299                              |
| Total short-term loans   | \$ 8,124,294                        | \$ 6,513,810                         |

Interest expense incurred for the three months ended December 31, 2011 and 2010 amounted to \$90,641 and \$6,299, respectively. For the three months ended December 31, 2011 and 2010, \$nil and \$60,152 interest expense was capitalized for assets, respectively. As of December 31, 2011, there are no restrictive covenants related to the loans stated above.

**Note 9 Statutory reserves**

The laws and regulations of the PRC require that before a foreign invested enterprise can legally distribute profits, it must first satisfy all tax liabilities, provide for losses in previous years, and make allocations, in proportions determined at the discretion of the board of directors, to the statutory reserve. The statutory reserves include the surplus reserve fund.

The Company is required to transfer 10% of its net income, as determined in accordance with the PRC accounting rules and regulations, to a statutory surplus reserve fund until such reserve balance reaches 50% of the Company's registered capital. The transfer to this reserve must be made before distribution of any dividends to shareholders. The Company had \$11,460,305 and \$11,224,490 statutory reserves as of and December 31, 2011 and September 30, 2011, respectively.

The surplus reserve fund is non-distributable other than during liquidation and can be used to fund previous years losses, if any, and may be utilized for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholding or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issue is not less than 50% of the registered capital.

**Note 10 Commitments and contingencies**

The Company's subsidiary, ZD Valve entered into a lease agreement for a manufacturing plant and office space with Zhengzhou Cheng Long Corporation, a related party, from January 1, 2008 to December 31, 2008. The lease agreement was subsequently extended to December 31, 2012. In 2009, ZD Valve made leasehold improvements to its leased manufacturing plant in the amount of \$615,260, which has been used as rental payments for the following two years. As of December 31, 2011, the prepaid rental had been fully amortized as rental expense.

The Company's subsidiary, Tonghai entered into a lease agreement for an office space with Jia Hong Yao, an unrelated party, from September 20, 2009 to September 19, 2014 with annual lease payments of \$227,549.

For the three months ended December 31, 2011 and 2010, total lease expense, including amounts included in cost of sales and administrative expenses, was totally \$176,340 and \$162,102, respectively.

The future minimum lease payments at December 31, 2011, are as follows:

|  | Amount       |
|--|--------------|
| Year ending December 31, 2012                | \$ 529,693   |
| Year ending December 31, 2013                | 430,196      |
| Year ending December 31, 2014                | 338,176      |
| Year ending December 31, 2015 and thereafter | 200,481      |
| Total  | \$ 1,498,546 |

**Restricted Share Grant Agreements**

On May 16, 2011, the Company entered into Restricted Stock Grant Agreements (the "Stock Grant Agreement") with three officers of the Company. Pursuant to the Stock Grant Agreement, the Company granted 500,000 shares of restricted stock to Mr. Jianbao Wang, the Company's Chief Executive Officer, 250,000 shares to Mr. Gang Wei, the Company's Chief Financial Officer, and 125,000 shares to Mr. Renrui Tang, the Company's Vice President of Finance.

125,000 shares of Mr. Jianbao Wang's restricted stock vested immediately on May 16, 2011. The remaining shares for Mr. Jianbao Wang and all restricted shares for Mr. Gang Wei and Mr. Renrui Tang will vest in three equal installments over a three-year period starting from January 1, 2012, subject to performance criteria set forth by the Board and the Compensation Committee.



Contingency

On February 4, 2011, a plaintiff filed a purported class action naming the Company, its Chairman and certain present and former senior executives as defendants, asserting claims for certain violations of the securities laws and seeking unspecified damages. The complaint, which was styled *Donald Foster, et al. v. China Valves Technology, Inc., et al.*, was filed in the U.S. District Court for the Southern District of New York. Several substantially identical complaints were subsequently filed in the same court. On or about June 29, 2011, the Court consolidated the three cases referenced above and appointed Bristol Investment Fund, LTD ( Bristol ) as lead plaintiff. In the consolidation order the Court renamed the case *In re China Valves Technology Securities Litigation*. On August 29, 2011, Bristol filed a consolidated class action complaint, which named additional defendants including an individual shareholder of the Company and the Company's auditor. The Company and the individual defendants filed a motion to dismiss the consolidated complaint in the class action on November 21, 2011. Plaintiffs filed their opposition to defendants motion dismiss. Defendants have 45 days from February 3, 2012 to file a reply.

The consolidated complaint purports to assert claims on behalf of a purported class of persons and entities who purchased shares of the Company's common stock at allegedly artificially high prices during the period between December 1, 2009 and January 13, 2011 and who suffered damages as a result of such purchases. The allegations in the consolidated complaint relate to the Company's acquisitions of Able Delight and Hanwei Valves and include allegations regarding the Company's financial statements and press releases. The complaint alleges, among other things, that the Company's statements about the nature and quality of the Company's acquisition of Able Delight were materially false and misleading and that the Company's statements failed to describe the role in the transaction of an alleged related party. In addition, the complaint alleges that the Company's statements about the Hanwei Valves acquisition were materially false and misleading because they failed to disclose the alleged involvement of certain related parties and allegedly misdescribed the transaction as a purchase of assets rather than as a purchase of an entity. The Company intends to contest the allegations and to defend itself vigorously.

