

CHINA AUTOMOTIVE SYSTEMS INC  
Form 10-Q  
November 09, 2012

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

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended September 30, 2012

Or

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

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

Commission file number: **000-33123**

**China Automotive Systems, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or

**33-0885775**

(I.R.S. employer identification  
number)

organization)

**No. 1 Henglong Road, Yu Qiao Development Zone, Shashi District**

**Jing Zhou City, Hubei Province, the People's Republic of China**

**(Address of principal executive offices)**

**(86) 716- 832- 9196**

Issuer's telephone number

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ 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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☒  
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 ☒

As of November 8, 2012, the Company had 28,043,019 shares of common stock issued and outstanding.

**CHINA AUTOMOTIVE SYSTEMS, INC.**

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## Cautionary Statement

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. These statements relate to future events or the Company's future financial performance. The Company has attempted to identify forward-looking statements by terminology including "anticipates," "believes," "expects," "can," "continues," "could," "estimates," "expects," "may," "plans," "potential," "predicts," "should" or "will" or the negative of these terms or other comparable terminology. Such statements are subject to certain risks and uncertainties, including the matters set forth in this Quarterly Report or other reports or documents the Company files with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance or achievements. Undue reliance should not be placed on these forward-looking statements, which speak only as of the date hereof. The Company's expectations are as of the date this Form 10-Q is filed, and the Company does not intend to update any of the forward-looking statements after the date this Quarterly Report on Form 10-Q is filed to confirm these statements to actual results, unless required by law. All of the forward-looking statements are qualified in their entirety by reference to the factors discussed under Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, as filed with the Securities and Exchange Commission, and Item 1A "Risk Factors" of Part II in this report.

**PART 1 — FINANCIAL INFORMATION****Item 1.****FINANCIAL STATEMENTS.****China Automotive Systems, Inc. and Subsidiaries****Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income***(In thousands of USD, except share and per share amounts)*

|                                                                                  | Three Months Ended September 30, |                   |
|----------------------------------------------------------------------------------|----------------------------------|-------------------|
|                                                                                  | 2012                             | 2011<br>(Note 25) |
| Net product sales                                                                |                                  |                   |
| Unrelated parties                                                                | \$ 70,245                        | \$ 63,262         |
| Related parties (Note 28)                                                        | 2,939                            | 7,652             |
|                                                                                  | 73,184                           | 70,914            |
| Cost of product sold                                                             |                                  |                   |
| Unrelated parties                                                                | 56,231                           | 55,496            |
| Related parties (Note 28)                                                        | 4,452                            | 2,830             |
|                                                                                  | 60,683                           | 58,326            |
| Gross profit                                                                     | 12,501                           | 12,588            |
| Gain on other sales                                                              | 704                              | 466               |
| Less: Operating expenses                                                         |                                  |                   |
| Selling expenses                                                                 | 2,437                            | 2,010             |
| General and administrative expenses                                              | 2,487                            | 3,128             |
| Research and development expenses                                                | 2,818                            | 2,466             |
| Total operating expenses                                                         | 7,742                            | 7,604             |
| Income from operations                                                           | 5,463                            | 5,450             |
| Other income, net                                                                | 238                              | 49                |
| Financial expenses, net                                                          | (437)                            | (1,281)           |
| Gain on change in fair value of derivative                                       | -                                | 7,788             |
| Income before income tax expenses and equity in earnings of affiliated companies | 5,264                            | 12,006            |
| Less: Income taxes                                                               | 891                              | 992               |
| Equity in earnings of affiliated companies                                       | 27                               | 43                |
| Income from continuing operations                                                | 4,400                            | 11,057            |
| Discontinued operations - net of income tax (Note 25)                            | -                                | 434               |
| Net income                                                                       | 4,400                            | 11,491            |
| Net income attributable to noncontrolling interests                              | 996                              | 1,382             |
| Net income attributable to parent company                                        | 3,404                            | 10,109            |
| Allocation to convertible notes holders                                          | -                                | (1,071)           |
| Net income attributable to parent company's common shareholders                  | \$ 3,404                         | \$ 9,038          |

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Net income attributable to parent company's common shareholders per share

|                                                                |            |            |
|----------------------------------------------------------------|------------|------------|
| Basic                                                          |            |            |
| Income from continuing operations attributable to shareholders | \$ 0.12    | \$ 0.31    |
| Income per share from discontinued operations                  | -          | 0.01       |
| Net income attributable to shareholders                        | \$ 0.12    | \$ 0.32    |
| Diluted                                                        |            |            |
| Income from continuing operations attributable to shareholders | \$ 0.12    | \$ 0.09    |
| Income per share from discontinued operations                  | -          | 0.01       |
| Net income attributable to shareholders                        | \$ 0.12    | \$ 0.10    |
| Weighted average number of common shares outstanding           |            |            |
| Basic                                                          | 28,260,302 | 28,083,534 |
| Diluted                                                        | 28,260,880 | 31,503,995 |
| Comprehensive income:                                          |            |            |
| Net income                                                     | \$ 4,400   | \$ 11,491  |
| Foreign currency translation (loss) gain, net of tax           | (556       | ) 4,212    |
| Comprehensive income                                           | 3,844      | 15,703     |
| Comprehensive income attributable to noncontrolling interests  | 904        | 2,112      |
| Comprehensive income attributable to parent company            | \$ 2,940   | \$ 13,591  |

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

**China Automotive Systems, Inc. and Subsidiaries****Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income***(In thousands of USD, except share and per share amounts)*

|                                                                                                         | Nine Months Ended September 30, |                   |
|---------------------------------------------------------------------------------------------------------|---------------------------------|-------------------|
|                                                                                                         | 2012                            | 2011<br>(Note 25) |
| Net product sales                                                                                       |                                 |                   |
| Unrelated parties                                                                                       | \$ 215,157                      | \$ 205,543        |
| Related parties (Note 28)                                                                               | 19,325                          | 29,954            |
|                                                                                                         | 234,482                         | 235,497           |
| Cost of product sold                                                                                    |                                 |                   |
| Unrelated parties                                                                                       | 176,834                         | 177,573           |
| Related parties (Note 28)                                                                               | 14,137                          | 12,858            |
|                                                                                                         | 190,971                         | 190,431           |
| Gross profit                                                                                            | 43,511                          | 45,066            |
| Gain on other sales                                                                                     | 2,625                           | 1,375             |
| Less: Operating expenses                                                                                |                                 |                   |
| Selling expenses                                                                                        | 6,704                           | 6,653             |
| General and administrative expenses                                                                     | 8,999                           | 10,290            |
| Research and development expenses                                                                       | 10,060                          | 5,986             |
| Total operating expenses                                                                                | 25,763                          | 22,929            |
| Income from operations                                                                                  | 20,373                          | 23,512            |
| Other income, net                                                                                       | 317                             | 154               |
| Financial expenses, net                                                                                 | (1,850)                         | (2,887)           |
| Gain (loss) on change in fair value of derivative                                                       | (449)                           | 19,374            |
| Gain on redemption of convertible notes                                                                 | 1,421                           | -                 |
| Gain on convertible notes conversion                                                                    | -                               | 1,564             |
| Income before income tax expenses and equity in earnings of affiliated companies                        | 19,812                          | 41,717            |
| Less: Income taxes                                                                                      | 3,666                           | 4,045             |
| Equity in earnings of affiliated companies                                                              | 139                             | 129               |
| Income from continuing operations                                                                       | 16,285                          | 37,801            |
| Discontinued operations (including after-tax disposition gain of \$2,494) - net of income tax (Note 25) | 2,651                           | 1,535             |
| Net income                                                                                              | 18,936                          | 39,336            |
| Net income attributable to noncontrolling interests                                                     | 3,279                           | 5,241             |
| Net income attributable to parent company                                                               | 15,657                          | 34,095            |
| Allocation to convertible notes holders                                                                 | (925)                           | (3,831)           |
| Net income attributable to parent company's common shareholders                                         | \$ 14,732                       | \$ 30,264         |

Net income attributable to parent company's common shareholders per share

Basic

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|                                                                |            |            |
|----------------------------------------------------------------|------------|------------|
| Income from continuing operations attributable to shareholders | \$ 0.44    | \$ 1.06    |
| Income per share from discontinued operations                  | 0.08       | 0.03       |
| Net income attributable to shareholders                        | \$ 0.52    | \$ 1.09    |
| Diluted                                                        |            |            |
| Income from continuing operations attributable to shareholders | \$ 0.44    | \$ 0.48    |
| Income per share from discontinued operations                  | 0.08       | 0.02       |
| Net income attributable to shareholders                        | \$ 0.52    | \$ 0.50    |
| Weighted average number of common shares outstanding           |            |            |
| Basic                                                          | 28,260,302 | 27,881,821 |
| Diluted                                                        | 28,261,529 | 31,531,253 |
| Comprehensive income:                                          |            |            |
| Net income                                                     | \$ 18,936  | \$ 39,336  |
| Foreign currency translation (loss) gain, net of tax           | (1,280 )   | 9,228      |
| Comprehensive income                                           | 17,656     | 48,564     |
| Comprehensive income attributable to noncontrolling interests  | 3,023      | 6,842      |
| Comprehensive income attributable to parent company            | \$ 14,633  | \$ 41,722  |

The accompanying notes are an integral part of the condensed unaudited consolidated financial statements in this Report.



**China Automotive Systems, Inc. and Subsidiaries****Condensed Consolidated Balance Sheets***(In thousands of USD unless otherwise indicated)*

|                                                                       | September 30, 2012<br>(Unaudited) | December 31, 2011 |
|-----------------------------------------------------------------------|-----------------------------------|-------------------|
| <b>ASSETS</b>                                                         |                                   |                   |
| Current assets:                                                       |                                   |                   |
| Cash and cash equivalents                                             | \$ 72,490                         | \$ 72,961         |
| Pledged cash deposits                                                 | 24,494                            | 21,821            |
| Accounts and notes receivable, net - unrelated parties                | 196,540                           | 200,940           |
| Accounts and notes receivable, net - related parties                  | 9,432                             | 11,519            |
| Accounts receivable from sale of a subsidiary                         | 4,361                             | -                 |
| Advance payments and others - unrelated parties                       | 1,590                             | 2,215             |
| Advance payments and others - related parties                         | 446                               | 630               |
| Inventories                                                           | 48,033                            | 51,607            |
| Current deferred tax assets                                           | 3,750                             | 3,687             |
| Total current assets                                                  | 361,136                           | 365,380           |
| Non-current assets:                                                   |                                   |                   |
| Property, plant and equipment, net                                    | 85,501                            | 84,843            |
| Intangible assets, net                                                | 711                               | 837               |
| Other receivables, net - unrelated parties                            | 2,791                             | 1,877             |
| Other receivables, net - related parties                              | 1,071                             | 500               |
| Advance payment for property, plant and equipment - unrelated parties | 1,714                             | 1,472             |
| Advance payment for property, plant and equipment - related parties   | 4,276                             | 3,712             |
| Long-term investments                                                 | 3,602                             | 3,485             |
| Non-current deferred tax assets                                       | 4,379                             | 4,341             |
| Total assets                                                          | \$ 465,181                        | \$ 466,447        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                           |                                   |                   |
| Current liabilities:                                                  |                                   |                   |
| Bank and government loans                                             | \$ 37,001                         | \$ 10,316         |
| Accounts and notes payable - unrelated parties                        | 157,558                           | 169,456           |
| Accounts and notes payable - related parties                          | 3,713                             | 2,053             |
| Customer deposits                                                     | 1,253                             | 1,181             |
| Accrued payroll and related costs                                     | 4,736                             | 5,177             |
| Accrued expenses and other payables                                   | 22,151                            | 22,618            |
| Accrued pension costs                                                 | 4,355                             | 4,067             |
| Taxes payable                                                         | 6,132                             | 2,029             |
| Amounts due to shareholders/directors                                 | 341                               | 352               |
| Deferred tax liabilities                                              | 31                                | 311               |
| Total current liabilities                                             | 237,271                           | 217,560           |
| Long-term liabilities:                                                |                                   |                   |
| Convertible notes payable                                             | -                                 | 23,571            |
| Compound derivative liabilities                                       | -                                 | 559               |

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|                                                                     |         |         |
|---------------------------------------------------------------------|---------|---------|
| Accrued make-whole redemption interest expense of convertible notes | -       | 7,616   |
| Advances payable                                                    | 3,184   | 984     |
| Total liabilities                                                   | 240,455 | 250,290 |

Commitments and Contingencies (Note 29)

Stockholders' equity-

|                                                                                                                                                           |            |            |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Common stock, \$0.0001 par value - Authorized - 80,000,000 shares; Issued and Outstanding – 28,260,302 shares at September 30, 2012 and December 31, 2011 | 3          | 3          |
| Additional paid-in capital                                                                                                                                | 39,371     | 39,296     |
| Retained earnings-                                                                                                                                        |            |            |
| Appropriated                                                                                                                                              | 9,953      | 9,026      |
| Unappropriated                                                                                                                                            | 114,243    | 99,513     |
| Accumulated other comprehensive income                                                                                                                    | 24,267     | 25,291     |
| Total parent company stockholders' equity                                                                                                                 | 187,837    | 173,129    |
| Noncontrolling interests                                                                                                                                  | 36,889     | 43,028     |
| Total stockholders' equity                                                                                                                                | 224,726    | 216,157    |
| Total liabilities and stockholders' equity                                                                                                                | \$ 465,181 | \$ 466,447 |

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

**China Automotive Systems, Inc. and Subsidiaries****Condensed Unaudited Consolidated Statements of Cash Flows***(In thousands of USD unless otherwise indicated)*

|                                                                                                   | Nine Months Ended September 30, |           |
|---------------------------------------------------------------------------------------------------|---------------------------------|-----------|
|                                                                                                   | 2012                            | 2011      |
| Cash flows from operating activities:                                                             |                                 |           |
| Net income                                                                                        | \$ 18,936                       | \$ 39,336 |
| Adjustments to reconcile net income from operations to net cash provided by operating activities: |                                 |           |
| Stock-based compensation                                                                          | 76                              | -         |
| Depreciation and amortization                                                                     | 10,668                          | 10,144    |
| Increase (decrease) in allowance for doubtful accounts                                            | 16                              | (78 )     |
| Inventory write downs                                                                             | 501                             | -         |
| Deferred income taxes                                                                             | (1,268 )                        | (251 )    |
| Equity in earnings of affiliated companies                                                        | (139 )                          | (129 )    |
| Gain on sales of a subsidiary                                                                     | (2,848 )                        | -         |
| Gain on convertible notes conversion                                                              | -                               | (1,564 )  |
| Gain on redemption of convertible notes                                                           | (1,421 )                        | -         |
| Loss (gain) on change in fair value of derivative                                                 | 449                             | (19,374 ) |
| Amortization of debt issue cost                                                                   | 135                             | -         |
| Loss on fixed assets disposals                                                                    | 44                              | 116       |
| Changes in operating assets and liabilities:                                                      |                                 |           |
| (Increase) decrease in:                                                                           |                                 |           |
| Pledged deposits                                                                                  | (5,118 )                        | 1,460     |
| Accounts and notes receivable                                                                     | (4,741 )                        | 6,714     |
| Advance payments and others                                                                       | 570                             | 506       |
| Inventories                                                                                       | (4,306 )                        | (12,614 ) |
| Increase (decrease) in:                                                                           |                                 |           |
| Accounts and notes payable                                                                        | (462 )                          | 8,504     |
| Customer deposits                                                                                 | 337                             | 252       |
| Accrued payroll and related costs                                                                 | (180 )                          | (249 )    |
| Accrued expenses and other payables                                                               | (6,702 )                        | 1,489     |
| Accrued pension costs                                                                             | 315                             | (81 )     |
| Taxes payable                                                                                     | 4,294                           | (2,798 )  |
| Advances payable                                                                                  | 2,210                           | 346       |
| Net cash provided by operating activities                                                         | 11,366                          | 31,729    |
| Cash flows from investing activities:                                                             |                                 |           |
| Decrease (increase) in other receivables                                                          | (1,598 )                        | 625       |
| Proceeds from disposal of equipment                                                               | 622                             | 134       |
| Payments to acquire property, plant and equipment                                                 | (16,982 )                       | (10,805 ) |
| Payments to acquire intangible assets                                                             | (62 )                           | (121 )    |
| Proceeds from sales of a subsidiary                                                               | 3,561                           | -         |

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|                                                              |           |   |           |   |
|--------------------------------------------------------------|-----------|---|-----------|---|
| Net cash used in investing activities                        | (14,459   | ) | (10,167   | ) |
| Cash flows from financing activities:                        |           |   |           |   |
| Proceeds from government and bank loan                       | 36,402    |   | 8,655     |   |
| Repayments of bank loan                                      | (7,097    | ) | (3,863    | ) |
| Paid debt issue cost for bank loan                           | (230      | ) | -         |   |
| Dividends paid to the noncontrolling interests               | (2,387    | ) | (1,692    | ) |
| Redemption of convertible notes                              | (23,571   | ) | -         |   |
| Increase (decrease) in amounts due to shareholders/directors | (8        | ) | (20       | ) |
| Net cash provided by financing activities                    | 3,109     |   | 3,080     |   |
| Effects of exchange rate on cash and cash equivalents        | (487      | ) | 2,001     |   |
| Net increase in cash and cash equivalents                    | (471      | ) | 26,643    |   |
| Cash and cash equivalents at beginning of period             | 72,961    |   | 49,424    |   |
| Cash and cash equivalents at end of period                   | \$ 72,490 |   | \$ 76,067 |   |

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

**China Automotive Systems, Inc. and Subsidiaries**

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

*(In thousands of USD unless otherwise indicated)*

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

|                            | Nine Months Ended<br>September 30, |          |
|----------------------------|------------------------------------|----------|
|                            | 2012                               | 2011     |
| Cash paid for interest     | \$ 10,435                          | \$ 1,689 |
| Cash paid for income taxes | \$ 3,810                           | \$ 7,190 |

**SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:**

|                                                                                     | Nine Months Ended<br>September 30, |           |
|-------------------------------------------------------------------------------------|------------------------------------|-----------|
|                                                                                     | 2012                               | 2011      |
| Issuance of common shares for the conversion of convertible notes                   | \$ -                               | \$ 10,112 |
| Advance payments for acquiring property, plant and equipment                        | 5,990                              | 7,303     |
| Dividends payable to noncontrolling interests                                       | 707                                | -         |
| Noncontrolling interests contribution of capital with property, plant and equipment | 2,846                              | -         |
| Accounts receivable from sale of a subsidiary                                       | 4,361                              | -         |

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

**China Automotive Systems, Inc. and Subsidiaries****Condensed Unaudited Consolidated Statements of Changes in Equity***(In thousands of USD, except shares)*

|                                                          | Common<br>Stock<br>Shares | Amount | Additional<br>paid-in<br>capital | Retained<br>Earnings<br>-Appropriated | Retained<br>Earnings<br>Unappropriated | Accumulated<br>Other<br>Comprehensive<br>Income | Noncontrolling<br>Interests | Total      |
|----------------------------------------------------------|---------------------------|--------|----------------------------------|---------------------------------------|----------------------------------------|-------------------------------------------------|-----------------------------|------------|
| Beginning balance,<br>January 1, 2011                    | 27,175,826                | \$ 3   | \$ 28,565                        | \$ 8,768                              | \$ 58,980                              | \$ 15,958                                       | \$ 35,967                   | \$ 148,241 |
| Comprehensive<br>income                                  |                           |        |                                  |                                       |                                        |                                                 |                             |            |
| Net income                                               | -                         | -      | -                                | -                                     | 34,095                                 | -                                               | 5,241                       | 39,336     |
| Other comprehensive<br>income, net of tax:               | -                         | -      | -                                | -                                     | -                                      | -                                               | -                           | -          |
| Foreign currency<br>translation                          | -                         | -      | -                                | -                                     | -                                      | 7,627                                           | 1,601                       | 9,228      |
| Appropriation of<br>retained earnings                    | -                         | -      | -                                | 259                                   | (259 )                                 | -                                               | -                           | -          |
| Dividends declared                                       | -                         | -      | -                                | -                                     | -                                      | -                                               | (2,005 )                    | (2,005 )   |
| Conversion of<br>convertible notes                       | 907,708                   | -      | 10,112                           | -                                     | -                                      | -                                               | -                           | 10,112     |
| Ending balance,<br>September 30, 2011                    | 28,083,534                | \$ 3   | \$ 38,677                        | \$ 9,027                              | \$ 92,816                              | \$ 23,585                                       | \$ 40,804                   | \$ 204,912 |
| Beginning balance,<br>January 1, 2012                    | 28,260,302                | \$ 3   | \$ 39,296                        | \$ 9,026                              | \$ 99,513                              | \$ 25,291                                       | \$ 43,028                   | \$ 216,157 |
| Comprehensive<br>income:                                 |                           |        |                                  |                                       |                                        |                                                 |                             |            |
| Net income (loss)                                        | -                         | -      | -                                | -                                     | 15,657                                 | -                                               | 3,279                       | 18,936     |
| Other comprehensive<br>income, net of tax:               | -                         | -      | -                                | -                                     | -                                      | -                                               | -                           | -          |
| Foreign currency<br>translation                          | -                         | -      | -                                | -                                     | -                                      | (1,024 )                                        | (256 )                      | (1,280 )   |
| Share-based<br>compensation                              | -                         | -      | 75                               | -                                     | -                                      | -                                               | -                           | 75         |
| Appropriation of<br>retained earnings                    | -                         | -      | -                                | 927                                   | (927 )                                 | -                                               | -                           | -          |
| Dividends declared                                       | -                         | -      | -                                | -                                     | -                                      | -                                               | (6,846 )                    | (6,846 )   |
| Capital contribution<br>from noncontrolling<br>interests | -                         | -      | -                                | -                                     | -                                      | -                                               | 2,846                       | 2,846      |
| Disposition of<br>Zhejiang                               | -                         | -      | -                                | -                                     | -                                      | -                                               | (5,162 )                    | (5,162 )   |

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|                                       |            |      |           |          |            |           |           |            |
|---------------------------------------|------------|------|-----------|----------|------------|-----------|-----------|------------|
| Ending balance,<br>September 30, 2012 | 28,260,302 | \$ 3 | \$ 39,371 | \$ 9,953 | \$ 114,243 | \$ 24,267 | \$ 36,889 | \$ 224,726 |
|---------------------------------------|------------|------|-----------|----------|------------|-----------|-----------|------------|

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

**China Automotive Systems, Inc. and Subsidiaries****Notes to Condensed Unaudited Consolidated Financial Statements****Three Months and Nine Months Ended September 30, 2012 and 2011****1. Organization and Business**

China Automotive Systems, Inc., “China Automotive,” was incorporated in the State of Delaware on June 29, 1999 under the name Visions-In-Glass, Inc. China Automotive, including, when the context so requires, its subsidiaries and the joint ventures described below, is referred to herein as the “Company.” The Company is primarily engaged in the manufacture and sale of automotive systems and components, as described below.

