

CHINA AUTOMOTIVE SYSTEMS INC  
Form 10-Q  
November 09, 2010

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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, 2010

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  
organization)

33-0885775  
(I.R.S. employer identification number)

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

(Address of principal executive offices)

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

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

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report. )

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

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 September 30, 2010, the Company had 27,115,826 shares of common stock issued and outstanding.

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## CHINA AUTOMOTIVE SYSTEMS, INC.

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## PART 1 — FINANCIAL INFORMATION

## Item 1. Financial Statements

China Automotive Systems, Inc.  
Condensed Consolidated Statements of Operations (Unaudited)

|   | Three Months Ended September<br>30, |               |
|---|-------------------------------------|---------------|
|   | 2010                                | 2009          |
| Net product sales, including \$1,717,483 and \$1,384,458 to related parties for the three months ended September 30, 2010 and 2009                | \$ 76,102,844                       | \$ 64,654,369 |
| Cost of product sold, including \$4,885,768 and \$3,477,109 purchased from related parties for the three months ended September 30, 2010 and 2009 | 57,929,284                          | 49,168,626    |
| Gross profit  | 18,173,560                          | 15,485,743    |
| Add: Gain (loss) on other sales   | (152,481)                           | 284,234       |
| Less: Operating expenses-   |                                     |               |
| Selling expenses  | 2,095,321                           | 2,180,864     |
| General and administrative expenses   | 2,286,784                           | 2,739,886     |
| R&D expenses  | 1,247,881                           | 531,383       |
| Depreciation and amortization   | 219,720                             | 663,408       |
| Total Operating expenses  | 5,849,706                           | 6,115,541     |
| Income from operations  | 12,171,373                          | 9,654,436     |
| Add: Other income, net (note 21)  | -                                   | -             |
| Financial income (expenses) net (note 22)   | (271,422)                           | (401,121)     |
| Gain on change in fair value of derivative (note 23)  | 509,705                             | 3,129,794     |
| Income before income taxes  | 12,409,656                          | 12,383,109    |
| Less: Income taxes (note 24)  | 1,866,157                           | 1,789,836     |
| Net income  | \$ 10,543,499                       | \$ 10,593,273 |
| Net income attributable to non-controlling interest   | 2,350,280                           | 2,036,762     |
| Net income attributable to parent company   | \$ 8,193,219                        | \$ 8,556,511  |
| Net income per common share attributable to parent company common shareholders-   |                                     |               |
| Basic (note 25)   | \$ 0.30                             | \$ 0.32       |
| Diluted (note 25)   | \$ 0.26                             | \$ 0.28       |
| Weighted average number of common shares outstanding -  |                                     |               |
| Basic   | 27,112,689                          | 26,983,717    |
| Diluted   | 31,564,305                          | 31,412,485    |

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

China Automotive Systems, Inc.  
Condensed Consolidated Statements of Operations (Unaudited)

|   | Nine Months Ended September 30, |                |
|---|---------------------------------|----------------|
|   | 2010                            | 2009           |
| Net product sales, including \$6,319,594 and \$3,257,716 to related parties for the nine months ended September 30, 2010 and 2009                 | \$ 245,416,671                  | \$ 171,836,094 |
| Cost of product sold, including \$14,481,952 and \$8,463,331 purchased from related parties for the nine months ended September 30, 2010 and 2009 | 184,897,834                     | 129,141,078    |
| Gross profit  | 60,518,837                      | 42,695,016     |
| Add: Gain on other sales  | 981,128                         | 523,860        |
| Less: Operating expenses-   |                                 |                |
| Selling expenses  | 6,866,249                       | 4,866,041      |
| General and administrative expenses   | 7,737,989                       | 6,787,918      |
| R&D expenses  | 4,291,044                       | 1,415,531      |
| Depreciation and amortization   | 829,865                         | 1,742,162      |
| Total Operating expenses  | 19,725,147                      | 14,811,652     |
| Income from operations  | 41,774,818                      | 28,407,224     |
| Add: Other income, net (note 21)  | 266,379                         | -              |
| Financial income (expenses) net (note 22)   | (1,052,782)                     | (1,318,829)    |
| Gain (loss) on change in fair value of derivative (note 23)   | 752,997                         | 591,511        |
| Income before income taxes  | 41,741,412                      | 27,679,906     |
| Less: Income taxes (note 24)  | 6,442,971                       | 4,714,124      |
| Net income  | \$ 35,298,441                   | \$ 22,965,782  |
| Net income attributable to non-controlling interest   | 8,227,985                       | 6,074,110      |
| Net income attributable to parent company   | \$ 27,070,456                   | \$ 16,891,672  |
| Net income per common share attributable to parent company common shareholders-   |                                 |                |
| Basic (note 25)   | \$ 1.00                         | \$ 0.63        |
| Diluted (note 25)   | \$ 0.88                         | \$ 0.58        |
| Weighted average number of common shares outstanding -  |                                 |                |
| Basic   | 27,078,180                      | 26,983,402     |
| Diluted   | 31,539,402                      | 31,627,696     |

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

China Automotive Systems, Inc.  
Condensed Consolidated Statements of Comprehensive Income (Unaudited)

|   | Three Months Ended September 30, |               |
|---|----------------------------------|---------------|
|   | 2010                             | 2009          |
| Net income  | \$ 10,543,499                    | \$ 10,593,273 |
| Other comprehensive income:                                   |                                  |               |
| Foreign currency translation gain (loss)                      | 2,183,555                        | 38,176        |
| Comprehensive income  | \$ 12,727,054                    | \$ 10,631,449 |
| Comprehensive income attributable to non-controlling interest | 2,751,145                        | 2,047,034     |
| Comprehensive income attributable to parent company           | \$ 9,975,909                     | \$ 8,584,415  |

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

China Automotive Systems, Inc.  
Condensed Consolidated Statements of Comprehensive Income (Unaudited)

|   | Nine Months Ended September 30, |               |
|---|---------------------------------|---------------|
|   | 2010                            | 2009          |
| Net income  | \$ 35,298,441                   | \$ 22,965,782 |
| Other comprehensive income:                                   |                                 |               |
| Foreign currency translation gain                             | 3,111,383                       | (164,153)     |
| Comprehensive income  | \$ 38,409,824                   | \$ 22,801,629 |
| Comprehensive income attributable to non-controlling interest | 8,780,511                       | 6,093,502     |
| Comprehensive income attributable to parent company           | \$ 29,629,313                   | \$ 16,708,127 |

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

China Automotive Systems, Inc.  
Condensed Consolidated Balance Sheets

|  | September 30,<br>2010<br>(Unaudited) | December 31, 2009     |
|--|--------------------------------------|-----------------------|
| <b>ASSETS</b>  |                                      |                       |
| Current assets:  |                                      |                       |
| Cash and cash equivalents  | \$ 49,201,859                        | \$ 43,480,176         |
| Pledged cash deposits (note 3)   | 21,090,382                           | 12,742,187            |
| Accounts and notes receivable, net, including \$2,573,240 and \$1,441,939 from related parties at September 30, 2010 and December 31, 2009 (note 4)      | 181,845,502                          | 154,863,292           |
| Advance payments and other, including \$1,409,460 and \$0 to related parties at September 30, 2010 and December 31, 2009                                 | 3,150,827                            | 2,413,556             |
| Inventories (note 6)   | 40,867,074                           | 27,415,697            |
| Current deferred tax assets (note 9)   | 2,891,740                            | 1,381,868             |
| <b>Total current assets</b>  | <b>\$ 299,047,384</b>                | <b>\$ 242,296,776</b> |
| Long-term Assets:  |                                      |                       |
| Property, plant and equipment, net (note 7)  | \$ 66,977,567                        | \$ 60,489,798         |
| Intangible assets, net (note 8)  | 586,474                              | 561,389               |
| Other receivables, net, including \$369,351 and \$65,416 from related parties at September 30, 2010 and December 31, 2009 (note 5)                       | 3,278,171                            | 1,064,224             |
| Advance payments for property, plant and equipment, including \$7,444,795 and \$2,579,319 to related parties at September 30, 2010 and December 31, 2009 | 17,636,239                           | 6,369,043             |
| Long-term investments  | 80,584                               | 79,084                |
| Non-current deferred tax assets (note 9)   | 1,278,198                            | 2,172,643             |
| <b>Total assets</b>  | <b>\$ 388,884,617</b>                | <b>\$ 313,032,957</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                       |
| Current liabilities:   |                                      |                       |
| Bank loans (note 10)   | \$ 8,953,754                         | \$ 5,125,802          |
| Accounts and notes payable, including \$2,126,954 and \$1,537,827 to related parties at September 30, 2010 and December 31, 2009 (note 11)               | 143,298,745                          | 107,495,833           |
| Convertible notes payable (note 12)  | 28,961,253                           | 28,640,755            |
| Compound derivative liabilities (note 13)  | 127,012                              | 880,009               |
| Customer deposits  | 1,908,479                            | 1,918,835             |
| Accrued payroll and related costs  | 3,165,578                            | 3,040,705             |
| Accrued expenses and other payables (note 14)  | 14,647,357                           | 17,708,681            |
| Accrued pension costs (note 15)  | 3,987,756                            | 3,778,187             |
| Taxes payable (note 16)  | 10,686,208                           | 11,365,016            |
| Amounts due to shareholders/directors (note 17)  | 103,215                              | -                     |
| <b>Total current liabilities</b>   | <b>\$ 215,839,357</b>                | <b>\$ 179,953,823</b> |
| Long-term liabilities:   |                                      |                       |
| Other long-term liabilities (note 18)  | 4,377,538                            | 233,941               |
| <b>Total liabilities</b>   | <b>\$ 220,216,895</b>                | <b>\$ 180,187,764</b> |
| Significant concentrations (note 26)   |                                      |                       |
| Related party transactions (note 27 )  |                                      |                       |
| Commitments and contingencies (note 28 )   |                                      |                       |
| Stockholders' equity:  |                                      |                       |

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|   |    |             |    |             |
|---|----|-------------|----|-------------|
| Preferred stock, \$0.0001 par value - Authorized - 20,000,000 shares Issued and Outstanding – None  | \$ | -           | \$ | -           |
| Common stock, \$0.0001 par value - Authorized - 80,000,000 shares Issued and Outstanding 27,115,826 and 27,046,244 shares at September 30, 2010 and December 31, 2009 (note 19) |    | 2,711       |    | 2,704       |
| Additional paid-in capital (note 19)  |    | 28,216,671  |    | 27,515,064  |
| Retained earnings-  |    |             |    |             |
| Appropriated  |    | 8,767,797   |    | 8,324,533   |
| Unappropriated  |    | 85,269,215  |    | 58,642,023  |
| Accumulated other comprehensive income  |    | 13,746,601  |    | 11,187,744  |
| Total parent company stockholders' equity   |    | 136,002,995 |    | 105,672,068 |
| Non-controlling interests (note 20)   |    | 32,664,727  |    | 27,173,125  |
| Total stockholders' equity  | \$ | 168,667,722 | \$ | 132,845,193 |
| Total liabilities and stockholders' equity  | \$ | 388,884,617 | \$ | 313,032,957 |

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



China Automotive Systems, Inc. and Subsidiaries  
Consolidated Statements of Stockholders' Equity  
Period Ended September 30, 2010 (unaudited) and December 31, 2009

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained Earnings |                | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total parent<br>company<br>stockholders'<br>Equity | 'Non-controlling<br>Interests | Total<br>shareholders'<br>Equity |
|---|-----------------|----------------------------------|-------------------|----------------|---|--|-------------------------------|----------------------------------|
|   |                 |                                  | Appropriated      | Unappropriated |   |  |                               |                                  |
| Balance at January 1, 2009                      | \$ 2,698        | \$ 26,648,154                    | \$ 7,525,777      | \$ 36,026,516  | \$ 11,127,505   | \$ 81,330,650                                      | \$ 23,222,566                 | \$ 104,553,216                   |
| Foreign currency translation gain               | \$ -            | -                                | -                 | -              | 60,239  | 60,239   | 22,365                        | 82,604                           |
| Shares issued for stock options exercised       | \$ 6            | 420,234                          | -                 | -              | -   | 420,240  | -                             | 420,240                          |
| Share-based compensation                        | \$ -            | 446,676                          | -                 | -              | -   | 446,676  | -                             | 446,676                          |
| Appropriation of retained earnings              | \$ -            | -                                | 798,756           | (798,756)      | -   | -  | (3,944,619)                   | (3,944,619)                      |
| Net income for the year ended December 31, 2009 | \$ -            | -                                | -                 | 23,414,263     | -   | 23,414,263   | 7,872,813                     | 31,287,076                       |
| Balance at December 31, 2009                    | \$ 2,704        | \$ 27,515,064                    | \$ 8,324,533      | \$ 58,642,023  | \$ 11,187,744   | \$ 105,672,068                                     | \$ 27,173,125                 | \$ 132,845,193                   |
| Foreign currency translation gain               | -               | -                                | -                 | -              | 2,558,857   | 2,558,857  | 552,526                       | 3,111,383                        |
| Shares issued for stock options exercised       | 7               | 278,893                          | -                 | -              | -   | 278,900  | -                             | 278,900                          |
| Share-based compensation                        | -               | 422,714                          | -                 | -              | -   | 422,714  | -                             | 422,714                          |
| Appropriation of retained earnings              | -               | -                                | 443,264           | (443,264)      | -   | -  | (3,288,909)                   | (3,288,909)                      |
| Net income for the period ended                 | -               | -                                | -                 | 27,070,456     | -   | 27,070,456   | 8,227,985                     | 35,298,441                       |

September 30,  
2010

Balance at  
September 30,

|      |          |               |              |               |               |                |               |                |
|------|----------|---------------|--------------|---------------|---------------|----------------|---------------|----------------|
| 2010 | \$ 2,711 | \$ 28,216,671 | \$ 8,767,797 | \$ 85,269,215 | \$ 13,746,601 | \$ 136,002,995 | \$ 32,664,727 | \$ 168,667,722 |
|------|----------|---------------|--------------|---------------|---------------|----------------|---------------|----------------|

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

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China Automotive Systems, Inc.  
Condensed Consolidated Statements of Cash Flows (Unaudited)

|  | Nine Months Ended September 30, |                |
|--|---------------------------------|----------------|
|  | 2010                            | 2009           |
| <b>Cash flows from operating activities:</b>   |                                 |                |
| Net income   | \$ 35,298,441                   | \$ 22,965,782  |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities: |                                 |                |
| Stock-based compensation   | 422,714                         | 321,663        |
| Depreciation and amortization  | 6,955,969                       | 5,940,068      |
| Allowance for doubtful accounts (Recovered)  | (1,127,767)                     | (1,484,680)    |
| Deferred income taxes assets   | (540,385)                       | (531,244)      |
| Amortization for discount of convertible note payable  | 320,498                         | 612,635        |
| (Gain) loss on change in fair value of derivative  | (752,997)                       | (591,511)      |
| Other operating adjustments  | 324,963                         | (226,916)      |
| <b>Changes in operating assets and liabilities:</b>  |                                 |                |
| (Increase) decrease in:  |                                 |                |
| Pledged deposits   | (8,012,615)                     | (2,505,479)    |
| Accounts and notes receivable  | (22,430,886)                    | (33,727,451)   |
| Advance payments and other   | (678,156)                       | (593,563)      |
| Inventories  | (12,728,686)                    | (2,794,500)    |
| Accounts and notes payable   | 33,298,924                      | 30,025,373     |
| Customer deposits  | (34,138)                        | 316,133        |
| Accrued payroll and related costs  | 67,681                          | 346,723        |
| Accrued expenses and other payables  | (174,491)                       | 2,685,922      |
| Accrued pension costs  | 137,283                         | 53,613         |
| Taxes payable  | (891,031)                       | 3,528,700      |
| Advances payable   | 149,229                         | (317)          |
| Net cash provided by operating activities  | \$ 29,604,550                   | \$ 24,340,951  |
| <b>Cash flows from investing activities:</b>   |                                 |                |
| (Increase) decrease in other receivables   | (2,221,935)                     | 125,815        |
| Cash received from equipment sales   | 396,489                         | 678,132        |
| Cash paid to acquire property, plant and equipment   | (24,005,602)                    | (8,814,876)    |
| Cash paid to acquire intangible assets   | (60,586)                        | (321,671)      |
| Net cash (used in) investing activities  | \$ (25,891,634)                 | \$ (8,332,600) |
| <b>Cash flows from financing activities:</b>   |                                 |                |
| Proceeds from bank loans   | 3,685,215                       | 2,197,177      |
| Dividends paid to the non-controlling interest holders of Joint-venture companies                            | (2,871,603)                     | (4,176,583)    |
| Repayment of convertible note payable  | -                               | (5,000,000)    |
| Shares issued for stock options exercised  | 278,900                         | 8,790          |
| Increase (decrease) in amounts due to shareholders/directors   | 97,406                          | (287,854)      |
| Net cash provided by (used in) financing activities  | \$ 1,189,918                    | \$ (7,258,470) |
| Cash and cash equivalents affected by foreign currency   | \$ 818,849                      | \$ 31,219      |
| Net increase in cash and cash equivalents  | 5,721,683                       | 8,781,100      |
| Cash and cash equivalents at beginning of period   | 43,480,176                      | 37,113,375     |
| Cash and cash equivalents at end of period   | \$ 49,201,859                   | \$ 45,894,475  |

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



China Automotive Systems, Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows (Unaudited) (continued)

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

|                            | Nine Months Ended September 30, |              |
|----------------------------|---------------------------------|--------------|
|                            | 2010                            | 2009         |
| Cash paid for interest     | \$ 1,146,971                    | \$ 1,217,604 |
| Cash paid for income taxes | \$ 5,362,363                    | \$ 3,113,660 |

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

China Automotive Systems, Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
Three Months and Nine Months Ended September 30, 2010 and 2009

## 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 subsidiaries’ interests in the Sino-foreign 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 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.