On September 14, 2011, a plaintiff filed an action, derivatively and on behalf of the Company, naming its Chairman and certain senior executives as defendants, and naming the Company as a nominal defendant. The complaint, which is styled *Gervat v. Fang et al.*, was filed in the U.S. District Court for the Southern District of New York, and asserts claims for breach of fiduciary duty, gross mismanagement, and other common law claims, and seeks unspecified damages. On October 11, 2011, the plaintiff filed an Amended Complaint with substantially similar claims. The parties have stipulated to a scheduling order that would stay all proceedings in the derivative action pending resolution by the Court of the defendants' motion to dismiss the class action consolidated complaint.

Nevertheless, there is possibility that a loss may have been incurred from above class actions. In accordance with ASC Topic 450, no loss contingency was accrued as of December 31, 2011 since the possible loss or range of loss cannot be reasonable estimated.

**Note 11 Related party transactions**

The Company had the following significant related party balances as of December 31, 2011 and September 30, 2011, respectively:

|   | December 31,<br>2011<br>(Unaudited) | September 30,<br>2011<br>(unaudited) |
|---|-------------------------------------|--------------------------------------|
| Advances on inventory purchase - related party, the Casting Company                   | 529,176                             | 1,552,123                            |
| Accounts payable related party, payable to Zhengzhou Tonghai Trade                    | -                                   | (783,148)                            |
| Accounts payable related party: Kaifeng Zhenghe Northern Song Porcelain Art Co., Ltd. | -                                   | (3,323)                              |
|   | (274,165)                           | (94,226)                             |

Other payable: cash advance from officers, unsecured, interest-free, due on demand

|       |            |            |
|-------|------------|------------|
| Total | \$ 255,011 | \$ 671,426 |
|-------|------------|------------|

The Company had the following significant related party transactions for the three months periods ended December 31, 2011 and 2010, respectively:

(1) On August 26, 2008, Kaifeng Valve purchased some land use rights and real estate from Kaifeng High-Pressure Valve Steel Casting Co., Ltd, a company controlled by the Company's chairman, Mr. Siping Fang, through the issuance of 2,750,000 shares of the Company's common stock at \$3.576 per share. On April 11, 2009, Kaifeng Valve and the Casting Company entered into a leasing agreement pursuant to which the Casting Company leased back the portion of the Real Estate used at an annual rental of \$400,000 for a period of two years starting on April 1, 2009. The lease agreement was automatically extended for one more year when no disagreement was raised as of April 1, 2011. For the three months period ended December 31, 2011 and 2010, total rental income from the Casting Company amount to \$100,000 and \$100,000, respectively.

(2) The Company also purchases raw material, such as castings, from and sells scrap metals and valves to the Casting Company. Total raw material purchase from the related party amounted to \$663,732 and \$1,370,322 for the three months ended December 31, 2011 and 2010, respectively. The Company also sold a total of \$ 0.03million and \$0.04million of valves to the Casting Company for the three months ended December 31, 2011 and 2010, respectively.

(3) The Company makes finished goods and raw material purchases from and valve sales to related party -Zhengzhou Tonghai Trade Co., Ltd, which is established by an officer of the Company. Total valve purchases from Zhengzhou Tonghai Trade Co., Ltd amounted to \$1,213,054 and \$1,471,792 for the three months ended December 31, 2011 and 2010, respectively. Total valve sales to Zhengzhou Tonghai Trade Co., Ltd amounted to \$0.02million and \$0.47million for the three months ended December 31, 2011 and 2010, respectively.

**Note 12 Stock compensation**

On April 27, 2011, the Compensation Committee of the Board of Directors approved the grant of restricted stock to three directors and three officers of the Company. On May 1, 2011, the Company entered into a restricted stock grant agreement with each of the directors. Pursuant to the Stock Grant Agreement, the Company granted 25,000 shares of restricted stock to each of Mr. William Haus, Mr. Peter Li and Mr. Zengbiao Yu, independent directors of the Company. The restricted stock granted vested immediately on May 1, 2011.

On May 16, 2011, the Company entered into the Stock Grant Agreement with three officers of the Company. Pursuant to the Stock Grant Agreement, the Company granted 500,000 shares of restricted stock to Mr. Jianbao Wang, the Company's Chief Executive Officer, 250,000 shares to Mr. Gang Wei, the Company's Chief Financial Officer, and 125,000 shares to Mr. Renrui Tang, the Company's Vice President of Finance. 125,000 shares of Mr. Jianbao Wang's restricted stock vested immediately on May 16, 2011. The remaining shares for Mr. Jianbao Wang and all restricted shares for Mr. Gang Wei and Mr. Renrui Tang will vest in three equal installments over a three-year period starting from January 1, 2012, subject to performance criteria set forth by the Board and the Compensation Committee.

For the three months ended December 31, 2011 and 2010, \$547,500 and \$32,171 were recorded as compensation expense in the Company's income statements, respectively.