Great Genesis Holdings Limited, a company incorporated in Hong Kong on January 3, 2003 under the Companies Ordinance in Hong Kong as a limited liability company, “Genesis,” is a wholly-owned subsidiary of the Company. Great Genesis is mainly engaged in the manufacture and sale of automotive systems and components through its controlled subsidiaries and the joint ventures, as described below.

Henglong USA Corporation, “HLUSA,” incorporated on January 8, 2007 in Troy, Michigan, is a wholly-owned subsidiary of the Company, and is mainly engaged in marketing of automotive parts in North America, and provides after-sales service and research and development support accordingly.

The Company owns the following aggregate net interests in the entities established in the People's Republic of China (“PRC”) and Brazil as of September 30, 2012 and December 31, 2011.

| Name of Entity                                                                          | Percentage Interest |   |                   |   |
|-----------------------------------------------------------------------------------------|---------------------|---|-------------------|---|
|                                                                                         | September 30, 2012  |   | December 31, 2011 |   |
| Shashi Jiulong Power Steering Gears Co., Ltd., “Jiulong” <sup>†</sup>                   | 81.00               | % | 81.00             | % |
| Jingzhou Henglong Automotive Parts Co., Ltd., “Henglong” <sup>2</sup>                   | 80.00               | % | 80.00             | % |
| Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., “Shenyang” <sup>3</sup>  | 70.00               | % | 70.00             | % |
| Zhejiang Henglong & Vie Pump-Manu Co., Ltd., “Zhejiang” <sup>4</sup>                    | -                   | % | 51.00             | % |
| Universal Sensor Application Inc., “USAI” <sup>5</sup>                                  | 83.34               | % | 83.34             | % |
| Wuhan Jielong Electric Power Steering Co., Ltd., “Jielong” <sup>6</sup>                 | 85.00               | % | 85.00             | % |
| Wuhu HengLong Automotive Steering System Co., Ltd., “Wuhu” <sup>7</sup>                 | 77.33               | % | 77.33             | % |
| Hubei Henglong Automotive System Group Co., Ltd, “Hubei Henglong” <sup>8</sup>          | 100.00              | % | 100.00            | % |
| Jingzhou Henglong Automotive Technology (Testing) Center, “Testing Center” <sup>9</sup> | 80.00               | % | 80.00             | % |



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|                                                                                           |       |   |       |   |
|-------------------------------------------------------------------------------------------|-------|---|-------|---|
| Beijing Henglong Automotive System Co., Ltd., “Beijing Henglong” <sup>10</sup>            | 50.00 | % | 50.00 | % |
| Chongqing Henglong Hongyan Automotive System Co., Ltd, “Chongqing Henglong” <sup>11</sup> | 70.00 | % | -     | % |
| CAAS Brazil’s Imports And Trade In Automotive Parts Ltd., “Brazil Henglong” <sup>12</sup> | 80.00 | % | -     | % |

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

2. Henglong was established in 1997 and mainly engages in the production of rack and pinion power steering gear for cars and light-duty vehicles.

3. Shenyang was established in 2002 and focuses on power steering parts for light duty vehicles.

4. Zhejiang was established in 2002 and mainly engages in the production and sales of power steering pumps. The Company sold its 51% equity interest in Zhejiang on May 21, 2012. Please see Note 25.

5. USAI was established in 2005 and mainly engages in the production and sales of sensor modules.

6. Jielong was established in 2006 and mainly engages in the production and sales of electric power steering, “EPS.”

7. Wuhu was established in 2006 and mainly engages in the production and sales of automobile steering systems.

8. On March 7, 2007, Genesis established Jingzhou Hengsheng Automotive System Co., Ltd., “Hengsheng,” its wholly-owned subsidiary, to engage in the production and sales of automotive steering systems. The registered capital of Hengsheng at the time of establishment was \$10 million. On February 10, 2010, the registered capital of Hengsheng was increased to \$16 million. On October 12, 2011, the board of directors of the Company approved a reorganization of the Company’s subsidiaries operating in China. As a result of the reorganization, all of Genesis’s equity interests of its subsidiaries operating in China, except for Shenyang and Zhejiang, were transferred to Hengsheng, the Company’s new China-based holding company. The reorganization was completed on January 19, 2012, subsequent to which the registered capital of Hengsheng was increased to \$39 million. As the reorganized entities were under common control of the Company, the reorganization did not have any impact on the Company’s consolidated financial position or results of operations and should not impact the tax treatment of the Company or its subsidiaries in any material respect. On July 8, 2012, Hengsheng changed its name to Hubei Henglong Automotive System Group Co., Ltd, “Hubei Henglong”.

9. Testing Center was established in 2009 and mainly engages in the research and development of new products.

10. Beijing Henglong was established in 2010 and mainly engages in the design, development and manufacture of both hydraulic and electric power steering systems and parts. According to the joint venture agreement, the Company does not have voting control of Beijing Henglong. Therefore, the Company's consolidated financial statements do not include Beijing Henglong, and such investment is accounted for by the equity accounting method.

11. On February 21, 2012, Hubei Henglong and SAIC-IVECO Hongyan Company, "SAIC-IVECO," established a Sino-foreign joint venture company, Chongqing Henglong, to design, develop and manufacture both hydraulic and electric power steering systems and parts. The new joint venture is located in Chongqing City and has a registered capital of RMB60 million, of which RMB42 million, or 70%, is held by Hubei Henglong. The registered capital of Chongqing Henglong was fully contributed by Hubei Henglong in cash of \$6.7 million (equivalent to RMB42 million) in January and February 2012 and by SAIC-IVECO in property, plant and equipment with fair value of \$2.8 million (equivalent to RMB18 million) in April 2012.

12. On August 21, 2012, Hubei Henglong established a Sino-foreign joint venture company with two Brazilian citizens, Ozias Gaia Da Silva and Ademir Dal' Evedove. The joint-venture company is called CAAS Brazil's Imports And Trade In Automotive Parts Ltd., "Brazil Henglong". Brazil Henglong engages mainly in the importation and sales of automotive parts in Brazil. The new joint venture is located in Brazil and has a registered capital of BRL1.6 million, of which BRL1.3 million, or 80%, is held by Hubei Henglong. As of September 30, 2012, Hubei Henglong had contributed \$0.8 million (equivalent to BRL1.3 million), Mr. Ozias Gaia Da Silva and Mr. Ademir Dal' Evedove have not yet contributed any capital.

## 2. Basis of Presentation and Significant Accounting Policies

### (a)

### *Basis of Presentation*

Basis of Presentation – For the three months and nine months ended September 30, 2012 and 2011, the accompanying condensed unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. The details of subsidiaries are disclosed in Note 1. Significant inter-company balances and transactions have been eliminated upon consolidation. The condensed unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("US GAAP") for interim financial information and with the instructions to Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by such accounting principles for complete financial statements. These financial statements should be read in conjunction with the consolidated financial statements and related footnotes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

The accompanying interim condensed consolidated financial statements are unaudited, but in the opinion of the Company's management, contain all adjustments, which include normal recurring adjustments, necessary to present

fairly the financial position as of September 30, 2012, the results of operations and cash flows for the three months and nine months ended September 30, 2012 and 2011, respectively.

The condensed consolidated balance sheet as of December 31, 2011 is derived from the Company's audited financial statements at that date but does not include all of the information and footnotes required by US GAAP for complete financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although the Company's management believes that the disclosures contained in these financial statements are adequate to make the information presented herein not misleading. For further information, please refer to the financial statements and the notes thereto included in the Company's 2011 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

The results of operations for the three months and nine months ended September 30, 2012 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2012.

Estimation -The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

(b)

*Recent Accounting Pronouncements*

In December 2011, the FASB issued ASU 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities* (ASU 2011-11). This newly issued accounting standard requires an entity to disclose both gross and net information about instruments and transactions eligible for offset in the statements of financial position as well as instruments and transactions executed under a master netting or similar arrangement and was issued to enable users of financial statements to understand the effects or potential effects of those arrangements on their financial position. This ASU is required to be applied retrospectively and is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. As this accounting standard only requires enhanced disclosure, the adoption of this standard is not expected to have an impact on the Company's financial position.

(c)

*Significant Accounting Policies*

Foreign Currencies – China Automotive, the parent company and HLUSA maintain their books and records in United States Dollars, “USD,” their functional currency. The Company's subsidiaries based in the PRC and Genesis maintain their books and records in Renminbi, their functional currency. The Company's subsidiary based in Brazil maintains its books and records in Brazilian reais (BRL), its functional currency. In accordance with *FASB Accounting Standards Codification* (“ASC”) Topic 830, foreign currency transactions denominated in currencies other than the functional currency are remeasured into the functional currency at the rate of exchange prevailing at the balance sheet date for monetary items. Nonmonetary items are remeasured at historical rates. Income and expenses are remeasured at the rate in effect on the transaction dates. Transaction gains and losses, if any, are included in the determination of net income for the period.

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

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

In July 2004, the Company adopted a stock incentive plan. The maximum number of common shares for issuance under this plan is 2,200,000 with a period of 10 years. The stock incentive plan provides for the issuance, to the Company's officers, directors, management and employees, of options to purchase shares of the Company's common stock. Since the adoption of the stock incentive plan, the Company has issued 501,350 stock options, and 1,698,650 stock options remain issuable in the future. As of September 30, 2012, the Company had 90,000 stock options

outstanding.

The Company has adopted ASC Topic 718, “Accounting for Stock-Based Compensation,” which establishes a fair value method of accounting for stock based compensation plans. The cost of stock options issued to employees is measured on the grant date based on the fair value. The fair value is determined using the Black-Scholes option pricing model. The resulting amount is charged to expense on the straight-line basis over the period in which the Company expects to receive benefit, which is generally the vesting period.

Comprehensive Income – The Company has adopted ASC Topic 220, “Reporting Comprehensive Income,” which establishes standards for the reporting and display of comprehensive income, its components and accumulated balances in a full set of general purpose financial statements. ASC Topic 220 defines comprehensive income to include all changes in equity except those resulting from investments by owners and distributions to owners, including adjustments to minimum pension liabilities, accumulated foreign currency translation, and unrealized gains or losses on marketable securities.

Financial Instruments – The Company adopted the provisions of ASC Topic 815, “Derivatives and Hedging Activities,” that address the determination of whether an instrument meets the definition of a derivative being indexed to a company’s own stock for purposes of applying the scope exception as provided for in accordance with ASC 815-15. Upon adoption of the standard on the effective date, the Company bifurcated the conversion feature embedded in the convertible notes (see Note 13), classifying it in liabilities and measuring it at fair value at each reporting period, with changes reflected in earnings, until the convertible notes are settled.

Fair Value Measurements – For purposes of fair value measurements, the Company applies the applicable provisions of ASC Topic 820, “Fair Value Measurements”. Accordingly, fair value for the Company’s financial accounting and reporting purposes represents the estimated price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the designated measurement date. With an objective to increase consistency and comparability in fair value measurements and related disclosures, the Financial Accounting Standard Board established the fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels.

Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. 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. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available. As at September 30, 2012 and December 31, 2011, the Company did not have any fair value assets and liabilities classified as Level 1.

Level 2 Inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. As at September 30, 2012 and December 31, 2011, the Company did not have any fair value assets and liabilities classified as Level 2.

Level 3 Inputs are unobservable inputs for the asset or liability. Unobservable inputs are used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. The compound derivative liabilities are classified as Level 3 as the inputs reflect management's best estimate of what market participants would use in pricing the liability at the measurement date. For a summary of changes in Level 3 derivative liabilities for the year ended December 31, 2011 and for the nine months ended September 30, 2012, please see Note 14.

### 3. Pledged cash deposits

Pledged cash deposits act as guarantee for the Company's notes payable as it regularly pays some of its suppliers by bank notes. The Company has to deposit a cash deposit, equivalent to 30%- 40% of the face value of the relevant bank note, at a bank in order to obtain the bank note.

### 4. Accounts and notes receivable, net

The Company's accounts and notes receivable at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                                                           | September 30, 2012 | December 31, 2011 |
|-----------------------------------------------------------|--------------------|-------------------|
| Accounts receivable - unrelated parties                   | \$ 98,009          | \$ 109,326        |
| Notes receivable - unrelated parties <sup>(1) (2)</sup>   | 99,733             | 92,805            |
|                                                           | 197,742            | 202,131           |
| Less: allowance for doubtful accounts - unrelated parties | (1,202 )           | (1,191 )          |

|                                       |            |            |
|---------------------------------------|------------|------------|
|                                       | 196,540    | 200,940    |
| Accounts receivable - related parties | 9,432      | 11,519     |
|                                       | \$ 205,972 | \$ 212,459 |

- (1) Notes receivable represent accounts receivable in the form of bills of exchange for which acceptances are guaranteed and settlements are handled by banks.

Jingzhou Henglong Automotive Parts Co., Ltd., “Henglong,” a subsidiary of the Company, collateralized its notes receivable of RMB 225 million (equivalent to approximately \$35.6 million) in favor of Industrial and Commercial Bank of China, Jingzhou Branch (“ICBC Jingzhou”) to obtain the Henglong Standby Letter of Credit (as defined in Note 11 below) as security for the non-revolving credit facility in the amount of \$30 million provided by ICBC Macau (as defined in Note 11 below) to the Company in May 2012.

## 5. Inventories

The Company’s inventories at September 30, 2012 and December 31, 2011 consisted of the following (figures are in thousands of USD):

|                 | September 30, 2012 | December 31, 2011 |
|-----------------|--------------------|-------------------|
| Raw materials   | \$ 13,073          | \$ 15,604         |
| Work in process | 7,495              | 7,344             |
| Finished goods  | 27,465             | 28,659            |
|                 | \$ 48,033          | \$ 51,607         |

## 6. Other receivables, net

The Company's other receivables at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                                                          | September 30, 2012 | December 31, 2011 |
|----------------------------------------------------------|--------------------|-------------------|
| Other receivables - unrelated parties <sup>(1)</sup>     | \$ 2,851           | \$ 1,933          |
| Less: allowance for doubtful accounts- unrelated parties | (60 )              | (56 )             |
|                                                          | 2,791              | 1,877             |
| Other receivables- related parties <sup>(1)</sup>        | 1,705              | 1,137             |
| Less: allowance for doubtful accounts- related parties   | (634 )             | (637 )            |
|                                                          | 1,071              | 500               |
|                                                          | \$ 3,862           | \$ 2,377          |

Other receivables consist of amounts advanced to both related and unrelated parties, primarily as unsecured (1)demand loans, with no stated interest rate or due date. These receivables originate as part of the Company's normal operating activities and are periodically settled in cash.

## 7. Long term Investments

On September 30, 2012 and December 31, 2011, the Company's balance of long-term investment was \$3.6 million and \$3.5 million, respectively. For the long-term investments in which the Company has no voting control, such investments were accounted for using the equity method or cost method.

On January 24, 2010, the Company invested \$3.1 million to establish a fifty-fifty joint venture company, Beijing Henglong, with an unrelated party. The Company accounts for its operating results with the equity method of accounting. On September 30, 2012 and 2011, the Company had \$3.5 million and \$3.3 million of net equity in Beijing Henglong, respectively.

The Company's share of net assets and net income is reported as "long-term investment" on the condensed unaudited consolidated balance sheets and "equity in earnings of affiliated companies" on the condensed unaudited consolidated statements of operations and comprehensive income. The Company's condensed unaudited consolidated financial statements reflect the equity earnings of non-consolidated affiliates of \$0.03 million and \$0.04 million in the three months ended September 30, 2012 and 2011, respectively. The Company's condensed unaudited consolidated financial statements reflect the equity earnings of non-consolidated affiliates of \$0.1 million and \$0.1 million for the nine months ended September 30, 2012 and 2011, respectively.



**8. Property, plant and equipment, net**

The Company's property, plant and equipment at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                                | September 30, 2012 | December 31, 2011 |
|--------------------------------|--------------------|-------------------|
| Land use rights and buildings  | \$ 39,863          | \$ 39,528         |
| Machinery and equipment        | 92,174             | 100,327           |
| Electronic equipment           | 6,083              | 6,354             |
| Motor vehicles                 | 2,806              | 2,956             |
| Construction in progress       | 14,997             | 6,547             |
|                                | 155,923            | 155,712           |
| Less: Accumulated depreciation | (70,422)           | (70,869)          |
|                                | \$ 85,501          | \$ 84,843         |

Depreciation charges for the three months ended September 30, 2012 and 2011, were \$3.3 million and \$3.5 million respectively; for the nine months ended September 30, 2012 and 2011, they were \$10.5 million and \$10.0 million, respectively.

As of September 30, 2012 and December 31, 2011, the Company had pledged property, plant and equipment with net book value of \$61.5 million and \$83.0 million for its comprehensive credit facilities with banks in China.

## 9. Intangible assets

The Company's intangible assets at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                             | September 30, 2012 | December 31, 2011 |
|-----------------------------|--------------------|-------------------|
| Costs:                      |                    |                   |
| Patent technology           | \$ 1,884           | \$ 1,896          |
| Management software license | 604                | 579               |
|                             | 2,488              | 2,475             |
| Less: Amortization          | (1,777)            | (1,638)           |
|                             | \$ 711             | \$ 837            |

For the nine months ended September 30, 2012 and 2011, amortization expenses were \$0.2 million and \$0.1 million, respectively; for the three months ended September 30, 2012 and 2011, amortization expenses were not material.

## 10. Deferred Income Tax Assets

In accordance with the provisions of ASC Topic 740, "Income Taxes," the Company assesses, on a quarterly basis, its ability to realize its deferred tax assets. Based on the more likely than not standard in the guidance and the weight of available evidence, the Company believes a valuation allowance against its deferred tax assets is necessary. In determining the need for a valuation allowance, the Company considered the following significant factors: an assessment of recent years' profitability and losses by tax authorities; the Company's expectation of profits based on margins and volumes expected to be realized, which are based on current pricing and volume trends; the long period in all significant operating jurisdictions before the expiry of net operating losses, noting further that a portion of the deferred tax asset is composed of deductible temporary differences that are subject to an expiry period until realized under tax law. The Company will continue to evaluate the provision of valuation allowance in future periods.

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The components of estimated deferred income tax assets at September 30, 2012 and December 31, 2011 were as follows (figures are in thousands of USD):

|                                                                      | September 30,<br>2012 | December 31,<br>2011 |
|----------------------------------------------------------------------|-----------------------|----------------------|
| Losses carry forward (U.S.) <sup>(1)</sup>                           | \$ 7,610              | \$ 4,012             |
| Losses carry forward (PRC) <sup>(1)</sup>                            | 2,300                 | 1,351                |
| Product warranties and other reserves                                | 3,011                 | 3,513                |
| Property, plant and equipment                                        | 3,776                 | 4,095                |
| Accrued make-whole interest expense for convertible notes            | -                     | 2,665                |
| Share-based compensation                                             | 240                   | 213                  |
| Bonus accrual                                                        | 102                   | 206                  |
| Other accruals                                                       | 654                   | 791                  |
| Others                                                               | 626                   | 137                  |
| Total deferred tax assets                                            | 18,318                | 16,983               |
| Less: taxable temporary difference related to revenue recognition    | (534 )                | (817 )               |
| Total deferred tax assets, net                                       | 17,784                | 16,166               |
| Less: Valuation allowance                                            | (9,655 )              | (8,138 )             |
| Total deferred tax assets, net of valuation allowance <sup>(2)</sup> | \$ 8,129              | \$ 8,028             |

- The net operating losses carry forward for the U.S. entity for income tax purposes are available to reduce future years' taxable income. These losses will expire, if not utilized, in 20 years. Net operating losses carry forward for non-U.S. entities can be carried forward for 5 years to offset taxable income. However, as of September 30, 2012, valuation allowance was \$9.7 million, including \$8.0 million allowance for the Company's deferred tax assets in the United States and \$1.7 million allowance for the Company's non-U.S. deferred tax assets. Based on the Company's current operations in the United States, management believes that the deferred tax assets in the United States are not likely to be realized in the future. For the non-U.S. deferred tax assets, pursuant to certain tax laws and regulations in China, the management believes such amount will not be used to offset future taxable income.

