

CHINA AUTOMOTIVE SYSTEMS INC

Form 10-Q

November 13, 2013

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, 2013

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**

**33-0885775**

(State or other jurisdiction of incorporation or  
organization)

(I.R.S. employer identification number)

**No. 1 Henglong Road, Yu Qiao Development Zone, Shashi District  
Jing Zhou City, Hubei Province, the People's Republic of China  
(Address of principal executive offices)**

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

Issuer's telephone number

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

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☐

Non-accelerated filer (Do not check if a smaller reporting company) ☐ Smaller reporting company ☒

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

Yes ☐ No ☒

As of November 13, 2013, the Company had 28,043,019 shares of common stock issued and outstanding.

**CHINA AUTOMOTIVE SYSTEMS, INC.**

INDEX

|                                                                                                                                                           | Page |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| <b>Part I Financial Information</b>                                                                                                                       |      |
| Item 1. Financial Statements.                                                                                                                             | 4    |
| Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income for the Three Months and Nine Months Ended September 30, 2013 and 2012 | 4    |
| Condensed Unaudited Consolidated Balance Sheets as of September 30, 2013 and December 31, 2012                                                            | 6    |
| Condensed Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2013 and 2012                                           | 7    |
| Notes to Condensed Unaudited Consolidated Financial Statements                                                                                            | 9    |
| Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.                                                            | 30   |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk.                                                                                       | 44   |
| Item 4. Controls and Procedures.                                                                                                                          | 44   |
| <b>Part II Other Information</b>                                                                                                                          |      |
| Item 1. Legal Proceedings.                                                                                                                                | 44   |
| Item 1A. Risk Factors.                                                                                                                                    | 45   |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.                                                                                      | 45   |
| Item 3. Defaults Upon Senior Securities.                                                                                                                  | 46   |
| Item 4. Mine Safety Disclosures.                                                                                                                          | 46   |
| Item 5. Other Information.                                                                                                                                | 46   |
| Item 6. Exhibits.                                                                                                                                         | 46   |
| Signatures                                                                                                                                                | 47   |

### **Cautionary Statement**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. These statements relate to future events or the Company's future financial performance. The Company has attempted to identify forward-looking statements by terminology including "anticipates," "believes," "expects," "can," "continues," "could," "estimates," "expects," "may," "plans," "potential," "predicts," "should" or "will" or the negative of these terms or other comparable terminology. statements are subject to certain risks and uncertainties, including the matters set forth in this Quarterly Report or other reports or documents the Company files with the Securities and Exchange Commission from time to time, which could cause actual results or outcomes to differ materially from those projected. Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, the Company cannot guarantee future results, levels of activity, performance or achievements. Undue reliance should not be placed on these forward-looking statements, which speak only as of the date hereof. The Company's expectations are as of the date this Form 10-Q is filed, and the Company does not intend to update any of the forward-looking statements after the date this Quarterly Report on Form 10-Q is filed to confirm these statements to actual results, unless required by law. All of the forward-looking statements are qualified in their entirety by reference to the factors discussed under Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, as filed with the Securities and Exchange Commission, and Item 1A "Risk Factors" of Part II in this report.

**PART I FINANCIAL INFORMATION****Item FINANCIAL STATEMENTS.****1.**

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

|                                                                                  | Three Months Ended September 30, |           |
|----------------------------------------------------------------------------------|----------------------------------|-----------|
|                                                                                  | 2013                             | 2012      |
| Net product sales                                                                |                                  |           |
| Unrelated parties                                                                | \$ 81,753                        | \$ 70,245 |
| Related parties (Note 29)                                                        | 9,166                            | 2,939     |
|                                                                                  | 90,919                           | 73,184    |
| Cost of product sold                                                             |                                  |           |
| Unrelated parties                                                                | 63,894                           | 56,231    |
| Related parties (Note 29)                                                        | 10,500                           | 4,452     |
|                                                                                  | 74,394                           | 60,683    |
| Gross profit                                                                     | 16,525                           | 12,501    |
| Gain on other sales                                                              | 5,030                            | 704       |
| Less: Operating expenses                                                         |                                  |           |
| Selling expenses                                                                 | 2,647                            | 2,437     |
| General and administrative expenses                                              | 2,821                            | 2,487     |
| Research and development expenses                                                | 5,117                            | 2,818     |
| Total operating expenses                                                         | 10,585                           | 7,742     |
| Income from operations                                                           | 10,970                           | 5,463     |
| Other income, net                                                                | 499                              | 238       |
| Financial income (expenses), net                                                 | 689                              | (437)     |
| Income before income tax expenses and equity in earnings of affiliated companies | 12,158                           | 5,264     |
| Less: Income taxes                                                               | 1,854                            | 891       |
| Equity in earnings of affiliated companies                                       | 125                              | 27        |
| Net income                                                                       | 10,429                           | 4,400     |
| Net income attributable to non-controlling interests                             | 1,805                            | 996       |
| Net income attributable to parent company's common shareholders                  | \$ 8,624                         | \$ 3,404  |
| Comprehensive income:                                                            |                                  |           |
| Net income                                                                       | \$ 10,429                        | \$ 4,400  |
| Other comprehensive income (loss):                                               |                                  |           |
| Foreign currency translation gain (loss), net of tax                             | 1,218                            | (556)     |
| Comprehensive income                                                             | 11,647                           | 3,844     |
| Comprehensive income attributable to non-controlling interests                   | 2,010                            | 904       |
| Comprehensive income attributable to parent company                              | \$ 9,637                         | \$ 2,940  |
| Net income attributable to parent company's common shareholders per share        |                                  |           |
| Basic                                                                            | \$ 0.31                          | \$ 0.12   |
| Diluted-                                                                         | \$ 0.31                          | \$ 0.12   |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

Weighted average number of common shares outstanding

|         |            |            |
|---------|------------|------------|
| Basic   | 28,043,019 | 28,260,302 |
| Diluted | 28,062,297 | 28,260,880 |

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

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

|                                                                                  | Nine Months Ended September 30, |            |
|----------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                                  | 2013                            | 2012       |
| Net product sales                                                                |                                 |            |
| Unrelated parties                                                                | \$ 259,627                      | \$ 215,157 |
| Related parties (Note 29)                                                        | 26,344                          | 19,325     |
|                                                                                  | 285,971                         | 234,482    |
| Cost of product sold                                                             |                                 |            |
| Unrelated parties                                                                | 208,525                         | 176,834    |
| Related parties (Note 29)                                                        | 23,171                          | 14,137     |
|                                                                                  | 231,696                         | 190,971    |
| Gross profit                                                                     | 54,275                          | 43,511     |
| Gain on other sales                                                              | 6,762                           | 2,625      |
| Less: Operating expenses                                                         |                                 |            |
| Selling expenses                                                                 | 9,611                           | 6,704      |
| General and administrative expenses                                              | 10,164                          | 8,999      |
| Research and development expenses                                                | 13,134                          | 10,060     |
| Total operating expenses                                                         | 32,909                          | 25,763     |
| Income from operations                                                           | 28,128                          | 20,373     |
| Other income, net                                                                | 573                             | 317        |
| Financial income (expenses), net                                                 | 380                             | (1,850)    |
| Loss on change in fair value of derivative                                       | -                               | (449)      |
| Gain on redemption of convertible notes                                          | -                               | 1,421      |
| Income before income tax expenses and equity in earnings of affiliated companies | 29,081                          | 19,812     |
| Less: Income taxes                                                               | 5,172                           | 3,666      |
| Equity in earnings of affiliated companies                                       | 251                             | 139        |
| Income from continuing operations                                                | 24,160                          | 16,285     |
| Discontinued operations - net of income tax (Note 26)                            | -                               | 2,651      |
| Net income                                                                       | 24,160                          | 18,936     |
| Net income attributable to non-controlling interests                             | 4,616                           | 3,279      |
| Net income attributable to parent company                                        | 19,544                          | 15,657     |
| Allocation to convertible notes holders                                          | -                               | (925)      |
| Net income attributable to parent company's common shareholders                  | \$ 19,544                       | \$ 14,732  |
| Comprehensive income:                                                            |                                 |            |
| Income from continuing operations                                                | \$ 24,160                       | \$ 16,285  |
| Income from discontinued operations                                              | -                               | 2,651      |
| Net income                                                                       | 24,160                          | 18,936     |
| Other comprehensive income (loss):                                               |                                 |            |
| Foreign currency translation gain (loss), net of tax - continuing operations     | 5,265                           | (1,205)    |
| Foreign currency translation loss, net of tax - discontinued operations          | -                               | (75)       |
| Foreign currency translation gain (loss), net of tax                             | 5,265                           | (1,280)    |
| Comprehensive income - continuing operations                                     | 29,425                          | 15,080     |
| Comprehensive income - discontinued operations                                   | -                               | 2,576      |
| Comprehensive income                                                             | 29,425                          | 17,656     |
| Comprehensive income attributable to non-controlling interests                   | 5,507                           | 3,023      |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                                                           |    |            |    |            |
|---------------------------------------------------------------------------|----|------------|----|------------|
| Comprehensive income attributable to parent company                       | \$ | 23,918     | \$ | 14,633     |
| Net income attributable to parent company's common shareholders per share |    |            |    |            |
| Basic                                                                     |    |            |    |            |
| Income per share from continuing operations attributable to shareholders  | \$ | 0.70       | \$ | 0.44       |
| Income per share from discontinued operations                             |    | -          |    | 0.08       |
|                                                                           | \$ | 0.70       | \$ | 0.52       |
| Diluted-                                                                  |    |            |    |            |
| Income per share from continuing operations attributable to shareholders  | \$ | 0.70       | \$ | 0.44       |
| Income per share from discontinued operations                             |    | -          |    | 0.08       |
|                                                                           | \$ | 0.70       | \$ | 0.52       |
| Weighted average number of common shares outstanding                      |    |            |    |            |
| Basic                                                                     |    | 28,043,019 |    | 28,260,302 |
| Diluted                                                                   |    | 28,054,008 |    | 28,261,529 |