The following is a summary of the stock options activity:

|                                  | Number of<br>Options<br>Outstanding | Weighted-<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|-------------------------------------|---|---------------------------------|
| Outstanding at October 1, 2011   | 50,000                              | \$ 6.90                                   | \$ -                            |
| Granted                          | -                                   | -   | -                               |
| Forfeited                        | -                                   | -   | -                               |
| Exercised                        | -                                   | -   | -                               |
| Outstanding at December 31, 2011 | 50,000                              | 6.90                                      | -                               |
| Exercisable at December 31, 2011 | 50,000                              | 6.90                                      | -                               |

Following is a summary of the status of options outstanding at December 31, 2011:

**Outstanding and Exercisable Options**

| <u>Exercise Price</u> | Number | Average<br>Remaining<br>Contractual<br>Life |
|-----------------------|--------|---|
| \$6.00                | 27,500 | 2.50  |
| \$8.00                | 22,500 | 1.90  |
| Total                 | 50,000 | 2.23  |

There is no aggregate intrinsic value of exercisable shares as of December 31, 2011.



**Note 13 - Earnings per Share**

The Company reports earnings per share in accordance with the provisions of the accounting standard regarding ASC260 "Earnings per Share." This accounting standard requires presentation of basic and diluted earnings per share in conjunction with the disclosure of the methodology used in computing such earnings per share. Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted average common shares outstanding during the period. Diluted earnings per share takes into account the potential dilution (using the treasury stock method) that could occur if securities or other contracts to issue common stock were exercised and converted into common stock.

Common stock equivalents represent the dilutive effect of the assumed exercise of the outstanding stock options and warrants, using the treasury stock method, at either the beginning of the respective period presented or the date of issuance, whichever is later, and only if the common stock equivalents are considered dilutive based upon the Company's net income (loss) position at the calculation date.

The following is a reconciliation of the basic and diluted earnings per share computation for the three months ended December 31, 2011 and 2010:

| <b>Basic earnings per share</b>                            | Three months ended December 31, |                     |
|--|---------------------------------|---------------------|
|  | 2011<br>(unaudited)             | 2010<br>(unaudited) |
| Net income attributable to holders of common shares        | \$ 8,199,258                    | \$ 6,408,159        |
| Basic weighted average number of common shares outstanding | 35,869,654                      | 34,647,847          |
| Basic earnings per share                                   | \$ 0.23                         | \$ 0.18             |

| <b>Dilutive earnings per share</b>                            | Three months ended December 31, |                     |
|---|---------------------------------|---------------------|
|   | 2011<br>(unaudited)             | 2010<br>(unaudited) |
| Net income attributable to holders of common shares           | \$ 8,199,258                    | \$ 6,408,159        |
| Basic weighted average number of common shares outstanding    | 35,869,654                      | 34,647,847          |
| Warrants  | -                               | 92,431              |
| Stock compensation  | -                               | 18,801              |
| Dilutive weighted average number of common shares outstanding | 35,869,654                      | 34,759,079          |
| Dilutive earnings per share                                   | \$ 0.23                         | \$ 0.18             |

No options in the three months ended December 31, 2011.

The 50,000 option shares granted to its independent directors and 750,000 restricted stock granted to its officers in 2011 were anti-dilutive for the three months ended December 31, 2011 as the average stock price was lower than the exercise prices. No anti-dilutive for the three months ended December 31, 2010.

**Note 14 Segment reporting**

The Company sells valves which are used by customers in various industries. The production process, class of customer, selling practice and distribution process are the same for all valves. The Company's chief operating decision-makers (i.e. chief executive officer and his direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by product lines for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Based on qualitative and quantitative criteria established by the accounting standard regarding Disclosures about Segments of an Enterprise and Related Information, the Company considers itself to be operating within one reportable segment.

In accordance with the enterprise-wide disclosure requirements of the accounting standard, the Company's net revenue from external customers by main product lines (based upon primary markets defined by the Chinese Valve Industry Association) and by geographic areas is as follows (unaudited):

| (in thousands)        | Three Months Ended December 31, |           |
|-----------------------|---------------------------------|-----------|
|                       | 2011                            | 2010      |
|                       | (Unaudited)                     |           |
| Power Supply          | \$ 13,026                       | \$ 13,165 |
| Petrochemical and Oil | 21,038                          | 18,289    |
| Water Supply          | 7,529                           | 9,078     |
| Metallurgy            | 3,393                           | 2,763     |
| Other                 | 10,733                          | 9,034     |
| Total sales revenue   | \$ 55,719                       | \$ 52,329 |

| (in thousands)            | Three Months Ended December 31, |           |
|---------------------------|---------------------------------|-----------|
|                           | 2011                            | 2010      |
|                           | (Unaudited)                     |           |
| Domestic sales in the PRC | \$ 52,375                       | \$ 50,150 |
| International sales       | 3,344                           | 2,179     |
| Total sales revenue       | \$ 55,719                       | \$ 52,329 |

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

### Special Note Regarding Forward Looking Statements

In addition to historical information, this report 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. We use words such as believe, expect, anticipate, project, target, plan, optimistic, intend, expressions which are intended to identify forward-looking statements. Such statements include, among others, those concerning market and industry segment growth and demand and acceptance of new and existing products; any projections of sales, earnings, revenue, margins or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements regarding future economic conditions or performance; as well as all assumptions, expectations, predictions, intentions or beliefs about future events. You are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, including those identified in Item 1A, Risk Factors described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011, as well as assumptions, which, if they were to ever materialize or prove incorrect, could cause the results of the Company to differ materially from those expressed or implied by such forward-looking statements.