- Approximately \$4.4 million and \$4.3 million of deferred income tax asset as of September 30, 2012 and December 31, 2011, respectively, are included in non-current deferred tax assets in the accompanying condensed unaudited consolidated balance sheets. The remaining \$3.7 million and \$3.7 million of deferred income tax assets as of September 30, 2012 and December 31, 2011, respectively, are included in current deferred tax assets.

## 11.

### Bank and government loans- net

Loans consist of the following at September 30, 2012 and December 31, 2011 (figures are in thousands of USD):

|                                           | September 30, 2012 | December 31, 2011 |
|-------------------------------------------|--------------------|-------------------|
| Short-term bank loan (RMB) <sup>(1)</sup> | \$ 5,520           | \$ 10,316         |
| Short-term bank loan (USD) <sup>(2)</sup> | 30,000             | -                 |
| Short-term government loan <sup>(3)</sup> | 1,576              | -                 |
| Subtotal                                  | 37,096             | 10,316            |
| Debt issue cost                           | (230 )             | -                 |
| Amortization                              | 135                | -                 |
|                                           | \$ 37,001          | \$ 10,316         |

These loans are secured by property, plant and equipment of the Company and are repayable within one year.

- (1) Please see Note 8. At September 30, 2012 and December 31, 2011, the weighted average interest rate was 6.85 % and 6.72% per annum, respectively. Interest is to be paid on the twentieth day of each month and the principal repayment is at maturity.

- (2) On May 18, 2012, the Company entered into a credit facility agreement, the "Credit Agreement," with Industrial and Commercial Bank of China (Macau) Limited, "ICBC Macau," to obtain a non-revolving credit facility in the amount of \$30 million, the "Credit Facility". The Credit Facility would have expired on November 3, 2012 unless the Company drew down the line of credit in full prior to such expiration date, and the maturity date for the loan drawdown was the earlier of (i) 18 months from the drawdown or (ii) 1 month before the expiry of the standby letter of credit obtained by Henglong from ICBC Jingzhou as security for the Credit Facility, the "Henglong Standby Letter of Credit". The interest rate of the Credit Facility is calculated based on a three-month LIBOR plus 2.25% per annum, subject to the availability of funds and fluctuation at ICBC Macau's discretion. The interest is calculated daily based on a 360-day year and it is to be fixed one day before the first day of each interest period.

The interest period is defined as three months from the date of drawdown. As of September 30, 2012, the interest rate was 2.683% per annum. As further security for the Credit Facility, the Company was required to provide ICBC Macau standby letters of credit for a total amount not less than \$31.6 million if the Credit Facility is fully drawn.

On May 22, 2012, the Company drew down the full amount of \$30.0 million under the Credit Facility and provided a standby letter of credit for an amount of \$31.6 million in favor of ICBC Macau. The loan drawdown will expire on May 15, 2013. The Henglong Standby Letter of Credit issued by ICBC Jingzhou with the collateralization of Henglong's notes receivable of RMB225 million (equivalent to approximately \$35.6 million) will expire on June 15, 2013. The Company also paid an arrangement fee of \$0.1 million to ICBC Macau and \$0.1 million to ICBC Jingzhou. The arrangement fees are amortized over the period of loan drawdown, and \$0.1 million was amortized for the nine months ended September 30, 2012.

(3) On March 1, 2012, the Company received an interest-free Chinese government loan of RMB10 million (equivalent to approximately \$1.6 million), which will mature in a year.

## 12.

## Accounts and notes payable

The Company's accounts and notes payable at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                                                  | September 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------------------|-----------------------|----------------------|
| Accounts payable - unrelated parties             | \$ 93,285             | \$ 112,149           |
| Notes payable - unrelated parties <sup>(1)</sup> | 64,273                | 57,307               |
|                                                  | 157,558               | 169,456              |
| Accounts payable- related parties                | 3,713                 | 2,053                |
|                                                  | \$ 161,271            | \$ 171,509           |

Notes payable represent accounts payable in the form of bills of exchange whose acceptances are guaranteed and (1) settlements are handled by banks. The Company has pledged cash deposits, notes receivable and certain property, plant and equipment to secure notes payable granted by banks.

### **13. Convertible notes payable**

In February 2008, the Company sold to two accredited institutional investors \$35.0 million of convertible notes, the “convertible notes,” with a scheduled maturity date of February 15, 2013.

The convertible notes bore annual interest rates of 3%, 3.5%, 4%, 4.5%, 5% and 5% for each year of 2008, 2009, 2010, 2011, 2012 and 2013, respectively. The interest on the convertible notes was to be computed commencing from the issuance date and will be payable in cash in arrears semi-annually on January 15, and July 15 of each year with the first interest payable date on July 15, 2008.

The Company and YA Global Investments L.P. (“YA Global”) reached a settlement agreement on April 8, 2009. Under the terms of the settlement agreement, the Company paid on April 15, 2009 a redemption amount of \$5.0 million to YA Global and YA Global waived its entitlement to the Other Make Whole Amount (as defined in the convertible notes). The amount waived was accounted for as a gain on redemption of the convertible notes.

On March 1, 2011, the provisional liquidator acting on behalf of Lehman Brothers Commercial Corporation Asia Limited (“LBCCA Liquidator”) converted \$6.4 million principal amount of the convertible notes at a conversion price of \$7.0822 per share, and in turn the Company issued 907,708 shares of its common stock to LBCCA Liquidator. On the said conversion date, the market price of the common shares issued was \$10.1 million (\$11.14 per share) and the value of the conversion consideration was \$11.7 million, including \$6.4 million of principal, \$1.5 million of coupon interest and make-whole amount payable and \$3.7 million of derivative liabilities under such principal. The amount of coupon interest, make-whole and derivative liabilities included in the value of the conversion consideration were determined by pro-rating the accrued coupon interest, accrued make-whole amount and the fair value of the derivative liabilities based on the principal amount of the convertible notes converted as a percentage of the outstanding balance prior to their conversion. The Company recorded a gain on the convertible notes conversion of \$1.6 million, which is the difference between the market price of the common stock and the conversion consideration.

On May 24, 2012, the Company and LBCCA Liquidator reached a settlement agreement. Under the terms of the settlement agreement, the Company redeemed all the convertible notes and paid a redemption amount of \$32.4 million to LBCCA Liquidator on May 25, 2012, the “Redemption Date,” including \$23.6 million of principal and \$8.8 million of interest. On the redemption date, the carrying value of the convertible notes was \$33.8 million, including \$23.6 million of principal, \$0.6 million of coupon interests, \$8.6 million of make-whole amount payable and \$1.0 million of derivative liabilities related to the convertible notes. The Company recorded a gain on redemption of convertible notes of \$1.4 million, which is the difference between the redemption amount and the carrying value of the convertible

notes.

#### 14. Compound derivative liabilities

The Company's derivative financial instruments (liabilities) consisted of a compound embedded derivative that originated in connection with the Company's Convertible Note Payable and Warrant Financing Arrangement. Derivative liabilities are carried at fair value. As discussed in Note 13 above, the Company redeemed the convertible notes on the Redemption Date. Therefore, the fair value of the derivative liabilities related to all the convertible notes as of the Redemption Date was included in the carrying value of the convertible notes for the calculation of gain on redemption in May 2012. The following table summarizes the compound derivative liabilities as of September 30, 2012 and December 31, 2011 (figures are in thousands of USD):

| Financial Instrument                                      | September 30, 2012 | December 31, 2011 |
|-----------------------------------------------------------|--------------------|-------------------|
| Compound derivative liability                             | \$ -               | \$ 559            |
| Common shares to which the derivative liability is linked | -                  | 3,328             |

Changes in the fair value of compound derivative liabilities are recorded in loss (gain) on change in fair value of derivative in the income statement. The following table summarizes the components of loss (gain) on change in fair value of derivative arising from fair value adjustments and other changes to compound derivative liabilities during the nine months ended September 30, 2012 and 2011 (figures are in thousands of USD):

|                                                               | Nine Months Ended September 30, |           |
|---------------------------------------------------------------|---------------------------------|-----------|
|                                                               | 2012                            | 2011      |
| Balances at January 1                                         | \$ 559                          | \$ 25,272 |
| Decrease due to convertible notes conversion on March 1, 2011 | -                               | (3,741 )  |
| Decrease due to convertible notes conversion on May 25, 2012  | (1,008 )                        | -         |
| Loss (gain) in fair value adjustments <sup>(1)</sup>          | 449                             | (19,374 ) |
| Balances at September 30                                      | \$ -                            | \$ 2,157  |

- (1). Recorded in the loss (gain) on change in fair value of derivative line in the condensed unaudited consolidated statements of operations and comprehensive income.

The Company's embedded conversion option derivative represents the conversion option, term-extending option, certain redemption and put features in the Company's convertible notes payable. See Note 13 for additional information about the Company's convertible notes payable. The features embedded in the convertible notes were combined into one compound embedded derivative that the Company measured at fair value using the Monte Carlo valuation technique. Monte Carlo simulates multiple outcomes over the period to maturity using multiple assumption inputs. The following table sets forth (i) the range of inputs for each significant assumption and (ii) the equivalent, or averages, of each significant assumption as of May 25, 2012 (Redemption Date), September 30, 2011 and December 31, 2011.

|                                | Range   |          |            |
|--------------------------------|---------|----------|------------|
| May 25, 2012 Assumptions:      | Low     | High     | Equivalent |
| Volatility                     | 65.33 % | 102.57 % | 79.02 %    |
| Market adjusted interest rates | 5.89 %  | 17.95 %  | 11.97 %    |
| Credit risk adjusted rates     | 16.87 % | 16.87 %  | 16.87 %    |
| Implied expected life (years)  | -       | -        | 0.73       |

|                                | Range   |         |            |
|--------------------------------|---------|---------|------------|
| December 31, 2011 Assumptions: | Low     | High    | Equivalent |
| Volatility                     | 51.63 % | 69.66 % | 60.40 %    |
| Market adjusted interest rates | 15.38 % | 21.87 % | 18.52 %    |
| Credit risk adjusted rates     | 17.17 % | 17.17 % | 17.17 %    |
| Implied expected life (years)  | -       | -       | 1.13       |

|                                 | Range   |         |            |
|---------------------------------|---------|---------|------------|
| September 30, 2011 Assumptions: | Low     | High    | Equivalent |
| Volatility                      | 49.84 % | 76.78 % | 63.59 %    |
| Market adjusted interest rates  | 9.46 %  | 18.13 % | 15.06 %    |
| Credit risk adjusted rates      | 17.43 % | 17.43 % | 17.43 %    |
| Implied expected life (years)   | -       | -       | 1.36       |





### 15. Accrued expenses and other payables

The Company's accrued expenses and other payables at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                                               | September 30, 2012 | December 31, 2011 |
|-----------------------------------------------|--------------------|-------------------|
| Accrued expenses                              | \$ 2,252           | \$ 2,802          |
| Accrued interest <sup>(1)</sup>               | 82                 | 626               |
| Other payables                                | 2,636              | 1,573             |
| Warranty reserves <sup>(2)</sup>              | 16,476             | 16,809            |
| Dividends payable to noncontrolling interests | 705                | 808               |
|                                               | \$ 22,151          | \$ 22,618         |

The accrued interest of \$0.1 million as of September 30, 2012 represented the credit facility interest on the date of (1) drawdown. The accrued interest of \$0.6 million as of December 31, 2011 represented coupon interest on convertible notes to be paid every six months (see Note 13).

The Company provides for the estimated cost of product warranties when the products are sold. Such estimates of (2) product warranties were based on, among other things, historical experience, product changes, material expenses, services and transportation expenses arising from the manufactured products. Estimates will be adjusted on the basis of actual claims and circumstances.

For the nine months ended September 30, 2012 and 2011, and for the year ended December 31, 2011, the warranties activities were as follows (figures are in thousands of USD):

|                                                      | Nine Months Ended September 30, |           | Year Ended        |
|------------------------------------------------------|---------------------------------|-----------|-------------------|
|                                                      | 2012                            | 2011      | December 31, 2011 |
| Balance at the beginning of period                   | \$ 16,809                       | \$ 13,944 | \$ 13,944         |
| Additions during the period                          | 6,865                           | 8,013     | 11,485            |
| Settlement within period, by cash or actual material | (6,661)                         | (6,099)   | (9,332)           |
| Foreign currency translation gain (loss)             | (105)                           | 588       | 712               |
| Decrease for warranty related to the subsidiary sold | (432)                           | -         | -                 |
| Balance at end of period                             | \$ 16,476                       | \$ 16,446 | \$ 16,809         |

### 16. Accrued make-whole redemption interest expense of convertible notes

In February 2008, the Company sold to two accredited institutional investors the convertible notes, with a scheduled maturity date of February 15, 2013. Pursuant to the terms of the convertible notes, on each of February 15, 2010 and February 15, 2011, the convertible note holders had the right, in their sole discretion, to require that the Company redeem the convertible notes in whole but not in part, by delivering written notice thereof to the Company. The portion of the convertible note subject to redemption pursuant to such annual redemption right would have been redeemed by the Company in cash at a price equal to the sum of the conversion amount being redeemed and the Annual Redemption Make Whole Amount. The “Annual Redemption Make Whole Amount” means a premium to the conversion amount such that the total amount received by the convertible notes holder upon any annual redemption represents a gross yield on the original principal amount of eleven percent (11%), with interest computed on the basis of the actual number of days elapsed over a 360-day year. On February 15, 2011, the remaining convertible notes holder did not exercise its annual redemption right. Subsequently, the Company redeemed all the convertible notes and paid a redemption amount of \$32.4 million to LBCCA Liquidator on the Redemption Date.

For the nine months ended September 30, 2012 and 2011, and for the year ended December 31, 2011, the activities of accrued provision on make-whole redemption interest pursuant to the terms of convertible notes were as follows (figures are in thousands of USD):

|                                                           | Nine Months Ended September 30, |          | Year Ended December 31, |
|-----------------------------------------------------------|---------------------------------|----------|-------------------------|
|                                                           | 2012                            | 2011     | 2011                    |
| Balance at beginning of the period                        | \$ 7,616                        | \$ 6,631 | \$ 6,631                |
| Amounts provided for during the period                    | 1,073                           | 1,839    | 2,487                   |
| Decrease due to redemption of convertible notes (Note 13) | (8,689 )                        | -        | -                       |
| Decrease due to conversion of convertible notes (Note 13) | -                               | (1,502 ) | (1,502 )                |
| Balance at end of period                                  | \$ -                            | \$ 6,968 | \$ 7,616                |

The amounts provided for during the periods are included in financial expenses, net (see Note 20).

## 17. Taxes payable

The Company's taxes payable at September 30, 2012 and December 31, 2011 are summarized as follows (figures are in thousands of USD):

|                         | September 30, 2012 | December 31, 2011 |
|-------------------------|--------------------|-------------------|
| Value-added tax payable | \$ 4,026           | \$ 1,514          |
| Income tax payable      | 1,827              | 424               |
| Other tax payable       | 279                | 91                |
|                         | \$ 6,132           | \$ 2,029          |

## 18. Advances payable

On September 30, 2012 and December 31, 2011, advances payable by the Company were \$3.2 million and \$1 million, respectively.

The amounts mainly represent advances made by the Chinese government to the Company as subsidies related to the improvement of production capacities and development of new products and technologies. For the government subsidies with no further conditions to be met, the amounts are recorded as other income when received; for the amounts with certain operating conditions, the government subsidies are recorded as advance payable when received

and will be recorded as a deduction of related expenses when the conditions are met.

The balances are unsecured, interest-free and will be repayable to the Chinese government if the usage of such advance does not continue to qualify for the subsidy.

## 19. Retained earnings—Appropriated

Pursuant to the relevant PRC laws and regulations, the profits distribution of the Company's PRC subsidiaries, which are based on their PRC statutory financial statements, other than the financial statement that was prepared in accordance with US GAAP, are available for distribution in the form of cash dividends after these subsidiaries have paid all relevant PRC tax liabilities, provided for losses in previous years, and made appropriations to statutory surplus at 10%.

When the statutory surplus reserve reaches 50% of the registered capital of a company, additional reserve is no longer required. However, the reserve cannot be distributed to joint venture partners. Based on the business licenses of the PRC subsidiaries, the registered capital of Henglong, Jiulong, Shenyang, Zhejiang, USAI, Jielong, Wuhu, Hubei Henglong and Chongqing are \$10.0 million, \$4.2 million (equivalent to RMB35.0 million), \$8.1 million (equivalent to RMB67.5 million), \$7.0 million, \$2.6 million, \$6.0 million, \$3.8 million (equivalent to RMB30.0 million), \$39 million and \$9.5 million (equivalent to RMB60.0 million), respectively.

During the nine months ended September 30, 2012 and 2011, the parent company did not declare any dividend or appropriate any statutory reserves, and the subsidiaries appropriated statutory reserves of \$0.9 million and \$0.3 million, respectively, in respect of the dividends declared.

## 20. Financial expenses, net

During the three months and nine months ended September 30, 2012 and 2011, the Company recorded financial expenses, net which are summarized as follows (figures are in thousands of USD):

|                                                    | Three Months Ended September 30, |        |
|----------------------------------------------------|----------------------------------|--------|
|                                                    | 2012                             | 2011   |
| Coupon interest and make-whole redemption interest | \$ -                             | \$ 906 |
| Interest expense                                   | 819                              | 192    |
| Interest income                                    | (409)                            | (175)  |
| Foreign exchange gain, net                         | 5                                | 289    |
| (Gain) loss of note discount, net                  | (7)                              | 40     |
| Handling charge                                    | 29                               | 29     |

|       |        |          |
|-------|--------|----------|
| Total | \$ 437 | \$ 1,281 |
|-------|--------|----------|

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|                                                    | Nine Months Ended September 30, |          |
|----------------------------------------------------|---------------------------------|----------|
|                                                    | 2012                            | 2011     |
| Coupon interest and make-whole redemption interest | \$ 1,551                        | \$ 2,692 |
| Interest expense                                   | 1,273                           | 427      |
| Interest income                                    | (981 )                          | (673 )   |
| Foreign exchange gain, net                         | (89 )                           | 232      |
| (Gain) loss of note discount, net                  | (32 )                           | 90       |
| Handling charge                                    | 128                             | 119      |
| Total                                              | \$ 1,850                        | \$ 2,887 |

## 21. Gain (loss) on change in fair value of derivative

During the three months and nine months ended September 30, 2012 and 2011, the Company recorded gain (loss) on change in fair value of derivative is summarized as follows (figures are in thousands of USD):

|                                                                   | Three Months Ended September 30, |          |
|-------------------------------------------------------------------|----------------------------------|----------|
|                                                                   | 2012                             | 2011     |
| Gain from change of fair value of compound derivative liabilities | \$ -                             | \$ 7,788 |

  

|                                                                          | Nine Months Ended September 30, |           |
|--------------------------------------------------------------------------|---------------------------------|-----------|
|                                                                          | 2012                            | 2011      |
| Gain (loss) from change of fair value of compound derivative liabilities | \$ (449 )                       | \$ 19,374 |

During the nine months ended September 30, 2012, the Company's common stock market price rose to \$3.82 on the Redemption Date, as compared to \$3.30 at the beginning of 2012. Thus, the intrinsic value of the embedded conversion feature in financial instruments increased and the fair value of compound derivative liabilities increased, resulting in an increase in loss on change in fair value of derivatives.

During the three months ended September 30, 2011, the Company's common stock market price dropped to \$4.72 from \$8.63 at the end of the prior quarter. Thus, the intrinsic value of the embedded conversion feature in financial instruments decreased, the fair value of compound derivative liabilities decreased, and the gain on change in fair value of derivatives increased (see Note 14).

During the nine months ended September 30, 2011, the Company's common stock market price dropped to \$4.72 from \$13.62 at the beginning of 2011. Thus, the intrinsic value of the embedded conversion feature in financial instruments decreased, the fair value of compound derivative liabilities decreased, and the gain on change in fair value of derivatives increased (see Note 14).

## **22. Gain on convertible notes conversion**

During the nine months ended September 30, 2011, the Company recognized a gain of \$1.6 million for convertible notes conversion in March 2011. There was no convertible note converted in the same period of 2012. The gain on convertible notes conversion represent the difference between the market price of the common stock and the conversion consideration (see Note 13).

## **23. Gain on redemption of convertible notes**

During the nine months ended September 30, 2012, the Company recognized a gain of \$1.4 million for redemption of convertible notes in May 2012. There were no convertible notes redeemed in the same period of 2011. The gain on redemption of convertible notes represents the difference between the redemption amount and the carrying value of the convertible notes (see Note 13).