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

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

|                                                                       | September<br>30, 2013 | December 31, 2012 |
|-----------------------------------------------------------------------|-----------------------|-------------------|
| <b>ASSETS</b>                                                         |                       |                   |
| Current assets:                                                       |                       |                   |
| Cash and cash equivalents                                             | \$ 54,702             | \$ 87,649         |
| Pledged cash deposits                                                 | 25,633                | 26,481            |
| Short-term investments                                                | 32,274                | -                 |
| Accounts and notes receivable, net - unrelated parties                | 247,002               | 211,306           |
| Accounts and notes receivable, net - related parties                  | 17,783                | 12,286            |
| Advance payments and others - unrelated parties                       | 2,336                 | 3,127             |
| Advance payments and others - related parties                         | 1,204                 | 779               |
| Inventories                                                           | 53,149                | 43,542            |
| Assets held for sale                                                  | 918                   | -                 |
| Current deferred tax assets                                           | 4,792                 | 4,392             |
| Total current assets                                                  | 439,793               | 389,562           |
| Non-current assets:                                                   |                       |                   |
| Property, plant and equipment, net                                    | 82,523                | 81,691            |
| Intangible assets, net                                                | 671                   | 676               |
| Other receivables, net - unrelated parties                            | 764                   | 849               |
| Other receivables, net - related parties                              | 67                    | 107               |
| Advance payment for property, plant and equipment - unrelated parties | 1,949                 | 1,001             |
| Advance payment for property, plant and equipment - related parties   | 829                   | 4,162             |
| Long-term investments                                                 | 3,933                 | 3,665             |
| Non-current deferred tax assets                                       | 5,549                 | 4,112             |
| Total assets                                                          | \$ 536,078            | \$ 485,825        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                           |                       |                   |
| Current liabilities:                                                  |                       |                   |
| Bank and government loans                                             | \$ 42,199             | \$ 40,284         |
| Accounts and notes payable - unrelated parties                        | 174,875               | 166,380           |
| Accounts and notes payable - related parties                          | 6,258                 | 4,521             |
| Customer deposits                                                     | 1,894                 | 870               |
| Accrued payroll and related costs                                     | 6,111                 | 5,472             |
| Accrued expenses and other payables                                   | 27,008                | 23,063            |
| Accrued pension costs                                                 | 5,002                 | 4,255             |
| Taxes payable                                                         | 8,979                 | 5,593             |
| Amounts due to shareholders/directors                                 | 303                   | 332               |
| Deferred tax liabilities                                              | 93                    | 46                |
| Advances payable                                                      | 2,635                 | -                 |
| Total current liabilities                                             | 275,357               | 250,816           |
| Long-term liabilities:                                                |                       |                   |
| Advances payable                                                      | -                     | 2,609             |
| Total liabilities                                                     | \$ 275,357            | \$ 253,425        |

Commitments and Contingencies (Note 30)

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

Stockholders' equity:

|                                                                                                                                                                      |            |            |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Common stock, \$0.0001 par value - Authorized - 80,000,000 shares; Issued 28,260,302 and 28,260,302 shares at September 30, 2013 and December 31, 2012, respectively | \$ 3       | \$ 3       |
| Additional paid-in capital                                                                                                                                           | 39,565     | 39,371     |
| Retained earnings-                                                                                                                                                   |            |            |
| Appropriated                                                                                                                                                         | 10,048     | 9,953      |
| Unappropriated                                                                                                                                                       | 138,778    | 119,329    |
| Accumulated other comprehensive income                                                                                                                               | 30,272     | 25,898     |
| Treasury stock 217,283 and 217,283 shares at September 30, 2013 and December 31, 2012, respectively                                                                  | (1,000)    | (1,000)    |
| Total parent company stockholders' equity                                                                                                                            | 217,666    | 193,554    |
| Non-controlling interests                                                                                                                                            | 43,055     | 38,846     |
| Total stockholders' equity                                                                                                                                           | 260,721    | 232,400    |
| Total liabilities and stockholders' equity                                                                                                                           | \$ 536,078 | \$ 485,825 |

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

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

|                                                                                                   | Nine Months Ended September 30, |           |
|---------------------------------------------------------------------------------------------------|---------------------------------|-----------|
|                                                                                                   | 2013                            | 2012      |
| Cash flows from operating activities:                                                             |                                 |           |
| Net income                                                                                        | \$ 24,160                       | \$ 18,936 |
| Adjustments to reconcile net income from operations to net cash provided by operating activities: |                                 |           |
| Stock-based compensation                                                                          | 194                             | 76        |
| Depreciation and amortization                                                                     | 10,964                          | 10,668    |
| Increase (decrease) in allowance for doubtful accounts                                            | (139)                           | 16        |
| Inventory write downs                                                                             | 480                             | 501       |
| Deferred income taxes                                                                             | (1,611)                         | (1,268)   |
| Equity in earnings of affiliated companies                                                        | (251)                           | (139)     |
| Gain on sale of a subsidiary                                                                      | -                               | (2,848)   |
| Gain on redemption of convertible notes                                                           | -                               | (1,421)   |
| Loss on change in fair value of derivative                                                        | -                               | 449       |
| Amortization of debt issue cost                                                                   | 58                              | 135       |
| Loss (gain) on fixed assets disposals                                                             | (4,288)                         | 44        |
| Changes in operating assets and liabilities:                                                      |                                 |           |
| (Increase) decrease in:                                                                           |                                 |           |
| Pledged deposits                                                                                  | 1,413                           | (5,118)   |
| Accounts and notes receivable                                                                     | (36,803)                        | (4,741)   |
| Advance payments and others                                                                       | 465                             | 570       |
| Inventories                                                                                       | (9,076)                         | (4,306)   |
| Increase (decrease) in:                                                                           |                                 |           |
| Accounts and notes payable                                                                        | 6,199                           | (462)     |
| Customer deposits                                                                                 | 1,016                           | 337       |
| Accrued payroll and related costs                                                                 | 514                             | (180)     |
| Accrued expenses and other payables                                                               | 3,459                           | (6,702)   |
| Accrued pension costs                                                                             | 653                             | 315       |
| Taxes payable                                                                                     | 3,256                           | 4,294     |
| Advances payable                                                                                  | (32)                            | 2,210     |
| Net cash provided by operating activities                                                         | 631                             | 11,366    |
| Cash flows from investing activities:                                                             |                                 |           |
| Increase in other receivables                                                                     | 158                             | (1,598)   |
| Cash received from property, plant and equipment sales                                            | 6,282                           | 622       |
| Payments to acquire property, plant and equipment                                                 | (9,065)                         | (16,982)  |
| Payments to acquire intangible assets                                                             | (109)                           | (62)      |
| Purchase of short-term investments                                                                | (32,197)                        | -         |
| Dividends from investment under cost method                                                       | 66                              | -         |
| Proceeds from sales of a subsidiary                                                               | -                               | 3,561     |
| Net cash used in investing activities                                                             | (34,865)                        | (14,459)  |
| Cash flows from financing activities:                                                             |                                 |           |
| Proceeds from government and bank loan                                                            | 15,588                          | 36,402    |
| Repayments of bank loan                                                                           | (14,758)                        | (7,097)   |
| Debt issuance costs paid for bank loan                                                            | -                               | (230)     |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                                       |           |           |
|-------------------------------------------------------|-----------|-----------|
| Dividends paid to the non-controlling interests       | (1,381)   | (2,387)   |
| Redemption of convertible notes                       | -         | (23,571)  |
| Decrease in amounts due to shareholders/directors     | (40)      | (8)       |
| Net cash provided by financing activities             | (591)     | 3,109     |
| Effects of exchange rate on cash and cash equivalents | 1,878     | (487)     |
| Net increase (decrease) in cash and cash equivalents  | (32,947)  | (471)     |
| Cash and cash equivalents at beginning of period      | 87,649    | 72,961    |
| Cash and cash equivalents at end of period            | \$ 54,702 | \$ 72,490 |