Readers are urged to carefully review and consider the various disclosures made by us in this report and our other filings with the SEC. These reports attempt to advise interested parties of the risks and factors that may affect our business, financial condition and results of operations and prospects. The forward-looking statements made in this report speak only as of the date hereof and we disclaim any obligation, except as required by law, to provide updates, revisions or amendments to any forward-looking statements to reflect changes in our expectations or future events

### Use of Terms

Except as otherwise indicated by the context and for the purposes of this report only, references in this report to:

- China Valves, the Company, we, us and our are to the combined business of China Valves Technology, Nevada corporation, and its direct and indirect subsidiaries;
- China Valves Holdings are to our wholly-owned direct subsidiary China Valves Technology Holdings Limited, a Hong Kong company;
- Changsha Valve are to our wholly-owned indirect subsidiary China Valves Technology (Changsha) Valve Co., Ltd., a PRC company;
- Hanwei Valve are to our wholly-owned indirect subsidiary Shanghai Pudong Hanwei Valve Co., Ltd., a PRC company;
- Kaifeng Valve are to our wholly-owned indirect subsidiary Henan Kaifeng High Pressure Valve Co., Ltd., a PRC company;
- Taide Valve are to our wholly-owned indirect subsidiary Taizhou Taide Valve Co., Ltd., a PRC company;
- ZD Valve are to our wholly-owned indirect subsidiary Zhengzhou City ZD Valve Co., Ltd., a PRC company;
- Yangzhou Rock are to our wholly-owned indirect subsidiary Yangzhou Rock Valve Lock Technology Co., Ltd., a PRC company;
- Henan Tonghai Fluid are to our wholly-owned indirect subsidiary Henan Tonghai Fluid Equipment Co., Ltd., a PRC company;
- Hong Kong are to the Hong Kong Special Administrative Region of the People's Republic of China;
- PRC and China are to the People's Republic of China;
- SEC are to the Securities and Exchange Commission;
- Securities Act are to the Securities Act of 1933, as amended;
- Exchange Act are to the Securities Exchange Act of 1934, as amended;
- Renminbi and RMB are to the legal currency of China; and

- U.S. dollars, dollars and \$ are to the legal currency of the United States.

## Overview of Our Business

China Valves Technology, Inc. is a leading developer, manufacturer and after market service provider of comprehensive flow management products and services in China. Our flow service solutions help customers solve problems in critical industries around the world.

As a recognized leader in supplying valves, actuators, forging and castings, valve locks and related services, we supply global infrastructure industries, including nuclear power, fossil power, hydropower, oil and gas, chemical and petrochemical, water treatment, mining and metal, as well as general industrial markets where our products and services add value. With approximately 2,000 employees in China and more than 50 distributors in more than 30 cities, we provide the most convenient services with a local presence.

China Valves has evolved through organic growth and strategic acquisitions. The Company was created in 2007 with the merger of two leading fluid motion and control companies - ZD Valve and Kaifeng Valve. We continually evaluate acquisitions and other strategic investment opportunities to broaden our product portfolio, service capabilities, geographic presence or operational capabilities to meet the growing needs of our customers. We now have six wholly-owned operating subsidiaries, six heritage brands and a comprehensive product line including over 800 models and 10,000 series.

Our principal executive offices are located at 21F Kineer Plaza, 226 Jinshui Road, Zhengzhou, Henan Province, the People's Republic of China, 475002. Our corporate telephone number is (86) 371-8612-7222. We maintain a website at <http://www.cvalve.com> that contains information about our company, but that information is not part of this report.

## First Quarter Financial Performance Highlights

We continued to experience strong demand for our products and services during the three-month period ended December 31, 2011, which resulted in growth in our sales and net income. The following are some financial highlights for the three-month period ended December 31, 2011:

- **Sales:** Sales increased \$3.4 million, or 6.5%, to \$55.7 million for the three months ended December 31, 2011, from \$52.3 million for the same period in 2010.
- **Gross profit:** Gross profit increased \$1.8 million, or 10.0%, to \$20.3 million for the three months ended December 31, 2011, from \$18.4 million for the same period in 2010.
- **Income from operations:** Income from operations increased \$2.4 million, or 30.0%, to \$10.5 million for the three months ended December 31, 2011, from \$8.1 million for the same period in 2010.
- **Net income:** Net income increased \$1.7 million, or 27.9%, to \$8.2 million for the three months ended December 31, 2011, from \$6.4 million for the same period in 2010.
- **Fully diluted net income per share:** Fully diluted net income per share was \$0.23 for the three months ended December 31, 2011, as compared to \$0.18 for the same period in 2010.

Our results of operations in the first fiscal quarter of 2012, as compared to the same period in fiscal 2010, was materially impacted by the selling of higher gross profit products including 24-way rotary valves manufactured by Hanwei Valve and the large size butterfly valves sold by Changsha Valve, and the decrease of general and administrative expenses of Changsha Valve in this quarter.

**Results of Operations****Comparison of Three Months Ended December 31, 2011 and 2010**

The following table sets forth key components of our results of operations for the periods indicated.