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 accordingly.

The Company owns the following aggregate net interests in nine Sino-foreign joint ventures organized in the PRC as of September 30, 2010 and 2009.

| Name of Entity   | Percentage Interest   |                       |
|--|-----------------------|-----------------------|
|  | September 30,<br>2010 | September 30,<br>2009 |
| Shashi Jiulong Power Steering Gears Co., Ltd., “Jiulong”                   | 81.00%                | 81.00%                |
| Jingzhou Henglong Automotive Parts Co., Ltd., “Henglong”                   | 80.00%                | 80.00%                |
| Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., “Shenyang”  | 70.00%                | 70.00%                |
| Zhejiang Henglong & Vie Pump-Manu Co., Ltd., “Zhejiang”                    | 51.00%                | 51.00%                |
| Universal Sensor Application Inc., “USAI”                                  | 83.34%                | 83.34%                |
| Wuhan Jielong Electric Power Steering Co., Ltd., “Jielong”                 | 85.00%                | 85.00%                |
| Wuhu HengLong Automotive Steering System Co., Ltd., “Wuhu”                 | 77.33%                | 77.33%                |
| Jingzhou Hengsheng Automotive System Co., Ltd, “Hengsheng”                 | 100.00%               | 100.00%               |
| Jingzhou Henglong Automotive Technology (Testing) Center, “Testing Center” | 80.00%                | -%                    |

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

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

In December 2009, Henglong, a subsidiary of Genesis, formed Jingzhou Henglong Automotive Technology (Testing) Center, “Testing Center”, which is mainly engaged in research and development of new products. The registered capital of Testing Center is RMB 30,000,000 (\$4,393,544 equivalent).

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

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

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

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

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

Hengsheng was established in 2007 and mainly engages in production and sales of automobile steering systems.

On February 11, 2010, the registered capital of Hengsheng was increased to \$16,000,000 from \$10,000,000.

On January 24, 2010, Genesis entered into a joint venture contract with Beijing Hainachuan Auto Parts Co., Ltd., to establish a joint venture company, Beijing Henglong Automotive System Co., Ltd., "Beijing Henglong", to design, develop and manufacture both hydraulic and electric power steering systems and parts. On October 19, 2010, both parties agreed to change the Joint venture company's investor into Hengsheng from Genesis, and left the other terms of the joint venture contract unchanged. Under PRC laws, the establishment of Beijing Henglong and the effectiveness of the equity joint venture contract are subject to approval by Administration For Industry and Commerce in Beijing.

## 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, 2010 and 2009, the accompanying unaudited consolidated financial statements include the accounts of the Company and its subsidiaries. The subsidiaries include nine Sino-foreign Joint-ventures mentioned in Note 1. Significant inter-company balances and transactions have been eliminated upon consolidation. The unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America.

Comments - 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, the results of operations and cash flows for the three months and nine months ended September 30, 2010 and 2009 respectively.

The consolidated balance sheet as of December 31, 2009 is derived from the Company's audited 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 therein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's 2009 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

The results of operations for the nine months ended September 30, 2010 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2010.

### (b) Significant Accounting Policies

Estimation -The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Foreign Currencies - The Company maintains its books and records in Renminbi, "RMB", the currency of the PRC, its functional currency. In accordance with guidance now incorporated in ASC Topic 830 (formerly FAS 52), foreign currency transactions in RMB are reflected using the temporal method. Under this method, all monetary items are translated into the functional currency at the rate of exchange prevailing at the balance sheet date. Non-monetary items



are translated at historical rates. Income and expenses are translated at the rate in effect on the transaction dates. Transaction gains and losses, if any, are included in the determination of net income for the period.

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

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

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 456,350 stock options under this plan, and there remain 1,743,650 stock options issuable in the future. As of September 30, 2010, the Company had 296,768 stock options outstanding.

The Company has adopted ASC Topic 718 (formerly SFAS 123R), "Accounting for Stock-Based Compensation", which establishes a fair value method of accounting for stock-based compensation plans. In accordance with guidance now incorporated in ASC Topic 718, the cost of stock options and warrants issued to employees and non-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 (formerly SFAS No. 130), "Reporting Comprehensive Income". ASC Topic 220 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 - Derivative financial instruments, as defined in ASC Topic 815 (formerly FAS 133), Accounting for Derivative Financial Instruments and Hedging Activities (ASC Topic 815), consist of financial instruments or other contracts that contain a notional amount and one or more underlying, e.g. interest rate, security price or other variable, require no initial net investment and permit net settlement. Derivative financial instruments may be free-standing or embedded in other financial instruments. Further, derivative financial instruments are initially, and subsequently, measured at fair value and recorded as liabilities or, in rare instances, assets.

The Company generally does not use derivative financial instruments to hedge exposures to cash-flow, market or foreign-currency risks. However, the Company has entered into certain other financial instruments and contracts, such as debt financing arrangements that embody features that are either (i) not afforded equity classification, (ii) embody risks not clearly and closely related to host contracts, or (iii) may be net-cash settled by the counterparty. As required by ASC Topic 815 (formerly FAS 133), these instruments are required to be carried as derivative liabilities, at fair value, in the Company's financial statements.

Registration Payment Arrangements - The Company has entered into registration payment arrangements with certain investors that provide for the payment of damages for failures to register common shares underlying the investor's financial instruments. ASC Topic 825 (formerly FASB Staff Position 00-19-2), Accounting for Registration Payment Arrangements, provides for the exclusion of registration payments, such as the liquidated damages, from the consideration of classification of financial instruments. Rather, such registration payments would be accounted for pursuant to ASC Topic 450 (formerly FASB No. 5), "Accounting for Contingencies", which is the Company's current accounting practice. That is, all registration payments will require recognition when they are both probable and reasonably estimable. The Company does not currently believe that damages are probable.

Fair Value Measurements - The Company has adopted the provisions of ASC Topic 820 (formerly SFAS 157), "Fair Value Measurements", except as it applies to those nonfinancial assets and nonfinancial liabilities. ASC Topic 820 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. In February 2008, FASB Staff delayed the effective date of ASC Topic 820 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

Non-controlling Interests in Consolidated Financial Statements - In December 2007, the FASB issued guidance now incorporated in ASC Topic 810 "Consolidation" (formerly Statement of Financial Accounting Standards ("SFAS") 160). The guidance clarifies the accounting for non-controlling interests and establishes accounting and reporting standards for the non-controlling interest in a subsidiary, including classification as a component of stockholders' equity. This guidance was effective for the Company's fiscal year beginning January 1, 2009. The Company has adopted this guidance in its consolidated financial statements for the period ended September 30, 2010.

Accounting for Convertible Debt Instruments - The Company has adopted the provisions of ASC Topic 470, originally issued as FSP APB 14-1, "Accounting for Convertible Debt Instruments That May be Settled in Cash upon Conversion (Including Partial Cash Settlement)". ASC Topic 470 specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity's non-convertible debt borrowing rate when interest cost is recognized in subsequent periods. ASC Topic 470, formerly FSP APB 14-1, is effective beginning from January 1, 2009 for the Company, and this standard must be applied on a retrospective basis. Since the Company's Convertible Notes agreements do not have a term for cash, or other assets, settlement upon conversion (Including Partial Cash Settlement), the adoption of ASC 480 did not have an impact on the Company's consolidated financial position and results of operations.

(c) Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) approved the "FASB Accounting Standards Codification" ("Codification", "FASB ASC") as the single source of authoritative generally accepted accounting principles (GAAP) and created a new Topic 105, Generally Accepted Accounting Principles, in the General Principles and Objective Section of the Codification. Topic 105 is effective for interim and annual periods ending after September 15, 2009, and its adoption did not have an impact on our financial condition or results of operations.

In October 2009, the FASB issued ASU No. 2009-13, Revenue Recognition (ASC Topic 605) - Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force. This guidance modifies the fair value requirements of ASC subtopic 605-25, Revenue Recognition-Multiple Element Arrangements by allowing the use of the "best estimate of selling price" in addition to vendor-specific objective evidence (VSOE) and verifiable objective evidence (VOE) (now referred to as TPE standing for third-party evidence) for determining the selling price of a deliverable. A vendor is now required to use its best estimate of the selling price when VSOE or TPE of the selling price cannot be determined. This update is effective for fiscal years beginning on or after June 15, 2010. However, early adoption is allowed. The Company has adopted this guidance. The adoption of this guidance did not have a material impact on the Company's consolidated results of operations and financial position.

In January 2010, FASB issued ASU No. 2010-06, Fair Value Measurements and Disclosures (ASC Topic 820) — Improving Disclosures About Fair Value Measurements. The ASU requires new disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. It also clarifies existing fair value disclosures about the level of disaggregation and about inputs and valuation techniques used to measure fair value. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Other than requiring additional disclosures, the adoption of this new guidance will not have a material impact on the Company's consolidated results of operations and financial position.

In February 2010, FASB issued ASU 2010-09 Subsequent Event (Topic 855) Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 removes the requirement for a SEC filer to disclose a date through which subsequent events have been evaluated in both issued and revised financial statements. Revised financial statements include financial statements revised as a result of either correction of an error or retrospective application of GAAP. All of the amendments in ASU 2010-09 are effective upon issuance of the final ASU, except for the use of the issued date for conduit debt obligors. That amendment is effective for interim or annual periods ending after June 15, 2010. The Company adopted ASU 2010-09 in February 2010 and did not disclose the date through which subsequent events have been evaluated.

In April 2010, the FASB issued Accounting Standards Update (ASU) No.2010-17, Revenue Recognition — Milestone Method (ASU 2010-17). ASU 2010-17 provides guidance in applying the milestone method of revenue recognition to research or development arrangement. Under this guidance a company may recognize revenue contingent upon the achievement of a milestone in its entirety, in the period in which the milestone is achieved, only if the milestone meets all the criteria within the guidance to be considered substantive. This ASU is effective on a prospective basis for research and development milestones achieved in fiscal years, beginning on or after June 15, 2010, which for the Company is no later than January 1, 2011. Early adoption is permitted; however, adoption of this guidance as of a date other than January 1, 2011 will require the Company to apply this guidance retrospectively effective as of January 1, 2010 and will require disclosure of the effect of this guidance as applied to all previously reported interim periods in the fiscal year of adoption. The effect of this guidance will be limited to future transactions. The Company does not expect adoption of this standard to have a material impact on its financial position or results of operations as it has no material research and development arrangements which will be accounted for under the milestone method.

In July 2010, the FASB issued Accounting Standards Update No. 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses (“ASU 2010-20”). ASU 2010-20 amends existing disclosure guidance to require an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. ASU 2010-20 is effective for fiscal and interim periods ending after December 15, 2010. The Company will review the requirements under the standard to determine what impacts, if any, the adoption of the standard would have on our consolidated financial statement.

## 3. Pledged cash deposits

Pledged as guarantee for its notes payable, the Company 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

The Company's accounts receivable at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                       | September 30, 2010 | December 31, 2009 |
|---------------------------------------|--------------------|-------------------|
| Accounts receivable                   | \$ 106,900,633     | \$ 104,120,926    |
| Notes receivable                      | 79,060,458         | 56,062,744        |
|                                       | 185,961,091        | 160,183,670       |
| Less: allowance for doubtful accounts | (4,115,589)        | (5,320,378)       |
| Balance at the end of the period      | \$ 181,845,502     | \$ 154,863,292    |

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

The activity in the Company's allowance for doubtful accounts during the nine months ended September 30, 2010 (unaudited) and the year ended December 31, 2009 are summarized as follows:

|  | September 30, 2010 | December 31, 2009 |
|--|--------------------|-------------------|
| Balance at beginning of period                 | \$ 5,320,378       | \$ 4,910,478      |
| Amounts provided (recovered) during the period | (1,182,987)        | 406,228           |
| Foreign currency translation gain (loss)       | (21,802)           | 3,672             |
| Balance at the end of the period               | \$ 4,115,589       | \$ 5,320,378      |

## 5. Other receivables

The Company's other receivables at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                       | September 30, 2010 | December 31, 2009 |
|---------------------------------------|--------------------|-------------------|
| Other receivables                     | \$ 3,980,336       | \$ 1,804,334      |
| Less: allowance for doubtful accounts | (702,165)          | (740,110)         |
| Balance at the end of the period      | \$ 3,278,171       | \$ 1,064,224      |

Other receivables consist of amounts advanced to both related and unrelated parties, primarily as unsecured demand loans, with no stated interest rate or due date.

The activity in the Company's allowance for doubtful accounts of other receivable during the nine months ended September 30, 2010 (unaudited) and the year ended December 31, 2009 are summarized as follows:

|                                    | September 30, 2010 | December 31, 2009 |
|------------------------------------|--------------------|-------------------|
| Balance at beginning of the period | \$ 740,110         | \$ 659,837        |
| Amounts provided during the period | 38,930             | 79,618            |

|  |    |          |    |         |
|--|----|----------|----|---------|
| Foreign currency translation gain (loss) |    | (76,875) |    | 655     |
| Balance at the end of the period         | \$ | 702,165  | \$ | 740,110 |

## 6. Inventories

The Company's inventories at September 30, 2010 (Unaudited) and December 31, 2009 consisted of the following:

|                                  | September 30, 2010 | December 31, 2009 |
|----------------------------------|--------------------|-------------------|
| Raw materials                    | \$ 15,644,318      | \$ 10,683,448     |
| Work in process                  | 8,069,044          | 6,824,137         |
| Finished goods                   | 19,492,647         | 12,017,195        |
|                                  | 43,206,009         | 29,524,780        |
| Less: provision for loss         | (2,338,935)        | (2,109,083)       |
| Balance at the end of the period | \$ 40,867,074      | \$ 27,415,697     |

## 7. Property, plant and equipment

The Company's property, plant and equipment at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                  | September 30, 2010 | December 31, 2009 |
|----------------------------------|--------------------|-------------------|
| Land use rights and buildings    | \$ 35,897,061      | \$ 33,100,702     |
| Machinery and equipment          | 72,494,384         | 62,982,885        |
| Electronic equipment             | 5,427,275          | 5,054,502         |
| Motor vehicles                   | 2,893,263          | 2,634,696         |
| Construction in progress         | 2,756,020          | 1,939,256         |
|                                  | 119,468,003        | 105,712,041       |
| Less: Accumulated depreciation   | (52,490,436)       | (45,222,243)      |
| Balance at the end of the period | \$ 66,977,567      | \$ 60,489,798     |

Depreciation charge for the nine months ended September 30, 2010 and the year ended December 31, 2009 are \$6,910,835 and \$8,429,863, respectively.



## 8. Intangible assets

The activities in the Company's intangible asset account at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                  | September 30, 2010 | December 31, 2009  |
|----------------------------------|--------------------|--------------------|
| <b>Costs:</b>                    |                    |                    |
| Patent technology                | \$ 1,410,288       | \$ 1,384,037       |
| Management software license      | 310,604            | 438,359            |
|                                  | 1,720,892          | 1,822,396          |
| <b>Less: Amortization</b>        | <b>(1,134,418)</b> | <b>(1,261,007)</b> |
| Balance at the end of the period | \$ 586,474         | \$ 561,389         |

## 9. Deferred Income Tax Assets

In accordance with the provisions of ASC Topic 740 "Income Taxes" (formerly SFAS 109), 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; 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 - ten years or more 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.

The components of estimated deferred income tax assets at September 30, 2010 (unaudited) and December 31, 2009 were as follows:

|                                       | September 30, 2010  | December 31, 2009   |
|---------------------------------------|---------------------|---------------------|
| Losses carry-forward (U.S.)           | \$ 4,267,310        | \$ 3,855,426        |
| Losses carry-forward (PRC)            | 349,587             | 421,629             |
| Product warranties and other reserves | 2,729,429           | 2,313,728           |
| Property, plant and equipment         | 3,002,335           | 2,818,497           |
| Bonus accrual                         | 174,224             | 306,030             |
| Other                                 | 586,577             | 395,649             |
|                                       | 11,109,462          | 10,110,959          |
| Valuation allowance *                 | (6,939,524)         | (6,556,448)         |
| <b>Total deferred tax assets**</b>    | <b>\$ 4,169,938</b> | <b>\$ 3,554,511</b> |

\*As of September 30, 2010, valuation allowance was \$6,939,524, including \$4,267,310 allowance for the Company's deferred tax assets in the U.S. and \$2,672,214 allowance for the Company's non-U.S. deferred tax assets. Based on the Company's current operations in the U.S., the management believes that the deferred tax assets in the U.S. 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 \$1,278,198 and \$2,172,643 of deferred income tax asset as of September 30, 2010 and December 31, 2009, respectively, are included in non-current deferred tax assets in the accompanying consolidated balance sheets. The remaining \$2,891,740 and \$1,381,868 of deferred income tax asset as of September 30, 2010 and

December 31, 2009, respectively, are included in the current deferred tax assets.

10. Bank loans

At September 30, 2010, the Company, through its Sino-foreign joint ventures, had outstanding fixed-rate short-term bank loans of \$8,953,754, with weighted average interest rate at 5.31% per annum. These loans are secured with some of the property and equipment of the Company, and are repayable within one year.

At December 31, 2009, the Company, through its Sino-foreign joint ventures, had outstanding fixed-rate short-term bank loans of \$5,125,802, with weighted average interest rate at 5.68% per annum. These loans are secured with some of the property and equipment of the Company and are repayable within one year.