## 24. Income tax rate

The Company's subsidiaries registered in the PRC are subject to state and local income taxes within the PRC at the applicable tax rate of 25% on the taxable income as reported in their PRC statutory financial statements in accordance with the relevant income tax laws applicable to foreign invested enterprise, unless preferential tax treatment is granted by local tax authorities. If the enterprise meets certain preferential terms according to the China income tax law, such as assessment as an "Advanced Technology Enterprise" by the government, then, the enterprise will be subject to enterprise income tax at a rate of 15%.

Pursuant to the New China Income Tax Law and the Implementing Rules ("New CIT") which were effective as of January 1, 2008, dividends generated after January 1, 2008 and payable by a foreign-invested enterprise to its foreign investors will be subject to a 10% withholding tax if the foreign investors are considered as non-resident enterprises without any establishment or place within China or if the dividends payable have no connection with the establishment or place of the foreign investors within China, unless any such foreign investor's jurisdiction of incorporation has a tax treaty with China that provides for a different withholding arrangement.

Genesis, the Company's wholly-owned subsidiary and the direct holder of the equity interests in the Company's subsidiaries in China, is incorporated in Hong Kong. According to the Mainland and Hong Kong Taxation Arrangement, dividends paid by a foreign-invested enterprise in China to its direct holding company in Hong Kong will be subject to withholding tax at a rate of no more than 5%, if the foreign investor owns directly at least 25% of the shares of the foreign-invested enterprise. Under the New CIT, if Genesis is regarded as a non-resident enterprise and therefore is required to pay a 5% withholding tax for any dividends payable to it from the PRC subsidiaries.

The Company provides for deferred income taxes on the unremitted earnings of foreign subsidiaries unless such earnings are deemed to be permanently reinvested outside the United States. During the nine months ended September 30, 2012 and 2011, the Company had a gross U.S. deferred income taxes of \$0.03 million and \$0.4 million, respectively, on foreign earnings of \$0.5 million and \$2.4 million, respectively, that it considered not permanently reinvested outside the United States.

As of September 30, 2012, the Company still has undistributed earnings of approximately \$117.7 million from investment in the PRC subsidiaries that are considered permanently reinvested. Had the undistributed earnings been considered not permanently reinvested, the tax provision of approximately \$5.9 million would have been provided for.

During 2008, Jiulong was awarded the title of "Advanced Technology Enterprise" and, based on the PRC income tax law, it was subject to enterprise income tax at a rate of 15% for 2008, 2009 and 2010. In 2011, the Company passed the re-assessment by the government, based on PRC income tax laws. Accordingly, it continues to be taxed at the 15% tax rate in 2011, 2012 and 2013.

During 2008, Henglong was awarded the title of “Advanced Technology Enterprise” and, based on the PRC income tax law, it was subject to enterprise income tax at a rate of 15% for 2008, 2009 and 2010. In 2011, the Company passed the re-assessment by the government, based on PRC income tax laws. Accordingly, it will continue to be taxed at the 15% tax rate in 2011, 2012 and 2013.

During 2009, Shenyang was awarded the title of “Advanced Technology Enterprise” and, based on the PRC income tax law, it was subject to enterprise income tax at a rate of 15% for 2009, 2010 and 2011. The government needs to re-assess whether Shenyang is entitled to “Advanced Technology Enterprise” status in 2012 and, if approved, the term of the said tax rate will be extended for another three years. If Shenyang fails to pass the re-assessment by the government, it would be subject to a tax rate of 25%. As of September 30, 2012, the re-assessment was still in progress, and a tax rate of 25% has been used for income tax calculation since January 1, 2012.

According to the New CIT, Wuhu has been subject to income tax at a rate of 11%, 12%, and 12.5%, respectively, for 2010, 2011 and 2012; Jielong has been subject to tax at a rate of 12.5% in 2010 and 2011, and 25% in 2012. Hubei Henglong has been subject to tax at a rate of 12.5% from 2010 to 2012. USAI and Testing Center were exempted from income tax in 2009, and each has been subject to income tax at a rate of 12.5% in 2010 and 2011, and 25% in 2012.

Based on Brazilian income tax laws, Brazil Henglong is subject to income tax at a uniform rate of 15%, and a resident legal person is subject to additional tax at a rate of 10% for the part of taxable income over BRL 0.24 million. The Company has no assessable income in Brazil for the nine months ended September 30, 2012 and 2011, and the year ended December 31, 2011.

The profits tax rate of Hong Kong is 16.5%. No provision for Hong Kong tax is made as Genesis is an investment holding company, and has no assessable income in Hong Kong for the nine months ended September 30, 2012 and 2011, and the year ended December 31, 2011.

The enterprise income tax rate of the United States is 35%. No provision for U.S. tax is made as the Company has no assessable income in the United States for the nine months ended September 30, 2012 and 2011, and for the year ended December 31, 2011.

The effective tax rate increased to 16.3% for the three months ended September 30, 2012 from 8.3% for the same period in 2011, which was primarily due to the permanent difference of gain on change in the fair value of derivative recorded in the third quarter of 2011. Since the derivative has been settled in the second quarter of 2012 pursuant to the redemption of convertible notes, there was no similar permanent difference in the third quarter of 2012.



**25. Discontinued operations - Zhejiang**

Zhejiang is mainly engaged in the production and sales of power steering pumps. Given the power steering pump business has slowly lost its market share in the recent years due to market competition, lower market demand and replacement of hydraulic pressure steering by electric power steering, the Company sold its 51% equity interest in Zhejiang to Vie Group, the non-controlling shareholder of Zhejiang, on May 21, 2012, the “Zhejiang Sale”. Pursuant to ASC Topic 205-20, Presentation of Financial Statements—Discontinued Operations, the business of Zhejiang, the “Zhejiang business,” is considered as a discontinued operation because: (a) the operations and cash flows of Zhejiang will be eliminated from the Company’s operations as the Company will not continue to purchase power steering pumps from Zhejiang starting from August 2012; and (b) the Company would not have the ability to influence the operation or financial policies of Zhejiang subsequent to the sale. Before the sale, Zhejiang was identified as a product sector for the sales of power steering pumps of the Company, please see Note 31 for the details of segment reporting. For the three months ended September 30, 2012 and 2011, the purchases from Zhejiang by the Company amounted to \$0 and \$1.3 million, respectively; and for the nine months ended September 30, 2012 and 2011, the purchases from Zhejiang by the Company amounted to \$0.5 million and \$1.6 million, respectively, which were eliminated for the preparation of the consolidated financial statements before the disposition of Zhejiang.

The unaudited consolidated statements of operations of the Company have been adjusted to reflect the discontinued Zhejiang business for the periods presented (figures are in thousands of USD).

|                                     | Three Months Ended September 30, 2011 |                                         |                             |
|-------------------------------------|---------------------------------------|-----------------------------------------|-----------------------------|
|                                     | Prior reported amount (a)             | Adjusted as discontinued operations (b) | Adjusted amount (c)=(a)-(b) |
| Net product sales                   |                                       |                                         |                             |
| Unrelated parties                   | \$ 67,185                             | \$ 3,923                                | \$ 63,262                   |
| Related parties                     | 7,818                                 | 166                                     | 7,652                       |
|                                     | 75,003                                | 4,089                                   | 70,914                      |
| Cost of product sold                |                                       |                                         |                             |
| Unrelated parties                   | 58,374                                | 2,878                                   | 55,496                      |
| Related parties                     | 2,842                                 | 12                                      | 2,830                       |
|                                     | 61,216                                | 2,890                                   | 58,326                      |
| Gross profit                        | 13,787                                | 1,199                                   | 12,588                      |
| Net gain on other sales             | 466                                   | -                                       | 466                         |
| Operating expenses:                 |                                       |                                         |                             |
| Selling expenses                    | 2,171                                 | 161                                     | 2,010                       |
| General and administrative expenses | 3,414                                 | 286                                     | 3,128                       |
| R&D expenses                        | 2,709                                 | 243                                     | 2,466                       |
| Total operating expenses            | 8,294                                 | 690                                     | 7,604                       |
| Operating income                    | 5,959                                 | 509                                     | 5,450                       |

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|                                                                                         |          |            |          |
|-----------------------------------------------------------------------------------------|----------|------------|----------|
| Other income, net                                                                       | 49       | -          | 49       |
| Financial expenses, net                                                                 | (1,279 ) | 2          | (1,281 ) |
| Loss on change in fair value of derivative                                              | 7,788    | -          | 7,788    |
| Income (loss) before income tax expenses and equity in earnings of affiliated companies | 12,517   | 511        | 12,006   |
| Less: Income taxes                                                                      | 1,069    | 77         | 992      |
| Add: Equity in earnings of affiliated companies                                         | 43       | -          | 43       |
| Income from continuing operations                                                       | -        | (11,057 )  | 11,057   |
| Discontinued operations - net of income tax                                             | -        | (434 )     | 434      |
| Net income                                                                              | 11,491   | -          | 11,491   |
| Net income attributable to noncontrolling interest                                      | 1,382    | -          | 1,382    |
| Net income attributable to parent company                                               | 10,109   | -          | 10,109   |
| Allocation to convertible notes holders                                                 | (1,071 ) | -          | (1,071 ) |
| Net income attributable to parent company's common shareholders                         | \$ 9,038 | \$ -       | \$ 9,038 |
| Basic                                                                                   | \$ 0.32  | \$ 0.32    | \$ -     |
| Income from continuing operations attributable to shareholders                          | -        | (0.31 )    | 0.31     |
| Income per share from discontinued operations                                           | -        | (0.01 )    | 0.01     |
| Diluted                                                                                 | 0.10     | 0.10       | -        |
| Income from continuing operations attributable to shareholders                          | -        | (0.09 )    | 0.09     |
| Income per share from discontinued operations                                           | \$ -     | \$ (0.01 ) | \$ 0.01  |

|                                                                                         | Nine Months Ended September 30, 2011 |                                                  |                                   |
|-----------------------------------------------------------------------------------------|--------------------------------------|--------------------------------------------------|-----------------------------------|
|                                                                                         | Prior<br>reported<br>amount<br>(a)   | Adjusted as<br>discontinued<br>operations<br>(b) | Adjusted<br>amount<br>(c)=(a)-(b) |
| Net product sales                                                                       |                                      |                                                  |                                   |
| Unrelated parties                                                                       | \$ 218,048                           | \$ 12,505                                        | \$ 205,543                        |
| Related parties                                                                         | 30,475                               | 521                                              | 29,954                            |
|                                                                                         | 248,523                              | 13,026                                           | 235,497                           |
| Cost of product sold                                                                    |                                      |                                                  |                                   |
| Unrelated parties                                                                       | 186,978                              | 9,405                                            | 177,573                           |
| Related parties                                                                         | 12,972                               | 114                                              | 12,858                            |
|                                                                                         | 199,950                              | 9,519                                            | 190,431                           |
| Gross profit                                                                            | 48,572                               | 3,506                                            | 45,066                            |
| Net gain on other sales                                                                 | 1,360                                | (15 )                                            | 1,375                             |
| Operating expenses:                                                                     |                                      |                                                  |                                   |
| Selling expenses                                                                        | 7,123                                | 470                                              | 6,653                             |
| General and administrative expenses                                                     | 10,869                               | 579                                              | 10,290                            |
| R&D expenses                                                                            | 6,609                                | 623                                              | 5,986                             |
| Total operating expenses                                                                | 24,601                               | 1672                                             | 22,929                            |
| Operating income                                                                        | 25,331                               | 1819                                             | 23,512                            |
| Other income, net                                                                       | 155                                  | -                                                | 155                               |
| Financial expenses, net                                                                 | (2,901 )                             | 14                                               | (2,887 )                          |
| Gain on change in fair value of derivative                                              | 19,374                               | -                                                | 19,374                            |
| Gain on convertible notes conversion                                                    | 1,564                                | -                                                | 1,564                             |
| Income (loss) before income tax expenses and equity in earnings of affiliated companies | 43,521                               | 1,804                                            | 41,717                            |
| Less: Income taxes                                                                      | 4,315                                | 270                                              | 4,045                             |
| Add: Equity in earnings of affiliated companies                                         | 129                                  | -                                                | 129                               |
| Income from continuing operations                                                       | -                                    | (37,801 )                                        | 37,801                            |
| Discontinued operations - net of income tax                                             | -                                    | (1,534 )                                         | 1,535                             |
| Net income                                                                              | 39,336                               | -                                                | 39,336                            |
| Net income attributable to noncontrolling interest                                      | 5,241                                | -                                                | 5,241                             |
| Net income attributable to parent company                                               | 34,095                               | -                                                | 34,095                            |
| Allocation to convertible notes holders                                                 | (3,831 )                             | -                                                | (3,831 )                          |
| Net income attributable to parent company's common shareholders                         | \$ 30,264                            | \$ -                                             | \$ 30,264                         |
| Net income (loss) attributable to parent company's common shareholders per share –      |                                      |                                                  |                                   |
| Basic                                                                                   | \$ 1.09                              | \$ 1.09                                          | \$ -                              |
| Income from continuing operations attributable to shareholders                          | -                                    | (1.06 )                                          | 1.06                              |
| Income per share from discontinued operations                                           | -                                    | (0.03 )                                          | 0.03                              |
| Diluted                                                                                 | 0.50                                 | 0.50                                             |                                   |
| Income from continuing operations attributable to shareholders                          | -                                    | (0.48 )                                          | 0.48                              |
| Income per share from discontinued operations                                           | \$ -                                 | \$ (0.02 )                                       | \$ 0.02                           |

The following table summarizes the results of the Zhejiang business included in the unaudited consolidated statements of operations as discontinued operations (figures are in thousands of USD).

|                                                                          | Three Months Ended September 30, |        |
|--------------------------------------------------------------------------|----------------------------------|--------|
|                                                                          | 2012                             | 2011   |
| Operational profit from component of discontinued operations, net of tax | \$ -                             | \$ 434 |
| Income from disposing component of discontinued operations, net of tax   | \$ -                             | \$ -   |
| Income from discontinued operations, net of tax                          | \$ -                             | \$ 434 |

|                                                                          | Nine Months Ended September 30, |          |
|--------------------------------------------------------------------------|---------------------------------|----------|
|                                                                          | 2012                            | 2011     |
| Operational profit from component of discontinued operations, net of tax | \$ 157                          | \$ 1,534 |
| Income from disposing component of discontinued operations, net of tax   | 2,494                           | -        |
| Income from discontinued operations, net of tax                          | \$ 2,651                        | \$ 1,534 |

The following table summarizes the revenue and pretax profit of the Zhejiang business reported as discontinued operations (figures are in thousands of USD).

|                                                         | Three Months Ended September 30, |          |
|---------------------------------------------------------|----------------------------------|----------|
|                                                         | 2012                             | 2011     |
| Revenue from component of discontinued operations       | \$ -                             | \$ 5,345 |
| Pretax profit from component of discontinued operations | \$ -                             | \$ 511   |

|                                                         | Nine Months Ended September 30, |           |
|---------------------------------------------------------|---------------------------------|-----------|
|                                                         | 2012                            | 2011      |
| Revenue from component of discontinued operations       | \$ 7,423                        | \$ 14,650 |
| Pretax profit from component of discontinued operations | \$ 165                          | \$ 1,804  |

Summarized assets and liabilities from the discontinued operations as of the disposal date were as follows (figures are in thousands of USD):

|                                         | May 21, 2012 |
|-----------------------------------------|--------------|
| Assets of discontinued operations       |              |
| Current assets                          | \$ 20,735    |
| Non-current assets                      | 6,623        |
| Total assets of discontinued operations | \$ 27,358    |
| Liabilities of discontinued operations  |              |
| Current liabilities                     | 16,823       |

|                                              |           |
|----------------------------------------------|-----------|
| Non-current liabilities                      | -         |
| Total liabilities of discontinued operations | \$ 16,823 |



For the nine months ended September 30, 2012, the Company recognized income of \$2.8 million (before tax) on the Zhejiang Sale, which represents the difference between the total proceeds of \$8.2 million and the Company's share of Zhejiang's net assets of \$5.4 million, which approximates the fair value at the date of disposal.

The Company did not make separate disclosure of the cash flows of Zhejiang in its condensed consolidated statements of cash flows in this Report, as they are considered to be immaterial in the periods presented.

## 26. Income per share

In periods when the Company generates income, the Company calculates basic earnings per share ("EPS") using the two-class method, pursuant to ASC Topic 260, "Earnings Per Share". The two-class method is required as the Company's convertible notes qualify as participating securities, having the right to receive dividends should dividends be declared on common stock. Under this method, earnings for the period are allocated on a pro-rata basis to the common stockholders and to the holders of convertible notes based on the weighted average number of common shares outstanding and the number of shares that could be converted. The Company does not use the two-class method in periods when it generates a loss as the holders of the convertible notes do not participate in losses.

For diluted earnings per share, the Company uses the more dilutive of the if-converted method or the two-class method for convertible notes and the treasury stock method for options, assuming the issuance of common shares, if dilutive, resulting from the exercise of options and warrants.

The calculations of diluted income per share attributable to the parent company were (figures are in thousands of USD):

|                                                                               | Three Months Ended September 30, |           |
|-------------------------------------------------------------------------------|----------------------------------|-----------|
|                                                                               | 2012                             | 2011      |
| Numerator:                                                                    |                                  |           |
| Net income attributable to the parent company                                 | \$ 3,404                         | \$ 10,109 |
| Allocation to convertible notes holders                                       | -                                | (1,071 )  |
| Net income attributable to the parent company's common shareholders – Basic   | 3,404                            | 9,038     |
| Dilutive effect of:                                                           |                                  |           |
| Add: Allocation to convertible notes holders                                  | -                                | 1,071     |
| Add: Interest expenses of convertible notes payable                           | -                                | 906       |
| Less: Gain on change in fair value of derivative                              | -                                | (7,788 )  |
| Net income attributable to the parent company's common shareholders – Diluted | \$ 3,404                         | \$ 3,227  |

Denominator:

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|                                                                      |            |            |
|----------------------------------------------------------------------|------------|------------|
| Weighted average shares outstanding                                  | 28,260,302 | 28,083,534 |
| Dilutive effects of stock options                                    | 578        | 92,197     |
| Dilutive effect of convertible notes                                 | -          | 3,328,264  |
| Denominator for dilutive income per share – Diluted                  | 28,260,880 | 31,503,995 |
| Net income per common share attributable to parent company – Basic   | \$ 0.12    | \$ 0.32    |
| Net income per common share attributable to parent company – Diluted | \$ 0.12    | \$ 0.10    |

The calculations of diluted income from continuing operations per share attributable to the parent company were (figures are in thousands of USD):

|                                                                                                          | Three Months Ended September 30, |            |
|----------------------------------------------------------------------------------------------------------|----------------------------------|------------|
|                                                                                                          | 2012                             | 2011       |
| Numerator:                                                                                               |                                  |            |
| Net income from continuing operations                                                                    | \$ 4,400                         | \$ 11,057  |
| Net income from continuing operations attributable to noncontrolling interest                            | 996                              | 1,170      |
| Net income from continuing operations attributable to shareholders                                       | 3,404                            | 9,887      |
| Allocation to convertible notes holders                                                                  | -                                | (1,047 )   |
| Net income from continuing operations attributable to the parent company's common shareholders – Basic   | 3,404                            | 8,840      |
| Dilutive effect of:                                                                                      |                                  |            |
| Add: Allocation to convertible notes holders                                                             | -                                | 1,047      |
| Add: Interest expenses of convertible notes payable                                                      | -                                | 906        |
| Less: Gain on change in fair value of derivative                                                         | -                                | (7,788 )   |
| Net income from continuing operations attributable to the parent company's common shareholders – Diluted | \$ 3,404                         | \$ 3,005   |
| Denominator:                                                                                             |                                  |            |
| Weighted average shares outstanding                                                                      | 28,260,302                       | 28,083,534 |
| Dilutive effects of stock options                                                                        | 578                              | 92,197     |
| Dilutive effect of convertible notes                                                                     | -                                | 3,328,264  |
| Denominator for dilutive income per share – Diluted                                                      | 28,260,880                       | 31,503,995 |
| Net income from continuing operations per common share attributable to parent company – Basic            | \$ 0.12                          | \$ 0.31    |
| Net income from continuing operations per common share attributable to parent company – Diluted          | \$ 0.12                          | \$ 0.09    |

The following table summarizes potential common shares outstanding excluded from the calculation of diluted income per share for the three months ended September 30, 2012 and 2011, because such an inclusion would have an anti-dilutive effect (figures are in thousands of USD).

|                                     | Three Months Ended September 30, |        |
|-------------------------------------|----------------------------------|--------|
|                                     | 2012                             | 2011   |
| Shares issuable under stock options | 67,500                           | 52,500 |
| Total                               | 67,500                           | 52,500 |