(All amounts, other than percentages, in thousands of U.S. dollars)

|   | <b>Three months ended<br/>December 31, 2011</b> |                     | <b>Three months ended<br/>December 31, 2010</b> |                     |
|---|---|---------------------|---|---------------------|
|   | Amount<br>(Unaudited)                           | % of Total<br>Sales | Amount<br>(Unaudited)                           | % of Total<br>Sales |
| TOTAL SALES                                 | \$ 55,719                                       | 100.0%              | \$ 52,329                                       | 100 %               |
| COST OF SALES                               | (35,434)  | (63.6)              | (33,882)  | (64.7)              |
| GROSS PROFIT                                | 20,285  | 36.4                | 18,447  | 35.3                |
| <b>OPERATING EXPENSES:</b>                  |   |                     |   |                     |
| Selling                                     | (3,777)   | (6.8)               | (3,763)   | (7.2)               |
| General and administrative                  | (5,871)   | (10.5)              | (6,534)   | (12.5)              |
| Research and development                    | (107)   | (0.2)               | (47)  | (0.1)               |
| Total operating expenses                    | (9,755)   | (17.5)              | (10,344)  | (19.8)              |
| INCOME FROM OPERATIONS                      | 10,530  | 18.9                | 8,102   | 15.5                |
| <b>OTHER INCOME (EXPENSE):</b>              |   |                     |   |                     |
| Other income, net                           | 141   | 0.3                 | 179   | 0.3                 |
| Interest and finance expense, net           | (91)  | (0.2)               | (19)  | 0.1                 |
| Gain from acquisition                       | -   | -                   | 2,699   | 5.2                 |
| Change in fair value of warrant liabilities | -   | -                   | (523)   | (1.0)               |
| Total other income, net                     | 50  | 0.1                 | 2,336   | 4.5                 |
| <b>INCOME BEFORE INCOME TAXES</b>           |   |                     |   |                     |
| TAXES                                       | 10,580  | 19.0                | 10,438  | 20.0                |
| <b>PROVISION FOR INCOME TAXES</b>           |   |                     |   |                     |
| TAXES                                       | (2,381)   | (4.3)               | ( 4,030)  | (7.8)               |
| NET INCOME                                  | \$ 8,199  | 14.7                | \$ 6,408  | 12.2                |

**Sales.** Our sales revenue for the three months ended December 31, 2011 amounted to \$55.7 million, which is approximately \$3.4 million, or 6.5%, more than that of the same period in 2010, when we had revenue of \$52.3 million. The increase was primarily attributed to strong demand for our ball valves, butterfly valves and globe valves and strong demand for our valves in the petrochemical and oil industries. Sales increases of the three types of products for the three months ended December 31, 2011 were 6.2%, 10.9% and 8.5%, respectively, compared with the same period in 2010. Sales in the petrochemical and oil industries increased 15% compared with the same period in 2010.

The following tables set forth our sales by valve types, in terms of sales revenues for the three months ended December 31, 2011 and 2010.

|  | <b>Three Months Ended December 31,</b> |             |
|--|--|-------------|
|  | <b>2011</b>                            | <b>2010</b> |
| (All amounts in thousands of U.S. dollars) | (Unaudited)                            |             |

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|                              |    |        |    |        |
|------------------------------|----|--------|----|--------|
| Gate valves                  | \$ | 10,620 | \$ | 11,363 |
| Check valves                 |    | 2,507  |    | 2,806  |
| Globe valves                 |    | 2,594  |    | 2,391  |
| Safety valves                |    | 811    |    | 768    |
| Butterfly valves             |    | 21,332 |    | 19,230 |
| Ball valves                  |    | 8,936  |    | 8,411  |
| Vent valves                  |    | 274    |    | 69     |
| Other valves and accessories |    | 8,645  |    | 7,291  |
| Total sales revenue          |    | 55,719 |    | 52,329 |
|                              |    | 25     |    |        |

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The China Valve Industry Association divides the valve market into five primary segments; (i) power; (ii) petrochemical; (iii) oil; (iv) water supply; and (v) metallurgy. Our revenues in these markets are as follows:

| (All amounts in thousands of U.S. dollars) | <b>Three Months Ended December 31,</b> |             |
|--|--|-------------|
|  | <b>2011</b>                            | <b>2010</b> |
|  |  | (Unaudited) |
| Power Supply                               | \$ 13,026                              | \$ 13,165   |
| Petrochemical and Oil                      | 21,038                                 | 18,289      |
| Water Supply                               | 7,529                                  | 9,078       |
| Metallurgy                                 | 3,393                                  | 2,763       |
| Other                                      | 10,733                                 | 9,034       |
| Total sales revenue                        | \$ 55,719                              | \$ 52,329   |

**Cost of sales.** Cost of sales, which consists of raw materials, direct labor and manufacturing overhead expenses, was \$35.4 million for the three month period ended December 31, 2011, an increase of \$1.6 million, or 4.6%, as compared with \$33.9 million for the same period in 2010. Cost of sales as a percentage of total sales were 63.6% and 64.7% for the three month periods ended on December 31, 2011 and 2010, respectively. The raw material costs in the overall costs were approximately 79% and 81% for the three months ended December 31, 2011 and 2010, respectively. Labor cost in the overall costs was approximately 9% and 6% for the three months ended December 31, 2011 and 2010, respectively. The increase in our cost of sales in the three months ended December 31, 2011 was consistent with our increase in sales revenue during the same period.

**Gross profit and gross margin.** Gross profit was \$20.3 million for the three months ended December 31, 2011, an increase of \$1.9 million, or 10.0%, as compared with \$18.4 million for the three months ended December 31, 2010. Our gross profit margin increased to 36.4% as compared to 35.3% in the same period of 2010. The increase in gross margin was mainly because during the period we sold more high-end valves with higher profit margin, which includes 24-way rotary valves manufactured and sold by Hanwei Valve and the large size butterfly valves sold by Changsha Valve, which contributed to the increase in gross profit margin.