#### 11. Accounts and notes payable

The Company's accounts and notes payable at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                  | September 30, 2010 | December 31, 2009 |
|----------------------------------|--------------------|-------------------|
| Accounts payable                 | \$ 86,139,428      | \$ 69,454,231     |
| Notes payable                    | 57,159,317         | 38,041,602        |
| Balance at the end of the period | \$ 143,298,745     | \$ 107,495,833    |

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

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

#### 12. Convertible notes payable

The Company's Convertible Notes payable at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|   | September 30, 2010 | December 31, 2009 |
|---|--------------------|-------------------|
| Convertible Notes payable, face value       | \$ 30,000,000      | \$ 30,000,000     |
| Less: discount of Convertible Notes payable | (1,038,747)        | (1,359,245)       |
| Balance at the end of the period            | \$ 28,961,253      | \$ 28,640,755     |

The Company's discount of Convertible Notes payable at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                      | September 30, 2010 | December 31, 2009 |
|--------------------------------------|--------------------|-------------------|
| Balance at beginning of year         | \$ 1,359,245       | \$ 2,077,923      |
| Less: amortization during the period | (320,498)          | (718,678)         |
| Balance at the end of the period     | \$ 1,038,747       | \$ 1,359,245      |

In February 2008, the Company sold to two accredited institutional investors \$35 million of convertible notes, the "Convertible Notes", with a scheduled maturity date of February 15, 2013. The Convertible Notes, including any accrued but unpaid interest, are convertible into common shares of the Company at a conversion price of \$8.8527 per share, subject to adjustment upon the occurrence of certain events.

The Convertible Notes bear annual interest rates of 3%, 3.5%, 4%, 4.5% and 5% for each year of 2008, 2009, 2010, 2011 and 2012. The interest on the Convertible Notes shall 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 being July 15, 2008. From and after the occurrence and during the continuance of an Event of Default defined in the relevant Convertible Note agreements, the interest rate then in effect shall be increased by two percent (2%) until the event of default is remedied.

The holders of the Convertible Notes will be entitled to convert any portion of the conversion amount into shares of common stock at the conversion price at any time or times on or after the thirtieth (30th) day after the issuance date and prior to the thirtieth (30th) Business Day prior to the expiry date of the Convertible Notes. A damage penalty will be paid if share certificates are not delivered timely after any conversion.

The Company will have the right to require the Convertible Note holders to convert all or any portion of the conversion amount then remaining under the Convertible Note obligation into shares of common stock, “Mandatory Conversion”, if at any time during a six-month period, the beginning day of each such six-month period, a “Mandatory Conversion Period Start Date”, the arithmetic average of the weighted average price of the common stock for a period of at least thirty (30) consecutive trading days following the Mandatory Conversion Period Start Date equals or exceeds the percentage of \$8.8527 set forth in the chart below as applicable to the indicated six month period:

|               |      |
|---------------|------|
| 0-6 months:   | 125% |
| 6-12 months:  | 125% |
| 12-18 months: | 135% |
| 18-24 months: | 135% |
| 24-30 months: | 145% |
| 30-36 months: | 145% |
| 36-42 months: | 155% |
| 42-48 months: | 155% |

On each six month anniversary of the issuance date beginning August 15, 2008, the conversion price will be adjusted downward to the Reset Reference Price, as defined below, if the weighted average price for the twenty (20) consecutive trading days immediately prior to the applicable six month anniversary, the “Reset Reference Price”, is less than 95% of the conversion price in effect as of such applicable six month anniversary date. The foregoing notwithstanding, the conversion price will not be reduced via such reset provision to less than \$7.0822. The conversion price is also subject to weighted-average antidilution adjustments, but in no event will the conversion price be reduced to less than \$6.7417. If and whenever on or after the issuance date, the Company issues or sells its shares of Common Stock or other convertible securities, except for certain defined exempt issuances, for a consideration per share less than a price equal to the conversion price in effect on the issuance date immediately prior to such issue or sale, the original conversion price then in effect shall be adjusted by a weighted-average antidilution formula, but in no event to a new conversion price less than \$6.7417.

The Company will not effect any conversion of the Convertible Notes, and each holder of the Convertible Notes will not have the right to convert any portion of the Convertible Notes to the extent that after giving effect to such conversion, such holders would beneficially own in excess of 4.99% of the number of shares of Common Stock outstanding immediately after giving effect to such conversion.

The Company will not effect a Mandatory Conversion of more than twelve percent (12%) of the original principal amount of the Convertible Notes, with the applicable accrued but unpaid interest, in any six month period or twenty-four percent (24%) of the original principal amount of the Convertible Notes, with the applicable accrued but unpaid interest, in any twelve (12) month period.

Upon the occurrence of an event of default with respect to the Convertible Notes, the Convertible Note holders may require the Company to redeem all or any portion of the Convertible Notes. Each portion of the Convertible Notes subject to redemption by the Company will be redeemed by the Company at a price equal to the sum of (i) the conversion amount to be redeemed and (ii) the Other Make Whole Amount. The “Other Make Whole Amount” will mean a premium to the conversion amount such that the total amount received by the Convertible Note holder upon redemption represents a gross yield to the Convertible Note holders on the original principal amount as of the redemption date equal to thirteen percent (13%), with interest computed on the basis of actual number of days elapsed over a 360-day year. The events of default include the Company’s failure to cure a conversion failure by delivery of the required number of shares of Common Stock, the Company’s failure to pay to the Convertible Note holder any amount of principal, interest, late charges or other amounts when and as due under the Convertible Notes and other events as defined in the Convertible Note agreements.

Upon the consummation of a change of control as defined in the Convertible Note agreements, the Convertible Note holder may require the Company to redeem all or any portion of the Convertible Notes. The portion of the Convertible Notes subject to redemption shall be redeemed by the Company in cash at a price equal to the sum of the conversion amount of being redeemed and the Other Make Whole Amount as defined above.

On each of February 15, 2010 and February 15, 2011, the Convertible Note holders will have 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 this Convertible Note subject to redemption pursuant to this annual redemption right will be 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” will mean a premium to the conversion amount such that the total amount received by the Convertible Note 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 actual number of days elapsed over a 360-day year.

In the event that the Company has not completed the necessary filings to list the conversion shares on its principal market by the date that is ninety (90) days after the issuance date or has not so listed the conversion shares by the date that is ninety (90) days after the issuance date or the shares of the Company's common stock are terminated from registration under the Securities Act of 1933, the Convertible Note holders will have the right, in its sole discretion, to require that the Company redeem all or any portion of the Convertible Notes. The portion of the Convertible Notes subject to redemption in connection with this listing default will be redeemed by the Company in cash at a price equal to the sum of the conversion amount being redeemed and the Other Make Whole Amount as mentioned above.

At any time following February 15, 2009, if the Weighted Average Price (WAP) for twenty (20) consecutive trading days is less than 45% of the Conversion Price in effect on the Issuance Date, as adjusted, namely \$3.187, the Convertible Note holder shall have the right, in its sole discretion, to require that the Company redeem all or any portion of the Convertible Notes. The portion of this Convertible Note subject to redemption in connection with the share price change of the underlying common stock will be redeemed by the Company in cash at a price equal to the sum of the conversion amount being redeemed and the Other Make Whole Amount as mentioned above.

Since the Company's stock Weighted Average Price for twenty (20) consecutive trading days ended on March 16, 2009 was below \$3.187, which is less than 45% of the Conversion Price in effect of the Issuance Date, as adjusted, the "WAP Default", each Convertible Note holder had the right, at its sole discretion, to require that the Company redeem all or any portion of the Convertible Notes by delivering written redemption notice to the Company within five (5) business days after the receipt of the Company's notice of the WAP Default.

On March 17, 2009, the Company delivered two WAP Default notices to the Convertible Note holders. On March 27, 2009, the Company received a letter from YA Global, one of the Convertible Note holders, electing to require the Company to redeem all the three Convertible Notes it held in the total principal amount of \$5,000,000, together with interest, late charges, if any, and the Other Make Whole Amount as defined in Section 5(d) of the Convertible Notes. After negotiation, the Company and YA Global reached a settlement agreement on April 8, 2009 and under the terms of the settlement agreement, the Company paid on April 15, 2009 a redemption amount of \$5,041,667 to YA Global and YA Global waived its entitlement to the Other Make Whole Amount.

Following the WAP Default notices, the Company received a letter from the provisional liquidator acting on behalf of Lehman Brothers Commercial Corporation Asia Limited, the "LBCCA Liquidator", the other Convertible Note holder, requesting an extension until April 24, 2009 to consider its rights under the Convertible Notes. The Company granted an extension to April 15, 2009. The LBCCA Liquidator further requested another extension to April 24, 2009. On April 24, 2009, LBCCA's lawyers sent three Holder Redemption Notices via fax electing to redeem the entire outstanding principal of \$30,000,000, together with interest, late charges, if any, and the Other Make Whole Amount, to be paid on July 23, 2009. The Company discussed settlement with the LBCCA Liquidator, and on or about July 22, 2009, the Company and the LBCCA Liquidator agreed to extend the applicable holder mandatory redemption date for two months to September 23, 2009 to give more time to pursue settlement discussion. The Company received a letter dated September 22, 2009 from the LBCCA Liquidator stating that upon the Company's acceptance of the revocation, all holder redemption notices dated April 24, 2009 shall be immediately revoked as if they were never issued, and the letter and the revocation did not purport to amend, restate or supplement any other terms and conditions under the three Notes and the Securities Purchase Agreement dated 1 February 2008 between the Company and LBCCA Liquidator. The Company accepted such revocation on September 23, 2009.

In connection with the Convertible Notes, the Company issued 1,317,864 detachable warrants, the "Warrants," to purchase from the Company shares of common stock of the Company at the exercise price of \$8.8527 per share. The Warrants are exercisable immediately and expired on February 15, 2009. The Warrants require net cash settlement in the event that there is a fundamental transaction, contractually defined as a merger, sale of substantially all assets, tender offer or share exchange. Due to this contingent redemption provision, in accordance with guidance now

incorporated in ASC Topic 480 (formerly SFAS 150), the warrants require liability classification and must be recorded at fair value each reporting period. As of the issuance date, i.e., February 15, 2008, the fair value of warrants was \$798,626, which was determined using the Black-Scholes option pricing model.

The Company has evaluated the convertible notes for terms and conditions that are not clearly and closely associated with the risks of the debt-type host instrument. Generally, such features require separation from the host contract and treatment as derivative financial instruments. Certain features, such as the conversion option, were found to be exempt. Other features, such as puts and redemption features, were found to require bifurcation and recognition as derivative liabilities. These derivative liabilities are recognized initially at fair value, using forward cash-flow valuation techniques. As of February 15, 2008, the compound derivative value amounted to \$1,703,962. This derivative will be adjusted to its estimated fair value at the completion of each reporting period until the debt arrangement is ultimately settled, converted or paid.



When a financial instrument contains embedded derivatives that require bifurcation, such as the redemption put, and freestanding instruments that are recorded at fair value each period, such as the warrants, the accounting is to record the embedded derivative and the freestanding instruments at fair value on inception and the residual proceeds are allocated to the debt instrument. Based on this premise, upon inception of the debt instruments, the Company recorded the redemption put at fair value \$1,703,962 and the Company recorded the warrants at fair value \$798,626. The remaining proceeds were then allocated to the debt instrument.

On the date of inception, allocation of basis in the financing arrangement to the warrants and derivative liability has resulted in an original issue discount to the face value of the convertible notes in the amount of \$2,502,588, which amount is subject to amortization over the Convertible Note's term using the effective method. As of September 30, 2010, the accumulated amortization expense balance recorded by the Company was \$1,463,841, remaining \$1,038,747 will be amortized over the remaining life of the instrument.

### 13. Compound derivative liabilities

The Company has evaluated the convertible notes for terms and conditions that are not clearly and closely associated with the risks of the debt-type host instrument (see Note 12). Generally, such features require separation from the host contract and treatment as derivative financial instruments. Certain features, such as the conversion option, were found to be exempt, as they satisfied the conditions for equity classification in ASC Topic 815, formerly paragraph 11(a) of SFAS 133, for instruments (1) indexed with the Company's own stock, and (2) classified as equity in financial position statement. Other features, such as puts and redemption features were found to require bifurcation and recognition as derivative liabilities based on the provision of ASC Topic 815, formerly paragraph 12 of SFAS 133. These derivative liabilities are recognized both at inception and the end of each reporting period at fair value, using forward cash-flow valuation techniques, until such liabilities arrangements are eventually settled, converted or paid. As of December 31, 2008, September 30, 2009, December 31, 2009, and September 30, 2010, the compound derivative value amounted to \$1,502,596, \$913,063, \$880,009 and \$127,011. The income from adjustment of fair value of compound derivative has been recorded in the income statement as gain or loss on change in fair value of derivative. (See note 12 and 23)

The fair value of compound derivative liabilities at inception and the end of each reporting period was calculated based on the following assumptions:

(1) Credit risk adjusted based on publicly available research/investigation: The Company develops credit risk assumptions by reference to corporate bond spreads in the market that the Company's equity security trades. Bond yields were selected as the principal market indicator because such yields are presumed to provide information that assigns yields directly to any company's assumed credit rating. Credit ratings are established through formal analysis of bond inception and trading activity by Standard & Poor, Moody's and Fitch. The Company believes that it is likely that a market-participant would look to this indicator for purposes of assessing the credit risk associated with the investment. The calculation of the risk adjusted yield requires its measurement against a risk-free rate. The Company has chosen the publicly quoted yields on zero-coupon US Government Securities.

(2) Probability of certain default event occurred: Compound derivatives are bifurcated pursuant to SFAS 133.12. The fair value of compound derivatives is predicated on a probability assessment of the likelihood of a triggering event and the incremental value embodied in the hybrid instrument (See Note 12 regarding the assessment of compound derivatives. For example: mandatory redemption requires the gross yield arrived at 13% and annual redemption requires the gross yield arrived at 11%). The Company has assessed the probability of the likelihood of a triggering event at inception and completion of each reporting period:

As of September 30, 2009 and December 31, 2008:



|  | December 31,<br>2008 | September 30,<br>2009 | Comments  |
|--|----------------------|-----------------------|---|
| Default put :                                      | 0.00%                | 0.00%                 |   |
| Service default                                    | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Bankruptcy/liquidation                             | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Material judgments                                 | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Suspension of listing*                             | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Non-registration events:                           | 0.50%                | 0.50%                 |   |
| Filing*  | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Effectiveness*                                     | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Continuous Effectiveness*                          | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Share non-delivery                                 | 0.50%                | 0.50%                 | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Mandatory redemption put:                          | 15.0%                | 1.50%                 |   |
| Maintenance of share price at a certain level**    | 15.0%                | 1.50%                 | This is not within the Company's control. This put is only available subsequent to February 15, 2009 and only if the stock price is <45% of the conversion price for 20 trading days. On December 31, 2008, the stock price has maintained a value barely above 45% of the adjusted conversion price, so the risk of mandatory redemption was high. On September 30, 2009, the stock price was 31.2% above the adjusted conversion price (\$7.0822). Moreover the Company received a revocation of such mandatory redemption notice, so the risk of mandatory redemption was low. |
| Suspension of listing and non-registration events* | Low                  | Low                   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Annual Redemption Rights:                          | 30.0%                | 7.06%                 |   |
| Allows for redemption rights on specific dates**   | 30.0%                | 7.06%                 | This is not within the Company's control. On December 31, 2008, the stock prices were below the adjusted conversion price, so the risk of annual redemption was high. On September 30, 2009, the stock price was  |

|   |       |       |  |
|---|-------|-------|--|
|   |       |       | 31.2% above the adjusted conversion price (\$7.0822), so the risk of annual redemption was low.  |
| Allows for redemption if < 10% of note is outstanding | Low   | Low   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC. |
| Henglong Make Whole Amount and Redemption Right       | Low   | Low   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC. |
| Change in Control Put:                                | 0.50% | 0.50% |  |
| Change in control**                                   | 0.50% | 0.50% | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC. |

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As of September 30, 2010 and December 31, 2009:

|  | December 31, 2009 | September 30, 2010 | Comments  |
|--|-------------------|--------------------|---|
| Default put:                                       | 0.00%             | 0.00%              |   |
| Service default                                    | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Bankruptcy/liquidation                             | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Material judgments                                 | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Suspension of listing*                             | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Non-registration events:                           | 0.50%             | 0.50%              |   |
| Filing*  | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Effectiveness*                                     | Low               | Low                | Please see Financial Statements Notes 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.   |
| Continuous Effectiveness*                          | Low               | Low                | Please see Financial Statements Notes 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.   |
| Share non-delivery                                 | 0.50%             | 0.50%              | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Mandatory redemption put:                          | 1.50%             | 1.50%              |   |
| Maintenance of share price at a certain level**    | 1.50%             | 1.50%              | This is not within the Company's control. This put is only available subsequent to February 15, 2009 and only if the stock price is <45% of the conversion price for 20 trading days. On December 31, 2009 and September 30, 2010, the stock price was 164% and 116% above the adjusted conversion price (\$7.0822). Moreover the Company received a revocation of such mandatory redemption notice, so the risk of mandatory redemption was low. |
| Suspension of listing and non-registration events* | Low               | Low                | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Annual Redemption Rights:                          | 11.7%             | 0.18%              |   |
| Allows for redemption rights on specific dates**   | 11.7%             | 0.18%              | This is not within the Company's control. On December 31, 2009 and September 30, 2010, the stock price was 164% and 116% above the adjusted conversion price, so the risk of annual redemption was low.   |

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|   |       |       |   |
|---|-------|-------|---|
| Allows for redemption if < 10% of note is outstanding | Low   | Low   | Please see Financial Statements Note 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC.  |
| Henglong Make Whole Amount and Redemption Right       | Low   | Low   | Please see the Financial Statements Notes 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with SEC. |
| Change in Control Put:                                | 0.50% | 0.50% |   |
| Change in control**                                   | 0.50% | 0.50% | Please see Financial Statements Notes 14 incorporated in the Company's Form 10-K for the year ended December 31, 2009 filed with the SEC  |

\*Represent the event is not within the Company's control, but the probability of a triggering event is low.

\*\*Represent the event is not within the Company's control, and the probability of a triggering event is high. The assessment of such probability was based on the probability of the historical trading price of the Company's common stock above or under Strike price for previous periods, same with the remaining period of the instruments. For example, the triggering event of maintaining the stock price at a certain level, a WAP default, is the Company's stock weighted average price for twenty (20) consecutive trading days below \$3.187, which is 45% of the reset Conversion Price of \$7.0822. The triggering event allowing the note holders to require the Company to redeem the notes on specific dates is when the Company's stock price becomes \$8.6 or lower.

According to the analysis and data above, change of the fair value of compound derivative liabilities for the reporting period was mainly based on the price change of the Company's trading common stock. It was estimated that, if the probability of the stock price above \$8.6 was high, the probability of redemption was low, because the Convertible notes holders would gain 11% or more income by converting into common stock at this price level, which was higher than the income from bond market or redemption of Convertible notes upon any occurrence of triggering events as defined in the debt agreement.

As of September 30, 2010, the fair value of compound derivative liabilities of \$127,012 decreased by \$752,997 as compared to \$880,009 on December 31, 2009, mainly as a result of the recent market recovery. As the Company's stock price rose dramatically, the probability of the Company's stock price trading above \$8.6 rose, accordingly, the probability of redemption declined.

As of September 30, 2009, the fair value of compound derivative liabilities of \$913,063 decreased by \$589,534 as compared to \$1,502,597 on December 31, 2008, mainly as a result of the recent market recovery, the Company's stock price rose dramatically. On September 30, 2009, the Company's stock price was 31.2% over the adjusted conversion price (\$7.0822). So the risk of annual redemption was low. Moreover the Company received a revocation of such mandatory redemption notice, so the risk of mandatory redemption was significantly low.

#### 14. Accrued expenses and other payables

The Company's accrued expenses and other payables at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|   | September 30, 2010 | December 31, 2009 |
|---|--------------------|-------------------|
| Accrued expenses  | \$ 3,341,798       | \$ 4,160,433      |
| Other payables  | 1,948,800          | 2,694,447         |
| Warranty reserves*  | 7,110,260          | 9,092,462         |
| Dividend payable to non-controlling interest shareholders of Joint-ventures | 2,246,499          | 1,761,339         |
| Balance at the end of the period  | \$ 14,647,357      | \$ 17,708,681     |

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

For the nine months ended September 30, 2010 (unaudited) and the year ended December 31, 2009, the warranties activities were as follows:

September 30, 2010    December 31, 2009

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|  |    |             |    |             |
|--|----|-------------|----|-------------|
| Balance at the beginning of period                   | \$ | 9,092,462   | \$ | 6,335,613   |
| Additions during the period                          |    | 7,254,858   |    | 10,192,749  |
| Settlement within period, by cash or actual material |    | (5,459,215) |    | (7,442,984) |
| Foreign currency translation gain (loss)             |    | 212,085     |    | 7,084       |
| Balance at end of period                             | \$ | 11,100,190  | \$ | 9,092,462   |

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\*\* As of September 30, 2010 and December 31, 2009, there are approximately \$11,100,190 and \$9,092,462 of warranty reserves, respectively, of which \$7,110,260 and \$9,092,462 are included in accrued expenses and other payables in the accompanying consolidated balance sheets. The remaining \$3,989,930 and \$0 of warranty reserves are included in the other long-term liabilities.

#### 15. Accrued pension costs

Since the Company's operations are all located in China, all the employees are located in China. The Company records pension costs and various employment benefits in accordance with the relevant Chinese social security laws, which is substantially based on a total of 31% of base salary as required by local governments. Base salary levels are the average salary determined by the local governments.

The activities in the Company's pension account during the nine months ended September 30, 2010 (unaudited) and the year ended December 31, 2009 are summarized as follows:

|                                    | September 30, 2010 | December 31, 2009 |
|------------------------------------|--------------------|-------------------|
| Balance at beginning of the period | \$ 3,778,187       | \$ 3,806,519      |
| Amounts provided during the period | 3,609,234          | 3,738,373         |
| Settlement during the period       | (3,471,951)        | (3,770,220)       |
| Foreign currency translation loss  | 72,286             | 3,515             |
| Balance at end of period           | \$ 3,987,756       | \$ 3,778,187      |

#### 16. Taxes payable

The Company's taxes payable at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                              | September 30, 2010 | December 31, 2009 |
|------------------------------|--------------------|-------------------|
| Value-added tax payable      | \$ 6,947,053       | \$ 9,290,149      |
| Income tax payable           | 3,512,893          | 1,733,942         |
| Other tax payable            | 226,262            | 340,925           |
| Balance at end of the period | \$ 10,686,208      | \$ 11,365,016     |

#### 17. Amounts due to shareholders/ directors

The activities in the amounts due to shareholders/directors at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                                       | September 30, 2010 | December 31, 2009 |
|---------------------------------------|--------------------|-------------------|
| Balance at the beginning of period    | \$ -               | \$ 337,370        |
| Increase (decrease) during the period | 97,406             | (337,915)         |
| Foreign currency translation loss     | 5,809              | 545               |
| Balance at end of period              | \$ 103,215         | \$ -              |

The amounts due to shareholders/directors were unsecured, interest-free and repayable on demand.

#### 18. Other long-term liabilities

The Company's other long-term liabilities at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|                              | September 30, 2010 | December 31, 2009 |
|------------------------------|--------------------|-------------------|
| Advances payable*            | \$ 387,608         | \$ 233,941        |
| Warranty reserves            | 3,989,930          | -                 |
| Balance at end of the period | \$ 4,377,538       | \$ 233,941        |

\*The amounts mainly represent advances made by the Chinese government to the Company as subsidy on interest on loans related to production facilities expansion.

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 (see notes 21).

#### 19. Share Capital and Additional paid-in capital

The activities in the Company's share capital and additional paid-in capital account during the nine months ended September 30, 2010 (unaudited) and the year ended December 31, 2009 are summarized as follows:

|   | Share Capital |           | Additional paid-in capital |
|---|---------------|-----------|----------------------------|
|   | Shares        | Par Value |                            |
| Balance at January 1, 2009                | 26,983,244    | \$ 2,698  | \$ 26,648,154              |
| Shares issued for stock options exercised | 63,000        | 6         | 420,234                    |
| Share-based compensation*                 | -             | -         | 446,676                    |
| Balance at December 31, 2009              | 27,046,244    | \$ 2,704  | \$ 27,515,064              |
| Shares issued for stock options exercised | 69,582        | 7         | 278,893                    |
| Share-based compensation*                 | -             | -         | 422,714                    |
| Balance at September 30, 2010 (unaudited) | 27,115,826    | \$ 2,711  | \$ 28,216,671              |

\* The stock options granted during 2009 and 2010 were exercisable immediately, the fair value on the grant date using the Black-Scholes option pricing model were \$196,650 and \$345,375, of which \$196,650 and \$172,688 have been recorded as compensation costs in 2009 and 2010. The remaining of \$172,687 will be recognized in the remaining months of 2010.

The stock options granted during 2008 were partially exercisable immediately, and partially exercisable pro rata during the grant term. The stock options' fair value on the grant date using the Black-Scholes option pricing model was \$845,478, of which \$345,426, \$250,026 and \$250,026 have been recorded as compensation costs in 2008, 2009 and 2010.

#### 20. Non-controlling interests

The Company's activities in respect of the amounts of the non-controlling interests' equity at September 30, 2010 (unaudited) and December 31, 2009 are summarized as follows:

|   | September 30, 2010 | December 31, 2009 |
|---|--------------------|-------------------|
| Balance at beginning of the period  | \$ 27,173,125      | \$ 23,222,566     |
| Add: Additions during the period –  |                    |                   |
| Income attributable to non-controlling interests                                      | 8,227,985          | 7,872,813         |
| Less: Decreases during the period   |                    |                   |
| Dividends declared to the non-controlling interest holders of Joint-venture companies | (3,288,910)        | (3,944,619)       |
| Foreign currency translation loss   | 552,527            | 22,365            |
| Balance at end of period  | \$ 32,664,727      | \$ 27,173,125     |

#### 21. Other Income

During the three months and nine months ended September 30, 2010 (unaudited), the other income was \$0 and \$266,379, mainly from Government subsidies. During the three months and nine months ended September 30, 2009 (unaudited), there was no such income.

Government subsidies represent refunds by the Chinese Government of interest paid to banks by companies entitled to such subsidies. This applies only to interest on loans related to production facilities expansion. The Company recorded the refunded interest on projects which achieved their goals into other income, and refunded interest on projects which have not achieved their goals into advances payable.

## 22. Financial (income) expenses

During the three months and nine months ended September 30, 2010 and 2009 (unaudited), the Company recorded financial expenses which are summarized as follows:

|   | Three Months Ended September 30, |            |
|---|----------------------------------|------------|
|   | 2010                             | 2009       |
| Interest expenses, net                                | \$ 331,910                       | \$ 272,321 |
| Foreign exchange (gain) loss, net                     | (157,538)                        | (20,539)   |
| (Income) loss of note discount, net                   | (52,185)                         | 18,025     |
| Amortization for discount of convertible note payable | 107,229                          | 105,650    |
| Bank charges  | 42,006                           | 25,664     |
| Total   | \$ 271,422                       | \$ 401,121 |

During the nine months ended September 30, 2010 and 2009 (unaudited), the Company recorded financial expenses which are summarized as follows:

|   | Nine Months Ended September 30, |              |
|---|---------------------------------|--------------|
|   | 2010                            | 2009         |
| Interest expenses, net                                | \$ 785,063                      | \$ 789,739   |
| Foreign exchange (gain) loss, net                     | (90,146)                        | (263,455)    |
| (Income) loss of note discount, net                   | (65,261)                        | 112,680      |
| Amortization for discount of convertible note payable | 320,498                         | 612,635      |
| Bank charges  | 102,628                         | 67,230       |
| Total   | \$ 1,052,782                    | \$ 1,318,829 |

## 23. Gain on change in fair value of derivative

During the three months ended September 30, 2010 (unaudited) and 2009, the Company recorded gain (loss) on change in fair value of derivatives, which is summarized as follows:

|   | Three Months Ended September 30, |              |
|---|----------------------------------|--------------|
|   | 2010                             | 2009         |
| Income from adjustment of fair value of compound derivative liabilities | 509,705                          | 3,129,794    |
| Total   | \$ 509,705                       | \$ 3,129,794 |

During the nine months ended September 30, 2010 (unaudited) and 2009, the Company recorded gain (loss) on change in fair value of derivatives, which is summarized as follows:

|   | Nine Months Ended September 30, |            |
|---|---------------------------------|------------|
|   | 2010                            | 2009       |
| Income from adjustment of fair value of liabilities in connection with warrants | \$ -                            | \$ 1,977   |
| Income from adjustment of fair value of compound derivative liabilities         | 752,997                         | 589,534    |
| Total   | \$ 752,997                      | \$ 591,511 |

## 24. Income taxes

The Company's subsidiaries registered in the PRC, whose enterprise income tax exemption has ceased, 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. The Company's PRC subsidiaries, which are awarded the title of Advanced Technology Enterprise, are subject to enterprise income tax at a rate of 15%.

On January 1, 2007, Jiulong has used up its enterprise income tax exemption. During 2008, Jiulong was subject to enterprise income tax at a rate of 25%. During 2009 and 2010, Jiulong was awarded the title of Advanced Technology Enterprises, and subject to enterprise income tax at a rate of 15% for 2009 and 2010.

On January 1, 1999, Henglong was granted an enterprise income tax holiday of a 100% enterprise income tax exemption for two years commencing from 1999, and a 50% enterprise national income tax deduction and a 100% local income tax deduction for the next nine years thereafter, from 2001 to 2009, for income tax purposes. Henglong is subject to enterprise national income tax at a rate of 15% for 2008 and 2009. During 2010, Henglong was awarded the title of Advanced Technology Enterprises, and subject to enterprise income tax at a rate of 15%.

On January 1, 2003, Shenyang was granted an enterprise income tax holiday of a 100% enterprise income tax exemption for two years commencing from 2003, a 75% enterprise national income tax deduction and a 100% local income tax deduction for the next three years thereafter, from 2005 to 2007, and a 50% enterprise national income tax deduction, from January 1, 2008, for income tax purposes and was subject to enterprise income tax at a rate of 18%. During 2009 and 2010, Shenyang was awarded the title of Advanced Technology Enterprises, and subject to enterprise income tax at a rate of 15% for 2009 and 2010.

On January 1, 2004, Zhejiang was granted an enterprise income tax holiday of a 100% enterprise income tax exemption for two years commencing from 2004, and a 50% enterprise national income tax deduction, and a 50% local income tax deduction for the next three years thereafter, from 2006 to 2008, for income tax purposes. During 2008, Zhejiang is subject to enterprise income tax at a rate of 16.5%, which is comprised of 15% enterprise national income tax and 1.5% local income tax. During 2009 and 2010, Zhejiang was awarded the title of Advanced Technology Enterprise, and is subject to enterprise income tax at a rate of 15% for 2009 and 2010.

Wuhu, Jielong and Hengsheng have an enterprise income tax exemption in 2008 and 2009, and are subject to income tax at a rate of 15% for the next three years thereafter, from 2010 to 2012, and a 25% enterprise national income tax commencing from January 1, 2013.

There is no assessable profit for USAI and Testing Center in 2009 and 2010. Based on PRC income tax laws, USAI and Testing Center have an enterprise income tax exemption in 2009, and are subject to income tax at a rate of 15% and 25% for the next three years thereafter, from 2010 to 2012, and a 25% enterprise national income tax for the years commencing from January 1, 2013.

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, 2010 and 2009. The enterprise income tax of Hong Kong is 16.5%.

No provision for US tax is made as the Company has no assessable income in the US for the nine months ended September 30, 2010 and 2009. The enterprise income tax of US is 35%.

## 25. Income per share

Basic income per share attributable to parent company common shareholders is calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted income per share is calculated based on the treasury stock method, assuming the issuance of common shares, if dilutive, resulting from the exercise of warrants. The dilution of convertible securities is reflected in diluted earnings per share by application of the "if converted" method.

The calculations of income per share attributable to parent company common shareholders were:





|   | Three Months Ended September 30, |              |
|---|----------------------------------|--------------|
|   | 2010                             | 2009         |
| <b>Numerator:</b>   |                                  |              |
| Net income attributable to parent company   | \$ 8,193,219                     | \$ 8,556,511 |
| Add: interest expenses of convertible notes payable, net of tax                           | 195,000                          | 262,500      |
| Add: Amortization for discount of convertible notes payable, net of tax                   | 69,441                           | 105,650      |
|   | \$ 8,457,660                     | \$ 8,924,661 |
| <b>Denominator:</b>   |                                  |              |
| Weighted average shares outstanding   | 27,112,689                       | 26,983,717   |
| Effect of dilutive securities   | 4,451,616                        | 4,428,768    |
|   | 31,564,305                       | 31,412,485   |
| Net income per common share attributable to Parent company common shareholders – basic    | \$ 0.30                          | \$ 0.32      |
| Net income per common share attributable to Parent company common shareholders – diluted* | \$ 0.26                          | \$ 0.28      |

|   | Nine Months Ended September 30, |               |
|---|---------------------------------|---------------|
|   | 2010                            | 2009          |
| <b>Numerator:</b>   |                                 |               |
| Net income attributable to Parent company   | \$ 27,070,456                   | \$ 16,891,672 |
| Add: interest expenses of convertible notes payable, net of tax                           | 572,813                         | 809,375       |
| Add: Amortization for discount of convertible notes payable, net of tax                   | 208,066                         | 612,635       |
|   | \$ 27,851,335                   | \$ 18,313,682 |
| <b>Denominator:</b>   |                                 |               |
| Weighted average shares outstanding   | 27,078,180                      | 26,983,402    |
| Effect of dilutive securities   | 4,461,222                       | 4,644,294     |
|   | 31,539,402                      | 31,627,696    |
| Net income per common share attributable to Parent company common shareholders – basic    | \$ 1.00                         | \$ 0.63       |
| Net income per common share attributable to Parent company common shareholders – diluted* | \$ 0.88                         | \$ 0.58       |

\* During the three months ended September 30, 2010 (unaudited), all the options outstanding have been included in the computation of diluted income per share, except the 22,500 options issued on July 7, 2010. The shares issuable upon conversion of Convertible Notes have been included in the computation.

\* During the nine months ended September 30, 2010 (unaudited), all the options outstanding have been included in the computation of diluted income per share. The shares issuable upon conversion of Convertible Notes have been included in the computation.

\* During the three months and nine months ended September 30, 2009, the options and warrants outstanding have not been included in the computation of diluted income per share, except the 22,500 options issued on June 2005, 22,500 options issued on October 2007, 22,500 options issued on June 2008, and 294,350 options issued in December 2008, because such inclusion would have had an anti-dilutive effect. The shares issuable upon conversion of Convertible Notes have been included in the computation.

\* During the nine months ended September 30, 2009, the options and warrants outstanding have not been included in the computation of diluted income per share, except the 294,350 options issued on December 10, 2008, because such inclusion would have had an anti-dilutive effect. The shares issuable upon conversion of Convertible Notes have been

included in the computation.

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## 26. Significant concentrations

The Company grants credit to its customers, generally on an open account basis. The Company's customers are all located in the PRC.

During the nine months ended September 30, 2010 (unaudited), the Company's ten largest customers accounted for 76.3% of its consolidated net sales, with each of two customers individually accounting for more than 10% of consolidated net sales, i.e. 15.3%, and 11.7% individually, or an aggregate of 27.0%. At September 30, 2010, approximately 16.2% of accounts receivable were from trade transactions with the aforementioned two customers.

During the nine months ended September 30, 2009 (unaudited), the Company's ten largest customers accounted for 79.4% of its consolidated net sales, with each of five customers individually accounting for more than 10% of consolidated net sales, i.e. 14.1%, 12.3%, 11.2%, and 10.6% individually, or an aggregate of 48.2%. At September 30, 2009, approximately 34.1% of accounts receivable were from trade transactions with the aforementioned four customers.

## 27. Related party transactions and balances

Related party transactions with companies with common directors are as follows:

Related sales (unaudited):

|                                     | Three Months Ended September 30, |              |
|-------------------------------------|----------------------------------|--------------|
|                                     | 2010                             | 2009         |
| Merchandise Sold to Related Parties | \$ 1,717,483                     | \$ 1,384,458 |
|                                     | Nine Months Ended September 30,  |              |
|                                     | 2010                             | 2009         |
| Merchandise Sold to Related Parties | \$ 6,319,594                     | \$ 3,257,716 |

Related purchases (unaudited):

|   | Three Months Ended September 30 , |               |
|---|-----------------------------------|---------------|
|   | 2010                              | 2009          |
| Materials Purchased from Related Parties  | \$ 4,885,768                      | \$ 3,477,109  |
| Technology Purchased from Related Parties | 119,383                           | 102,504       |
| Equipment Purchased from Related Parties  | 406,894                           | 841,924       |
| Total                                     | \$ 5,412,045                      | \$ 4,421,537  |
|   | Nine Months Ended September 30 ,  |               |
|   | 2010                              | 2009          |
| Materials Purchased from Related Parties  | \$ 14,481,952                     | \$ 8,463,331  |
| Technology Purchased from Related Parties | 295,861                           | 175,690       |
| Equipment Purchased from Related Parties  | 1,741,842                         | 2,345,650     |
| Total                                     | \$ 16,519,655                     | \$ 10,984,671 |

Related receivables (September 30, 2010, unaudited):

September 30, 2010 December 31, 2009

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|                     |    |           |    |           |
|---------------------|----|-----------|----|-----------|
| Accounts receivable | \$ | 2,573,240 | \$ | 1,441,939 |
| Other receivables   |    | 369,351   |    | 65,416    |
| Total               | \$ | 2,942,591 | \$ | 1,507,355 |

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Related advances (September 30, 2010, unaudited):

|   | September 30, 2010  | December 31, 2009   |
|---|---------------------|---------------------|
| Advanced Equipment Payment to Related Parties   | \$ 7,444,795        | \$ 2,579,319        |
| Advanced Expenses and Others to Related Parties | 1,409,460           | -                   |
| <b>Total</b>                                    | <b>\$ 8,854,255</b> | <b>\$ 2,579,319</b> |

Related payables (September 30, 2010 unaudited)

|                  | September 30, 2010 | December 31, 2009 |
|------------------|--------------------|-------------------|
| Accounts payable | \$ 2,126,954       | \$ 1,537,827      |

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

As of November 9, 2010, the date the Company issued this financial statement, Hanlin Chen, Chairman, owns 55.49% 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.

## 28. Commitments and contingencies

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

The following table summarizes the Company's major contractual payment obligations and commitments as of September 30, 2010 (unaudited):

|                                       | Payment Obligations by Period |                     |                  |             |             | Total                |
|---------------------------------------|-------------------------------|---------------------|------------------|-------------|-------------|----------------------|
|                                       | 2010 (a)                      | 2011                | 2012             | 2013        | Thereafter  |                      |
| Obligations for service agreements    | \$ 110,000                    | \$ 110,000          | \$ -             | \$ -        | \$ -        | \$ 220,000           |
| Obligations for purchasing agreements | 11,730,965                    | 5,374,543           | \$ 88,354        | \$ -        | -           | 17,193,862           |
| <b>Total</b>                          | <b>\$ 11,840,965</b>          | <b>\$ 5,484,543</b> | <b>\$ 88,354</b> | <b>\$ -</b> | <b>\$ -</b> | <b>\$ 17,413,862</b> |

(a) Remaining 3 months in 2010

## 29. Off-balance sheet arrangements

The Company does not have any transactions, obligations or relationships that could be considered off-balance sheet arrangements.

## 30. 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.

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During the nine months ended September 30, 2010 and 2009 (unaudited), the Company had nine product sectors, five of them were principal profit makers, which were reported as separate sectors which engaged in the production and sales of power steering (Henglong), power steering (Jiulong), power steering (Shenyang), power pumps (Zhejiang), and power steering (Wuhu). The other four sectors which were established in 2005, 2006 and 2007 respectively, engaged in the production and sales of sensor modules (USAI), electronic power steering (Jielong), power steering (Hengsheng), and provider of after sales and R&D services (HLUSA). Since the revenues, net income and net assets of these four sectors are less than 10% of its segment in the consolidated financial statements, the Company incorporated these four sectors into “other sectors”.

The Company’s product sectors information is as follows:

|  | Henglong      | Jiulong       | Shenyang     | Zhejiang     | Wuhu         | Other sector  | Other *         | Total         |
|--|---------------|---------------|--------------|--------------|--------------|---------------|-----------------|---------------|
| For the Three Months Ended September 30, 2010 (unaudited): |               |               |              |              |              |               |                 |               |
| Revenue  |               |               |              |              |              |               |                 |               |
| Net product sales – external                               | \$ 32,438,683 | \$ 19,627,536 | \$ 8,243,405 | \$ 5,209,763 | \$ 8,709,931 | \$ 1,873,526  | \$ -            | \$ 76,102,844 |
| Net product sales – internal                               | 3,867,397     | 644,897       | 874,497      | 298,653      | -            | 10,535,962    | (16,221,406)    | -             |
| Gain on other sales  | (33,676)      | (144,213)     | 52,562       | 17,233       | \$ 47,662    | \$ (92,753)   | \$ 704          | \$ (152,481)  |
| Total revenue  | \$ 36,272,404 | \$ 20,128,220 | \$ 9,170,464 | \$ 5,525,649 | \$ 8,757,593 | \$ 12,316,735 | \$ (16,220,702) | \$ 75,950,363 |
| Net income   | \$ 5,551,699  | \$ 1,322,547  | \$ 1,383,920 | \$ 1,044,941 | 679,989      | 424,793       | 135,610         | 10,543,499    |
| Net income attributable to non-controlling interests       |               |               |              |              |              |               |                 |               |
|  | 1,110,602     | 251,337       | 415,226      | 512,082      | 154,167      | 123,291       | (216,425)       | 2,350,280     |
| Net income attributable to Parent company                  |               |               |              |              |              |               |                 |               |
|  | \$ 4,441,097  | \$ 1,071,210  | \$ 968,694   | \$ 532,859   | \$ 525,822   | \$ 301,502    | \$ 352,035      | \$ 8,193,219  |

|  | Henglong | Jiulong | Shenyang | Zhejiang | Wuhu | Other sector | Other * | Total |
|--|----------|---------|----------|----------|------|--------------|---------|-------|
|--|----------|---------|----------|----------|------|--------------|---------|-------|

|  |               |               |              |              |              |             |                 |               |
|--|---------------|---------------|--------------|--------------|--------------|-------------|-----------------|---------------|
| For the Three Months Ended September 30, 2009 (unaudited): |               |               |              |              |              |             |                 |               |
| Revenue  |               |               |              |              |              |             |                 |               |
| Net product sales – external                               | \$ 29,368,493 | \$ 14,640,383 | \$ 8,190,846 | \$ 6,162,061 | \$ 6,233,803 | \$ 58,783   | \$ (12,494,686) | \$ 64,654,369 |
| Net product sales – internal                               | 7,036,610     | 527,244       | 531,012      | 67,390       | -            | 4,332,430   | 691             | -             |
| Gain on other sales  | 87,138        | 124,277       | 68,037       | 10,728       | \$ 15,803    | \$ (22,440) | \$ (12,493,995) | \$ 284,234    |



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|  |               |               |              |              |              |              |                 |               |
|--|---------------|---------------|--------------|--------------|--------------|--------------|-----------------|---------------|
| Total revenue  | \$ 36,492,241 | \$ 15,291,904 | \$ 8,789,895 | \$ 6,240,179 | \$ 6,249,606 | \$ 4,368,773 | \$ 64,819       | \$ 64,938,603 |
| Net income   | \$ 6,943,133  | \$ 1,395,959  | \$ 701,259   | \$ 926,179   | 32,785       | 529,139      | (262,751)       | 10,593,273    |
| Net income attributable to non-controlling interests | 1,388,627     | 265,232       | 210,378      | 453,828      | 7,432        | (25,984)     | 327,570         | 2,036,762     |
| Net income attributable to Parent company            | \$ 5,554,506  | \$ 1,130,727  | \$ 490,881   | \$ 472,351   | \$ 25,353    | \$ 555,123   | \$ (12,494,686) | \$ 8,556,511  |

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|   | Henglong       | Jiulong       | Shenyang      | Zhejiang      | Wuhu          | Other sector  | Other *        | Total          |
|---|----------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|
| For the Nine Months Ended September 30, 2010 (unaudited): |                |               |               |               |               |               |                |                |
| Revenue   |                |               |               |               |               |               |                |                |
| Net product sales – external                              | \$ 112,860,428 | \$ 64,452,631 | \$ 23,733,187 | \$ 16,368,355 | \$ 22,628,769 | \$ 5,373,301  | \$ -           | \$ 245,416,671 |
| Net product sales – internal                              | 25,834,595     | 1,951,660     | 4,643,477     | 1,870,369     | -             | 23,418,794    | (57,718,895)   | -              |
| Gain on other sales                                       | 845,015        | 132,988       | 91,789        | 50,184        | \$ 133,827    | \$ -270,358   | \$ (2,317)     | \$ 981,128     |
| Total revenue   | \$ 139,540,038 | \$ 66,537,279 | \$ 28,468,453 | \$ 18,288,908 | \$ 22,762,596 | \$ 28,521,737 | \$ -57,721,212 | \$ 246,397,799 |
| Net income  | \$ 21,766,839  | \$ 4,628,930  | \$ 3,169,070  | \$ 3,261,626  | 1,014,753     | 1,803,417     | (346,194)      | 35,298,441     |
| Net income attributable to non-controlling interests      | 4,353,628      | 879,552       | 950,771       | 1,598,258     | 230,058       | 146,951       | 68,767         | 8,227,985      |
| Net income attributable to parent company                 | \$ 17,413,211  | \$ 3,749,378  | \$ 2,218,299  | \$ 1,663,368  | \$ 784,695    | \$ 1,656,466  | \$ (414,961)   | \$ 27,070,456  |
|   | Henglong       | Jiulong       | Shenyang      | Zhejiang      | Wuhu          | Other sector  | Other *        | Total          |
| For the Nine Months Ended September 30, 2009 (unaudited): |                |               |               |               |               |               |                |                |
| Revenue   |                |               |               |               |               |               |                |                |
| Net product sales – external                              | \$ 77,090,690  | \$ 39,038,184 | \$ 20,351,125 | \$ 17,575,828 | \$ 17,390,572 | \$ 389,695    | \$ -           | \$ 171,836,094 |
| Net product sales – internal                              | 23,837,439     | 1,586,792     | 3,036,244     | 379,303       | -             | 4,356,464     | (33,196,242)   | -              |
| Gain on other sales                                       | 201,908        | 148,056       | 137,588       | 11,732        | \$ 48,213     | \$ (21,317)   | \$ (2,320)     | \$ 523,860     |
| Total revenue   | \$ 101,130,037 | \$ 40,773,032 | \$ 23,524,957 | \$ 17,966,863 | \$ 17,438,785 | \$ 4,724,842  | \$ 33,198,562  | \$ 172,359,954 |
| Net income  | \$ 18,922,252  | \$ 3,330,588  | \$ 2,371,728  | \$ 2,614,019  | (5,378)       | (241,723)     | (4,025,704)    | 22,965,782     |
| Net income attributable to non-controlling interests      | 3,784,450      | 632,812       | 711,518       | 1,280,869     | (1,219)       | (63,297)      | (271,023)      | 6,074,110      |
| Net income attributable to parent company                 | \$ 15,137,802  | \$ 2,697,776  | \$ 1,660,210  | \$ 1,333,150  | \$ (4,159)    | \$ (178,426)  | \$ (3,754,681) | \$ 16,891,672  |

\* Other includes activity not allocated to the product sectors and elimination of inter-sector transactions.

### 31. Reclassification

Product warranty costs which were classified as selling expenses in the previous periods have been re-classified as cost of product sold to achieve consistency with the presentation of the current period.

### 32. Subsequent Event

On January 24, 2010, Genesis entered into a joint venture contract with Beijing Hainachuan Auto Parts Co., Ltd., to establish a joint venture company, Beijing Henglong Automotive System Co., Ltd., "Beijing Henglong", to design, develop and manufacture both hydraulic and electric power steering systems and parts. On October 19, 2010, both parties agreed to change the Joint venture company's investor into Hengsheng from Genesis, and left the other terms of the joint venture contract unchanged. Under PRC laws, the establishment of Beijing Henglong and the effectiveness of the equity joint venture contract are subject to approval by Administration For Industry and Commerce in Beijing.

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

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

This Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2010 contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. Generally, the words "believes," "anticipates," "may," "will," "should," "expect," "intend," "estimate," "continue," and similar expressions or the negative thereof or comparable terminology are intended to identify forward-looking statements which include, but are not limited to, statements concerning the Company's expectations regarding its working capital requirements, financing requirements, business prospects, and other statements of expectations, beliefs, future plans and strategies, anticipated events or trends, and similar expressions concerning matters that are not historical facts. Such statements are subject to certain risks and uncertainties, including the matters set forth in this Quarterly Report or other reports or documents the Company files with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Undue reliance should not be placed on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update these forward-looking statements. In addition, the forward-looking statements in this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2010 involve known and unknown risks, uncertainties and other factors that could cause the actual results, performance or achievements of the Company to differ materially from those expressed in or implied by the forward-looking statements contained herein. Please see the discussion on risk factors in Item 1A of Part II of this quarterly report on Form 10-Q.

### GENERAL OVERVIEW:

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

Great Genesis Holdings Limited, a company incorporated 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.

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 accordingly.

The Company owns the following aggregate net interests in nine Sino-foreign joint ventures organized in the PRC as of September 30, 2010 and 2009.

| Name of Entity  | Percentage Interest |                    |
|---|---------------------|--------------------|
|   | September 30, 2010  | September 30, 2009 |
| Shashi Jiulong Power Steering Gears Co., Ltd., "Jiulong"                  | 81.00%              | 81.00%             |
| Jingzhou Henglong Automotive Parts Co., Ltd., "Henglong"                  | 80.00%              | 80.00%             |
| Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., "Shenyang" | 70.00%              | 70.00%             |
| Zhejiang Henglong & Vie Pump-Manu Co., Ltd., "Zhejiang"                   | 51.00%              | 51.00%             |
| Universal Sensor Application Inc., "USAI"                                 | 83.34%              | 83.34%             |

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|   |         |         |
|---|---------|---------|
| Wuhan Jielong Electric Power Steering Co., Ltd., “Jielong”                    | 85.00%  | 85.00%  |
| Wuhu HengLong Automotive Steering System Co., Ltd., “Wuhu”                    | 77.33%  | 77.33%  |
| Jingzhou Hengsheng Automotive System Co., Ltd, “Hengsheng”                    | 100.00% | 100.00% |
| Jingzhou Henglong Automotive Technology (Testing) Center,<br>“Testing Center” | 80.00%  | -%      |

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

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

In December 2009, Henglong, a subsidiary of Genesis, formed Jingzhou Henglong Automotive Technology (Testing) Center, "Testing Center", which is mainly engaged in research and development of new products. The registered capital of Testing Center is RMB 30,000,000 (\$4,393,544 equivalent).

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

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

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

Jielong was established in 2006 and mainly engages in production and sales of electric power steering, "EPS".

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

Hengsheng was established in 2007 and mainly engages in production and sales of automobile steering systems.

On February 11, 2010, the registered capital of Hengsheng was increased to \$16,000,000 from \$10,000,000.

On January 24, 2010, Genesis entered into a joint venture contract with Beijing Hainachuan Auto Parts Co., Ltd., to establish a joint venture company, Beijing Henglong Automotive System Co., Ltd., "Beijing Henglong", to design, develop and manufacture both hydraulic and electric power steering systems and parts. On October 19, 2010, both parties agreed to change the Joint venture company's investor into Hengsheng from Genesis, and left the other terms of the joint venture contract unchanged. Under PRC laws, the establishment of Beijing Henglong and the effectiveness of the equity joint venture contract are subject to approval by Administration For Industry and Commerce in Beijing.

#### CRITICAL ACCOUNTING POLICIES:

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

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 the Company 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 its financial condition or results of operations.

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

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| 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 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 (Vehicle Manufacturer) sourcing</li> <li>• VM policy decisions regarding warranty claims</li> </ul> VMs |
| 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 require 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 have material adverse effect on the Company's cost disclosure if such assessment were | 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 an allowance on an individual customer basis, under normal circumstances; the Company does not record any provision for doubtful accounts for those accounts receivable amounts which were in credit terms. For those receivables out of credit terms, certain | <ul style="list-style-type: none"> <li>• Customers' credit standing and financial condition</li> </ul>  |



|   |   |   |  |  |
|---|---|---|--|--|
|   |   | improper.   | proportional provision, namely 25% to 100%, will be recorded based on respective overdue terms.  |  |
| Deferred income taxes   | Recoverability of deferred tax assets                   | The Company is required to estimate whether recoverability of the Company's 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, discount of convertible note 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 conception and completion of each reporting period                             | The Company uses Black-Scholes option pricing model to determine fair value of warrant; uses forward cash-flow valuation techniques to determine fair value of compound derivative liabilities                                 | <ul style="list-style-type: none"> <li>• Expected term</li> <li>• Expected volatility</li> <li>• Risk-free rate or market interest rate similar with such instrument</li> <li>• Dividend distribution</li> <li>• Common stock trading price and exercise price</li> <li>• Credit risk</li> <li>• Probability of certain default event occurred</li> <li>• Derivative liabilities redeemed on a price of exercise plus premium</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 consolidated financial statements.

## EXECUTIVE SUMMARY

China Automotive Systems, Inc. is a leading global supplier of automotive power steering systems and other automotive systems. The Company has business relations with more than sixty vehicle manufacturers, including FAW Group and Dongfeng Auto Group, two 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, Xi'an BYD Auto Co., Ltd and Zhejiang Geely Automobile Co., Ltd., the largest private owned car manufacturers. From 2008, the Company has supplied power steering pumps and power steering gear to the Sino-Foreign joint ventures established by General Motors (GM), Citroen and Volkswagen. In 2009, the Company began to supply power steering gear to Chrysler North America. Most of the Company's production and research and development institutes are located in China. The Company has 3,000 employees dedicated to design, development, manufacture and sales of its products. The Company conducts its business across nine segments, of which five were principal profit makers, including Henglong, Jiulong, Shenyang, Zhejiang, and Wuhu. The Company expected that the other four segments will become new source of revenue in 2011.

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.

Financial results for the three months and nine months ended September 30, 2010 are summarized as follows:

• Sales of \$76,102,844 and \$245,416,671 in 2010 compared to \$64,654,369 and \$171,836,094 for the same periods of 2009.

• Gross margin of \$18,173,560, or 24%, and \$60,518,837, or 25%, of sales, up from \$15,485,743, or 24%, and \$42,695,016, or 25%, for the same periods of 2009.

• Selling expenses of \$2,095,321 and \$6,866,249 in 2010 compared to \$2,180,864 and \$4,866,041 for the same periods of 2009.

• General and administrative expenses of \$2,286,784 and \$7,737,989 compared to \$2,739,886 and \$6,787,918 for the same periods in 2009, respectively.

- Net income attributable to Parent company of \$8,193,219, or \$0.30 and \$0.26 per share on a basic and diluted basis, respectively, and \$27,070,456, or \$1.00 and \$0.88 per share, compared to \$8,556,511, or \$0.32 and \$0.28 per share on a basic and diluted basis, respectively, and \$16,891,672, or \$0.63 and \$0.58 per share, for the same periods in 2009.

- Cash of approximately \$49,201,859 as of September 30, 2010, \$5,721,683 higher than as of December 31, 2009.

• Cash provided by operating activities of \$29,604,550 compared to \$24,340,951 for the same nine-month period in 2009.

- Capital expenditures of \$24,066,188, higher than the same nine-month period in 2009 by \$14,929,641.

## RESULTS OF OPERATIONS—THREE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009:

|               | Net Sales     |               |               |        | Cost of sales |               |              |        |
|---------------|---------------|---------------|---------------|--------|---------------|---------------|--------------|--------|
|               | 2010          | 2009          | Change        |        | 2010          | 2009          | Change       |        |
| Henglong*     | \$ 36,306,679 | \$ 36,405,102 | \$ (98,423)   | -0.3%  | \$ 27,981,448 | \$ 26,027,481 | \$ 1,953,967 | 7.5%   |
| Jiulong**     | 20,272,433    | 15,167,625    | 5,104,808     | 33.7%  | 17,339,396    | 12,374,475    | 4,964,921    | 40.1%  |
| Shenyang      | 9,117,903     | 8,721,858     | 396,045       | 4.5%   | 7,091,850     | 7,372,924     | (281,074)    | -3.8%  |
| Zhejiang      | 5,508,417     | 6,229,451     | (721,034)     | -11.6% | 3,823,739     | 4,740,061     | (916,322)    | -19.3% |
| Wuhu          | 8,709,930     | 6,233,804     | 2,476,126     | 39.7%  | 7,706,526     | 5,903,930     | 1,802,596    | 30.5%  |
| Other Sectors | 12,408,888    | 4,391,213     | 8,017,675     | 182.6% | 10,784,539    | 3,143,166     | 7,641,373    | 243.1% |
| Other ***     | (16,221,406)  | (12,494,684)  | (3,726,722)   | 29.8%  | (16,798,214)  | (10,393,411)  | (6,404,803)  | 61.6%  |
| Total         | \$ 76,102,844 | \$ 64,654,369 | \$ 11,448,475 | 17.7%  | \$ 57,929,284 | \$ 49,168,626 | \$ 8,760,658 | 17.8%  |

\* Excluding \$4,609,000 of income and \$3,959,400 of cost for Column sales, which has been transferred to Jielong in 2010.

\*\* Including \$1,765,018 of income and \$1,436,327 of cost for Chrysler sales in 2010.

\*\*\* Other includes activity not allocated to the product sectors and elimination of inter-sector transactions.

## NET SALES

Net sales were \$76,102,844 for the three months ended September 30, 2010, compared with \$64,654,369 for the three months ended September 30, 2009, an increase of \$11,448,475, or 17.7%, mainly due to the increases in the income of Chinese residents and government investment leading to an increase in the sales of passenger vehicles and commercial vehicles, and the resultant increase in the Company's sales of steering gear and pumps; the Company has raised the technological contents in, and production efficiency of, its products as a result of technological improvement to its production lines, allowing the Company to reduce costs and, correspondingly, its sales prices which led to increased sales volumes.

Net sales for Henglong was \$36,306,679 for the three months ended September 30, 2010, compared with \$36,405,102 for the three months ended September 30, 2009, representing a decrease of \$98,423, or 0.3%. Net sales increase was mainly due to increased production volumes with a sales increase of \$7,361,880, decreased sales price with a sales decrease of \$8,155,145, and the effect of foreign currency translation with a sales increase of \$694,842.

Net sales for Jiulong was \$20,272,433 for the three months ended September 30, 2010, compared with \$15,167,625 for the three months ended September 30, 2009, representing an increase of \$5,104,808, or 33.7%. Net sales increase was mainly due to increased production volumes with a sales increase of \$4,260,203, increased sales price with a sales increase of \$555,110, and the effect of foreign currency translation with a sales increase of \$289,495.

Net sales for Shenyang was \$9,117,903 for the three months ended September 30, 2010, compared with \$8,721,858 for the three months ended September 30, 2009, representing an increase of \$396,045, or 4.5%. Net sales increase was mainly due to increased production volumes with a sales increase of \$484,483, decreased sales price with a sales decrease of \$254,907, and the effect of foreign currency translation with a sales increase of \$166,469.

Net sales for Zhejiang was \$5,508,417 for the three months ended September 30, 2010, compared with \$6,229,451 for the three months ended September 30, 2009, representing a decrease of \$721,034 or 11.6%. Net sales decrease was mainly due to increased production volumes with a sales decrease of \$255,790 and decreased sales price with a sales decrease of \$584,142 and the effect of foreign currency translation with a sales increase of \$118,898.

Net sales for Wuhu was \$8,709,930 for the three months ended September 30, 2010, compared with \$6,233,804 for the three months ended September 30, 2009, representing an increase of \$2,476,126, or 39.7%. Net sales decrease was mainly due to decreased production volumes with a sales increase of \$2,978,324 and decreased sales price with a sales decrease of \$616,531 and the effect of foreign currency translation with a sales increase of \$114,333.

Net sales for Other Sectors was \$12,408,888 for the three months ended September 30, 2010, compared with \$4,391,213 for the three months ended September 30, 2009, representing an increase of \$8,017,675 or 182.6%. Net sales increased mainly due to the development of new market.

## COST OF SALES

For the three months ended September 30, 2010, the cost of sales was \$57,929,284, compared with \$49,168,626 for the same period of 2009, an increase of \$8,760,658, or 17.8%, mainly due to the increase of sales.

Cost of sales for Henglong was \$27,981,448 for the three months ended September 30, 2010, compared with \$26,027,481 for the three months ended September 30, 2009, representing an increase of \$1,953,967, or 7.5%. Cost of sales increase was mainly due to increased sale volumes with a cost of sales increase of \$2,395,884, decreased unit price with a cost of sales decrease of \$938,644, and the effect of foreign currency translation with a cost increase of \$496,727.

Cost of sales for Jiulong was \$17,339,396 for the three months ended September 30, 2010, compared with \$12,374,475 for the three months ended September 30, 2009, representing an increase of \$4,964,921, or 40.1%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$3,157,720, increased unit price with a cost of sales increase of \$1,571,017, and the effect of foreign currency translation with a cost increase of \$236,184.

Cost of sales for Shenyang was \$7,091,850 for the three months ended September 30, 2010, compared with \$7,372,924 for the three months ended September 30, 2009, representing a decrease of \$281,074, or 3.8%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$363,225, decreased unit price with a cost of sales decrease of \$785,021, and the effect of foreign currency translation with a cost increase of \$140,722.

Cost of sales for Zhejiang was \$3,823,739 for the three months ended September 30, 2010, compared with \$4,740,061 for the three months ended September 30, 2009, representing a decrease of \$916,322, or 19.3%. Cost of sales decrease was mainly due to decreased sales volumes with a cost of sales decrease of \$197,630, decreased unit price with a cost of sales decrease of \$809,163, and the effect of foreign currency translation with a cost increase of \$90,471.

Cost of sales for Wuhu was \$7,706,526 for the three months ended September 30, 2010, compared with \$5,903,930 for the three months ended September 30, 2009, representing an increase of \$1,802,596, or 30.5%. Cost of sales decrease was mainly due to increased sales volumes with a cost of sales increase of \$2,813,702, decreased unit price with a cost of sales decrease of \$1,118,232, and the effect of foreign currency translation with a cost increase of \$107,126.

Cost of sales for Other Sectors was \$10,784,539 for the three months ended September 30, 2010, compared with \$3,143,166 for the three months ended September 30, 2009, representing an increase of \$7,641,373, or 243.1%. Cost of sales increase was mainly due to increased of sales.

Gross margin was 23.9% for the three months ended September 30, 2010, a decrease of 0.1% from 24.0% for the same period of 2009, primarily due to sales price reductions in excess of declines in unit cost. For the three months ended September 30, 2010, the Company classified product warranty expenses as selling cost, which were classified as selling expenses in previous periods. As a result, the Company reclassified product warranty expenses for the same period of 2009 as selling cost to achieve consistency with the presentation of the current period. Effects of the reclassification are set forth in the table below.

|                          | Three Months Ended September 30, |      |
|--------------------------|----------------------------------|------|
|                          | 2010                             | 2009 |
| Before reclassification: |                                  |      |

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|  |               |               |
|--|---------------|---------------|
| Net sales                                  | \$ 76,102,844 | \$ 64,654,369 |
| Cost of goods sold before reclassification | 56,791,941    | 47,015,047    |
| Gross profit before reclassification       | \$ 19,310,903 | \$ 17,639,322 |
| Gross margin before reclassification       | 25.4%         | 27.3%         |
| After reclassification:                    |               |               |
| Net sales                                  | \$ 76,102,844 | \$ 64,654,369 |
| Cost of goods sold add Warranty expenses   | 57,929,284    | 49,168,626    |
| Gross profit after reclassification        | \$ 18,173,560 | \$ 15,485,743 |
| Gross margin after reclassification        | 23.9%         | 24.0%         |
| Selling expenses before reclassification   | \$ 3,232,664  | \$ 4,334,443  |
| Minus: Warranty expenses                   | 1,137,343     | 2,153,579     |
| Selling expenses after reclassification    | \$ 2,095,321  | \$ 2,180,864  |

#### GAIN ON OTHER SALES

Gain on other sales consists of net amount retained from sales of materials and other assets. For the three months ended September 30, 2010, loss on other sales was \$152,481, compared with \$284,234 for the same period of 2009, a decrease of \$436,715, or 153.6%, mainly due to increased sales of materials.

#### SELLING EXPENSES

Selling expenses were \$2,095,321 for the three months ended September 30, 2010, compared with \$2,180,864 for the same period of 2009, a decrease of \$85,543, or 3.9%. Material decrease was supplies expenses.

#### GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses were \$2,286,784 for the three months ended September 30, 2010, compared with \$2,739,886 for the same period of 2009, a decrease of \$453,102, or 16.5%. Material decrease was option expense.

#### RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses were \$1,247,881 for the three months ended September 30, 2010, compared with \$531,383 for the three months ended September 30, 2009, an increase of \$716,498, or 134.8%.

The global automotive parts industry is highly competitive, winning and maintaining new business requires suppliers to rapidly produce advanced products on a cost-competitive basis. In order to maintain its competitiveness, the Company invested more in R & D expenses in 2010.

#### DEPRECIATION AND AMORTIZATION EXPENSE

For the three months ended September 30, 2010, depreciation and amortization expenses excluded from that recorded under cost of sales were \$219,720, compared with \$663,408 for the same period of 2009, a decrease of \$443,688, or 66.9%, as a result of certain fixed assets of the Company having been fully depreciated.

#### INCOME FROM OPERATIONS

Income from operations was \$12,171,373 for the three months ended September 30, 2010, compared with \$9,654,436 for the three months ended September 30, 2009, an increase of \$2,516,937, or 26.1%, as a result of an increase of \$2,687,817, or 17.4%, in gross profit, a decrease of \$436,715, or 153.6%, in gain on other sales, and a decrease of \$265,835, or 4.3%, in operating expenses.

#### FINANCIAL EXPENSES

Financial expenses were \$271,422 for the three months ended September 30, 2010, compared with \$401,121 for the three months ended September 30, 2009, a decrease of \$129,699, or 32.2%, primarily due to a decrease in convertible note interest expense, and a decrease in convertible note discount amortization.

#### GAIN (LOSS) ON CHANGE IN FAIR VALUE OF DERIVATIVE

Gain on change in fair value of derivative was \$509,705 for the three months ended September 30, 2010, compared with \$3,129,794 for the same period of 2009, a decrease of \$2,620,089.



The fair value of compound derivatives is predicated on a probability assessment of the likelihood of a triggering event and the incremental value embodied in the hybrid instrument. See Note 13 of the financial statements regarding the assessment of compound derivatives. For example: mandatory redemption requires the gross yield arrived at 13% and annual redemption requires the gross yield arrived at 11%.

On September 30, 2010, the fair value of compound derivatives was \$127,011, compared with \$636,716 on June 30, 2010, a decrease of \$509,705, mainly as a result of the recent capital market recovery. As the Company's stock price rose, the probability of the Company's stock price trading above \$8.6 rose, and the Convertible Note holders would gain more income by conversion than the income from bond market or redemption of Convertible Notes upon the occurrence of any triggering event as defined in the debt agreement. Thus, the probability of redemption decreased.

On September 30, 2009, the fair value of compound derivatives was \$913,063, compared with \$4,042,857 on June 30, 2009, a significant decrease of \$3,129,794, mainly as a result of the recent market recovery, the Company's stock price rose dramatically. On September 30, 2009, the Company's stock price was 31.2% over the adjusted conversion price (\$7.0822). So the risk of annual redemption was low. Moreover, the Company received a revocation of such mandatory redemption notice so the risk of mandatory redemption was significantly low.

#### INCOME BEFORE INCOME TAXES

Income before income taxes was \$12,409,656 for the three months ended September 30, 2010, compared with \$12,383,109 for the three months ended September 30, 2009, an increase of \$26,547, or 0.2%, including an increase in income from operations of \$2,516,937, a decrease in financial expenses of \$129,699, and a decrease in gain on change in fair value of derivative of \$2,620,089

#### INCOME TAXES

Income tax expense was \$1,866,157 for the three months ended September 30, 2010, compared with \$1,789,836 of income tax expense for the three months ended September 30, 2009, an increase of \$76,321, mainly due to an increase of taxable income.

#### NET INCOME

Net income was \$10,543,499 for the three months ended September 30, 2010, compared with \$10,593,273 for the three months ended September 30, 2009, a decrease of \$49,774, or 0.5%, including an increase in income before income taxes of \$26,547, or 0.2%, and an increase in income taxes expenses of \$76,321, or 4.3%.

#### NET INCOME ATTRIBUTABLE TO NON-CONTROLLING INTEREST

Non-controlling interest in the earnings of the Sino-foreign Joint-ventures amounted to \$2,350,280 for the three months ended September 30, 2010, compared with \$2,036,762 for the three months ended September 30, 2009, an increase of \$313,518, or 15.4%.

The Company owns different equity interest in nine Sino-foreign joint ventures, through which it conducts its operations. All the operating results of these nine Sino-foreign joint ventures were consolidated in the Company's financial statements as of September 30, 2010 and 2009. The Company records the non-controlling interest's share in the earnings of the respective Sino-foreign joint ventures for each period.

In 2010, non-controlling interest increased significantly compared with 2009, primarily due to the increase in Sino-foreign joint ventures' net income.

#### NET INCOME ATTRIBUTABLE TO PARENT COMPANY

Net income attributable to parent company was \$8,193,219 for the three months ended September 30, 2010, compared with a net income of \$8,556,511 for the three months ended September 30, 2009, a decrease of \$363,292, or 4.2%.

mainly due to the decrease in the gain on change in fair value of derivative.

RESULTS OF OPERATIONS—NINE MONTHS ENDED SEPTEMBER 30, 2010 AND 2009:

|               | Net Sales      |                |               |        | Cost of sales  |                |               |        |
|---------------|----------------|----------------|---------------|--------|----------------|----------------|---------------|--------|
|               | 2010           | 2009           | Change        |        | 2010           | 2009           | Change        |        |
| Henglong*     | \$ 138,695,623 | \$ 100,928,129 | \$ 37,767,494 | 37.4%  | \$ 105,072,685 | \$ 72,337,699  | \$ 32,734,986 | 45.3%  |
| Jiulong**     | 66,404,291     | 40,624,976     | 25,779,315    | 63.5%  | 57,012,846     | 34,369,946     | 22,642,900    | 65.9%  |
| Shenyang      | 28,376,664     | 23,387,369     | 4,989,295     | 21.3%  | 23,829,846     | 19,477,714     | 4,352,132     | 22.3%  |
| Zhejiang      | 18,238,724     | 17,955,131     | 283,593       | 1.6%   | 13,033,040     | 13,644,264     | (611,224)     | -4.5%  |
| Wuhu          | 22,628,769     | 17,390,572     | 5,238,197     | 30.1%  | 20,876,023     | 16,735,859     | 4,140,164     | 24.7%  |
| Other Sectors | 28,791,495     | 4,746,159      | 24,045,336    | 506.6% | 24,150,705     | 3,605,837      | 20,544,868    | 569.8% |
| Other ***     | (57,718,895)   | (33,196,242)   | (24,522,653)  | 73.9%  | (59,077,311)   | (31,030,241)   | (28,047,070)  | 90.4%  |
| Total         | \$ 245,416,671 | \$ 171,836,094 | \$ 73,580,577 | 42.8%  | \$ 184,897,834 | \$ 129,141,078 | \$ 55,756,756 | 43.2%  |

\* Excluding \$9,218,000 of income and \$7,919,000 of cost for Column sales, which has been transferred to Jielong in 2010.

\*\* Including \$9,497,104 of income and \$7,430,534 of cost for Chrysler sales in 2010.

\*\*\* Other includes activity not allocated to the product sectors and elimination of inter-sector transactions.

## NET SALES

Net sales were \$245,416,671 for the nine months ended September 30, 2010, compared with \$171,836,094 for the nine months ended September 30, 2009, an increase of \$73,580,577, or 42.8%, mainly due to the increases in the income of Chinese residents and huge government investment leading to an increase in the sales of passenger vehicles and commercial vehicles, and the resultant increase in the Company's sales of steering gear and pumps; the Company has raised the technological contents in, and production efficiency of, its products as a result of technological improvement to its production lines, allowing the Company to reduce costs and, correspondingly, its sales prices which led to increased sales volumes.

Net sales for Henglong was \$138,695,623 for the nine months ended September 30, 2010, compared with \$100,928,129 for the nine months ended September 30, 2009, representing an increase of 37,767,494, or 37.4%. Net sales increase was mainly due to increased production volumes with a sales increase of \$51,969,950, decreased sales price with a sales decrease of \$15,163,586, and the effect of foreign currency translation with a sales increase of \$961,130.

Net sales for Jiulong was \$66,404,291 for the nine months ended September 30, 2010, compared with \$40,624,976 for the nine months ended September 30, 2009, representing an increase of \$25,779,315, or 63.5%. Net sales increase was mainly due to increased production volumes with a sales increase of \$22,479,719, increased sales price with a sales increase of \$2,902,618, and the effect of foreign currency translation with a sales increase of \$396,978.

Net sales for Shenyang was \$28,376,664 for the nine months ended September 30, 2010, compared with \$23,387,369 for the nine months ended September 30, 2009, representing an increase of \$4,989,295, or 21.3%. Net sales increase was mainly due to increased production volumes with a sales increase of \$6,417,009, decreased sales price with a sales decrease of \$1,650,730, and the effect of foreign currency translation with a sales increase of \$223,016.

Net sales for Zhejiang was \$18,238,724 for the nine months ended September 30, 2010, compared with \$17,955,131 for the nine months ended September 30, 2009, representing an increase of \$283,593, or 1.6%. Net sales increase was mainly due to increased production volumes with a sales increase of \$1,255,966 and decreased sales price with a sales decrease of \$1,136,396 and the effect of foreign currency translation with a sales increase of \$164,023.

Net sales for Wuhu was \$22,628,769 for the nine months ended September 30, 2010, compared with \$17,390,572 for the nine months ended September 30, 2009, representing an increase of \$5,238,197, or 30.1%. Net sales increase was mainly due to increased production volumes with a sales increase of 5,639,983 and decreased sales price with a sales decrease of \$561,119 and the effect of foreign currency translation with a sales increase of \$159,333.

Net sales for Other Sectors was \$28,791,495 for the nine months ended September 30, 2010, compared with \$4,746,159 for the nine months ended September 30, 2009, representing an increase of \$24,045,336 or 506.6%. Net sales increased mainly due to the development of new market.

## COST OF SALES

For the nine months ended September 30, 2010, the cost of sales was \$184,897,834, compared with \$129,141,078 for the same period of 2009, an increase of \$55,756,756, or 43.2%, mainly due to the increase of sales.

Cost of sales for Henglong was \$105,072,685 for the nine months ended September 30, 2010, compared with \$72,337,699 for the nine months ended September 30, 2009, representing an increase of \$32,734,986, or 45.3%. Cost of sales increase was mainly due to increased sale volumes with a cost of sales increase of \$36,558,326, decreased unit price with a cost of sales decrease of \$4,511,589, and the effect of foreign currency translation with a cost increase of

\$688,249.

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Cost of sales for Jiulong was \$57,012,846 for the nine months ended September 30, 2010, compared with \$34,369,946 for the nine months ended September 30, 2009, representing an increase of \$22,642,900, or 65.9%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$18,814,832, increased unit price with a cost of sales increase of \$3,499,276, and the effect of foreign currency translation with a cost increase of \$328,792.

Cost of sales for Shenyang was \$23,829,846 for the nine months ended September 30, 2010, compared with \$19,477,714 for the nine months ended September 30, 2009, representing an increase of \$4,352,132, or 22.3%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$5,313,784, decreased unit price with a cost of sales decrease of \$1,148,723, and the effect of foreign currency translation with a cost increase of \$187,071.

Cost of sales for Zhejiang was \$13,033,040 for the nine months ended September 30, 2010, compared with \$13,644,264 for the nine months ended September 30, 2009, representing a decrease of \$611,224, or 4.5%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$957,338, decreased unit price with a cost of sales decrease of \$1,692,665, and the effect of foreign currency translation with a cost increase of \$124,103.

Cost of sales for Wuhu was \$20,876,023 for the nine months ended September 30, 2010, compared with \$16,735,859 for the nine months ended September 30, 2009, representing an increase of \$4,140,164, or 24.7%. Cost of sales increase was mainly due to increased sales volumes with a cost of sales increase of \$5,481,947, decreased unit price with a cost of sales decrease of \$1,492,002, and the effect of foreign currency translation with a cost increase of \$150,219.

Cost of sales for Other Sectors was \$24,150,705 for the nine months ended September 30, 2010, compared with \$3,605,837 for the nine months ended September 30, 2009, representing an increase of \$20,544,868, or 569.8%. Cost of sales increase was mainly due to increases of sales.

Gross margin was 24.7% for the nine months ended September 30, 2010, a decrease of 0.1% from 24.8% for the same period of 2009, primarily due to sales price reductions in excess of declines in unit cost. For the nine months ended September 30, 2010, the Company classified product warranty expenses as selling cost, which were classified as selling expenses in previous periods. As a result, the Company reclassified product warranty expenses for the same period of 2009 as selling cost to achieve consistency with the presentation of the current period. Effects of the reclassification are set forth in the table below.

|  | Nine Months Ended September 30, |                |
|--|---------------------------------|----------------|
|  | 2010                            | 2009           |
| <b>Before reclassification:</b>            |                                 |                |
| Net sales                                  | \$ 245,416,671                  | \$ 171,836,094 |
| Cost of goods sold before reclassification | 177,994,558                     | 123,497,209    |
| Gross profit before reclassification       | \$ 67,422,113                   | \$ 48,338,885  |
| Gross margin before reclassification       | 27.5%                           | 28.1%          |
| <b>After reclassification :</b>            |                                 |                |
| Net sales                                  | \$ 245,416,671                  | \$ 171,836,094 |
| Cost of goods sold add Warranty expenses   | 184,897,834                     | 129,141,078    |
| Gross profit after reclassification        | \$ 60,518,837                   | \$ 42,695,016  |
| Gross margin after reclassification        | 24.7%                           | 24.8%          |
| Selling expenses before reclassification   | \$ 13,769,525                   | \$ 10,509,910  |
| Minus: Warranty expenses                   | 6,903,276                       | 5,643,869      |

|   |              |              |
|---|--------------|--------------|
| Selling expenses after reclassification | \$ 6,866,249 | \$ 4,866,041 |
|---|--------------|--------------|

#### GAIN ON OTHER SALES

Gain on other sales consists of net amount retained from sales of materials and other assets. For the nine months ended September 30, 2010, gain on other sales was \$981,128, compared with \$523,860 for the same period of 2009, an increase of \$457,268, or 87.3%, mainly due to increased sales of materials.

## SELLING EXPENSES

Selling expenses were \$6,866,249 for the nine months ended September 30, 2010, compared with \$4,866,041 for the same period of 2009, an increase of \$2,000,208, or 41.1%. Material increases were salaries and wages expenses, and transportation expenses.

The salaries of salesmen were indexed with their selling performance. During the nine months ended September 30, 2010, sales revenue increased 42.8% compared with the same period of 2009, correspondingly increasing the salaries of sales persons.

The increase in transportation expense was due to increased sales and a rise in the price of oil, which led to increases in domestic transportation prices.

## GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses were \$7,737,989 for the nine months ended September 30, 2010, compared with \$6,787,918 for the same period of 2009, an increase of \$950,071, or 14.0%. Material increases were salaries and wages expenses, labor insurance expenses, and provision for bad debts.

The increase in salaries and wages was due to increased staff and performance bonuses resulting from enlarged business size and improved earnings.

The Company's labor insurance expenses were pension, medicare, injury insurance, unemployment insurance, and housing fund expenses. The increase in labor insurance expenses for the nine months ended September 30, 2010 was a result of an increase in the number of employees.

## RESEARCH AND DEVELOPMENT EXPENSES

Research and development expenses were \$4,291,044 for the nine months ended September 30, 2010, compared with \$1,415,531 for the nine months ended September 30, 2009, an increase of \$2,875,513, or 203.1%.

The global automotive parts industry is highly competitive; winning and maintaining new business requires suppliers to rapidly produce advanced products on a cost-competitive basis. In order to maintain its competitiveness, the Company needs to invest more in R & D expenses.

## DEPRECIATION AND AMORTIZATION EXPENSE

For the nine months ended September 30, 2010, depreciation and amortization expenses excluded from that recorded under cost of sales were \$829,865, compared with \$1,742,162 for the same period of 2009, a decrease of \$912,297, or 52.4%, as a result of certain fixed assets of the Company having been fully depreciated.

## INCOME FROM OPERATIONS

Income from operations was \$41,774,818 for the nine months ended September 30, 2010, compared with \$28,407,224 for the nine months ended September 30, 2009, an increase of \$13,367,594, or 47.1%, as a result of an increase of \$17,823,821, or 41.7%, in gross profit, an increase of \$457,268, or 87.3%, in gain on other sales, and an increase of \$4,913,495, or 33.2%, in operating expenses.

## FINANCIAL EXPENSES



Financial expenses were \$1,052,782 for the nine months ended September 30, 2010, compared with \$1,318,829 for the nine months ended September 30, 2009, a decrease of \$266,047, or 20.2%, primarily due to a decrease in convertible note interest expense, and a decrease in convertible note discount amortization.

**GAIN ON CHANGE IN FAIR VALUE OF DERIVATIVE**

Gain on change in fair value of derivative was \$752,997 for the nine months ended September 30, 2010, compared with a loss of \$591,511 for the same period of 2009, an increase of \$161,486.

The fair value of compound derivatives is predicated on a probability assessment of the likelihood of a triggering event and the incremental value embodied in the hybrid instrument. See Note 13 of the financial statements regarding the assessment of compound derivatives. For example: mandatory redemption requires the gross yield arrived at 13% and annual redemption requires the gross yield arrived at 11%.

On September 30, 2010, the fair value of compound derivatives was \$127,012, compared with \$880,009 on December 31, 2009, a decrease of \$752,997, mainly as a result of the recent capital market recovery. As the Company's stock price rose dramatically, the probability of the Company's stock price trading above \$8.6 rose, and the Convertible Note holders would gain more income by conversion than the income from bond market or redemption of Convertible Notes upon the occurrence of any triggering event as defined in the debt agreement. Thus, the probability of redemption decreased.

On September 30, 2009, the fair value of compound derivatives was \$913,063, compared with \$1,502,597 on December 31, 2008, a decrease of \$589,534, mainly as a result of the recent market recovery, the Company's stock price rose dramatically. On September 30, 2009, the Company's stock price was 31.2% over the adjusted conversion price (\$7.0822). So the risk of annual redemption was low. Moreover the Company received a revocation of such mandatory redemption notice so the risk of mandatory redemption was significantly low.

#### INCOME BEFORE INCOME TAXES

Income before income taxes was \$41,741,412 for the nine months ended September 30, 2010, compared with \$27,679,906 for the nine months ended September 30, 2009, an increase of \$14,061,506, or 50.8%, including an increase in income from operations of \$13,367,594, an increase in other income of \$266,379, a decrease in financial expenses of \$266,047, and an increase in gain on change in fair value of derivative of \$161,486.

#### INCOME TAXES

Income tax expense was \$6,442,971 for the nine months ended September 30, 2010, compared with \$4,714,124 of income tax expense for the nine months ended September 30, 2009, an increase of \$1,728,847, mainly due to an increase of taxable income.

#### NET INCOME

Net income was \$35,298,441 for the nine months ended September 30, 2010, compared with \$22,965,782 for the nine months ended September 30, 2009, an increase of \$12,332,659, or 53.7%, including an increase in income before income taxes of \$14,061,506, or 50.8%, and an increase in income tax expenses of \$1,728,847, or 36.7%.

#### NET INCOME ATTRIBUTABLE TO NON-CONTROLLING INTEREST

Net income attributable to non-controlling interest was \$8,227,985 for the nine months ended September 30, 2010, compared with \$6,074,110 for the nine months ended September 30, 2009, an increase of \$2,153,875, or 35.5%.

The Company owns different equity interest in nine Sino-foreign joint ventures, through which it conducts its operations. All the operating results of these nine Sino-foreign joint ventures were consolidated in the Company's financial statements as of September 30, 2010 and 2009. The Company records the non-controlling interest's share in the earnings of the respective Sino-foreign joint ventures for each period.

In 2010, non-controlling interest increased significantly compared with 2009, primarily due to the increase in Sino-foreign joint ventures' net income.

NET INCOME ATTRIBUTABLE TO PARENT COMPANY

Net income attributable to parent company was \$27,070,456 for the nine months ended September 30, 2010, compared with a net income of \$16,891,672 for the nine months ended September 30, 2009, an increase of \$10,178,784, or 60.3%, mainly due to the increase in the Company' net income.

## 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' acceptance, issuances of capital stock and notes and internally generated cash. As of September 30, 2010, the Company had cash and cash equivalents of \$49,201,859, compared with \$45,894,475 as of September 30, 2009, an increase of \$3,307,384, or 7.2%.

The Company had working capital of \$83,208,027 as of September 30, 2010, compared with \$87,486,058 as of September 30, 2009, a decrease of \$4,278,031, or 4.9%.

### Financing activities:

For the Company's bank loans and banker's acceptance bill facilities, the Company's banks require the Company to sign documents to 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, it can extend such one year facilities for another year.

The Company had bank loans maturing in less than one year of \$8,953,754 and bankers' acceptances of \$57,159,317 as of September 30, 2010.

The Company currently expects to be able to obtain similar bank loans and bankers' acceptance bills in the future if it can provide adequate mortgage security following the termination of the above mentioned agreements (See the table in section (a) Bank loan). 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 acceptance bills will be devalued by approximately \$9,008,085. If the Company wishes to obtain the same amount of bank loans and banker's acceptance bills, it will have to provide \$9,008,085 additional mortgages as of the maturity date of such agreements (See the table in section (a) Bank loan). The Company could obtain a reduced line of credit with a reduction of \$4,675,100, 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 February 15, 2008, the Company issued \$35,000,000 of convertible notes to Lehman Brothers Commercial Corporation Asia Limited, LBCCA, and YA Global Investments, L.P., YA Global, maturing in 5 years. According to the terms of the Senior Convertible Notes (as described in Note 12), convertible notes may be required to be repaid in cash on or prior to their maturity. For example, Convertible Note holders are entitled to require the Company redeem all or any portion of the Convertible Notes in cash, if the Weighted Average Price (WAP) for twenty (20) consecutive trading days is less than \$3.187 at any time following February 15, 2009, the "WAP Default", by delivering written redemption notice to the Company within five (5) business days after the receipt of the Company's notice of the WAP Default.

As a result of the worldwide financial turmoil in 2008 and the first half of 2009, the Company's stock's WAP for twenty (20) consecutive trading days ended on March 16, 2009 was below \$3.187. On March 17, 2009, the Company delivered two WAP Default notices to the Convertible Note holders. On March 27, 2009, the Company received a letter dated March 26, 2009 via fax from YA Global, one of the Convertible Note holders, electing to require the Company to redeem all the three Convertible Notes it held in the total principal amount of \$5,000,000, together with interest, late charges, if any, and the Other Make Whole Amount as defined in Section 5(d) of the Convertible Notes. After negotiation, on April 15, 2009, the Company paid YA Global \$5,041,667 for the total principal amount

(\$5,000,000), together with interest and late charges, if any. YA Global has waived its entitlement to the Other Make Whole Amount.

Following the WAP Default notices, the Company received a letter from the provisional liquidator acting on behalf of LBCCA, the "LBCCA Liquidator", requesting that it be granted an extension until April 24, 2009 to consider its rights under the Convertible Notes. The Company has granted an extension to April 15, 2009. The LBCCA Liquidator further requested another extension to April 24, 2009. On April 24, 2009, LBCCA's lawyers sent three Holder Redemption Notices via fax electing to redeem the entire outstanding principal of \$30,000,000, together with interest, late charges, if any, and the Other Make Whole Amount, to be paid on July 23, 2009. The Company has discussed settlement with the LBCCA Liquidator, and on or about July 22, 2009, the Company and the LBCCA Liquidator agreed to extend the applicable holder mandatory redemption date for two months to September 23, 2009 to give more time to the Company and the LBCCA Liquidator to pursue settlement discussion. The Company received a letter dated September 22, 2009 from the LBCCA Liquidator stating that upon the Company's acceptance of the revocation, all holder redemption notices dated April 24, 2009 shall be immediately revoked as if they were never issued, and the letter and the revocation did not purport to amend, restate or supplement any other terms and conditions under the three Notes and Securities Purchase Agreement dated 1 February 2008 between the Company and the LBCCA Liquidator. The Company accepted such revocation on September 23, 2009.

The Company's ability to redeem the Convertible Notes and meet its payment obligations depends on its cash position and its ability to refinance or generate significant cash flow, which is subject to general economic, financial and competition factors and other factors beyond the Company's control. The Company cannot assure you that it has sufficient funds available or will be able to obtain sufficient funds to meet its payment obligations under the Convertible Notes, and the Company's redemption of the Convertible Notes would result in an adverse effect on its liquidity and capital resources, business, results of operations or financial condition.

## (a) Bank loans

As of September 30, 2010, the principal outstanding under the Company's credit facilities and lines of credit was as follows:

|                                 | Bank                                    | Due Date | Amount available     | Amount Borrowed      |
|---------------------------------|---|----------|----------------------|----------------------|
| Comprehensive credit facilities | Bank of China                           | Oct -10  | \$ 7,610,691         | \$ 2,238,438         |
| Comprehensive credit facilities | China Construction Bank                 | Oct-10   | 8,953,754            | 5,713,734            |
| Comprehensive credit facilities | Shanghai Pudong Development Bank        | Oct-10   | 11,192,043           | 11,192,043           |
| Comprehensive credit facilities | Jingzhou Commercial Bank                | Oct-10   | 14,922,923           | 11,633,612           |
| Comprehensive credit facilities | Industrial and Commercial Bank of China | Nov-10   | 11,938,338           | 3,093,522            |
| Comprehensive credit facilities | Bank of Communications Co., Ltd         | Nov-10   | 3,402,426            | 910,298              |
| Comprehensive credit facilities | China Merchants Bank                    | Nov -10  | 362,627              | 362,627              |
| Comprehensive credit facilities | China CITIC Bank                        | Jul -11  | 19,847,488           | 19742281             |
| Comprehensive credit facilities | China Hua Xia Bank                      | Oct-10   | 7,461,462            | 5,969,169            |
| Comprehensive credit facilities | China Everbright Bank                   | Mar-11   | 5,257,346            | 5,257,346            |
| <b>Total</b>                    |   |          | <b>\$ 90,949,098</b> | <b>\$ 66,113,071</b> |

The Company may request banks to issue notes payable or bank loans within its credit line using a 364-day revolving line.

The Company refinanced its short-term debt during early 2010 at annual interest rates of 5.31%, and maturity terms of nine to twelve months. Pursuant to the refinancing arrangement, the Company pledged \$39,698,602 of equipment, land use rights and buildings as security for its comprehensive credit facility with the Bank of China; pledged \$18,243,303 of land use rights and buildings as security for its comprehensive credit facility with Shanghai Pudong Development Bank; pledged \$28,115,514 of land use rights and equipment as security for its revolving comprehensive credit facility with Jingzhou Commercial Bank; pledged \$5,677,413 of accounts receivable, land use rights and buildings as security for its comprehensive credit facility with Industrial and Commercial Bank of China; pledged \$13,209,487 of accounts receivable, land use rights and buildings as security for its comprehensive credit facility with China Construction Bank; pledged \$18,482,219 of land use rights, notes receivable and buildings as security for its comprehensive credit facility with China CITIC Bank; pledged \$6,535,496 of land use rights and buildings as security for its comprehensive credit facility with Bank of Communications Co., Ltd. The Company's subsidiary, Henglong's comprehensive credit facility with China Hua Xia Bank, was guaranteed by Jiulong, the Company's other subsidiary. The Company's subsidiary, Wuhu's comprehensive credit facility with China Everbright Back, was guaranteed by Henglong, the Company's other subsidiary. The Company's subsidiary, Zhejiang's comprehensive credit facility with China Merchants Bank, was guaranteed by Henglong, the Company's other subsidiary.

## (b) Financing from investors:

On February 15, 2008, the Company sold \$30,000,000 and \$5,000,000 convertible notes to Lehman Brothers Commercial Corporation Asia Limited, LBCCA, and YA Global Investments, L.P., YA Global, respectively, with a scheduled maturity date of February 15, 2013 and an initial conversion price for conversion into the Company's common stock of \$8.8527 per share. According to the terms of the convertible notes, the conversion price was reset to \$7.0822 as of August 15, 2008 based on the weighted average price of the stock on that date.

On April 15, 2009, the Company paid YA Global \$5,041,667 to redeem the total principal amount (\$5,000,000), together with interest, and late charges. YA Global has waived its entitlement to the Other Make Whole Amount.

Cash Requirements:

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.



|  | Payment Due Dates     |                       |                     |                  |                   |
|--|-----------------------|-----------------------|---------------------|------------------|-------------------|
|  | Total                 | Less than 1 year      | 1-3 years           | 3-5 years        | More than 5 Years |
| Short-term bank loan   | \$ 8,953,754          | \$ 8,953,754          | \$ -                | \$ -             | \$ -              |
| Notes payable  | 57,159,317            | 57,159,317            | -                   | -                | -                 |
| Convertible notes payable  | 30,000,000            | 30,000,000            | -                   | -                | -                 |
| Other contractual purchase commitments, including information technology | 17,413,862            | 11,840,965            | 5,484,543           | 88,354           | -                 |
| <b>Total</b>   | <b>\$ 113,526,933</b> | <b>\$ 107,954,036</b> | <b>\$ 5,484,543</b> | <b>\$ 88,354</b> | <b>\$ -</b>       |

Short-term bank loans:

The following table summarizes the contract information of short-term borrowings between the banks and the Company as of September 30, 2010:

| Bank   | Purpose         | Borrowing Date | Borrowing Term (Year) | Annual Percentage Rate | Date of Interest Payment | Date of Payment | Amount Payable on Due Date |
|--|-----------------|----------------|-----------------------|------------------------|--------------------------|-----------------|----------------------------|
| Bank of China  | Working Capital | Nov 10, 09     | 1                     | 5.31%                  | Pay monthly              | Nov 10, 10      | \$ 2,238,438               |
| China CITIC Bank Industrial and Commercial Bank of China | Working Capital | May 26, 10     | 1                     | 5.31%                  | Pay monthly              | May 26, 11      | 2,238,438                  |
| China Construction Bank                                  | Working Capital | May 14, 10     | 0.5                   | 4.86%                  | Pay monthly              | Nov 14, 10      | 1,492,293                  |
|  | Working Capital | Jun 17, 10     | 1                     | 5.31%                  | Pay monthly              | Jun 17, 11      | 2,984,585                  |
| <b>Total</b>   |                 |                |                       |                        |                          |                 | <b>\$ 8,953,754</b>        |

The Company must use the loans for the purposes described in the table. If the Company fails, it will be charged a penalty interest at 100% of the specified loan rate. The Company has to pay interest at the interest rate described in the table on the 20th of each month. If the Company fails, it will be charged a compound interest at the specified rate. The Company has to repay the principal outstanding on the specified date in the table. If it fails, it will be charged a penalty interest at 50% of the specified loan rate. Management believes that the Company had complied with such financial covenants as of September 30, 2010, and will continue to comply with them.

The following table summarizes the contract information of issuing notes payable between the banks and the Company as of September 30, 2010:

| Purpose         | Term (Month) | Due Date | Amount Payable on Due Date |
|-----------------|--------------|----------|----------------------------|
| Working Capital | 3-6          | Oct - 10 | \$ 8,812,285               |
| Working Capital | 3-6          | Nov - 10 | 11,068,630                 |
| Working Capital | 3-6          | Dec - 10 | 9,985,420                  |
| Working Capital | 3-6          | Jan - 11 | 9,779,738                  |
| Working Capital | 3-6          | Feb - 11 | 8,897,793                  |
| Working Capital | 3-6          | Mar - 11 | 8,615,451                  |
| <b>Total</b>    |              |          | <b>\$ 57,159,317</b>       |

The Company must use the loan for the purposes described in the table. If it fails, 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 to the Company, it will be charged a penalty interest at 150% of the specified loan rate. Management believes that the Company had complied with such financial covenants as of September 30, 2010, and will continue to comply with them.

The Company had approximately \$17,193,861 of capital commitments as of September 30, 2010, arising from equipment purchases for expanding production capacity. The Company intends to disperse \$11,730,965 in the remaining three months of 2010 using its working capital. Management believes that these capital commitments will not have a material adverse effect on the Company's liquidity.

Cash flows:

(a) Operating activities

Net cash generated from operations during the nine months ended September 30, 2010 was \$29,604,550, compared with \$24,340,951 for the same period of 2009, an increase of \$5,263,599.

Similar to the same period of 2009, the increased cash outflows from operating activities were primarily due to increases in accounts and notes receivable and inventories.

At September 30, 2010, the Company's cash outflow caused by increase of accounts and notes receivable and increase of inventories were \$2,780,000, \$23,000,000, and \$13,680,000 respectively, compared with December 31, 2009. Increase of accounts receivable was primarily due to sales increase during the nine months ended September 30, 2010. The credit terms on sale of goods between customers and the Company generally range from 3 to 4 months, which resulted in increased accounts receivable as sales increased. Increase of notes receivable was mainly due to the Company having sufficient working capital, thus leading to a decrease of the discount of notes receivable during the period. Since the notes receivable were based on bank credit standing, they may be converted into cash any time the Company elects. Therefore, the increase of notes receivable will not have a material adverse effect on the Company's future operating activities. Increase of inventories was primarily due to an increase of reserved raw materials and inventories as the increase of sales. These are a normal capital circulation and the Company believes that it will not have a material adverse effect on future cash flows.

(b) Investing activities

The Company expended net cash of \$25,891,634 in investment activities during the nine months ended September 30, 2010, compared with \$8,332,600 during the same period of 2009, an increase of 17,559,034. Similar to 2009, the Company invested in equipment and building facility to expand production to meet market needs. Cash used for equipment purchases and building facility during the nine months ended September 30, 2010 and 2009 were \$24,005,602 and \$8,814,876, respectively.

(c) Financing activities

During the nine months ended September 30, 2010, the Company provided net cash of \$1,189,918 from financing activities, as compared to expending net cash of \$7,258,470 in financing activities for the same period of 2009, an increase of \$8,448,388 as a result of the following factors:

The Company bank loans provided net cash of \$3,685,215 during the nine months ended September 30, 2010, compared to \$2,197,177 for the nine months ended September 30, 2009, an increase of \$1,488,038.

During the nine months ended September 30, 2010, the Company distributed dividends of \$2,871,603 to minority shareholders, and distributed \$4,176,583 in the same period of 2009.

The Company repaid YA Global \$5,000,000 for its convertible notes upon its request during the nine months ended September 30, 2009.

#### OFF-BALANCE SHEET ARRANGEMENTS

The Company does not have any transactions, obligations or relationships that could be considered off-balance sheet arrangements.

## COMMITMENTS AND CONTINGENCIES

The following table summarizes the Company's contractual payment obligations and commitments as of September 30, 2010:

|                                       | Payment Obligations by Period |              |           |      |            | Total         |
|---------------------------------------|-------------------------------|--------------|-----------|------|------------|---------------|
|                                       | 2010 (a)                      | 2011         | 2012      | 2013 | Thereafter |               |
| Obligations for service agreements    | \$ 110,000                    | \$ 110,000   | \$ -      | \$ - | \$ -       | \$ 220,000    |
| Obligations for purchasing agreements | 11,730,965                    | 5,374,543    | \$ 88,354 | \$ - | -          | 17,193,862    |
| Total                                 | \$ 11,840,965                 | \$ 5,484,543 | \$ 88,354 | \$ - | \$ -       | \$ 17,413,862 |

(a) Remaining 3 months in 2010.

#### SUBSEQUENT EVENT

On January 24, 2010, Genesis entered into a joint venture contract with Beijing Hainachuan Auto Parts Co., Ltd., to establish a joint venture company, Beijing Henglong Automotive System Co., Ltd., “Beijing Henglong”, to design, develop and manufacture both hydraulic and electric power steering systems and parts. On October 19, 2010, both parties agreed to change the Joint venture company’s investor into Hengsheng from Genesis, and left the other terms of the joint venture contract unchanged. Under PRC laws, the establishment of Beijing Henglong and the effectiveness of the equity joint venture contract are subject to approval by Administration For Industry and Commerce in Beijing.

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

Not applicable.

#### ITEM 4 CONTROLS AND PROCEDURES

##### ( a ) EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in reports the Company files with the SEC under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to the Company’s management, including its CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

The Company’s management carried out an evaluation, under the supervision and with the participation of the CEO and the CFO, of the effectiveness of the design and operation of the Company’s disclosure controls and procedures as of September 30, 2010. Based upon that evaluation, the CEO and CFO concluded that the Company’s disclosure controls and procedures were effective.

##### ( b ) CHANGES IN INTERNAL CONTROLS

There were no changes in the Company’s internal control over financial reporting during the quarter ended September 30, 2010 that have materially effected, or are reasonably likely to materially effect, the Company’s internal control over financial reporting.

### PART II.— OTHER INFORMATION

#### ITEM 1 LEGAL PROCEEDINGS

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

#### ITEM 1A RISK FACTORS

Any investment in the Company’s securities involves a high degree of risk. You should carefully consider the risks described below, together with the information contained elsewhere in this prospectus, before you make a decision to

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

#### Risks Related to the Company's Business and Industry

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

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

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

The Senior Convertible Notes are the Company's unsecured obligations, but are not obligations of its subsidiaries. In addition, the Company's secured commercial debt is senior to the Senior Convertible Notes.

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

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

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

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

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

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

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



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

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

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

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

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

As of September 30, 2010, approximately 15.3% of sales were to Xi'an BYD Electric Car Co., Ltd.; and approximately 11.7% were to Chery Automobile Corporation Limited, the Company's two largest customers.

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

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

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

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

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

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

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

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

The Company's management controls approximately 73.5 % of its outstanding common stock and may have conflicts of interest with its minority stockholders.

Members of the Company's management beneficially own approximately 73.5% of the outstanding shares of its common stock. As a result, these majority stockholders have control over decisions to enter into any corporate transaction and have the ability to prevent any transaction that requires the approval of stockholders, which could result in the approval of transactions that might not maximize stockholders' value. Additionally, these stockholders control the election of members of the Company's board, have the ability to appoint new members to its management team and control the outcome of matters submitted to a vote of the holders of its common stock. The interests of these majority stockholders may at times conflict with the interests of the Company's other stockholders. The Company regularly engages in transactions with entities controlled by one of more of its officers and directors.

Covenants contained in the Securities Purchase Agreement and the Senior Convertible Notes may restrict the Company's operating flexibility.

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

There is a limited public float of the Company's common stock. Of the Company's outstanding common stock, approximately 25.0% is considered part of the public float. The term "public float" refers to shares freely and actively tradable on the NASDAQ Global Market and not owned by officers, directors or affiliates, as such term is defined under the Securities Act. As a result of the limited public float and the limited trading volume on some days, the market price of the Company's common stock can be volatile, and relatively small changes in the demand for or supply of the Company's common stock can have a disproportionate effect on the market price for its common stock. This stock price volatility could prevent a security holder seeking to sell the Company's common stock or derivative securities from being able to sell them at or above the price at which the stock or derivative securities were bought, or at a price which a fully liquid market would report.

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

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

The Company does not pay cash dividends on its common stock.

The Company has never paid common stock cash dividends and does not anticipate doing so in the foreseeable future. In addition, the Securities Purchase Agreement prohibits the Company from paying cash dividends on common stock without the approval of the holders of the Senior Convertible Notes.

### Risks Related to Doing Business in China and Other Countries Besides the United States

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

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

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

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

The Company faces risks associated with currency exchange rate fluctuations; any adverse fluctuation may adversely affect its operating margins.

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

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

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

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

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

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

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

The Chinese Government's macroeconomic policies could have a negative effect on the Company's business and results of operations.

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

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

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

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

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

The Chinese legal system is based on written statutes and their interpretation by the Supreme People's Court. Although the Chinese government introduced new laws and regulations to modernize its business, securities and tax systems on January 1, 1994, China does not yet possess a comprehensive body of business law. Because Chinese laws and regulations are relatively new, interpretation, implementation and enforcement of these laws and regulations involve uncertainties and inconsistencies and it may be difficult to enforce contracts. In addition, as the Chinese legal system

develops, changes in such laws and regulations, their interpretation or their enforcement may have a material adverse effect on the Company's business operations. Moreover, interpretative case law does not have the same precedential value in China as in the United States, so legal compliance in China may be more difficult or expensive.

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

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



ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 RESERVED

ITEM 5 OTHER INFORMATION

None

ITEM 6. EXHIBITS

INDEX TO EXHIBITS

| Exhibit<br>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              |   |

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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\*

\* Filed herewith

SIGNATURES

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

CHINA AUTOMOTIVE SYSTEMS, INC.  
(Registrant)

Date: November 9, 2010

By: /s/ Qizhou Wu  
Qizhou Wu  
President and Chief Executive Officer

Date: November 9, 2010

By: /s/ Jie Li  
Jie Li  
Chief Financial Officer