The calculations of diluted income per share attributable to the parent company were (figures are in thousands of USD):

|                                                                               | Nine Months Ended September 30, |            |
|-------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                               | 2012                            | 2011       |
| Numerator:                                                                    |                                 |            |
| Net income attributable to the parent company                                 | \$ 15,657                       | \$ 34,095  |
| Allocation to convertible notes holders                                       | (925)                           | (3,831)    |
| Net income attributable to the parent company's common shareholders – Basic   | 14,732                          | 30,264     |
| Dilutive effect of:                                                           |                                 |            |
| Add: Allocation to convertible notes holders                                  | -                               | 3,831      |
| Add: Interest expenses of convertible notes payable                           | -                               | 2,691      |
| Less: Gain on change in fair value of derivative                              | -                               | (19,374)   |
| Less: Gain on convertible notes conversion                                    | -                               | (1,564)    |
| Net income attributable to the parent company's common shareholders – Diluted | \$ 14,732                       | \$ 15,848  |
| Denominator:                                                                  |                                 |            |
| Weighted average shares outstanding                                           | 28,260,302                      | 27,881,821 |
| Dilutive effects of stock options                                             | 1,227                           | 119,455    |
| Dilutive effect of convertible notes                                          | -                               | 3,529,977  |
| Denominator for dilutive income per share – Diluted                           | 28,261,529                      | 31,531,253 |
| Net income per common share attributable to parent company – Basic            | \$ 0.52                         | \$ 1.09    |
| Net income per common share attributable to parent company – Diluted          | \$ 0.52                         | \$ 0.50    |

The calculations of diluted income from continuing operations per share attributable to the parent company were (figures are in thousands of USD):

|                                                                                                          | Nine Months Ended September 30, |            |
|----------------------------------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                                                          | 2012                            | 2011       |
| Numerator:                                                                                               |                                 |            |
| Net income from continuing operations                                                                    | \$ 16,285                       | \$ 37,801  |
| Net income from continuing operations attributable to noncontrolling interest                            | 3,203                           | 4,489      |
| Net income from continuing operations attributable to shareholders                                       | 13,082                          | 33,312     |
| Allocation to convertible notes holders                                                                  | (773)                           | (3,744)    |
| Net income from continuing operations attributable to the parent company's common shareholders – Basic   | 12,309                          | 29,568     |
| Dilutive effect of:                                                                                      |                                 |            |
| Add: Allocation to convertible notes holders                                                             | -                               | 3,744      |
| Add: Interest expenses of convertible notes payable                                                      | -                               | 2,691      |
| Less: Gain on change in fair value of derivative                                                         | -                               | (19,374)   |
| Less: Gain on convertible notes conversion                                                               | -                               | (1,564)    |
| Net income from continuing operations attributable to the parent company's common shareholders – Diluted | \$ 12,309                       | \$ 15,065  |
| Denominator:                                                                                             |                                 |            |
| Weighted average shares outstanding                                                                      | 28,260,302                      | 27,881,821 |
| Dilutive effects of stock options                                                                        | 1,227                           | 119,455    |
| Dilutive effect of convertible notes                                                                     | -                               | 3,529,977  |
| Denominator for dilutive income per share – Diluted                                                      | 28,261,529                      | 31,531,253 |
| Net income from continuing operations per common share attributable to parent company – Basic            | \$ 0.44                         | \$ 1.06    |
| Net income from continuing operations per common share attributable to parent company – Diluted          | \$ 0.44                         | \$ 0.48    |

The following table summarizes potential common shares outstanding excluded from the calculation of diluted income per share for the nine months ended September 30, 2012 and 2011, because such an inclusion would have an anti-dilutive effect (figures are in thousands of USD).

|                                               | Nine Months Ended September 30, |        |
|-----------------------------------------------|---------------------------------|--------|
|                                               | 2012                            | 2011   |
| Shares issuable under stock options           | 60,000                          | 37,500 |
| Shares issuable pursuant to convertible notes | 1,775,074                       | -      |
| Total                                         | 1,835,074                       | 37,500 |

## **27. Significant concentrations**

A significant portion of the Company's business is conducted in China where the currency is the RMB. Regulations in China permit foreign owned entities to freely convert the RMB into foreign currency for transactions that fall under the "current account," which includes trade related receipts and payments, interest and dividends. Accordingly, the Company's Chinese subsidiaries may use RMB to purchase foreign exchange for settlement of such "current account" transactions without pre-approval. However, pursuant to applicable regulations, foreign-invested enterprises in China may pay dividends only out of their accumulated profits, if any, determined in accordance with the PRC law. In calculating accumulated profits, foreign investment enterprises in China are required to allocate at least 10% of their annual net income each year, if any, to fund certain reserve funds, including mandated employee benefits funds, unless these reserves have reached 50% of the registered capital of the enterprises.

China Automotive, the parent company, may depend on Genesis and HLUSA dividend payments, which are mainly generated from their subsidiaries in the PRC after they receive payments from the PRC subsidiaries. Under PRC law the PRC subsidiaries are required to set aside at least 10% of their respective accumulated profits, up to 50% of their paid-in capital, to fund certain mandated reserve funds that are not payable or distributable as cash dividends.

The PRC government also imposes controls on the convertibility of RMB into foreign currencies and, in certain cases, the remittance of currencies out of China, and the PRC subsidiaries may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currencies. If China Automotive is unable to receive dividend payments from its subsidiaries, China Automotive may be unable to effectively finance its operations or pay dividends on its shares.

Transactions other than those that fall under the "current account" and that involve conversion of RMB into foreign currency are classified as "capital account" transactions; examples of "capital account" transactions include repatriations of investment by or loans to foreign owners, or direct equity investments in a foreign entity by a China domiciled entity. "Capital account" transactions require prior approval from China's State Administration of Foreign Exchange, or SAFE, or its provincial branch to convert a remittance into a foreign currency, such as USD, and transmit the foreign currency outside of China.

This system could be changed at any time and any such change may affect the ability of the Company or its subsidiaries in China to repatriate capital or profits, if any, outside China. Furthermore, SAFE has a significant degree of administrative discretion in implementing the laws and has used this discretion to limit convertibility of current account payments out of China. Whether as a result of a deterioration in the Chinese balance of payments, a shift in the Chinese macroeconomic prospects or any number of other reasons, China could impose additional restrictions on capital remittances abroad. As a result of these and other restrictions under the laws and regulations of the PRC, the Company's PRC subsidiaries are restricted in their ability to transfer a portion of their net assets to the parent. The Company has no assurance that the relevant Chinese governmental authorities in the future will not limit further or eliminate the ability of the Company's PRC subsidiaries to purchase foreign currencies and transfer such funds to the Company to meet its liquidity or other business needs. Any inability to access funds in China, if and when needed for use by the Company outside of China, could have a material and adverse effect on the Company's liquidity and its business.

The Company grants credit to its customers including to Xiamen Joylon, Shanghai Fenglong and Jiangling Yude, that are related parties of the Company. The Company's customers are mostly located in the PRC.

During the nine months ended September 30, 2012, the Company's ten largest customers accounted for 73.4% of its consolidated net sales, with each of the two largest customers individually accounting for more than 10% of consolidated net sales, i.e., 12.2% and 10.5% individually, or an aggregate of 22.7%. At September 30, 2012, approximately 20.4% of accounts receivable were from trade transactions with the aforementioned two customers, one of them with a receivables balance of more than 10% of total accounts receivable, i.e., 12%.

During the nine months ended September 30, 2011, the Company's ten largest customers accounted for 73.1% of its consolidated net sales, with each of the two largest customers individually accounting for more than 10% of consolidated net sales, i.e., 12.0% and 10.0% individually, or an aggregate of 22.0%. At September 30, 2011,

approximately 16.5% of accounts receivable were from trade transactions with the aforementioned two customers.

## 28. Related party transactions and balances

*Related party transactions are as follows (figures are in thousands of USD):*

### Related sales

|                                     | Three Months Ended<br>September 30, |          |
|-------------------------------------|-------------------------------------|----------|
|                                     | 2012                                | 2011     |
| Merchandise sold to Related Parties | \$ 2,939                            | \$ 7,652 |
| Equipment sold to Related Parties   | 82                                  | -        |
|                                     | \$ 3,021                            | \$ 7,652 |

|                                     | Nine Months Ended<br>September 30, |           |
|-------------------------------------|------------------------------------|-----------|
|                                     | 2012                               | 2011      |
| Merchandise sold to Related Parties | \$ 19,325                          | \$ 29,954 |
| Equipment sold to Related Parties   | 82                                 | -         |
|                                     | \$ 19,407                          | \$ 29,954 |

*Related purchases*

|                                           | Three Months Ended September 30, |          |
|-------------------------------------------|----------------------------------|----------|
|                                           | 2012                             | 2011     |
| Materials purchased from related parties  | \$ 4,452                         | \$ 2,830 |
| Technology purchased from Related Parties | 433                              | 263      |
| Equipment purchased from related parties  | 402                              | 807      |
| Total                                     | \$ 5,287                         | \$ 3,900 |

|                                           | Nine Months Ended September 30, |           |
|-------------------------------------------|---------------------------------|-----------|
|                                           | 2012                            | 2011      |
| Materials purchased from related parties  | \$ 14,137                       | \$ 12,858 |
| Technology purchased from Related Parties | 433                             | 325       |
| Equipment purchased from related parties  | 2,169                           | 3,079     |
| Total                                     | \$ 16,739                       | \$ 16,262 |

*Related receivables*

|                     | September 30, 2012 | December 31, 2011 |
|---------------------|--------------------|-------------------|
| Accounts receivable | \$ 9,432           | \$ 11,519         |
| Other receivables   | 1,071              | 500               |
| Total               | \$ 10,503          | \$ 12,019         |

*Related advances*

|                                                 | September 30, 2012 | December 31, 2011 |
|-------------------------------------------------|--------------------|-------------------|
| Advanced equipment payment to Related Parties   | \$ 4,276           | \$ 3,712          |
| Advanced payments and others to Related Parties | 446                | 630               |
| Total                                           | \$ 4,722           | \$ 4,342          |

*Related payables*

|                  | September 30, 2012 | December 31, 2011 |
|------------------|--------------------|-------------------|
| Accounts payable | \$ 3,713           | \$ 2,053          |



These transactions were consummated under similar terms as those with the Company's third party customers and suppliers.

Related parties pledged certain land use rights and buildings as security for the Company's credit facilities provided by banks.

As of November 8, 2012, Hanlin Chen, Chairman, owns 63.2% of the common stock of the Company and has the effective power to control the vote on substantially all significant matters without the approval of other stockholders.

## **29. Commitments and contingencies**

### *Legal proceedings*

*Securities Action – Southern District of New York.* On October 25, 2011, a purported securities class action (the “Securities Action”) was filed in the United States District Court for the Southern District of New York on behalf of all purchasers of the Company's securities between March 25, 2010 and March 17, 2011. On February 24, 2012, the plaintiffs filed an amended complaint, changing the purported class period from May 12, 2009 through March 17, 2011. The amended complaint alleges that the Company, certain of its present officers and directors and the Company's former independent accounting firm violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and the rules promulgated thereunder, and seeks unspecified damages. The Company has filed a motion to dismiss the amended complaint, which was fully briefed on April 18, 2012. On August 8, 2012, the court denied the Company's motion to dismiss the amended complaint. On September 4, 2012, the Company filed an answer to the amended complaint. The Company continues to believe that the allegations in the complaint are without merit and intends to defend itself vigorously against the claims.

*Derivative Action – Delaware Chancery Court.* On December 23, 2011, a purported shareholder derivative action was filed in the Court of Chancery of the State of Delaware (the “Court of Chancery”) on behalf of the Company. The complaint alleges that certain of the Company's current officers and directors breached their fiduciary duties to the Company in relation to the Company's accounting of convertible notes issued in February, 2008. On January 25, 2012, a second purported shareholder derivative action was filed in the Court of Chancery on behalf of the Company. On February 3, 2012, the Court of Chancery consolidated the two cases, which were stayed pending the outcome of the motion to dismiss in the Securities Action. On October 23, 2012, the derivative plaintiffs filed a consolidated amended complaint on behalf of the Company. The consolidated complaint alleges that certain of the Company's current officers and directors breached their fiduciary duties to the Company in relation to the Company's accounting of the convertible notes issued in February 2008. The consolidated complaint sets forth three causes of action for breach of fiduciary duties, unjust enrichment and insider trading. The Company believes the allegations in the shareholder suit are without merit, and intends to defend itself vigorously against the claims.



The above-referenced actions do not specify an amount of damages that the plaintiffs seek. Moreover, because these matters are in early stages, the Company cannot determine whether an adverse outcome is probable, nor can it provide a reasonable estimate of potential losses related to these matters. Although the Company believes that it has meritorious defenses to each of these actions and intends to defend them vigorously, an adverse outcome in one or more of these matters could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

Other than the above, the Company is not a party to any pending or, to the best of the Company's knowledge, any threatened legal proceedings. In addition, no director, officer or affiliate of the Company, or owner of record of more than five percent of the securities of the Company, or any associate of any such director, officer or security holder is a party adverse to the Company or has a material interest adverse to the Company in reference to pending litigation.

#### *Other commitments and contingencies*

In addition to the convertible notes, bank loans, notes payables and the related interest, the following table summarizes the Company's major commitments and contingencies as of September 30, 2012 (figures are in thousands of USD):

|                                       | Payment obligations by period |         |       |      |            |          |
|---------------------------------------|-------------------------------|---------|-------|------|------------|----------|
|                                       | 2012<br>(1)                   | 2013    | 2014  | 2015 | Thereafter | Total    |
| Obligations for service agreements    | \$836                         | \$-     | \$-   | \$ - | \$ -       | \$836    |
| Interest on short-term bank loan      | 398                           | 502     | -     | -    | -          | 900      |
| Obligations for purchasing agreements | 8,623                         | 2,752   | 116   | -    | -          | 11,491   |
| Total                                 | \$9,857                       | \$3,254 | \$116 | \$ - | \$ -       | \$13,227 |

(1)

Remaining 3 months in 2012.

### **30. Off-balance sheet arrangements**

At September 30, 2012 and 2011, the Company did not have any significant transactions, obligations or relationships that could be considered off-balance sheet arrangements.

### **31. Segment reporting**

The accounting policies of the product sectors are the same as those described in the summary of significant accounting policies except that the disaggregated financial results for the product sectors have been prepared using a management approach, which is consistent with the basis and manner in which management internally disaggregates financial information for the purposes of assisting them in making internal operating decisions. Generally, the Company evaluates performance based on stand-alone product sector operating income and accounts for inter segment sales and transfers as if the sales or transfers were to third parties, at current market prices.

As of September 30, 2012 and 2011, the Company had eleven product sectors, five of them were principal profit makers, which were reported as separate sectors and engaged in the production and sales of power steering (Henglong, Jiulong, Shenyang, Wuhu and Hubei Henglong). The other six sectors were engaged in the production and sale of sensor modular (USAI), EPS (Jielong), provision of after sales and R&D services (HLUSA), production and sale of power steering (Chongqing Henglong, established in 2012), trade (Brazil Henglong, established in 2012), and the holding company (Genesis). Since the revenues, net income and net assets of these six sectors are less than 10% of its segment in the condensed unaudited consolidated financial statements, the Company incorporated these six sectors into "Other Sectors."

Hubei Henglong, which is mainly engaged in manufacturing automobile power steering products for export to the U.S. market, was previously included in "Other Sectors". Sales in Hubei Henglong have increased in recent years, as part of management's strategy for expanding sales to non-PRC based markets. Since the fourth quarter of 2011, Hubei Henglong has become a principal profit center and, considering its significant impact on the Company's performance, is now reported Hubei Henglong separately. The summary below presents, a reclassification for previous periods to conform to current period presentation. Such reclassifications have no effect on previously reported results of operations.

As discussed in Discontinued Operation - Zhejiang (see Note 25) above, Zhejiang was identified as a product sector for the sales of power steering pumps of the Group prior to disposal on May 21, 2012. After the Company sold its 51% equity interest in Zhejiang on May 21, 2012 and presented it as a discontinued operation, the Company has adjusted the information for Zhejiang's business in segment reporting for the same period in 2011.

The Company's product sector information from continuing operations is as follows (figures are in thousands of USD):

|                                               | <b>Net Sales</b>                 |           | <b>Net Income (Loss)</b>         |           |
|-----------------------------------------------|----------------------------------|-----------|----------------------------------|-----------|
|                                               | Three Months Ended September 30, |           | Three Months Ended September 30, |           |
|                                               | 2012                             | 2011      | 2012                             | 2011      |
| Henglong                                      | \$ 39,062                        | \$ 39,297 | \$ 4,117                         | \$ 4,879  |
| Jiulong                                       | 15,377                           | 15,370    | 284                              | 426       |
| Shenyang                                      | 7,314                            | 7,781     | 402                              | 541       |
| Wuhu                                          | 7,414                            | 8,556     | 729                              | (102 )    |
| Hubei Henglong                                | 9,982                            | 5,238     | 613                              | (57 )     |
| Other Sectors                                 | 6,635                            | 9,045     | (1,105 )                         | (511 )    |
| Total Segments                                | 85,784                           | 85,287    | 5,040                            | 5,176     |
| Corporate                                     | -                                | -         | (687 )                           | 12,435    |
| Eliminations                                  | (12,600 )                        | (14,373 ) | 47                               | (6,554 )  |
| Total consolidated from continuing operations | \$ 73,184                        | \$ 70,914 | \$ 4,400                         | \$ 11,057 |

|                                               | <b>Net Sales</b>                |            | <b>Net Income (Loss)</b>        |           |
|-----------------------------------------------|---------------------------------|------------|---------------------------------|-----------|
|                                               | Nine Months Ended September 30, |            | Nine Months Ended September 30, |           |
|                                               | 2012                            | 2011       | 2012                            | 2011      |
| Henglong                                      | \$ 123,713                      | \$ 141,006 | \$ 14,248                       | \$ 19,048 |
| Jiulong                                       | 54,572                          | 52,416     | 1,276                           | 2,106     |
| Shenyang                                      | 21,090                          | 22,498     | 628                             | 1,065     |
| Wuhu                                          | 24,208                          | 25,689     | 581                             | (223 )    |
| Hubei Henglong                                | 29,653                          | 14,814     | 8,946 (1)                       | 526       |
| Other Sectors                                 | 28,160                          | 30,092     | 390                             | (1,785 )  |
| Total Segments                                | 281,396                         | 286,515    | 26,069                          | 20,737    |
| Corporate                                     | -                               | -          | 3,424                           | 23,059    |
| Eliminations                                  | (46,914 )                       | (51,018 )  | (13,207 )(1)                    | (5,995 )  |
| Total consolidated from continuing operations | \$ 234,482                      | \$ 235,497 | \$ 16,285                       | \$ 37,801 |

(1)

\$7 million included in the balance was income from investment of Henglong, which has been eliminated at the consolidation level.

### **32. Subsequent events**

On August 28, 2012, the Company announced that its board of directors had approved a share repurchase program of up to \$5.0 million for its outstanding common shares over the next 12 months. Pursuant to this program, the Company has repurchased 217,283 shares of its common shares with total consideration of \$ 1.0 million from October 1, 2012 to the date of this Report.

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

### **General Overview**

China Automotive Systems, Inc. is a leading power steering systems supplier for the China automobile industry. The Company has business relations with more than sixty vehicle manufacturers, including FAW Group, Dongfeng Auto Group and Changan Automobile Group, three of the five largest automobile manufacturers in China; Shenyang Brilliance Jinbei Co., Ltd., the largest light vehicle manufacturer in China; Chery Automobile Co., Ltd, the largest state owned car manufacturer in China; BYD Auto Co., Ltd and Zhejiang Geely Automobile Co., Ltd., the largest privately owned car manufacturers in China. The PRC-based joint ventures of General Motors (GM), Volkswagen, Citroen and Chrysler North America are all key customers. Starting in 2008, the Company has supplied power steering pumps and power steering gear to the Sino-foreign joint ventures established by GM, Citroen and Volkswagen in China. The Company has supplied power steering gear to Chrysler North America since 2009.

Most of the Company's production and research and development institutes are located in China. The Company has approximately 3,000 employees dedicated to design, development, manufacture and sales of its products. By leveraging its extensive experience, innovative technology and geographic strengths, the Company aims to grow leading positions in automotive power steering systems and to further improve overall margins, long-term operating profitability and cash flows. To achieve these goals and to respond to industry factors and trends, the Company is continuing work to improve its operations and business structure and achieve profitable growth.

### **Corporate Structure**

The Company, through its subsidiaries, engages in the manufacture and sales of automotive systems and components. Great Genesis Holdings Limited, a company incorporated in Hong Kong on January 3, 2003 under the Companies Ordinance of Hong Kong as a limited liability company, "Genesis," is a wholly-owned subsidiary of the Company and the holding company of the Company's joint ventures in the PRC. Henglong USA Corporation, "HLUSA," incorporated on January 8, 2007 in Troy, Michigan, is a wholly-owned subsidiary of the Company, and mainly engages in marketing of automotive parts in North America, and provides after-sales service and research and development support. CAAS Brazil's Imports And Trade In Automotive Parts Ltd., "Brazil Henglong," was established by Hubei Henglong Automotive System Group Co., Ltd. (formerly known as Jingzhou Hengsheng Automotive System Co., Ltd), "Hubei Henglong," as a Sino-foreign joint venture company with two Brazilian citizens in Brazil in August 2012.

For more information on the Company's corporate structure, including the recently completed reorganization of certain PRC-based subsidiaries and the Zhejiang Sale, please see Note 1, "Organization and Business" and Note 25, "Discontinued operations – Zhejiang" under Item 1 – "Financial Statements" of Part I in this Report.