**Operating expenses.** Our total operating expenses decreased by \$0.5 million, or 5.7%, to \$9.8 million for the three months ended December 31, 2011, from \$10.3 million for the same period in 2010. The decrease was primarily attributable to a 10.1% decrease in our general and administrative expenses during the 2011 period. The reasons for the decrease are elaborated below. Total expenses as a percentage of sales decreased to 17.5% for the three months ended December 31, 2011 from 19.8% for the same period in 2010.

**Selling expenses.** Selling expenses, which consist primarily of sales commission, advertising and promotion expenses, freight charges and related compensation, were \$3.78 million for the three month period ended December 31, 2011, compared with \$3.76 million for the period ended December 31, 2010, an increase of \$0.02 million, or approximately 0.4%. The increase in our selling expenses in the three months ended December 31, 2011 was consistent with our increase in sales revenue during the same period.

**General and administrative expenses.** Our general and administrative expenses consist primarily of stock compensation expenses, related salaries and benefits, business development, traveling expenses, legal and professional expenses, depreciation, and bad debt expenses. The general and administrative expenses were \$5.9 million for the three month period ended December 31, 2011, compared with \$6.5 million for the period ended December 31, 2010, a decrease of \$0.6 million, or approximately 10.1%. The decrease was caused by the decrease of Changsha Valve's general and administrative expenses approximately \$1.6 million in the three months ended December 31, 2011, as compared with the same period in 2010 after a successful management integration. Management periodically reviewed accounts receivable balances and based on its assessment of the historical bad debt rate on individual customer receivable balances and aging, customers' financial conditions, project status in which our valves are used, retainage and current economic trends. Generally we consider a trade receivable as a doubtful account if it remains uncollected for more than one year from the due date or as specific events occurred to our customers which may



require us to reserve allowance even if the trade balance is less than one year. Due to the specificities of our industry, collectability of accounts receivable with aging more than one year was assessed case by case. Before our customers projects in which our valves installed are completed and/or the corresponding retainage is due, the customers receivable with aging more than one year is generally considered to be recoverable.

Further, our allowance for doubtful debts accounted for an insignificant portion of the receivable balance in spite of the increasing trade receivable balance throughout the reporting periods. Many of our customers with whom we have long-term business relationships have good settlement histories. In the absence of significant bad debt experience, we consider the existing policy as adequate.

For the three months ended December 31, 2011, based on individual collectability assessment, including aging analysis, customer visit and interviews and background research, management decided there would be a higher possibility of failure to collect from several customers due to unfavorable economic trends and poor market liquidity and a \$4.6 million allowance has been reserved against their accounts receivable.

**Income from Operations.** Income from operations was \$10.5million for the three-month period ended December 31, 2011, compared with \$8.1 million for the period ended December 31, 2010. The increase was primarily attributable to lower general and administrative expenses and higher gross margin in the first quarter of 2012.

**Income taxes.** We incurred income tax expenses of \$2.4 million for the three-month period ended December 31, 2011. This is a decrease of \$1.6 million, or 40.9%, from the taxes we incurred for the same period in 2010, which was \$4.0 million. The decrease was primarily due to lower taxable income resulting from lower non-deductible expenses. Our effective tax rate was 22.50% for the three-month period ended December 31, 2011, compared with 38.6% for the same quarter in 2010. The decrease was mainly due to the decrease of the income tax rate of ZD Valve from 25% to 15% as a High-Tech Company of PRC in the year of 2011 and the lower non-deductible expenses.

**Net income.** As a result of the foregoing factors, our net income increased by \$1.8 million, or 27.9%, to \$8.2 million for the three-month period ended December 31, 2011, from \$6.4 million for the same period in 2010. Net income as a percentage of sales was 14.7% and 12.2% for the three month periods ended December 31, 2011 and 2010, respectively. The increase was mainly attributable to increased sales of higher profit margin products, the lower general and administrative expenses and lower income taxes.

### **Liquidity and Capital Resources**

We have financed our operations primarily through cash flows from operations, augmented by short-term bank borrowings and equity contributions by our stockholders. As of December 31, 2011, we had cash and cash equivalents of \$21.4million. The following table sets forth a summary of our cash flows for the periods indicated:

**Cash Flow**

(all amounts in thousands of U.S. dollars)

|  | <b>Three Months Ended December 31,</b> |             |
|--|--|-------------|
|  | <b>2011</b>                            | <b>2010</b> |
|  | (Unaudited)                            |             |
| Net cash (used) provided by operating activities     | \$ (7,993)                             | \$ 14,348   |
| Net cash used in investing activities                | (851)                                  | (859)       |
| Net cash provided by financing activities            | 2,117                                  | 3,485       |
| Effect of foreign currency translation               | 29                                     | 459         |
| Net increase (decrease) in cash and cash equivalents | (6,698)                                | 17,433      |
| Cash and cash equivalents at beginning of the period | 28,077                                 | 8,388       |
| Cash and cash equivalent at end of the period        | \$ 21,379                              | \$ 25,821   |

***Operating Activities***

Net cash used by operating activities was \$8 million in the three months ended December 31, 2011, compared with net cash provided by operating activities of \$14.3 million for the same period in 2010. The decrease was primarily attributable to the increase in accounts receivable.

***Investing Activities***

Net cash used in investing activities remained the same at \$0.9 million as the three months ended December 31, 2011. The net cash used in investing activities during the period ended December 31, 2011 was primarily used for the purchase of equipment, software and payments made for construction in progress.

***Financing Activities***

Net cash provided by financing activities was \$2.1 million in the three months ended December 31, 2011, compared with \$3.5 million in the same period in 2010 as we received less net proceeds from short term loans since the Company's cash could meet the operating needs.

***Capital Expenditures***

The capital expenditures in the three months ended December 31, 2011 and 2010 are set out as below. Our capital expenditures were used primarily for plant construction and the purchase of equipment to expand our production capacity. The table below sets forth the breakdown of our capital expenditures by use for the periods indicated.

(All amounts in thousands of U.S. dollars)

|                                  | <b>Three Months Ended December 31,</b> |             |
|----------------------------------|--|-------------|
|                                  | <b>2011</b>                            | <b>2010</b> |
|                                  | (Unaudited)                            |             |
| Acquisition of intangible assets | \$ (52)                                | \$ (352)    |
| Purchase of equipment            | (835)                                  | (507)       |
| Total capital expenditures       | \$ (887)                               | \$ (859)    |

We believe that our current available working capital and bank loans should be adequate to sustain our operations at our current levels through at least the next twelve months.

**Obligations under Material Contracts**

Below is a table setting forth our contractual obligations as of December 31, 2011:

(All amounts in thousands of U.S. dollars)

| Contractual Obligations     | Total    | Payments Due by Period |           |           | More than 5 years |
|-----------------------------|----------|------------------------|-----------|-----------|-------------------|
|                             |          | Less than 1 year       | 1-3 years | 3-5 years |                   |
| Operating lease obligations | \$ 1,499 | \$ 530                 | \$ 956    | \$ 13     | \$ -              |

**Seasonality of our Sales**

Our operating results and operating cash flows historically have not been subject to seasonal variations. This pattern may change, however, as a result of new market opportunities or new product introductions.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to our investors.

**Critical Accounting Policies and Estimates**

Critical accounting policies are those we believe are most important to portraying our financial conditions and results of operations and also require the greatest amount of subjective or complex judgments by management. Judgments and uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. There have been no material changes to the critical accounting policies previously disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2011.

**Recent Accounting Pronouncements**

See Note 2 to our unaudited consolidated financial statements included elsewhere in this report.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Our operations are carried out in the PRC and we are subject to specific considerations and significant risks not typically associated with companies in North America and Western Europe. Accordingly, our business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC, and by the general state of the PRC economy. Our results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

**Interest Rate Risk**

We are exposed to interest rate risk primarily with respect to our short-term bank loans. Although the interest rates, which are based on the banks' prime rates with respect to our short-term loans, are fixed for the terms of the loans, the terms are typically three to twelve months for short-term bank loans and interest rates are subject to change upon renewal. There were no material changes in interest rates for short-term bank loans renewed during the three months

ended December 31, 2011.

A hypothetical 1.0% increase in the annual interest rates for all of our credit facilities under which we had outstanding borrowings as of December 31, 2011 would decrease net income before provision for income taxes by approximately \$0.03 million for the three months ended December 31, 2011. Management monitors the banks' prime rates in conjunction with our cash requirements to determine the appropriate level of debt balances relative to other sources of funds. We have not entered into any hedging transactions in an effort to reduce our exposure to interest rate risk.

## **Foreign Exchange Risk**

While our reporting currency is the U.S. Dollar, all of our consolidated revenues and consolidated costs and majority of expenses are denominated in RMB. All of our assets are denominated in RMB, except certain cash balances. As a result, we are exposed to foreign exchange risk as our revenues and results of operations may be affected by fluctuations in the exchange rate between U.S. Dollars and RMB. If RMB depreciates against the U.S. Dollar, the value of our RMB revenues, earnings and assets as expressed in our U.S. Dollar financial statements will decline. Assets and liabilities are translated at exchange rates at the balance sheet dates and revenue and expenses are translated at the average exchange rates and shareholders' equity is translated at historical exchange rates. Any resulting translation adjustments are not included in determining net income but are included in determining other comprehensive income, a component of stockholder's equity. We have not entered into any hedging transactions in an effort to reduce our exposure to foreign exchange risk.

The value of the RMB against the U.S. dollar and other currencies is affected by, among other things, changes in China's political and economic conditions. Since July 2005, the RMB has not been pegged to the U.S. dollar. Although the People's Bank of China is regularly involved in the foreign exchange market to prevent significant short-term fluctuations in the exchange rate, the RMB may appreciate or depreciate significantly in value against the U.S. dollar or Euro in the medium to long term. Moreover, it is possible that in the future, PRC authorities may lift restrictions on fluctuations in the RMB exchange rate and lessen involvement in the foreign exchange market.

## **Account Balances**

We maintain balances at financial institutions which, from time to time, may exceed Federal Deposit Insurance Corporation insured limits for the banks located in the United States or may exceed Hong Kong Deposit Protection Board insured limits for the banks located in Hong Kong. Balances at financial institutions or state-owned banks within the PRC are not covered by insurance. Total cash in banks and restricted cash as of December 31, 2011 and September 30, 2011 amounted to \$23,327,294 and \$29,508,367, respectively, all of which are not covered by insurance. We have not experienced any losses in such accounts and we do not believe that we are exposed to any significant risks on our cash in bank accounts.