## Critical Accounting Estimates

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

The Company considers an accounting estimate to be critical if:

It requires the Company to make assumptions about matters that were uncertain at the time it was making the estimate, and

- Changes in the estimate or different estimates that the Company could have selected would have had a material impact on the Company's financial condition or results of operations.



The table below presents information about the nature and rationale for the Company's critical accounting estimates:

| Balance Sheet Caption                                                       | Critical Estimate Item                               | Nature of Estimates Required                                                                                                                                                                                                                                                                                                                                               | Assumptions/Approaches Used                                                                                                                                                                                                                                                                                                    | Key Factors                                                                                                                   |
|-----------------------------------------------------------------------------|------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------|
| Accrued liabilities and other long-term liabilities                         | Warranty obligations                                 | Estimating warranty requires the Company to forecast the resolution of existing claims and expected future claims on products sold. VMs (Vehicle Manufacturers) are increasingly seeking to hold suppliers responsible for product warranties, which may impact the Company's exposure to these costs.                                                                     | The Company bases its estimate on historical trends of units sold and payment amounts, combined with its current understanding of the status of existing claims and discussions with its customers.                                                                                                                            | <ul style="list-style-type: none"> <li>· VM sourcing</li> <li>· VM policy decisions regarding warranty claims</li> </ul>      |
| Property, plant and equipment, intangible assets and other long-term assets | Valuation of long-lived assets and investments       | The Company is required from time-to-time to review the recoverability of certain of its assets based on projections of anticipated future cash flows, including future profitability assessments of various product lines.                                                                                                                                                | The Company estimates cash flows using internal budgets based on recent sales data, independent automotive production volume estimates and customer commitments.                                                                                                                                                               | <ul style="list-style-type: none"> <li>· Future production estimates</li> <li>· Customer preferences and decisions</li> </ul> |
| Accounts and notes receivables                                              | Provision for doubtful accounts and notes receivable | Estimating the provision for doubtful accounts and notes receivable requires the Company to analyze and monitor each customer's credit standing and financial condition regularly. The Company grants credit to its customers, generally on an open account basis. It will impact the Company's expense disclosure and results of operations if such estimate is improper. | The Company grants credit to its customers for three to four months based on each customer's current credit standing and financial data. The Company assesses the allowance on an individual customer basis, under normal circumstances. The Company records provision for bad debts based on specific identification methods. | <ul style="list-style-type: none"> <li>· Customers' credit standing and financial condition</li> </ul>                        |

|                                                                                 |                                                         |                                                                                                                                                                                                                       |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |                                                                                                                                                                                                                                                                                                                                   |
|---------------------------------------------------------------------------------|---------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Deferred income taxes                                                           | Recoverability of deferred tax assets                   | The Company is required to estimate whether recoverability of its deferred tax assets is more likely than not based on forecasts of taxable earnings in the related tax jurisdiction.                                 | The Company uses historical and projected future operating results, based upon approved business plans, including a review of the eligible carry forward period, tax planning opportunities and other relevant considerations.                                                                                                                                                                                                                                                                                                                                                              | <ul style="list-style-type: none"> <li>· Tax law changes</li> <li>· Variances in future projected profitability, including by taxing entity</li> </ul>                                                                                                                                                                            |
| Convertible notes payable, warrant liabilities, compound derivative liabilities | Warrant liabilities and compound derivative liabilities | The Company is required to estimate the fair value of warrant liabilities and compound derivative liabilities at the beginning and end of each reporting period.                                                      | The Company uses Black-Scholes option pricing model to determine fair value of warrant; uses Monte Carlo simulation ("MCS") valuation techniques to determine fair value of compound derivative liabilities.                                                                                                                                                                                                                                                                                                                                                                                | <ul style="list-style-type: none"> <li>· Expected volatility</li> <li>· Risk-free rate</li> <li>•interest market risk</li> <li>· Credit risk</li> <li>· Redemption activities before maturity</li> </ul>                                                                                                                          |
| Tax payable and deferred tax assets/liabilities                                 | Uncertain tax positions                                 | The Company is required to determine and assess all material positions, including all significant uncertain positions in all tax years that are still subject to assessment or challenge under relevant tax statutes. | <p>The Company applies a more likely than not threshold and a two-step approach for tax position measurement and financial statement recognition. For the two-step approach, the first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon settlement.</p> | <ul style="list-style-type: none"> <li>· An allocation or a shift of income between jurisdictions</li> <li>· The characterization of income or a decision to exclude reporting taxable income in a tax return</li> <li>· A decision to classify a transaction, entity, or other position in a tax return as tax exempt</li> </ul> |

In addition, there are other items within the Company's financial statements that require estimation, but are not as critical as those discussed above. These include the allowance for reserves for excess and obsolete inventory. Although not significant in recent years, changes in estimates used in these and other items could have a significant effect on the Company's condensed unaudited consolidated financial statements.

## Recent Accounting Pronouncements

Please see Note 2 to the Condensed Unaudited Consolidated Financial Statements under Item 1 of Part I of this Report.

## Results of Operations

### Results of Operations—Three Months Ended September 30, 2012 and 2011

|                               | Net Sales<br>(in thousands of USD,<br>except percentages) |          |          |        | Cost of Sales<br>(in thousands of USD,<br>except percentages) |          |         |       |
|-------------------------------|-----------------------------------------------------------|----------|----------|--------|---------------------------------------------------------------|----------|---------|-------|
|                               | 2012                                                      | 2011     | Change   |        | 2012                                                          | 2011     | Change  |       |
| Henglong                      | \$39,062                                                  | \$39,297 | \$(235 ) | -0.6 % | \$30,855                                                      | \$30,885 | \$(30 ) | 0.1 % |
| Jiulong                       | 15,377                                                    | 15,370   | 7        | 0.0    | 13,776                                                        | 13,455   | 321     | 2.4   |
| Shenyang                      | 7,314                                                     | 7,781    | (467 )   | -6.0   | 6,254                                                         | 6,670    | (416 )  | -6.2  |
| Wuhu                          | 7,414                                                     | 8,556    | (1,142)  | -13.3  | 6,802                                                         | 8,385    | (1,583) | -18.9 |
| Hubei Henglong <sup>(1)</sup> | 9,982                                                     | 5,238    | 4,744    | 90.6   | 9,033                                                         | 4,617    | 4,416   | 95.6  |
| Other Sectors                 | 6,635                                                     | 9,045    | (2,410)  | -26.6  | 6,614                                                         | 8,804    | (2,190) | -24.9 |
| Elimination                   | (12,600)                                                  | (14,373) | 1,773    | -12.3  | (12,651)                                                      | (14,490) | 1,839   | -12.7 |
| Total                         | \$73,184                                                  | \$70,914 | \$2,270  | 3.2 %  | \$60,683                                                      | \$58,326 | \$2,357 | 4.0 % |

Hubei Henglong was previously included in "Other Sectors." The Company is now reporting Hubei Henglong as a separate sector, as it has recently become a principal profit center. As such, a reclassification has been made to all periods presented to conform to the current period presentation. Such reclassifications have no effect on previously reported results of operations.

### Net Sales

Net sales were \$73.2 million for the three months ended September 30, 2012, compared with \$70.9 million for the same period in 2011, representing an increase of \$2.3 million, or 3.2%. The increase was mainly due to the increased sales of newly developed products to North America and continuing growth of automotive market demand in China, which was further encouraged by an incentive policy issued by the Chinese government relating to purchase of low-emission cars and fuel-efficient cars in May 2012. The increase in sales also reflects the positive impact of volume growth of \$21.5 million and movements in foreign exchange rates of \$0.2 million which were offset by the decline in average selling price with an impact of \$19.4 million. Further analysis is as follows:

Net sales for Henglong were \$39.1 million for the three months ended September 30, 2012, compared with \$39.3 million for the same period in 2011, representing a decrease of \$0.2 million, or 0.6%, which was mainly due to the decrease in selling prices as a result of fierce competition among certain customers. During the three months ended September 30, 2012, the small net sales increase was mainly due to the improvement in quality and decrease in selling price of our products, which led to an increase in purchase of our products by the joint-brands auto companies. An increase in sales volume led to a sales increase of \$14.8 million, a decrease in selling price led to a sales decrease of \$15.1 million and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.1 million.

Net sales for Jiulong were \$15.4 million for the three months ended September 30, 2012, which was consistent with \$15.4 million for the same period in 2011, which was mainly due to an increase in sales volume with a sales increase of \$0.9 million due to an increase in the demand for commercial vehicles in the Chinese market and the effect of foreign currency translation of the RMB against the U.S. dollar which led to a sales increase of \$0.1 million, offset by a decrease in selling price which led to a sales decrease of \$1.0 million.

Net sales for Shenyang were \$7.3 million for the three months ended September 30, 2012, compared with \$7.8 million for the same period in 2011, representing a decrease of \$0.5 million, or 6%. The net sales decrease was mainly due to an increase in sales volumes with a sales increase of \$1.5 million, a decrease in selling price which led to a sales decrease of \$2.0 million.

Net sales for Wuhu were \$7.4 million for the three months ended September 30, 2012, compared with \$8.6 million for the same period in 2011, representing a decrease of \$1.1 million, or 13.3%. Since the majority of the products of Wuhu were sold to local Chinese brand auto distributors, the decreasing demand for local Chinese brand autos from end customers due to the aggressive pricing strategy adopted by Sino-foreign joint brand auto distributors has led to the decrease in sales volumes and prices for Wuhu's products.

Net sales for Hubei Henglong were \$10.0 million for the three months ended September 30, 2012, compared with \$5.2 million for the same period in 2011, representing an increase of \$4.8 million, or 90.6%. Hubei Henglong's products were all sold to the United States, The net sales increase was mainly due to sales of the newly developed products to a United States customer. An increase in sales volumes led to a sales increase of \$4.3 million and an increase in selling price led to a sales increase of \$0.5 million.

Net sales for Other Sectors were \$6.6 million for the three months ended September 30, 2012, compared with \$9.0 million for the same period in 2011, representing a decrease of \$2.4 million or 26.6%. In March, 2012, the Company introduced new steering products to the auto market to replace some of its old products. As the introduction of these new products was still at a very early stage, the total sales volume of Other Sectors in the third quarter of 2012 declined compared to the same period of 2011. The Company reduced the selling price of the new steering products as a promotion. The decrease in sales volume and selling price led to a decrease in sales by \$0.8 million and \$1.6 million, respectively. As a result, there was a decrease in sales for Other Sectors for the three months ended September 30, 2012.

### *Cost of Sales*

For the three months ended September 30, 2012, the cost of sales was \$60.7 million, compared with \$58.3 million for the same period of 2011, representing an increase of \$2.3 million, or 4.0%. The increase in the cost of sales was mainly due to the net effect of a net increase in sales volumes with a cost of sales increase of \$23.2 million, a decrease in unit cost with a cost of sales decrease of \$21.1 million and the appreciation of the RMB against the U.S. dollar with a cost of sales increase of \$0.2 million. The decrease in the unit cost of sales was primarily due to a decrease in the cost of raw materials, such as steel. Further analysis is as follows:

Cost of sales for Henglong was \$30.9 million for the three months ended September 30, 2012, which was consistent with \$30.9 million for the same period of 2011. This was mainly due to an increase in sales volumes with a cost of

sales increase of \$17.9 million, which was offset by the adoption of technical innovations in the production processes in 2012 and a decrease in unit material costs which led to a cost of sales decrease of \$18.0 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.1 million.

Cost of sales for Jiulong was \$13.8 million for the three months ended September 30, 2012, compared with \$13.5 million for the same period of 2011, representing an increase of \$0.3 million, or 2.4%. The increase in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$0.8 million, a decrease in unit cost with a cost of sales decrease of \$0.6 million and the effect of foreign currency translation of the RMB against the U.S. dollar resulting in a cost of sales increase of \$0.1 million.

Cost of sales for Shenyang was \$6.3 million for the three months ended September 30, 2012, compared with \$6.7 million for the same period of 2011, representing a decrease of \$0.4 million, or 6.2%. The decrease in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$1.5 million and a decrease in unit cost with a cost of sales decrease of \$1.9 million.

Cost of sales for Wuhu was \$6.8 million for the three months ended September 30, 2012, compared with \$8.4 million for the same period of 2011, representing a decrease of \$1.6 million, or 18.9%. The decrease in cost of sales was mainly due to a decrease in sales volumes with a cost of sales decrease of \$0.8 million and a decrease in unit cost which led to a cost of sales decrease of \$0.8 million.

Cost of sales for Hubei Henglong was \$9.0 million for the three months ended September 30, 2012, compared with \$4.6 million for the same period of 2011, representing an increase of \$4.4 million, or 95.6%. The increase in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$3.7 million and an increase in unit cost which led to a cost of sales increase of \$0.7 million.

Cost of sales for Other Sectors was \$6.6 million for the three months ended September 30, 2012, compared with \$8.8 million for the same period of 2011, representing a decrease of \$2.2 million, or 24.9%. The decrease in cost of sales was mainly due to a decrease in sale volumes which led to a cost of sales decrease of \$1.7 million and a decrease in unit cost which led to a cost of sales decrease of \$0.5 million.

Gross margin was 17.1% for the three months ended September 30, 2012, representing a 0.7% decrease from 17.8% for the same period of 2011, which was primarily due to an increase in sales volumes of lower gross margin products of Hubei Henglong.

#### *Gain on Other Sales*

Gain on other sales mainly consisted of net amount retained from sales of materials and scraps. For the three months ended September 30, 2012, gain on other sales amounted to \$0.7 million, while it amounted to \$0.5 million for the same period of 2011, representing an increase of \$0.2 million, or 40%, which was mainly due to an increase in materials and scraps sales.

#### *Selling Expenses*

Selling expenses were \$2.4 million for the three months ended September 30, 2012, compared with \$2.0 million for the same period of 2011, representing an increase of \$0.4 million, or 21.2%, mainly due to an increase in salaries and wages expenses of salesmen, as a result of an increase in the number of salesmen.

*General and Administrative Expenses*

General and administrative expenses were \$2.5 million for the three months ended September 30, 2012, compared with \$3.1 million for the same period of 2011, representing a decrease of \$0.6 million, or 20.5%, which was mainly due to decreases in salaries and wages expenses of administrative staff.

During the three months ended September 30, 2012, the Company paid lower performance bonuses to management as the Company did not achieve the performance targets pre-determined by the board of directors.

*Research and Development Expenses*

Research and development expenses were \$2.8 million for the three months ended September 30, 2012, compared with \$2.5 million for the three months ended September 30, 2011, representing an increase of \$0.3 million, or 14.3%, which was mainly due to the development and trial production of EPS. In summary, expenses for mold improvement increased by \$0.5 million, external technical support fees decreased by \$0.6 million and the salaries and wages expenses of research and development related staff increased by \$0.4 million.



The global automotive parts industry is highly competitive; winning and maintaining new business requires suppliers to rapidly produce innovative products on a cost-competitive basis. From 2012, in addition to purchasing advanced manufacturing equipment for newly developed products and hiring senior technicians, the Company has started giving bonuses to technical personnel who make an outstanding contribution to product research and development. As a result, the research and development expenses increased significantly.

#### *Income from Operations*

Income from operations was \$5.5 million for the three months ended September 30, 2012, which was consistent with \$5.5 million for the three months ended September 30, 2011, including a decrease of \$0.1 million, or 0.7%, in gross profit, an increase of \$0.2 million, or 51.1%, in gain on other sales, and an increase of \$0.1 million, or 1.8%, in operating expenses.

#### *Other Income, Net*

Other income was \$0.2 million for the three months ended September 30, 2012, compared to \$0.1 million for the three months ended September 30, 2011, an increase of \$0.1 million, primarily as a result of increased government subsidies.

#### *Financial Expenses, Net*

Financial expenses were \$0.4 million for the three months ended September 30, 2012, compared to financial expenses of \$1.3 million for the same period of 2011, representing a decrease of \$0.9 million, or 65.8%, which is mainly due to a decrease in interest expenses of convertible notes as a result of the early redemption in May 2012.

#### *Gain (Loss) on Change in Fair Value of Derivative*

Gain on change in fair value of derivative was \$7.8 million for the three months ended September 30, 2011, and there was no such gain for the three months ended September 30, 2012.

The Company had redeemed all convertible notes by May 2012. Therefore, there was no gain or loss on change of fair value of derivatives associated with convertible notes for the three months ended September 30, 2012.

*Income Before Income Tax Expenses and Equity In Earnings Of Affiliated Companies*

Income before income tax expenses and equity in earnings of affiliated companies was \$5.2 million for the three months ended September 30, 2012, compared with \$12.0 million for the three months ended September 30, 2011, a decrease of \$6.7 million, or 56.2%, which was mainly due to an increase in other income of \$0.1 million, a decrease in financial expenses of \$0.9 million, and a decrease in gain on change in fair value of derivative of \$7.7 million.

*Income Taxes*

Income tax expense was \$0.9 million for the three months ended September 30, 2012, compared with \$1.0 million of income tax expense for the three months ended September 30, 2011, a decrease of \$0.1 million, or 10.2%, which was mainly due to a decrease of income before income tax. The effective tax rate increased to 16.9% for the three months ended September 30, 2012 from 8.3% for the same period in 2011, which was primarily due to the permanent difference of gain on change in the fair value of derivative recorded in the third quarter of 2011. Since the derivative has been settled in the second quarter of 2012 pursuant to the redemption of convertible notes, there is no similar permanent difference in the third quarter of 2012.

*Income From Continuing Operations*

Net income from continuing operations was \$4.4 million for the three months ended September 30, 2012, compared with \$11.0 million for the three months ended September 30, 2011, a decrease of \$6.7 million, or 60.2%, which was mainly due to a decrease in income before income tax expenses and equity in earnings of affiliated companies of \$6.6 million and a decrease in income taxes expenses of \$0.1 million.

*Net Income*

Net income was \$4.4 million for the three months ended September 30, 2012, compared with net income of \$11.5 million for the three months ended September 30, 2011, representing a decrease of \$7.1 million, or 61.7%, which was mainly due to a decrease in income from continuing operations of \$6.7 million and a decrease in income from discontinued operations of \$0.4 million.



*Net Income Attributable to Noncontrolling Interests*

Net income attributable to noncontrolling interests amounted to \$1.0 million for the three months ended September 30, 2012, compared with \$1.4 million for the three months ended September 30, 2011, representing a decrease of \$0.4 million, or 27.9%, primarily due to the decrease in non-wholly owned subsidiaries' net income.

Taking into account the Zhejiang Sale, the Company owns different equity interests in ten non-wholly owned subsidiaries established in the PRC and Brazil, through which it conducts its operations. Except for Beijing Henglong, which is accounted under the equity method, all the operating results of these non-wholly owned subsidiaries were consolidated in the Company's financial statements as of September 30, 2012 and 2011. For the three months ended September 30, 2012 and 2011, the Company recorded \$1.0 million and \$1.2 million for the noncontrolling interests' share in the earnings of the consolidated non-wholly owned subsidiaries, respectively.

*Net Income Attributable to Parent Company*

Net income attributable to parent company was \$3.4 million for the three months ended September 30, 2012, compared with net income of \$10.1 million for the three months ended September 30, 2011, a decrease of \$6.7 million, reflecting a decrease in net income.

**Results of Operations—Nine Months Ended September 30, 2012 and 2011**

|                               | Net Sales<br>(in thousands of USD,<br>except percentages) |           |            |         | Cost of Sales<br>(in thousands of USD,<br>except percentages) |           |            |         |
|-------------------------------|-----------------------------------------------------------|-----------|------------|---------|---------------------------------------------------------------|-----------|------------|---------|
|                               | 2012                                                      | 2011      | Change     |         | 2012                                                          | 2011      | Change     |         |
| Henglong                      | \$123,713                                                 | \$141,006 | \$(17,293) | -12.3 % | \$97,062                                                      | \$110,981 | \$(13,919) | -12.5 % |
| Jiulong                       | 54,572                                                    | 52,416    | 2,156      | 4.1     | 47,457                                                        | 45,435    | 2,022      | 4.5     |
| Shenyang                      | 21,090                                                    | 22,498    | (1,408 )   | -6.3    | 18,456                                                        | 19,600    | (1,144 )   | -5.8    |
| Wuhu                          | 24,208                                                    | 25,689    | (1,481 )   | -5.8    | 22,626                                                        | 24,814    | (2,188 )   | -8.8    |
| Hubei Henglong <sup>(1)</sup> | 29,653                                                    | 14,814    | 14,839     | 100.2   | 26,362                                                        | 12,648    | 13,714     | 108.4   |
| Other Sectors                 | 28,160                                                    | 30,092    | (1,932 )   | -6.4    | 25,828                                                        | 28,782    | (2,954 )   | -10.3   |
| Elimination                   | (46,914 )                                                 | (51,018 ) | 4,104      | -8.0    | (46,820 )                                                     | (51,829 ) | 5,009      | -9.7    |
| Total                         | \$234,482                                                 | \$235,497 | \$(1,015 ) | -0.4 %  | \$190,971                                                     | \$190,431 | \$540      | 0.3 %   |

Hubei Henglong was previously included in “Other Sectors.” The Company is now reporting Hubei Henglong as a separate sector, as it has recently become a principal profit center. As such, a reclassification has been made to all periods presented to conform to the current period presentation. Such reclassifications have no effect on previously reported results of operations.

*Net Sales*

Net sales were \$234.5 million for the nine months ended September 30, 2012, compared with \$235.5 million for the same period in 2011, a decrease of \$1.0 million, or 0.4%. The decrease was mainly due to higher oil prices in the PRC market from January to April 2012, which significantly increased the car usage costs in the PRC. In May 2012, the Chinese government started to grant subsidies to customers who purchased low-emission cars and fuel-efficient cars, which led to a gradual improvement of the Chinese automotive market and an increase in the Company’s sale volumes. Historically, more than 90% of the Company’s business is derived from the PRC and denominated in RMB. The overall increase in sales volume led to a sales increase of \$17.5 million, a decrease in the average selling price led to a sales decrease of \$25.4 million and the appreciation of the RMB against the U.S. dollar led to a sales increase of \$6.9 million compared with the same period of 2011. Further analysis is as follows:

Net sales for Henglong were \$123.7 million for the nine months ended September 30, 2012, compared with \$141.0 million for the same period in 2011, representing a decrease of \$17.3 million, or 12.3%. Henglong is mainly engaged in the production of rack and pinion power steering gear for small cars and light duty vehicles. Domestic manufacturers of small cars and light duty vehicles, which are the main customers of Henglong, were forced to reduce the selling price of such kinds of vehicles, in order to compete against foreign joint venture manufacturers. The Company also reduced its selling price to the domestic manufacturers, which led to a decline in sales of \$23.2 million, offset by an increase in sales volume and appreciation of RMB against USD which resulted in sales increase

of \$2.5 million and \$3.4 million respectively.

Net sales for Jiulong were \$54.6 million for the nine months ended September 30, 2012, compared with \$52.4 million for the same period in 2011, representing an increase of \$2.2 million, or 4.1%. The net sales increase was mainly due to the sales of newly developed steering gear models, which led to an increase in the Company's market share of relevant market segments. Net sales increase was mainly due to an increase in sales volume with a sales increase of \$2.0 million, a decrease in selling price which led to a sales decrease of \$1.1 million and the appreciation of the RMB against the U.S. dollar which led to a sales increase of \$1.3 million.

Net sales for Shenyang were \$21.1 million for the nine months ended September 30, 2012, compared with \$22.5 million for the same period in 2011, representing a decrease of \$1.4 million, or 6.3%. The net sales decrease was mainly due to an increase in sales volumes with a sales increase of \$0.2 million, a decrease in selling price which led to a sales decrease of \$2.1 million, and the appreciation of the RMB against the U.S. dollar which led to a sales increase of \$0.5 million.

Net sales for Wuhu were \$24.2 million for the nine months ended September 30, 2012, compared with \$25.7 million for the same period in 2011, representing a decrease of \$1.5 million, or 5.8%. The net sales decrease was mainly due to a decrease in sales volumes with a sales decrease of \$2.3 million, an increase in selling prices resulting from the sale of newly developed steering gear models that have a higher selling price than those of older models, which resulted in a sales increase of \$0.2 million, and the appreciation of the RMB against the U.S. dollar which led to a sales increase of \$0.6 million.

Net sales for Hubei Henglong were \$29.7 million for the nine months ended September 30, 2012, compared with \$14.8 million for the same period in 2011, representing an increase of \$14.8 million, or 100.2%. The net sales increase was mainly due to sales of the newly developed products to a United States customer (Hubei Henglong's products were all sold to the United States). The net increase in sales was mainly due to an increase in sales volumes with a sales increase of \$14.9 million, a decrease in selling price which led to a sales decrease of \$0.4 million and the appreciation of the RMB against the U.S. dollar which led to a sales increase of \$0.3 million.

Net sales for Other Sectors were \$28.1 million for the nine months ended September 30, 2012, compared with \$30.1 million for the same period in 2011, representing a decrease of \$1.9 million, or 6.4%. The decrease in sales was mainly due to a decrease in sales volumes, which led to a sales decrease of \$3.8 million, an increase in selling prices resulting from the sale of newly developed steering gear models that have a higher selling price than those of older models, which led to a sales increase of \$1.1 million, and the appreciation of the RMB against the U.S. dollar which led to a sales increase of \$0.8 million.

#### *Cost of Sales*

For the nine months ended September 30, 2012, the cost of sales was \$191.0 million, compared with \$190.4 million for the same period of 2011, an increase of \$0.6 million, or 0.3%. The increase in cost of sales was mainly due to a net increase in sales volumes with a cost of sales increase of \$18.9 million, a decrease in unit cost with a cost of sales decrease of \$24.1 million and the appreciation of the RMB against the U.S. dollar with a cost of sales increase of \$5.8 million. The decrease in the unit cost of sales was primarily due to a decrease in the material costs, such as steel. Further analysis is as follows:

Cost of sales for Henglong was \$97.1 million for the nine months ended September 30, 2012, compared with \$111.0 million for the same period of 2011, representing a decrease of \$13.9 million, or 12.5%. The decrease in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$6.9 million, the adoption of technical innovations in production processes in 2012 and a decrease in unit material costs leading to a cost of sales decrease of \$23.5 million, which was offset by the effect of foreign currency translation of the RMB against the U.S. dollar with a cost of sales increase of \$2.7 million.

Cost of sales for Jiulong was \$47.5 million for the nine months ended September 30, 2012, compared with \$45.4 million for the same period of 2011, representing an increase of \$2.0 million, or 4.5%. The increase in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$1.4 million, a decrease in unit cost with a cost of sales decrease of \$0.5 million and the effect of foreign currency translation of the RMB against the U.S. dollar with a cost of sales increase of \$1.1 million.

Cost of sales for Shenyang was \$18.5 million for the nine months ended September 30, 2012, compared with \$19.6 million for the same period of 2011, representing a decrease of \$1.1 million, or 5.8%. The decrease in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$0.4 million, a decrease in unit cost with a cost of sales decrease of \$2.0 million and the effect of foreign currency translation of the RMB against the

U.S. dollar with a cost of sales increase of \$0.5 million.

Cost of sales for Wuhu was \$22.6 million for the nine months ended September 30, 2012, compared with \$24.8 million for the same period of 2011, representing a decrease of \$2.2 million, or 8.8%. The decrease in cost of sales was mainly due to a decrease in sales volumes with a cost of sales decrease of \$2.2 million and a decrease in unit cost with a cost of sales decrease of \$0.6 million, which were offset by the effect of foreign currency translation of the RMB against the U.S. dollar with a cost of sales increase of \$0.6 million.

Cost of sales for Hubei Henglong was \$26.4 million for the nine months ended September 30, 2012, compared with \$12.6 million for the same period of 2011, representing an increase of \$13.7 million, or 108.4%. The net increase in cost of sales was mainly due to an increase in sales volumes with a cost of sales increase of \$12.6 million, an increase in unit cost with a cost of sales increase of \$0.8 million and the appreciation of the RMB against U.S. dollar with a cost of sales increase of \$0.3 million.



Cost of sales for Other Sectors was \$25.8 million for the nine months ended September 30, 2012, compared with \$28.8 million for the same period of 2011, representing a decrease of \$3.0 million, or 10.3%. The decrease in cost of sales was mainly due to a decrease in sales volumes with a cost of sales decrease of \$5.4 million, which was offset by an increase in cost of sales of \$1.7 million resulting from the increase in cost of supplies for production and the appreciation of the RMB against the U.S. dollar with a cost of sales increase of \$0.7 million. Other Sectors are mainly engaged in the production of electrical power steering, “EPS,” and, given that the Company’s market share of EPS sales in the PRC market is relatively low and the Company has not yet reached a production level which meets the economies of scale, the Company could not purchase relevant materials from suppliers with a lower price. In addition, certain suppliers of materials for other products also increased their selling prices as a result of inflation.

Gross margin was 18.6% for the nine months ended September 30, 2012, representing a 0.5% decrease from 19.1% for the same period of 2011, which was primarily due to a decrease in selling price and an increase in sales volumes of lower gross margin products of Hubei Henglong.

#### *Gain on Other Sales*

Gain on other sales mainly consisted of net amount retained from sales of materials and scraps. For the nine months ended September 30, 2012, gain on other sales amounted to \$2.6 million, while it amounted to \$1.4 million for the same period of 2011. The increase of \$1.2 million, or 85.7%, was mainly due to an increase in materials and scraps sales.

#### *Selling Expenses*

Selling expenses were \$6.7 million for the nine months ended September 30, 2012, which was consistent with \$6.7 million for the same period of 2011.

#### *General and Administrative Expenses*

General and administrative expenses were \$9.0 million for the nine months ended September 30, 2012, compared with \$10.3 million for the same period of 2011, representing a decrease of \$1.3 million, or 12.5%, mainly due to decreases in salaries and wages expenses.

During the nine months ended September 30, 2012, the Company paid lower performance bonuses to management as the Company did not achieve the performance targets pre-determined by the board of directors.

#### *Research and Development Expenses*

Research and development expenses were \$10.0 million for the nine months ended September 30, 2012, compared with \$6.0 million for the nine months ended September 30, 2011, representing an increase of \$4.0 million, or 68.1%, mainly due to development and trial production of EPS. In summary, expenses for mold improvement increased by \$2.2 million, external technical support fees increased by \$0.1 million, the salaries and wages expenses of research and development related staff increased by \$1.9 million and other R&D expense decreased by \$0.2 million.

The global automotive parts industry is highly competitive; winning and maintaining new business requires suppliers to rapidly produce innovative products on a cost-competitive basis. From 2012, in addition to purchasing advanced manufacturing equipment for newly developed products and hiring senior technicians, the Company has started giving bonuses to technical personnel who make an outstanding contribution to product research and development. As a result, research and development expenses increased significantly.

#### *Income from Operations*

Income from operations was \$20.4 million for the nine months ended September 30, 2012, compared with \$23.5 million for the nine months ended September 30, 2011, representing a decrease of \$3.1 million, or 13.2%, including a decrease of \$1.6 million, or 3.5%, in gross profit, an increase of \$1.2 million, or 85.7%, in gain on other sales, and an increase of \$2.7 million, or 12.4%, in operating expenses.

#### *Other Income, Net*

Other income was \$0.3 million for the nine months ended September 30, 2012, compared to \$0.2 million for the nine months ended September 30, 2011, an increase of \$0.1 million, primarily as a result of increased government subsidies.

*Financial Expenses, Net*

Financial expenses were \$1.9 million for the nine months ended September 30, 2012, compared to financial expenses of \$2.9 million for the same period of 2011, representing a decrease of \$1.0 million, or 35.9%, which was mainly due to the decrease in interest expenses of the convertible notes as a result of the early redemption in May 2012.

*Gain (Loss) on Change in Fair Value of Derivative*

Loss on change in fair value of derivative was \$0.5 million for the nine months ended September 30, 2012, compared with a gain of \$19.4 million for the same period of 2011, a change of \$19.9 million.

During the nine months ended September 30, 2012, the Company's stock price rose to \$3.82 on the Redemption Date, from \$3.30 at the beginning of 2012. Thus, the intrinsic value of the embedded conversion feature in financial instruments increased, which led to an increase in the fair value of compound derivative liabilities. This resulted in a loss on change in fair value of derivatives (see Note 14).

During the nine months ended September 30, 2011, the Company's stock price dropped to \$4.72 from \$13.62 at the beginning of 2011. Thus, the intrinsic value of the embedded conversion feature in financial instruments decreased which led to a decrease in the fair value of compound derivative liabilities. This resulted in a gain on change in fair value of derivatives (see Note 14).

*Gain on Convertible Notes Conversion*

On March 1, 2011, LBCCA Liquidator converted \$6.4 million principal amount of the convertible notes, and in turn the Company recognized a gain of \$1.6 million. There were no convertible notes being converted in the same period of 2012 (see Note 13).

*Gain on Redemption of Convertible Notes*

On the Redemption Date, the Company redeemed convertible notes issued to LBCCA Liquidator. The Company recorded a gain of \$1.4 million for the redemption of convertible notes, whereas there was no convertible note redeemed in the same period of 2011 (see Note 13).

*Income Before Income Tax Expenses and Equity In Earnings Of Affiliated Companies*

Income before income tax expenses and equity in earnings of affiliated companies was \$19.8 million for the nine months ended September 30, 2012, compared with \$41.7 million for the nine months ended September 30, 2011, a decrease of \$21.9 million, or 52.5%, mainly due to a decrease in income from operations of \$3.1 million, an increase in other income of \$0.1 million, a decrease in financial expenses of \$1.0 million, a decrease in gain on change in fair value of derivative of \$19.8 million, an increase in gain on redemption of convertible notes of \$1.4 million and a decrease in gain on conversion of convertible notes of \$1.5 million.

*Income Taxes*

Income tax expense was \$3.7 million for the nine months ended September 30, 2012, compared with \$4.0 million of income tax expense for the nine months ended September 30, 2011, a decrease of \$0.3 million, or 9.4%. The effective tax rate increased to 18.5% for the nine months ended September 30, 2012 from 9.7% for the same period in 2011, primarily due to the utilization of the tax losses that did not carry forward against the gain on change in the fair value of derivative and the gain on redemption and conversion of the convertible notes.

*Income From Continuing Operations*

Net income from continuing operations was \$16.3 million for the nine months ended September 30, 2012, compared with \$37.8 million for the nine months ended September 30, 2011, a decrease of \$21.5 million, or 56.9%, mainly due to a decrease in income tax expenses and equity in earnings of affiliated companies of \$21.9 million and a decrease in income tax expense of \$0.4 million.

*Discontinued Operations*

The Company sold its 51% equity interest in Zhejiang in May 2012 (see Note 25). The net income from discontinued operations was \$2.7 million for the nine months ended September 30, 2012, which included a gain on such sale of \$2.5 million (after tax) and the net operational income of \$0.2 million. For the same period of 2011, net income from discontinued operations mainly was the net operational income of \$1.5 million.

*Net Income*

Net income was \$18.9 million for the nine months ended September 30, 2012, compared with net income of \$39.3 million for the nine months ended September 30, 2011, a decrease of \$20.4 million, or 51.9%, mainly due to a decrease in income from continuing operations of \$21.5 million and an increase in income from discontinued operations of \$1.1 million.

*Net Income Attributable to Noncontrolling Interests*

Net income attributable to noncontrolling interests amounted to \$3.3 million for the nine months ended September 30, 2012, compared with \$5.2 million for the nine months ended September 30, 2011, a decrease of \$1.9 million, or 36.5%, primarily due to the decrease in non-wholly owned subsidiaries' net income.

Taking into account the Zhejiang Sale, the Company owns different equity interests in ten non-wholly owned subsidiaries established in the PRC and Brazil, through which it conducts its operations. Except for Beijing Henglong, which is accounted under the equity method, all the operating results of these non-wholly owned subsidiaries were consolidated in the Company's financial statements as of September 30, 2012 and 2011. For the nine months ended September 30, 2012 and 2011, the Company recorded \$3.2 million and \$4.5 million for the noncontrolling interests' share in the earnings of the consolidated non-wholly owned subsidiaries, respectively.

*Net Income Attributable to Parent Company*

Net income attributable to parent company was \$15.6 million for the nine months ended September 30, 2012, compared with net income of \$34.1 million for the nine months ended September 30, 2011, a decrease of \$18.5 million, reflecting a decrease of \$20.4 million in net income and a decrease of \$1.9 million in net income attributable to noncontrolling interests.

**Liquidity and Capital Resources**

*Capital Resources and Use of Cash*

The Company has historically financed its liquidity requirements from a variety of sources, including short-term borrowings under bank credit agreements, bankers' acceptances, issuances of capital stock and notes and internally generated cash. As of September 30, 2012, the Company had cash and cash equivalents of \$72.5 million, compared with \$73.0 million as of December 31, 2011, a decrease of \$0.5 million, or 0.1%.

The Company had working capital of \$123.9 million as of September 30, 2012, compared with \$147.8 million as of December 31, 2011, a decrease of \$ 23.9 million, or 16.2%. According to the terms of the convertible notes, convertible notes payable, compound derivative liabilities and accrued make-whole redemption interest expense for

the convertible notes were recorded as non-current liabilities as of December 31, 2011. On the Redemption Date, the Company redeemed the convertible notes, including principal, coupon interest and make-whole amount payable, and an increased short-term bank loan of \$26.7 million (see Notes 11, 13, 14 and 16). The working capital of the Company therefore decreased.

The Company intends to indefinitely reinvest the funds in subsidiaries established in the PRC.

The Company believes that, in view of its current cash position as of September 30, 2012, the cash expected to be generated from the operations and funds available from bank borrowings as detailed in subsequent paragraphs will be sufficient to meet its working capital and capital expenditure requirements (including the repayment of bank loans) for at least twelve months commencing from September 30, 2012.

#### *Capital Source*

The Company's capital source is multifaceted, such as bank loans and banker's acceptance facilities. In financing activities and operating activities, the Company's banks require the Company to sign line of credit agreements and repay such facilities within one year. On the condition that the Company can provide adequate mortgage security and has not violated the terms of the line of credit agreement, such one year facilities can be extended for another year.

The Company had short-term bank and government loans of \$37.0 million, including bank loans of RMB35.0 million (equivalent to \$5.5 million) and, \$30.0 million and a government loan of \$1.6 million (see Note 11); and bankers' acceptances of \$64.3 million (see Note 12) as of September 30, 2012.

The Company currently expects to be able to obtain similar bank loans (i.e., RMB loans) and bankers' acceptance facilities in the future if it can provide adequate mortgage security following the termination of the above-mentioned agreements (see the table under "Bank Arrangements" below for more information). If the Company is not able to do so, it will have to refinance such debt as it becomes due or repay that debt to the extent it has cash available from operations or from the proceeds of additional issuances of capital stock. Owing to depreciation, the value of the mortgages securing the above-mentioned bank loans and banker's acceptances will be devalued by approximately \$14.4 million over the next 12 months. If the Company wishes to obtain the same amount of bank loans and banker's acceptances, it will have to provide \$14.4 million additional mortgages as of the maturity date of such agreements (see the table under "Bank Arrangements" below for more information). The Company can still obtain a reduced line of credit with a reduction of \$8.0 million, which is 55.7% (the mortgage rates) of \$14.4 million, if it cannot provide additional mortgages. The Company expects that the reduction of bank loans will not have a material adverse effect on its liquidity.

On May 18, 2012, the Company entered the Credit Agreement with ICBC Macau to obtain the Credit Facility. The Credit Facility would have expired on November 3, 2012, unless the Company drew down the line of credit in full prior to such expiration date and the maturity date for the loan drawdown was the earlier of (i) 18 months from the drawdown or (ii) 1 month before the expiry of the Henglong Standby Letter of Credit.

The interest rate of the Credit Facility is calculated based on a three-month LIBOR plus 2.25% per annum, subject to the availability of funds and fluctuation at ICBC Macau's discretion. The interest is calculated daily on a 360-day basis and it is to be fixed one day before the first day of each interest period. The interest period is defined as three months from the date of drawdown. As of September 30, 2012, the interest rate was 2.683% per annum.

As further security for the Credit Facility, the Company is required to provide ICBC Macau a standby letter of credit for a total amount of not less than \$31.6 million if the Credit Facility is fully drawn.

On May 22, 2012, the Company drew down the full amount of \$30.0 million under the Credit Facility and provided a standby letter of credit for an amount of \$31.6 million in favor of ICBC Macau. The loan drawdown will expire on May 15, 2013. The Henglong Standby Letter of Credit issued by ICBC Jingzhou with the collateralization of Henglong's notes receivable of RMB 225.0 million (equivalent to approximately \$35.6 million) will expire on June 15, 2013. The Company also paid an arrangement fee of \$0.1 million and \$0.1 million to ICBC Macau and ICBC Jingzhou. The arrangement fees are amortized over the period of the loan drawdown, and \$0.1 million was amortized for the three months and nine months ended September 30, 2012. Please refer to Note 11.

On the Redemption Date, the Company redeemed all of the outstanding convertible notes, including \$23.6 million of principal and \$8.8 million of interest.

### *Bank Arrangements*

As of September 30, 2012, the principal outstanding under the Company's credit facilities and lines of credit was as follows (figures are in thousands of USD):

|                                    | Bank          | Due Date | Amount Available <sup>(5)</sup> | Amount Used | Assessed Mortgage Value |
|------------------------------------|---------------|----------|---------------------------------|-------------|-------------------------|
| 1. Comprehensive credit facilities | Bank of China | Mar-13   | \$ 22,236                       | \$ 7,572    | \$ 6,836                |
|                                    |               | Jun-13   | 31,541                          | 10,206      | 60,658                  |



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|                                                       |                                         |        |            |           |                |                           |
|-------------------------------------------------------|-----------------------------------------|--------|------------|-----------|----------------|---------------------------|
| 2. Comprehensive credit facilities                    | Jingzhou Commercial Bank                |        |            |           |                |                           |
| 3. Comprehensive credit facilities <sup>(6)</sup>     | China Construction Bank                 | Oct-12 | 12,616     | 3,154     |                | 31,923                    |
| 4. Comprehensive credit facilities <sup>(1)</sup>     | Shanghai Pudong Development Bank        | Dec-13 | 15,770     | 20,917    | <sup>(2)</sup> | 12,785                    |
| 5. Comprehensive credit facilities <sup>(1) (6)</sup> | China CITIC Bank                        | Sep-12 | 16,401     | 14,462    |                | 14,674                    |
| 6. Comprehensive credit facilities                    | Industrial and Commercial Bank of China | Jul-13 | 12,616     | 3,154     |                | -                         |
| 7. Comprehensive credit facilities <sup>(1)</sup>     | China Hua Xia Bank                      | Mar-13 | 25,233     | 3,991     |                | 32,825                    |
| 8. Comprehensive credit facilities                    | China Everbright Bank                   | Aug-14 | 4,731      | 6,316     | <sup>(2)</sup> | 8,075                     |
| 9. Comprehensive credit facilities                    | ICBC Macau                              | May-13 | 30,000     | 30,000    |                | 35,483                    |
| Total                                                 |                                         |        | \$ 171,144 | \$ 99,772 | <sup>(3)</sup> | \$ 203,259 <sup>(4)</sup> |

Each of Henglong's comprehensive credit facility with China CITIC Bank, Henglong and Jielong's comprehensive credit facility with Shanghai Pudong Development Bank, and Henglong's comprehensive credit facility with <sup>(1)</sup> China Hua Xia Bank, needs to be guaranteed by Jiulong, another subsidiary of the Company, in addition to the above pledged assets.

- (2) The amount used was in excess of the amount available because certain issued bank notes were 100% secured by pledged deposits without utilization of credit lines.
- (3) Total amount used includes bank loans of \$35.5 million and notes payable of \$64.3 million as of September 30, 2012 (see Notes 11 and 12).
- (4) As at September 30, 2012, the pledged assets included deposits of \$68.3 million pledged for notes and receivables payable and other pledged assets with assessed value of \$134.9 million.

The amount available is used for the drawdown of bank loan and issuance of bank notes. For the drawdown of (5) bank loans, this amount represents the amount that the Company can borrow immediately; for issuance of bank notes, the Company needs to pledge additional collateral in order to utilize these bank facilities.

As at the date of this Report, the comprehensive credit line arrangements with China Construction Bank and China CITIC Bank have expired. The Company is negotiating the renewal of the credit line arrangements with them and (6) expects to complete the renewal in late November 2012. As the Company has obtained sufficient comprehensive lines of credit from other banks, the Company does not anticipate any significant adverse impact on its financial position if the Company fails to renew.

The Company may request the banks to issue notes payable or bank loans within its credit line using a 365-day revolving line.

The Company refinanced its short-term debt during 2012 at annual interest rates of 6.31% to 7.57 %, and maturity terms of twelve months. Pursuant to the comprehensive credit line arrangement the Company pledged: (1) land use rights with an assessed value of \$6.8 million as security for its comprehensive credit facility with the Bank of China; (2) equipment with an assessed value of approximately \$60.7 million as security for its revolving comprehensive credit facility with Jingzhou Commercial Bank; (3) equipment, land use rights and buildings with an assessed value of approximately \$31.9 million as security for its comprehensive credit facility with China Construction Bank; (4) land use rights and buildings with an assessed value of approximately \$12.8 million as security for its comprehensive credit facility with Shanghai Pudong Development Bank; (5) land use rights and buildings with an assessed value of approximately \$14.7 million as security for its comprehensive credit facility with China CITIC Bank; (6) accounts receivable with an assessed value of approximately \$32.8 million as security for its comprehensive credit facility with China Hua Xia Bank; (7) land use rights and buildings with an assessed value of approximately \$8.1 million as security for its comprehensive credit facility with China Everbright Bank; and (8) \$35.5 million of notes receivable held by Henglong.

#### *Cash Requirements*

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The following table summarizes the Company's expected cash outflows resulting from financial contracts and commitments. The Company has not included information on its recurring purchases of materials for use in its manufacturing operations. These amounts are generally consistent from year to year, closely reflecting the Company's levels of production, and are not long-term in nature (being less than three months in length).

|                                                                      | Payment Due Dates<br>( in thousands of USD) |                     |              |              |                         |
|----------------------------------------------------------------------|---------------------------------------------|---------------------|--------------|--------------|-------------------------|
|                                                                      | Total                                       | Less than 1<br>year | 1-3<br>years | 3-5<br>years | More than<br>5<br>Years |
| Short-term loan including interest payable                           | \$37,996                                    | \$ 37,996           | \$ -         | \$ -         | \$ -                    |
| Notes payable <sup>(1)</sup>                                         | 64,273                                      | 64,273              | -            | -            | -                       |
| Other contractual purchase commitments, including service agreements | 12,327                                      | 9,459               | 2,868        | -            | -                       |
| Total                                                                | \$114,596                                   | \$ 111,728          | \$ 2,868     | \$ -         | \$ -                    |

(1) Notes payable do not bear interest.

### *Short-term Loans*

The following table summarizes the contract information of short-term borrowings among the banks and the government of the PRC and the Company as of September 30, 2012 (figures are in thousands of USD):

| Bank                    | Purpose         | Borrowing Date | Borrowing Term (Months) | Annual Percentage Rate | Date of Interest Payment | Due Date    | Amount Payable on Due Date |
|-------------------------|-----------------|----------------|-------------------------|------------------------|--------------------------|-------------|----------------------------|
| China Construction Bank | Working Capital | 26-Jun-12      | 12                      | 6.31 %                 | Pay monthly              | 25-Jun-13   | \$ 3,154                   |
| China CITIC Bank        | Working Capital | 4-Jul-12       | 12                      | 7.57 %                 | Pay monthly              | 4-Jul-13    | 2,366                      |
| ICBC Macau              | Working Capital | 22- May -12    | 12                      | 2.71 %                 | Pay quarterly            | 15- May -13 | 30,000                     |
| Bank loans subtotal     |                 |                |                         |                        |                          |             | 35,520                     |
| The government of China | Working Capital | 1- Mar -12     | 9                       | -                      | -                        | 25-Nov-12   | 1,576                      |
| Total                   |                 |                |                         |                        |                          |             | \$ 37,096                  |

The Company must use the loans for the purpose described in the table. For the three bank loans, if the Company fails to do so, it will be charged a penalty interest at 100% of the specified loan rate listed in the table above. Except for the loan granted by ICBC Macau as disclosed in the section “Capital Source” above, the Company has to pay interest at the interest rate described in the table on the 20th of each month. If the Company fails to do so, it will be charged compound interest at the specified rate in the above table. The Company has to repay the principal outstanding on the specified date in the table. If it fails to do so, it will be charged a penalty interest at 50% of the specified loan rate. For the government loan, the Company has to repay the principal outstanding on the specified date in the table. If it fails to do so, it will be charged a penalty rate at 0.3% per day in addition to the penalty interest of the loan rate that is published by the People’s Bank of China for the same period.

Management believes that the Company had complied with such financial covenants as of September 30, 2012, and will continue to comply with them.

### *Notes Payable*

The following table summarizes the contract information of issuing notes payable between the banks and the Company as of September 30, 2012 (figures are in thousands of USD):

| Purpose                        | Term (Month) | Due Date | Amount Payable on<br>Due Date |
|--------------------------------|--------------|----------|-------------------------------|
| Working Capital <sup>(1)</sup> | 3-6          | Oct -12  | \$ 9,024                      |
| Working Capital                | 3-6          | Nov -12  | 11,716                        |
| Working Capital                | 3-6          | Dec -12  | 11,354                        |
| Working Capital                | 3-6          | Jan -13  | 11,046                        |
| Working Capital                | 3-6          | Feb -13  | 11,812                        |
| Working Capital                | 3-6          | Mar -13  | 9,321                         |
| Total (Note 12)                |              |          | \$ 64,273                     |

(1) The notes payable were settled in October 2012.

The Company must use notes payable for the purpose described in the table. If it fails to do so, the banks will no longer issue the notes payable, and it may have an adverse effect on the Company's liquidity and capital resources. The Company has to deposit sufficient cash in the designated account of the bank on the due date of notes payable for payment to the suppliers. If the bank has advanced payment for the Company, it will be charged a penalty interest at 50% of the loan rate that is published by the People's Bank of China for the same period. Management believes that the Company had complied with such financial covenants as of September 30, 2012, and will continue to comply with them.

## *Cash Flows*

### (a) Operating activities

Net cash provided by operations during the nine months ended September 30, 2012 was \$11.4 million, compared with net cash provided of \$31.7 million for the same period of 2011, a decrease of \$20.3 million.

During the nine months ended September 30, 2012, the decrease in net cash provided by operations was mainly due to the net effect of: (1) the decrease in net income (excluding non-cash items) by \$3.1 million, (2) the change of balance of pledged deposits which led to a decrease in net cash provided by operations of \$6.6 million, (3) the change of balance of accounts and notes receivable which led to a decrease in net cash provided by operations of \$11.5 million, (4) the change of balance of inventories which led to an increase in net cash provided by operations of \$8.3 million, (5) the change of balance of accounts and notes payable which led to a decrease in net cash provided by operations of \$9.1 million, (6) the change of balance of accrued expenses and other accounts payable which led to a decrease in net cash provided by operation of \$8.2 million, (7) the change of balance of tax payable which led to an increase in cash provided by operations of \$7.1 million, and (8) the change of balance of advance payable which led to an increase in net cash provided by operations of \$1.9 million.

### (b) Investing activities

The Company used net cash of \$14.5 million in investment activities during the nine months ended September 30, 2012, compared with \$10.2 million during the same period of 2011, representing an increase of \$4.3 million, which was mainly due to (1) a net cash increase of \$3.6 million pursuant to the Company's sale of its 51% equity interest in Zhejiang (see Note 25) on May 2012, and (2) compared to the same period of last year, the expenses to acquire equipment increased by \$6.2 million to improve the Company's production capacity.

### (c) Financing activities

During the nine months ended September 30, 2012, the Company obtained net cash of \$3.1 million from financing activities, which was consistent with net cash of \$3.1 million provided by financing activities for the same period of 2011. In the nine months ended September 30, 2012, the Company entered into a \$30.0 million bank loan from ICBC Macau, and paid \$23.6 million of principal and interest for redemption of the convertible notes.

## *Off-Balance Sheet Arrangements*

At September 30, 2012 and 2011, the Company did not have any significant transactions, obligations or relationships that could be considered off-balance sheet arrangements.

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

#### *Interest*

The Company's exposure to changes in interest rates results primarily from its credit facility borrowings. As of September 30, 2012, the Company had \$30 million of outstanding indebtedness, which is subject to interest rate fluctuations. Based on the amount of such borrowings as of September 30, 2012, it is expected that a hypothetical 100 basis point increase in the then current LIBOR rate would increase the Company's interest expense by \$0.3 million on an annual basis.

The level of outstanding indebtedness fluctuates from time to time and may result in additional interest amount.

There were no material changes to the disclosure made in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 regarding other market risks.

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

##### *A. Disclosure Controls and Procedures*

The Company's management, under the supervision and with the participation of its chief executive officer and chief financial officer, Messrs. Wu Qizhou and Li Jie, respectively, evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2012, the end of the period covered by this Report. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports, such as this Form 10-Q, that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2012. Based on that evaluation, Messrs. Wu and Li concluded that the Company's disclosure controls and procedures were not effective as of September 30, 2012.

The Company's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of its disclosure control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected.

##### *B. Changes in Internal Control Over Financial Reporting*

Other than the changes mentioned below, there have been no changes in the Company's internal control over financial reporting during the three-month period ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

##### Remediation of Previously Disclosed Material Weakness

As previously disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, the Company identified the following material weakness in its internal control over financial reporting:



The Company did not have sufficient personnel with appropriate levels of accounting knowledge and experience to address complex U.S. GAAP accounting issues and to prepare and review financial statements and related disclosures under U.S. GAAP. Specifically, the Company's controls did not operate effectively to ensure the appropriate and timely analysis of and accounting for unusual and non-routine transactions and certain financial statement accounts, including, but not limited to, accounting and disclosure for the convertible notes and accounting for deferred taxes.

During the three months ended September 30, 2012, the Company implemented the following remediation measures to address the above material weakness:

1. the Company hired a key member in its corporate accounting unit who has in-depth knowledge and experience in U.S. GAAP;
2. the Company's key accounting personnel has continued to attend training on U.S. GAAP; the Company required members of its finance team to perform extensive research to enhance their knowledge of the relevant U.S. GAAP interpretations and its application. The research topics included the discontinued operation
3. relating to the disposal of a subsidiary, the retirement of debts relating to the redemption of convertible notes, the government grants, the comparison of U.S. GAAP and Chinese GAAP, and other issues that the Company believes to be critical in the recent quarterly financial reporting.

Management has not yet tested all of these measures but anticipates that these remediation methods will assist in the establishment of an effectively designed and operating process of internal control over financial reporting.

## PART II. — OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS.

*Securities Action – Southern District of New York.* On October 25, 2011, a purported securities class action (the “Securities Action”) was filed in the United States District Court for the Southern District of New York on behalf of all purchasers of the Company’s securities between March 25, 2010 and March 17, 2011. On February 24, 2012, the plaintiffs filed an amended complaint, changing the purported class period from May 12, 2009 through March 17, 2011. The amended complaint alleges that the Company, certain of its present officers and directors and the Company’s former independent accounting firm violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and the rules promulgated thereunder, and seeks unspecified damages. The Company has filed a motion to dismiss the amended complaint, which was fully briefed on April 18, 2012. On August 8, 2012, the court denied the Company’s motion to dismiss the amended complaint. On September 4, 2012, the Company filed an answer to the amended complaint. The Company continues to believe that the allegations in the complaint are without merit and intends to defend itself vigorously against the claims.

*Derivative Action – Delaware Chancery Court.* On December 23, 2011, a purported shareholder derivative action was filed in the Court of Chancery of the State of Delaware (the “Court of Chancery”) on behalf of the Company. The complaint alleges that certain of the Company’s current officers and directors breached their fiduciary duties to the Company in relation to the Company’s accounting of convertible notes issued in February, 2008. On January 25, 2012, a second purported shareholder derivative action was filed in the Court of Chancery on behalf of the Company. On February 3, 2012, the Court of Chancery consolidated the two cases, which were stayed pending the outcome of the motion to dismiss in the Securities Action. On October 23, 2012, the derivative plaintiffs filed a consolidated amended complaint on behalf of the Company. The consolidated complaint alleges that certain of the Company’s current officers and directors breached their fiduciary duties to the Company in relation to the Company’s accounting of the convertible notes issued in February 2008. The consolidated complaint sets forth three causes of action for breach of fiduciary duties, unjust enrichment and insider trading. The Company believes the allegations in the shareholder suit are without merit, and intends to defend itself vigorously against the claims.

The above-referenced actions do not specify an amount of damages that the plaintiffs seek. Moreover, because these matters are in early stages, the Company cannot determine whether an adverse outcome is probable, nor can it provide a reasonable estimate of potential losses related to these matters. Although the Company believes that it has meritorious defenses to each of these actions and intends to defend them vigorously, an adverse outcome in one or more of these matters could have a material adverse effect on the Company’s business, financial condition, results of operations or liquidity.

Other than the above, the Company is not a party to any pending or, to the best of the Company’s knowledge, any threatened legal proceedings. In addition, no director, officer or affiliate of the Company, or owner of record of more than five percent of the securities of the Company, or any associate of any such director, officer or security holder is a

party adverse to the Company or has a material interest adverse to the Company in reference to pending litigation.

#### **ITEM 1A. RISK FACTORS.**

There have been no material changes from the risk factors previously disclosed in Item 1A of the Company's 2011 Annual Report on Form 10-K other than as set forth below:

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

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

Furthermore, on September 17, 2012, the United States filed a trade case with the World Trade Organization, "WTO," against the PRC complaining the PRC government's purported provision of subsidies to the automobile and automobile-parts enterprises in the PRC. If the WTO rules against China in this trade case, the cost of sales of the Company could increase due to the imposition of any tariff and/or the Company's ability to export products to the United States could be limited, which could affect the Company's business and operating results.

In addition, under Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC has adopted additional disclosure requirements related to the source of certain "conflict minerals" for issuers for which such "conflict minerals" are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, by that issuer. The metals covered by the rules include tin, tantalum, tungsten and gold, commonly referred to as "3TG." If these materials are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, the rules require a reasonable country of origin inquiry be conducted to determine if an issuer knows or, has reason to believe, any of the minerals used in the production process may have originated from the Democratic Republic of the Congo or an adjoining country. In such a case, if an issuer were not able to determine that the minerals did not originate from a covered country or conclude that there is no reason to believe that the minerals used in the production process may have originated in a covered country, that issuer could be required to perform supply chain due diligence on members of its supply chain. Global supply chains can have multiple layers, thus the costs of complying with these new requirements could be substantial. These new requirements may also reduce the number of suppliers that provide conflict-free metals, and may affect a company's ability to obtain products in sufficient quantities or at competitive prices. If the Company were to source such 3TG minerals that are necessary to the functionality or production of a product manufactured, or contracted to be manufactured, compliance costs with these rules and/or the unavailability of raw materials could have a material adverse effect on the Company's results of operations.

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

None.

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

None.

## **ITEM 4. MINE SAFETY DISCLOSURES**

Not Applicable.

## **ITEM 5. OTHER INFORMATION.**

None.



## ITEM 6. EXHIBITS.

### INDEX TO EXHIBITS

| Exhibit Number | Description                                                                                                                                                                                                                                                                                                      |
|----------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1(i)         | Certificate of Incorporation (incorporated by reference from the filing on Form 10KSB File No. 000-33123.)                                                                                                                                                                                                       |
| 3.1(ii)        | Bylaws (incorporated by reference from the Form 10KSB for the year ended December 31, 2002.)                                                                                                                                                                                                                     |
| 10.1           | Joint-venture Agreement, dated March 31, 2006, as amended on May 2, 2006, between Great Genesis Holdings Limited and Wuhu Chery Technology Co., Ltd. (incorporated by reference to the exhibit 10.8 to the Company's Form 10Q Quarterly Report on May 10, 2006 )                                                 |
| 10.2           | Securities Purchase Agreement dated February 1, 2008 among us, Lehman Brothers Commercial Corporation Asia Limited, and YA Global Investments, L.P. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)                                                                 |
| 10.3           | Securities Purchase Agreement dated February 15, 2008 between us and the investors. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)                                                                                                                                 |
| 10.4           | Escrow Agreement dated February 15, 2008 among us, U.S. Bank National Association, Lehman Brothers Commercial Corporation Asia Limited, and YA Global Investments, L.P. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)                                             |
| 10.5           | Registration Rights Agreement dated February 15, 2008 among us, Lehman Brothers Commercial Corporation Asia Limited, and YA Global Investments, L.P. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)                                                                |
| 10.6           | Senior convertible note dated February 15, 2008 in the original principal amount of \$8,571,429 issued by us in favor of TFINN & CO. as nominee for Lehman Brothers Commercial Corporation Asia Limited. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)            |
| 10.7           | Senior convertible note dated February 15, 2008 in the original principal amount of \$6,428,571 issued by us in favor of TFINN & CO. as nominee for Lehman Brothers Commercial Corporation Asia Limited. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)            |
| 10.8           | Senior convertible note dated February 15, 2008 in the original principal amount of \$15,000,000 issued by us in favor of TFINN & CO. as nominee for Lehman Brothers Commercial Corporation Asia Limited. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)           |
| 10.9           | Closing Warrant to purchase 564,799 shares of common stock at \$8.8527 per share, dated February 15, 2008, issued by us in favor of TFINN & CO. as nominee for Lehman Brothers Commercial Corporation Asia Limited. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.) |
| 10.10          | Escrow Warrant to purchase 564,799 shares of common stock at \$8.8527 per share, dated February 15, 2008, issued by us in favor of TFINN & CO. as nominee for Lehman Brothers Commercial Corporation Asia Limited. (incorporated by reference to the Company's Form 10-K for the year ended December 31, 2007.)  |
| 31.1           | Rule 13a-14(a) Certification*                                                                                                                                                                                                                                                                                    |
| 31.2           | Rule 13a-14(a) Certification*                                                                                                                                                                                                                                                                                    |
| 32.1           | Section 1350 Certification*                                                                                                                                                                                                                                                                                      |
| 32.2           | Section 1350 Certification*                                                                                                                                                                                                                                                                                      |
| 101+           | The following materials from the China Automotive Systems, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, filed on November 9, 2012 formatted in Extensible Business Reporting                                                                                                     |

Language (XBRL):

- (i) Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income,
- (ii) Condensed Unaudited Consolidated Balance Sheets,
- (iii) Condensed Unaudited Consolidated Statements of Cash Flows,
- (iv) Condensed Unaudited Consolidated Statements of Changes in Equity, and
- (v) related notes

\* filed herewith

XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not  
+ filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

## SIGNATURES

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

CHINA AUTOMOTIVE SYSTEMS, INC.  
(Registrant)

Date: November 9, 2012 By: */s/ Qizhou Wu*  
Qizhou Wu  
President and Chief Executive Officer

Date: November 9, 2012 By: */s/ Jie Li*  
Jie Li  
Chief Financial Officer