## **Inflation**

Inflationary factors such as increases in the cost of our sales and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross margin and selling, general and administrative expenses as a percentage of net sales if the selling prices of our products do not increase with these increased costs.

## **ITEM 4. CONTROLS AND PROCEDURES.**

### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Disclosure controls and procedures refer to controls and other procedures designed to ensure that information required to be disclosed in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC 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.

As required by Rule 13a-15(e), our management has carried out an evaluation, with the participation and under the supervision of our Chief Executive Officer, Mr. Jianbao Wang and our Chief Financial Officer, Mr. Gang Wei, of the

effectiveness of the design and operation of our disclosure controls and procedures, as of December 31, 2011. Based upon, and as of the date of this evaluation, Messrs. Wang and Wei, determined that, because of the material weaknesses described in Item 9A Controls and Procedures of our Annual Report on Form 10-K for the year ended September 30, 2011, which we are still in the process of remediating as of December 31, 2011, our disclosure controls and procedures were not effective. Investors are directed to Item 9A of our Annual Report on Form 10-K for the year ended September 30, 2011 for the description of these weaknesses.

During the quarter, the Company made following progress to improve internal controls.

- (a) Hired a third party to help the Company to improve disclosure controls and procedures; and
- (b) Strengthened the internal audit function by hired qualified personnel.

#### **Changes in Internal Control over Financial Reporting**

We regularly review our system of internal control over financial reporting and make changes to our processes and systems to improve controls and increase efficiency, while ensuring that we maintain an effective internal control environment. Changes may include such activities as implementing new, more efficient systems, consolidating activities, and migrating processes.

There were no changes in our internal controls over financial reporting during the first quarter of fiscal 2012 that have materially affected, or are reasonably likely to materially affect, our over financial reporting.

**PART II**  
**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

On February 4, 2011, a plaintiff filed a purported class action naming the Company, its Chairman and certain present and former senior executives as defendants, asserting claims for certain violations of the securities laws and seeking unspecified damages. The complaint, which was styled Donald Foster, et al. v. China Valves Technology, Inc., et al., was filed in the U.S. District Court for the Southern District of New York. Several substantially identical complaints were subsequently filed in the same court. On or about June 29, 2011, the Court consolidated the three cases referenced above and appointed Bristol Investment Fund, LTD ( Bristol ) as lead plaintiff. In the consolidation order the Court renamed the case In re China Valves Technology Securities Litigation. On August 29, 2011, Bristol filed a consolidated class action complaint, which named additional defendants including an individual shareholder of the Company and the Company's auditor.

The consolidated complaint purports to assert claims on behalf of a purported class of persons and entities who purchased shares of the Company's common stock at allegedly artificially high prices during the period between December 1, 2009 and January 13, 2011 and who suffered damages as a result of such purchases. The allegations in the consolidated complaint relate to the Company's acquisitions of Able Delight and Hanwei Valves and include allegations regarding the Company's financial statements and press releases. The complaint alleges, among other things, that the Company's statements about the nature and quality of the Company's acquisition of Able Delight were materially false and misleading and that the Company's statements failed to describe the role in the transaction of an alleged related party. In addition, the complaint alleges that the Company's statements about the Hanwei Valves acquisition were materially false and misleading because they failed to disclose the alleged involvement of certain related parties and allegedly misdescribed the transaction as a purchase of assets rather than as a purchase of an entity. The Company intends to contest the allegations and to defend itself vigorously.

On September 14, 2011, a plaintiff filed an action, derivatively and on behalf of the Company, naming its Chairman and certain senior executives as defendants, and naming the Company as a nominal defendant. The complaint, which is styled Gervat v. Fang et al., was filed in the U.S. District Court for the Southern District of New York, and asserts claims for breach of fiduciary duty, gross mismanagement, and other common law claims, and seeks unspecified damages. On October 11, 2011, the plaintiff filed an Amended Complaint with substantially similar claims. The parties have stipulated to a scheduling order that would stay all proceedings in the derivative action pending resolution by the Court of the defendants' motion to dismiss the class action consolidated complaint.

The Company and the individual defendants filed a motion to dismiss the consolidated complaint in the class action on November 21, 2011. Plaintiffs filed their opposition to defendants' motion to dismiss. Defendants have 45 days from February 3, 2012 to file a reply.



**ITEM 1A. RISK FACTORS.**

There are no material changes from the risk factors previously disclosed in Item 1A Risk Factors of our Annual Report on Form 10-K for the year ended September 30, 2011.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. MINE SAFETY DISCLOSURES.**

None.

**ITEM 5. OTHER INFORMATION.**

We have no information to disclose that was required to be in a report on Form 8-K during the period covered by this report, but was not reported. There have been no material changes to the procedures by which security holders may recommend nominees to our board of directors.

**ITEM 6. EXHIBITS.**

The following exhibits are filed as part of this report or incorporated by reference:

| <b><u>Exhibit</u></b> | <b><u>Description</u></b>  |
|-----------------------|--|
| <b><u>No.</u></b>     |  |
| <u>31.1</u>           | <u>Certifications of Principal Executive Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| <u>31.2</u>           | <u>Certifications of Principal Financial Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>  |
| <u>32.1</u>           | <u>Certifications of Principal Executive Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.2</u>           | <u>Certifications of Principal Financial Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |