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

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

**SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:**

|                            | Nine Months Ended<br>September 30, |           |
|----------------------------|------------------------------------|-----------|
|                            | 2013                               | 2012      |
| Cash paid for interest     | \$ 972                             | \$ 10,435 |
| Cash paid for income taxes | \$ 4,217                           | \$ 3,810  |

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

|                                                                                      | Nine Months Ended<br>September 30, |          |
|--------------------------------------------------------------------------------------|------------------------------------|----------|
|                                                                                      | 2013                               | 2012     |
| Advance payments for acquiring property, plant and equipment                         | \$ 2,777                           | \$ 5,990 |
| Accounts receivable from sale of a subsidiary                                        | \$ -                               | \$ 4,361 |
| Non-controlling interests contribution of capital with property, plant and equipment | \$ -                               | \$ 2,846 |
| Dividends payable to non-controlling interests                                       | \$ 86                              | \$ 707   |

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

**China Automotive Systems, Inc. and Subsidiaries**  
**Notes to Condensed Unaudited Consolidated Financial Statements**  
**Three Months and Nine Months Ended September 30, 2013 and 2012**

**1. Organization and business**

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

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

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

The Company owns the following aggregate net interests in the entities established in the People's Republic of China, the “PRC,” and Brazil as of September 30, 2013 and December 31, 2012.

| Name of Entity                                                                            | Percentage Interest<br>September 30,<br>2013 |   | December 31,<br>2012 |   |
|-------------------------------------------------------------------------------------------|----------------------------------------------|---|----------------------|---|
| Shashi Jiulong Power Steering Gears Co., Ltd., “Jiulong” <sup>6</sup>                     | 81.00                                        | % | 81.00                | % |
| Jingzhou Henglong Automotive Parts Co., Ltd., “Henglong” <sup>2</sup>                     | 80.00                                        | % | 80.00                | % |
| Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., “Shenyang” <sup>3</sup>    | 70.00                                        | % | 70.00                | % |
| Universal Sensor Application Inc., “USAF” <sup>4</sup>                                    | 83.34                                        | % | 83.34                | % |
| Wuhan Jielong Electric Power Steering Co., Ltd., “Jielong” <sup>5</sup>                   | 85.00                                        | % | 85.00                | % |
| Wuhu HengLong Automotive Steering System Co., Ltd., “Wuhu” <sup>6</sup>                   | 77.33                                        | % | 77.33                | % |
| Hubei Henglong Automotive System Group Co., Ltd, “Hubei Henglong” <sup>7</sup>            | 100.00                                       | % | 100.00               | % |
| Jingzhou Henglong Automotive Technology (Testing) Center, “Testing Center” <sup>8</sup>   | 80.00                                        | % | 80.00                | % |
| Beijing Henglong Automotive System Co., Ltd., “Beijing Henglong” <sup>9</sup>             | 50.00                                        | % | 50.00                | % |
| Chongqing Henglong Hongyan Automotive System Co., Ltd, “Chongqing Henglong” <sup>10</sup> | 70.00                                        | % | 70.00                | % |
| CAAS Brazil’s Imports And Trade In Automotive Parts Ltd., “Brazil Henglong” <sup>11</sup> | 80.00                                        | % | 80.00                | % |

1. Jiulong was established in 1993 and mainly engages in the production of integral power steering gear for heavy-duty vehicles.
2. Henglong was established in 1997 and mainly engages in the production of rack and pinion power steering gears for cars and light-duty vehicles.

3. Shenyang was established in 2002 and focuses on power steering parts for light duty vehicles.
4. USAI was established in 2005 and mainly engages in the production and sales of sensor modules.
5. Jielong was established in 2006 and mainly engages in the production and sales of electric power steering, “EPS.”
6. Wuhu was established in 2006 and mainly engages in the production and sales of automobile steering systems.
7. On March 7, 2007, Genesis established Hubei Henglong, formerly known as Jingzhou Hengsheng Automotive System Co., Ltd., its wholly-owned subsidiary, to engage in the production and sales of automotive steering systems. The registered capital of Hubei Henglong at the time of establishment was \$10 million. On February 10, 2010, the registered capital of Hubei Henglong was increased to \$16 million. On October 12, 2011, the board of directors of the Company approved a reorganization of the Company’s subsidiaries operating in China. As a result of the reorganization, all of Genesis’s equity interests of its subsidiaries operating in China, except for Shenyang, were transferred to Hubei Henglong, the Company’s new China-based holding company. The reorganization was completed on January 19, 2012, subsequent to which the registered capital of Hubei Henglong was increased to \$39.0 million. As the reorganized entities were under common control of the Company, the reorganization did not have any impact on the Company’s consolidated financial position or results of operations and should not impact the tax treatment of the Company or its subsidiaries in any material respect. On July 8, 2012, Hubei Henglong changed its name to Hubei Henglong Automotive System Group Co., Ltd.

8. In December 2009, Henglong, a subsidiary of Genesis, formed the Testing Center, which mainly engages in the research and development of new products. The registered capital of the Testing Center was RMB30.0 million, equivalent to approximately \$4.4 million.
9. On January 24, 2010, Genesis entered into a joint venture contract with Beijing Hainachuan Auto Parts Co., Ltd. to establish Beijing Henglong as a joint venture company to design, develop and manufacture both hydraulic and electric power steering systems and parts. On September 16, 2010, with Beijing Hainachuan's agreement, Genesis transferred its interest in the joint venture to Hubei Henglong, and left the other terms of the joint venture contract unchanged. According to the joint venture agreement, the Company does not have voting control of Beijing Henglong. Therefore, the Company's consolidated financial statements do not include Beijing Henglong, and such investment is accounted for through the equity method.
10. On February 21, 2012, Hubei Henglong and SAIC-IVECO Hongyan Company, "SAIC-IVECO," established a Sino-foreign joint venture company, Chongqing Henglong, to design, develop and manufacture both hydraulic and electric power steering systems and parts. The joint venture is located in Chongqing City and has a registered capital of RMB60 million, of which RMB42 million, or 70%, is held by Hubei Henglong. The registered capital of Chongqing Henglong was fully contributed by Hubei Henglong in cash of \$6.7 million (equivalent to RMB42 million) in January and February 2012 and by SAIC-IVECO in property, plant and equipment with fair value of \$2.8 million (equivalent to RMB18 million) in April 2012.
11. On August 21, 2012, Brazil Henglong was established as a Sino-foreign joint venture company by Hubei Henglong and two Brazilian citizens, Ozias Gaia Da Silva and Ademir Dal' Evedove. Brazil Henglong engages mainly in the import and sales of automotive parts in Brazil. Such joint venture is located in Brazil and has a registered capital of \$1.0 million (equivalent to BRL1.6 million), of which \$0.8 million (equivalent to BRL1.3 million), or 80%, is held by Hubei Henglong, and of which \$0.2 million (equivalent to BRL0.3 million), or 20%, is held by Mr. Ozias Gaia Da Silva and Mr. Ademir Dal' Evedove.

## **2. Basis of presentation and significant accounting policies**

### *(a) Basis of Presentation*

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

The accompanying interim condensed consolidated financial statements are unaudited, but in the opinion of the Company's management, contain all necessary adjustments, which include normal recurring adjustments, for a fair statement of the results of operations, financial position and cash flows for the interim periods presented.

The condensed consolidated balance sheet as of December 31, 2012 is derived from the Company's audited financial statements at that date but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although the Company's management believes that the disclosures contained in these financial statements are adequate to make the information presented herein not misleading. For further information, please refer to the financial statements and the notes thereto included in the Company's 2012 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

The results of operations for the three months and nine months ended September 30, 2013 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2013.

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

*(b) Recent Accounting Pronouncements*

In February 2013, the FASB issued *ASU 2013-04, "Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation is Fixed at the Reporting Date"*. This update provides guidance for the recognition, measurement and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this update is fixed at the reporting date, except for obligations addressed within existing guidance in U.S. GAAP. The guidance requires an entity to measure those obligations as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance in this update also requires an entity to disclose the nature and amount of the obligation as well as other information about those obligations. This update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. This update should be applied retrospectively to all prior periods presented for those obligations resulting from joint and several liability arrangements within this update's scope that exist at the beginning of an entity's fiscal year of adoption. An entity may elect to use hindsight for the comparative periods (if it changed its accounting as a result of adopting the amendments in this update) and should disclose that fact. Early adoption is permitted. The adoption of this standard is not expected to have any impact on the Company's financial position.

In March 2013, the FASB issued *ASU 2013-05, "Parent's Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity"*. This update provides that when a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a non-profit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to apply the guidance in *Subtopic 830-30* to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. For an equity method investment that is a foreign entity, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale of such an equity method investment. However, this treatment does not apply to an equity method investment that is not a foreign entity. In those instances, the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the foreign entity that contains the equity method investment. Additionally, the amendments in this update clarify that the sale of an investment in a foreign entity includes both (1) events that result in the loss of a controlling financial interest in a foreign entity (that is, irrespective of any retained investment) and (2) events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (sometimes also referred to as a "step acquisition"). Accordingly, the cumulative translation adjustment should be released into net income upon the occurrence of those events. This update is effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. Early adoption is permitted. The adoption of this standard is not expected to have any impact on the Company's financial position or operating results.

On July 18, 2013, the FASB issued *ASU 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists"* (Income Taxes - Topic 740). This update applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, unless otherwise provided in the

update. To the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The assessment of whether a deferred tax asset is available is based on the unrecognized tax benefit and deferred tax asset that exist at the reporting date and should be made presuming disallowance of the tax position at the reporting date. For example, an entity should not evaluate whether the deferred tax asset has expired before the statute of limitations on the tax position or whether the deferred tax asset may be used prior to the unrecognized tax benefit being settled. The amendments in this update do not require new recurring disclosures. The amendments in this update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The Company is currently evaluating the impact of adopting this update on its financial statements.

(c) *Significant Accounting Policies*

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

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

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

In July 2004, the Company adopted a stock incentive plan. The maximum number of common shares for issuance under this plan is 2,200,000 with a period of 10 years. The stock incentive plan provides for the issuance, to the Company’s officers, directors, management and employees, of options to purchase shares of the Company’s common stock. Since the adoption of the stock incentive plan, the Company has issued 523,850 stock options, and 1,676,150 stock options remain issuable in the future. As of September 30, 2013, the Company had 105,000 stock options outstanding.

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

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

**Financial Instruments** The Company adopted the provisions of *ASC Topic 815, “Derivatives and Hedging Activities,”* that address the determination of whether an instrument meets the definition of a derivative being indexed to a company’s own stock for purposes of applying the scope exception as provided for in accordance with *ASC 815-15*. Upon adoption of the standard on the effective date, the Company bifurcated the conversion feature embedded in the convertible notes, classifying it in liabilities and measuring it at fair value at each reporting period, with changes reflected in earnings, until the convertible notes are settled (see Note 24).

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

Cash and cash equivalents, pledged cash deposits, short-term investments, accounts and notes receivable, accounts and notes payable, advance payment or payable, other receivable or payable, accrued expenses and bank and government loans are carried at cost on the consolidated balance sheets, and the carrying amount approximate their fair value because of the short-term nature of these financial instruments.

- Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2 Inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. As of September 30, 2013 and December 31, 2012, the Company did not have any fair value assets and liabilities classified as Level 2.

Level 3 Inputs are unobservable inputs for the asset or liability. Unobservable inputs are used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Therefore, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. The compound derivative liabilities are classified as Level 3 as the inputs reflect management's best estimate of what market participants would use in pricing the liability at the measurement date. As of September 30, 2013 and December 31, 2012, the Company did not have any fair value assets and liabilities classified as Level 3. For a summary of changes in Level 3 derivative liabilities for the three months and nine months ended September 30, 2013 and 2012, please see Note 24.

### 3. Pledged cash deposits

Pledged cash deposits act as guarantee for the Company's notes payable as it regularly pays some of its suppliers by bank notes. The Company has to deposit certain amount, equivalent to 30% - 100% of the face value of the relevant bank note, at a bank in order to obtain the bank note.

### 4. Short-term investments

Short-term investments comprise time deposits with maturity terms of three months or more but due within one year. The carrying values of time deposits approximate fair value because of their short maturities. The interest earned is recognized in the condensed unaudited statements of operations and comprehensive income over the contractual term of the deposit.

### 5. Accounts and notes receivable, net

The Company's accounts and notes receivable as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                                           | September<br>30, 2013 | December 31, 2012 |
|-----------------------------------------------------------|-----------------------|-------------------|
| Accounts receivable - unrelated parties <sup>(1)</sup>    | \$ 130,437            | \$ 117,136        |
| Notes receivable - unrelated parties <sup>(2) (3)</sup>   | 117,805               | 95,436            |
|                                                           | 248,242               | 212,572           |
| Less: allowance for doubtful accounts - unrelated parties | (1,240)               | (1,266)           |
| Accounts and notes receivable- unrelated parties          | 247,002               | 211,306           |
| Accounts and notes receivable - related parties           | 17,783                | 12,286            |
|                                                           | \$ 264,785            | \$ 223,592        |

(1) As of September 30, 2013, the Company has pledged \$15.7 million of accounts receivable as security for its comprehensive credit facility with banks in China.

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

- (3) Henglong collateralized its notes receivable in an amount of RMB256.3 million (equivalent to approximately \$41.7 million) as security for the credit facility with banks in China and the Chinese government, including RMB216.1 million (equivalent to approximately \$35.1 million) in favor of Industrial and Commercial Bank of China, Jingzhou Branch, "ICBC Jingzhou," for the purpose of obtaining the Henglong Standby Letter of Credit (as defined in Note 13) which is used as security for the non-revolving credit facility in the amount of \$30.0 million provided by Industrial and Commercial Bank of China (Macau) Limited, "ICBC Macau," to the Company in May 2012. The Credit Facility was drawn down on May 22, 2012 and its original maturity date was May 22, 2013. Such maturity date was extended to May 13, 2014 (see Note 13); and RMB40.2 million (equivalent to approximately \$6.6 million) in favor of the Chinese government as security for the interest-free government loan (see Note 13).

**6. Inventories**

The Company's inventories as of September 30, 2013 and December 31, 2012 consisted of the following (figures are in thousands of USD):

|                 | September<br>30, 2013 | December 31, 2012 |
|-----------------|-----------------------|-------------------|
| Raw materials   | \$ 13,872             | \$ 11,144         |
| Work in process | 8,378                 | 7,094             |
| Finished goods  | 30,899                | 25,304            |
|                 | \$ 53,149             | \$ 43,542         |

Provision for inventories valuation amounted to \$0.5 million and \$0.5 million for the nine months ended September 30, 2013 and 2012, respectively.

**7. Other receivables, net**

The Company's other receivables as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                                          | September<br>30, 2013 | December 31, 2012 |
|----------------------------------------------------------|-----------------------|-------------------|
| Other receivables - unrelated parties <sup>(1)</sup>     | \$ 826                | \$ 905            |
| Less: allowance for doubtful accounts- unrelated parties | (62)                  | (56)              |
|                                                          | \$ 764                | \$ 849            |

  

|                                                    | September<br>30, 2013 | December 31, 2012 |
|----------------------------------------------------|-----------------------|-------------------|
| Other receivables - related parties <sup>(1)</sup> | \$ 674                | \$ 715            |
| Less: allowance for doubtful accounts              | (607)                 | (608)             |
|                                                    | \$ 67                 | \$ 107            |

(1) 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. These receivables originate as part of the Company's normal operating activities and are periodically settled in cash.

**8. Assets held for sale**

Assets held for sale represents the remaining land use rights to be sold within the 12 months following September 30, 2013. According to the agreement signed between the Company and Jingzhou Land Reserve Center ("JLRC"), a local PRC government bureau, the Company has agreed to transfer the land use rights over 136,392 square meters of a piece of land in total located at Jingzhou city, Hubei Province, the PRC, to JLRC for total consideration of approximately \$13.0 million. The collection of the consideration is subject to JLRC's completion of its sale of such land use rights to be tendered in the open market. As of September 30, 2013, the Company recognized and received consideration of \$4.6 million upon the completion by JLRC of sale of a portion of the land use rights, and a related gain of \$4.1 million (before tax) for the sale of partial land use rights was recorded as gain on other sales. The cost of the land use rights over the remaining portion of the land was recorded as assets held for sale. Gain for the sale of the remaining land use rights will be recognized upon the completion by JLRC of its sale of the land use rights and the settlement of the related consideration to the Company.

**9. Long term investments**

As of September 30, 2013 and December 31, 2012, the Company's balance of long-term investment was \$3.9 million and \$3.7 million, respectively. For the long-term investments in which the Company has no voting control, such investments were accounted for using the equity method or cost method.

On January 24, 2010, the Company invested \$3.1 million to establish a fifty-fifty joint venture company, Beijing Henglong, with an unrelated party. The Company accounts for its operating results with the equity method of accounting. As of September 30, 2013 and 2012, the Company had \$3.8 million and \$3.5 million of net equity in Beijing Henglong, respectively.

The Company's share of net assets and net income is reported as "long-term investment" on the condensed unaudited consolidated balance sheets and "equity in earnings of affiliated companies" on the condensed unaudited consolidated statements of operations and comprehensive income. The Company's condensed unaudited consolidated financial statements reflect the equity earnings of non-consolidated affiliates of \$0.1 million and \$0.03 million for the three months ended September 30, 2013 and 2012, respectively, and the equity earnings of non-consolidated affiliates of \$0.3 million and \$0.1 million for the nine months ended September 30, 2013 and 2012, respectively.

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

The Company's property, plant and equipment as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                | September<br>30, 2013 | December 31, 2012 |
|--------------------------------|-----------------------|-------------------|
| Land use rights and buildings  | \$ 38,159             | \$ 36,881         |
| Machinery and equipment        | 110,100               | 96,368            |
| Electronic equipment           | 6,572                 | 6,174             |
| Motor vehicles                 | 3,109                 | 2,942             |
| Construction in progress       | 10,220                | 13,280            |
|                                | 168,160               | 155,645           |
| Less: Accumulated depreciation | (85,637)              | (73,954)          |
|                                | \$ 82,523             | \$ 81,691         |

Depreciation charges were \$3.7 million and \$3.3 million for the three months ended September 30, 2013 and 2012, respectively, and \$10.8 million and \$10.5 million for the nine months ended September 30, 2013 and 2012, respectively.

As of September 30, 2013, the Company had pledged property, plant and equipment with net book value of \$52.7 million for its comprehensive credit facilities with banks in China.

**11. Intangible assets**

The Company's intangible assets as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                             | September<br>30, 2013 | December 31, 2012 |
|-----------------------------|-----------------------|-------------------|
| Costs:                      |                       |                   |
| Patent technology           | \$ 2,050              | \$ 1,901          |
| Management software license | 640                   | 622               |
|                             | 2,690                 | 2,523             |
| Less: Amortization          | (2,019)               | (1,847)           |
|                             | \$ 671                | \$ 676            |

Amortization expenses were \$0.04 million and \$0.06 million for the three months ended September 30, 2013 and 2012, respectively, and \$0.1 million and \$0.2 million for the nine months ended September 30, 2013 and 2012, respectively.

**12. Deferred income tax assets**

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

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

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 as of September 30, 2013 and December 31, 2012 are as follows (figures are in thousands of USD):

|                                                                      | September 30,<br>2013 | December 31,<br>2012 |
|----------------------------------------------------------------------|-----------------------|----------------------|
| Losses carry forward (U.S.) <sup>(1)</sup>                           | \$ 7,778              | \$ 7,004             |
| Losses carry forward (PRC) <sup>(1)</sup>                            | 2,054                 | 1,887                |
| Product warranties and other reserves                                | 3,731                 | 3,253                |
| Property, plant and equipment                                        | 5,328                 | 3,774                |
| Share-based compensation                                             | 296                   | 240                  |
| Bonus accrual                                                        | 304                   | 196                  |
| Other accruals                                                       | 1,112                 | 696                  |
| Others                                                               | 705                   | 839                  |
| Total deferred tax assets                                            | 21,307                | 17,889               |
| Less: taxable temporary difference related to revenue recognition    | (533)                 | (397)                |
| Total deferred tax assets, net                                       | 20,774                | 17,492               |
| Less: Valuation allowance                                            | (10,433)              | (8,988)              |
| Total deferred tax assets, net of valuation allowance <sup>(2)</sup> | \$ 10,341             | \$ 8,504             |

- (1) The net operating losses carry forward for the U.S. entity for income tax purposes are available to reduce future years' taxable income. These losses will expire, if not utilized, in 20 years. Net operating losses carry forward for non-U.S. entities can be carried forward for 5 years to offset taxable income. However, as of September 30, 2013, valuation allowance was \$10.4 million, including \$8.6 million allowance for the Company's deferred tax assets in the United States and \$1.8 million allowance for the Company's non-U.S. deferred tax assets. Based on the Company's current operations in the United States, management believes that the deferred tax assets in the United States are not likely to be realized in the future. For the non-U.S. deferred tax assets, pursuant to certain tax laws and regulations in China, the management believes such amount will not be used to offset future taxable income.
- (2) Approximately \$4.4 million and \$4.1 million of deferred income tax asset as of September 30, 2013 and December 31, 2012, respectively, are included in non-current deferred tax assets in the accompanying condensed unaudited consolidated balance sheets. The remaining \$4.8 million and \$4.4 million of deferred income tax assets as of September 30, 2013 and December 31, 2012, respectively, are included in current deferred tax assets.

### 13. Bank and government loans, net

Loans consist of the following at September 30, 2013 and December 31, 2012 (figures are in thousands of USD):

|                                           | September<br>30, 2013 | December 31, 2012 |
|-------------------------------------------|-----------------------|-------------------|
| Short-term bank loan <sup>(1) (2)</sup>   | \$ 5,693              | \$ 10,341         |
| Short-term bank loan <sup>(3)</sup>       | 30,000                | 30,000            |
| Short-term government loan <sup>(4)</sup> | 6,506                 | -                 |
| Subtotal                                  | 42,199                | 40,341            |
| Debt issue cost                           | (57)                  | (230)             |
| Amortization                              | 57                    | 173               |
|                                           | \$ 42,199             | \$ 40,284         |

- (1) These loans are secured by property, plant and equipment of the Company and are repayable within one year. Please see Note 10. At September 30, 2013 and December 31, 2012, the weighted average interest rate was 6.24% and 6.46% per annum, respectively. Interest is paid on the twentieth day of each month and the principal repayment is at maturity.
- (2) On September 25, 2012, Jiulong entered into a one-year loan agreement with China Construction Bank Jingzhou branch in the amount of \$3.2 million. The agreement contains certain financial and non-financial covenants, including but not limited to restrictions on the utilization of the funds and the maintenance of an asset-liability ratio not exceeding 60%. The Company was in compliance with these covenants as of September 30, 2013. The Company repaid \$1.4 million and \$1.8 million in June and July, 2013, respectively.
- (3) On May 18, 2012, the Company entered into a credit facility agreement, the "Credit Agreement," with ICBC Macau to obtain a non-revolving credit facility in the amount of \$30.0 million, the "Credit Facility". The Credit Facility would have expired on November 3, 2012 unless the Company drew down the line of credit in full prior to such expiration date, and the maturity date for the loan drawdown was the earlier of (i) 18 months from the drawdown or (ii) 1 month before the expiry of the standby letter of credit obtained by Henglong from ICBC Jingzhou as security for the Credit Facility, the "Henglong Standby Letter of Credit". The interest rate of the Credit Facility is calculated based on a three-month LIBOR plus 2.25% per annum, subject to the availability of funds and fluctuation at ICBC Macau's discretion. The interest is calculated daily based on a 360-day year and it is fixed one day before the first day of each interest period. The interest period is defined as three months from the date of

drawdown. As security for the Credit Facility, the Company was required to provide ICBC Macau with the Henglong Standby Letter of Credit for a total amount not less than \$31.6 million if the Credit Facility is fully drawn.

On May 22, 2012, the Company drew down the full amount of \$30.0 million under the Credit Facility and provided the Henglong Standby Letter of Credit for an amount of \$31.6 million in favor of ICBC Macau. The Henglong Standby Letter of Credit issued by ICBC Jingzhou is collateralized by Henglong's notes receivable of RMB216.0 million (equivalent to approximately \$35.1 million). The Company also paid an arrangement fee of \$0.1 million to ICBC Macau and \$0.1 million to ICBC Jingzhou. The original maturity date of the Credit Facility was May 22, 2013. On May 7, 2013, ICBC Macau agreed to extend the maturity date of the Credit Facility to May 13, 2014. The interest rate of the Credit Facility under the extended term is calculated based on the three-month LIBOR plus 2.0% per annum. Except for the above, all other terms and conditions as stipulated in the Credit Agreement remain unchanged. As of September 30, 2013, the interest rate of the Credit Facility was 2.25%.

- (4) On January 31, 2013, the Company received an interest-free Chinese government loan of RMB40.0 million (equivalent to approximately \$6.6 million), which will mature on December 31, 2013. Henglong has pledged RMB40.2 million (equivalent to approximately \$6.5 million) of notes receivable, which will mature on December 31, 2013, as security for such government loan (see Note 5).

#### 14. Accounts and notes payable

The Company's accounts and notes payable as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                                  | September 30,<br>2013 | December 31,<br>2012 |
|--------------------------------------------------|-----------------------|----------------------|
| Accounts payable - unrelated parties             | \$ 104,392            | \$ 99,100            |
| Notes payable - unrelated parties <sup>(1)</sup> | 70,483                | 67,280               |
| Accounts and notes payable - unrelated parties   | 174,875               | 166,380              |
| Accounts payable - related parties               | 6,258                 | 4,521                |
|                                                  | \$ 181,133            | \$ 170,901           |

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

#### 15. Accrued expenses and other payables

The Company's accrued expenses and other payables as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                                | September 30,<br>2013 | December 31, 2012 |
|------------------------------------------------|-----------------------|-------------------|
| Accrued expenses                               | \$ 3,389              | \$ 2,557          |
| Accrued interest                               | 86                    | 87                |
| Other payables                                 | 2,607                 | 2,176             |
| Warranty reserves <sup>(1)</sup>               | 20,840                | 18,081            |
| Dividends payable to non-controlling interests | 86                    | 162               |
|                                                | \$ 27,008             | \$ 23,063         |

- (1) 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, services and transportation expenses arising from the manufactured products. Estimates will be adjusted on the basis of actual claims and circumstances.

For the nine months ended September 30, 2013 and 2012, and for the year ended December 31, 2012, the warranties activities were as follows (figures are in thousands of USD):

|                                                      | Nine Months Ended September 30, |           | Year Ended<br>December 31, |
|------------------------------------------------------|---------------------------------|-----------|----------------------------|
|                                                      | 2013                            | 2012      | 2012                       |
| Balance at beginning of the period                   | \$ 18,081                       | \$ 16,809 | \$ 16,809                  |
| Additions during the period                          | 8,554                           | 6,865     | 10,931                     |
| Settlement within period, by cash or actual material | (6,199)                         | (6,661)   | (9,264)                    |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                                      |           |           |           |
|------------------------------------------------------|-----------|-----------|-----------|
| Foreign currency translation gain (loss)             | 404       | (105)     | 41        |
| Decrease for warranty related to the subsidiary sold | -         | (432)     | (436)     |
| Balance at end of the period                         | \$ 20,840 | \$ 16,476 | \$ 18,081 |

**16. Taxes payable**

The Company's taxes payable as of September 30, 2013 and December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                         | September 30, 2013 | December 31, 2012 |
|-------------------------|--------------------|-------------------|
| Value-added tax payable | \$ 5,049           | \$ 4,347          |
| Income tax payable      | 3,467              | 878               |
| Other tax payable       | 463                | 368               |
|                         | \$ 8,979           | \$ 5,593          |

**17. Advances payable**

As of September 30, 2013 and December 31, 2012, advances payable by the Company were \$2.64 million and \$2.61 million, respectively.

The amounts are special subsidies made by the Chinese government to the Company to offset the cost and charges related to the improvement of production capacities and improvement of the quality of products. For the government subsidies with no further conditions to be met, the amounts are recorded as other income when received; for the amounts with certain operating conditions, the government subsidies are recorded as advances payable when received and will be recorded as a deduction of related expenses and cost of acquired assets when the conditions are met.

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

**18. Additional paid-in capital**

The Company's positions in respect of the amounts of additional paid-in capital for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                         | Nine Months Ended September 30, |           | Year Ended December 31, |
|-----------------------------------------|---------------------------------|-----------|-------------------------|
|                                         | 2013                            | 2012      | 2012                    |
| Balance at beginning of the period      | \$ 39,371                       | \$ 39,296 | \$ 39,296               |
| Share-based compensation <sup>(1)</sup> | 194                             | 75        | 75                      |
| Balance at end of the period            | \$ 39,565                       | \$ 39,371 | \$ 39,371               |

(1) On August 13, 2013 and August 15, 2012, the Company granted 22,500 and 22,500 stock options to the Company's independent directors, with the exercise price equal to the closing price of the Company's common stock traded on NASDAQ on the date of grant. The fair value of stock options was determined at the date of grant using the Black-Scholes option pricing model. The Black-Scholes option model requires management to make various estimates and assumptions, including expected term, expected volatility, risk-free rate, and dividend yield. The expected term represents the period of time that stock-based compensation awards granted are expected to be outstanding and is estimated based on considerations including the vesting period, contractual term and anticipated employee exercise patterns. Expected volatility is based on the historical volatility of the Company's stock. The risk-free rate is based on the U.S. Treasury yield curve in relation to the contractual life of stock-based compensation instruments. The dividend yield assumption is based on historical patterns and future expectations for the Company's dividends.

Assumptions used to estimate the fair value of stock options on the grant dates are as follows:

| Issuance Date   | Expected volatility | Risk-free rate | Expected term (years) | Dividend yield |
|-----------------|---------------------|----------------|-----------------------|----------------|
| August 13, 2013 | 131.5%              | 1.49%          | 5                     | 0.00%          |
| August 15, 2012 | 149.2%              | 0.67%          | 5                     | 0.00%          |

The above stock options were vested and exercisable immediately. Their fair value on the grant dates of August 13, 2013 and August 15, 2012 using the Black-Scholes option pricing model was \$0.2 million and \$0.1 million, respectively. During the nine months ended September 30, 2013 and 2012, the Company recognized stock-based compensation expenses of \$0.2 million and \$0.1 million, respectively.

**19. Retained earnings****Appropriated**

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

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

The Company's activities in respect of the amounts of the appropriated retained earnings for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                    | Nine Months Ended September 30, |          | Year Ended December 31, |
|------------------------------------|---------------------------------|----------|-------------------------|
|                                    | 2013                            | 2012     | 2012                    |
| Balance at beginning of the period | \$ 9,953                        | \$ 9,026 | \$ 9,026                |
| Appropriation of retained earnings | 95                              | 927      | 927                     |
| Balance at end of the period       | \$ 10,048                       | \$ 9,953 | \$ 9,953                |

**Unappropriated**

The Company's activities in respect of the amounts of the unappropriated retained earnings for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                           | Nine Months Ended September 30, |            | Year Ended December 31, |
|-------------------------------------------|---------------------------------|------------|-------------------------|
|                                           | 2013                            | 2012       | 2012                    |
| Balance at beginning of the period        | \$ 119,329                      | \$ 99,513  | \$ 99,513               |
| Net income attributable to parent company | 19,544                          | 15,657     | 20,743                  |
| Appropriation of retained earnings        | (95)                            | (927)      | (927)                   |
| Balance at end of the period              | \$ 138,778                      | \$ 114,243 | \$ 119,329              |

**20. Accumulated other comprehensive income**

The Company's activities in respect of the amounts of the accumulated other comprehensive income for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are summarized as follows (figures are in thousands of USD):

|  | Nine Months Ended September 30, | Year Ended December 31, |
|--|---------------------------------|-------------------------|
|  |                                 |                         |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                                                        | 2013      | 2012      | 2012      |
|------------------------------------------------------------------------|-----------|-----------|-----------|
| Balance at beginning of the period                                     | \$ 25,898 | \$ 25,291 | \$ 25,291 |
| Foreign currency translation adjustment attributable to parent company | 4,374     | (1,024)   | 607       |
| Balance at end of the period                                           | \$ 30,272 | \$ 24,267 | \$ 25,898 |

**21. Non-controlling interests**

The Company's activities in respect of the amounts of the non-controlling interests' equity for the nine months ended September 30, 2013 and 2012, and the year ended December 31, 2012 are summarized as follows (figures are in thousands of USD):

|                                                                                       | Nine Months Ended September 30, |           | Year Ended December 31, |
|---------------------------------------------------------------------------------------|---------------------------------|-----------|-------------------------|
|                                                                                       | 2013                            | 2012      | 2012                    |
| Balance at beginning of the period                                                    | \$ 38,846                       | \$ 43,028 | \$ 43,028               |
| Income attributable to non-controlling interests                                      | 4,616                           | 3,279     | 4,744                   |
| Dividends declared to the non-controlling interest holders of joint-venture companies | (1,299)                         | (6,846)   | (6,846)                 |
| Discontinued operations Zhejiang                                                      | -                               | (5,162)   | (5,162)                 |
| Capital contribution from non-controlling interests                                   | -                               | 2,846     | 3,012                   |
| Foreign currency translation gain (loss)                                              | 892                             | (256)     | 70                      |
| Balance at end of the period                                                          | \$ 43,055                       | \$ 36,889 | \$ 38,846               |

**22. Gain on other sales**

Gain on other sales mainly consisted of net amount retained from sales of materials, property, plant and equipment and scraps. For the three months and nine months ended September 30, 2013, gain on other sales amounted to \$5.0 million and \$6.8 million, respectively, as compared to \$0.7 million and \$2.6 million, respectively, for the same periods of 2012. In the third quarter of 2013, the Company sold part of its land use rights and recognized a the gain of \$4.1 million, which represented the difference between the selling price of \$4.6 million and the net book value of the land use rights of \$0.5 million.

**23. Financial (income) expenses, net**

During the three months and nine months ended September 30, 2013 and 2012, the Company recorded financial expenses, net which are summarized as follows (figures are in thousands of USD):

|                                       | Three Months Ended September 30, |        |
|---------------------------------------|----------------------------------|--------|
|                                       | 2013                             | 2012   |
| Interest expense                      | \$ 284                           | \$ 819 |
| Interest income                       | (1,143)                          | (409)  |
| Foreign exchange gain, net            | 24                               | 5      |
| Loss of note discount, net            | (3)                              | (7)    |
| Bank fees                             | 149                              | 29     |
| Total financial (income) expense, net | \$ (689)                         | \$ 437 |

  

|                                                                   | Nine Months Ended September 30, |          |
|-------------------------------------------------------------------|---------------------------------|----------|
|                                                                   | 2013                            | 2012     |
| Coupon interest and make-whole redemption interest <sup>(1)</sup> | \$ -                            | \$ 1,551 |
| Interest expense                                                  | 1,289                           | 1,273    |
| Interest income                                                   | (2,298)                         | (981)    |
| Foreign exchange gain, net                                        | 71                              | (89)     |
| Loss of note discount, net                                        | 9                               | (32)     |
| Bank fees                                                         | 549                             | 128      |
| Total financial (income) expense, net                             | \$ (380)                        | \$ 1,850 |

- (1) On May 24, 2012, the Company and LBCCA Liquidator reached a settlement agreement. Under the terms of the settlement agreement, the Company redeemed all the remaining convertible notes on May 25, 2012, the redemption date. As a result, there was no coupon interest and make-whole redemption interest related to the convertible notes during the three months ended September 30, 2012 and the nine months ended September 30, 2013 (see Note 24).

**24. Gain and loss on change in fair value of derivative**

On May 24, 2012, the Company and LBCCA Liquidator reached a settlement agreement. Under the terms of the settlement agreement, the Company redeemed all the remaining convertible notes on May 25, 2012, the redemption date. As a result, there was no gain or loss on change in fair value of derivative during the three months ended September 30, 2012 and the nine months ended September 30, 2013. During the nine months ended September 30, 2012, the Company recorded a loss on change in fair value of derivative of \$0.4 million.



In February 2008, the Company issued to two accredited institutional investors, namely Lehman Brothers Commercial Corporation Asia Limited (“Lehman Brothers”) and YA Global Investments L.P (“YA Global”), convertible notes in the principal amount of \$35.0 million, with a scheduled maturity date of February 15, 2013 (“convertible notes”).

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

On March 1, 2011, the provisional liquidator acting on behalf of Lehman Brothers (“LBCCA Liquidator”) converted \$6.4 million principal amount of the convertible notes at a conversion price of \$7.0822 per share, and in turn the Company issued 907,708 shares of its common stock to LBCCA Liquidator.

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

The Company’s derivative financial instruments (liabilities) consist of the compound embedded derivative that originated in connection with the above-mentioned convertible note payable and financing arrangement. Derivative liabilities are carried at fair value.

Changes in the fair value of compound derivative liabilities were recorded as a loss on change in fair value of derivative in the condensed unaudited consolidated statement of operations and comprehensive income for the nine months ended September 30, 2012. The following table summarizes the components of loss on change in fair value of derivative arising from fair value adjustments to compound derivative liabilities during the nine months ended September 30, 2012 (figures are in thousands of USD):

|                                                              | Nine Months Ended September 30, 2012 |
|--------------------------------------------------------------|--------------------------------------|
| Balances at January 1                                        | \$ 559                               |
| Decrease due to convertible notes conversion on May 25, 2012 | (1,008)                              |
| Loss in fair value adjustments                               | 449                                  |
| Balances at September 30                                     | \$ -                                 |

Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and external market factors. In addition, option-based techniques are highly volatile and sensitive to changes in the trading market price of the Company's common stock, which has a high estimated volatility. As of January 1, 2012 and September 30, 2012, the Company calculated the fair value of derivative liabilities to be \$0.6 million and \$nil, respectively. During the nine months ended September 30, 2012, there was a change in the balance of the fair value of the Company’s derivative liabilities at the beginning and the end of the period, mainly due to changes in the price of the Company’s common stock. During the nine months ended September 30, 2012, the market price of the Company’s common stock rose to \$3.82, comparing to \$3.30 on January 1, 2012. Since the Company’s derivative liabilities consisted of a conversion option that was embedded in the convertible notes payable, the intrinsic value of the conversion option was sensitive to changes in the trading market price of the Company’s common stock. Since derivative financial instruments are initially and subsequently carried at fair values, the Company’s income or loss reflects the volatility in these estimate and assumption changes.

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

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

The Monte Carlo technique requires the use of inputs that range across all levels in the fair value hierarchy. As a result, the technique is a Level 3 valuation technique in its entirety. The calculations of fair value utilized the Company's trading market values on the calculation dates. The contractual conversion prices were adjusted to give effect to the value associated with the down-round and anti-dilution protection. Expected volatility for each interval in the Monte Carlo process was established based upon the Company's historical volatility for historical periods consistent with the term of each interval in the calculation. Market adjusted interest rates give effect to expected trends or changes in market interest rates by reference to historical trends in LIBOR. Credit risk adjusted rates, or yields, were developed using bond curves, risk-free rates, market and industry adjustment factors for companies with similar credit standings as the Company's.

## **25. Income tax rate**

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

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

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

According to PRC tax regulation, the Company should withhold income taxes for the profit distributed from the PRC subsidiaries to Genesis, the subsidiaries' holding company incorporated in Hong Kong. The Company accounts for the profit that the PRC subsidiaries intended to distribute to Genesis as deferred tax liabilities. During the nine months ended September 30, 2013 and the year ended December 31, 2012, the Company recognized deferred tax liabilities of \$0.05 million and \$0.04 million for profit to be distributed to Genesis of \$0.9 million and \$0.8 million, respectively. The Company intended to re-invest the remaining undistributed profits generated from the PRC subsidiaries in those subsidiaries permanently. As of September 30, 2013 and December 31, 2012, the Company still has undistributed earnings of approximately \$154.2 million and \$124.8 million, respectively, from investment in the PRC subsidiaries that are considered permanently reinvested. Had the undistributed earnings been distributed to Genesis and not permanently reinvested, the tax provision as of September 30, 2013 and December 31, 2012 of approximately \$7.7 million and \$6.2 million, respectively, would have been recorded. Such undistributed profits will be reinvested in Genesis and not further distributed to the parent company incorporated in the United States going forward.

During 2008, Jiulong was awarded the title of "High & New Technology Enterprise" and, based on the PRC income tax law, it was subject to enterprise income tax at a rate of 15% for 2008, 2009 and 2010. In 2011, the Company passed the re-assessment of the government based on PRC income tax laws. Accordingly, the Company will continue to be

taxed at the 15% tax rate in 2011, 2012 and 2013.

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

During 2009, Shenyang was awarded the title of “High & New Technology Enterprise” and, based on the PRC income tax law, it was subject to enterprise income tax at a rate of 15% for 2009, 2010 and 2011. In 2012, the Company passed the re-assessment of the government based on PRC income tax laws. Accordingly, it will continue to be taxed at the 15% tax rate in 2012, 2013 and 2014.

According to the New CIT, Wuhu has been subject to income tax at a rate of 11%, 12% and 12.5%, respectively, for 2010, 2011 and 2012. Wuhu was awarded the title of “High & New Technology Enterprise” and, based on the PRC income tax law, it will be subject to enterprise income tax at a rate of 15% for 2013 and 2014.

According to the New CIT, Jielong has been subject to tax at a rate of 12.5% in 2010 and 2011, and 25% in 2012 and 2013.

According to the New CIT, Hubei Henglong has been subject to tax at a rate of 12.5% from 2010 to 2012. In November 2011, Hubei Henglong was awarded the title of “High & New Technology Enterprise”, based on the PRC income tax law. Accordingly, it will be subject to enterprise income tax at a rate of 15% for 2013 and 2014.

According to the New CIT, USAI and Testing Center were exempted from income tax in 2009, and each has been subject to income tax at a rate of 12.5% in 2010 and 2011, and 25% in 2012 and 2013.

Chongqing Henglong was established in 2012. According to the New CIT, Chongqing Henglong is subject to income tax at a uniform rate of 25%. No provision for Chongqing Henglong is made as it had no assessable income for the three months and nine months ended September 30, 2013 and 2012.

Based on Brazilian income tax laws, Brazil Henglong is subject to income tax at a uniform rate of 15%, and a resident legal person is subject to additional tax at a rate of 10% for the part of taxable income over \$0.12 million (equivalent to BRL 0.24 million). The Company had no assessable income in Brazil for the three months and nine months ended September 30, 2013 and 2012.

The profits tax rate of Hong Kong is 16.5%. No provision for Hong Kong tax is made as Genesis is an investment holding company, and had no assessable income in Hong Kong for the three months and nine months ended September 30, 2013 and 2012.

The enterprise income tax rate of the United States is 35%. No provision for U.S. tax is made as the Company had no assessable income in the United States for the three months and nine months ended September 30, 2013 and 2012.

The effective tax rate decreased to 15.3% and 17.8%, respectively, for the three months and nine months ended September 30, 2013 from 16.9% and 18.5%, respectively, for the same periods in 2012, which was primarily due to an increase in the weight of pretax income of lower tax rate subsidiaries, such as Henglong, in the Company’s total pretax income during the three months and nine months ended September 30, 2013.

## **26. Discontinued operations Zhejiang**

Zhejiang Henglong & Vie Pump-Manu Co., Ltd., “Zhejiang,” in which the Company owned 51% equity interest prior to its disposal in May 2012, was mainly engaged in the production and sales of power steering pumps. Given the power steering pump business has slowly lost its market share in the recent years due to market competition, lower market demand and replacement of hydraulic pressure steering by electric power steering, the Company sold its 51% equity interest in Zhejiang to Vie Group, the non-controlling shareholder of Zhejiang, on May 21, 2012, the “Zhejiang Sale”. Pursuant to ASC Topic 205-20, “*Presentation of Financial Statements Discontinued Operations*”, the business of Zhejiang, the “Zhejiang business,” is considered as discontinued operations because: (a) the operations and cash flows of Zhejiang will be eliminated from the Company’s operations as the Company will not continue to purchase power steering pumps from Zhejiang starting from August 2012; and (b) the Company would not have the ability to influence the operation or financial policies of Zhejiang subsequent to the sale. Before the sale, Zhejiang was identified as a product sector for the sales of power steering pumps of the Company, please see Note 28 for the details of segment reporting. For the nine months ended September 30, 2012, the purchases from Zhejiang by the Company amounted to \$0.4 million, which were eliminated for the preparation of the consolidated financial statements before the disposition of Zhejiang. There was no purchase from Zhejiang for the three months and nine months ended September 30, 2013.

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

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

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

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

|                                                         | Nine Months<br>Ended September 30, 2012 |
|---------------------------------------------------------|-----------------------------------------|
| Revenue from component of discontinued operations       | \$ 7,423                                |
| Pretax profit from component of discontinued operations | \$ 165                                  |

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

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

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

## 27. Income per share

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

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

The calculation of diluted income per share attributable to the parent company for the three months ended September 30, 2013 were (figures are in thousands of USD, except share and per share amounts):

|                                                                                       | Three Months Ended September 30,<br>2013 | 2012       |
|---------------------------------------------------------------------------------------|------------------------------------------|------------|
| Numerator:                                                                            |                                          |            |
| Net income attributable to the parent company's common shareholders Basic and Diluted | \$ 8,624                                 | \$ 3,404   |
| Denominator:                                                                          |                                          |            |
| Weighted average shares outstanding                                                   | 28,043,019                               | 28,260,302 |
| Dilutive effects of stock options                                                     | 19,278                                   | 578        |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                                                                      |            |            |
|--------------------------------------------------------------------------------------|------------|------------|
| Denominator for dilutive income per share    Diluted                                 | 28,062,297 | 28,260,880 |
| Net income per share attributable to parent company's common shareholders    Basic   | \$    0.31 | \$    0.12 |
| Net income per share attributable to parent company's common shareholders    Diluted | \$    0.31 | \$    0.12 |

As of September 30, 2013 and 2012, the exercise prices for 60,000 shares and 67,500 shares, respectively, of outstanding stock options were above the weighted average market price of the Company's common stock during the three months ended September 30, 2013 and 2012, respectively, and these stock options were excluded from the calculation of the diluted income per share for the corresponding periods presented.

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

The calculations of diluted income per share attributable to the parent company for the nine months ended September 30, 2013 were (figures are in thousands of USD, except share and per share amounts):

|                                                                                       | Nine Months Ended September 30, |            |
|---------------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                                       | 2013                            | 2012       |
| Numerator:                                                                            |                                 |            |
| Net income attributable to the parent company's common shareholders                   | \$ 19,544                       | \$ 15,657  |
| Allocation to convertible notes holders                                               | -                               | (925)      |
| Net income attributable to the parent company's common shareholders Basic and Diluted | 19,544                          | 14,732     |
| Denominator:                                                                          |                                 |            |
| Weighted average shares outstanding                                                   | 28,043,019                      | 28,260,302 |
| Dilutive effects of stock options                                                     | 10,989                          | 1,227      |
| Denominator for dilutive income per share Diluted                                     | 28,054,008                      | 28,261,529 |
| Net income per share attributable to parent company's common shareholders Basic       | \$ 0.70                         | \$ 0.52    |
| Net income per share attributable to parent company's common shareholders Diluted     | 0.70                            | 0.52       |

The calculations of diluted income from continuing operations per share attributable to the parent company for the nine months ended September 30, 2013 were (figures are in thousands of USD, except share and per share amounts):

|                                                                                                                  | Nine Months Ended September 30, |            |
|------------------------------------------------------------------------------------------------------------------|---------------------------------|------------|
|                                                                                                                  | 2013                            | 2012       |
| Numerator:                                                                                                       |                                 |            |
| Net income from continuing operations                                                                            | \$ 24,160                       | \$ 16,285  |
| Net income from continuing operations attributable to non-controlling interest                                   | 4,616                           | 3,203      |
| Net income from continuing operations attributable to shareholders                                               | 19,544                          | 13,082     |
| Allocation to convertible notes holders                                                                          | -                               | (773)      |
| Net income from continuing operations attributable to the parent company's common shareholders Basic and Diluted | 19,544                          | 12,309     |
| Denominator:                                                                                                     |                                 |            |
| Weighted average shares outstanding                                                                              | 28,043,019                      | 28,260,302 |
| Dilutive effects of stock options                                                                                | 10,989                          | 1,227      |
| Denominator for dilutive income per share Diluted                                                                | 28,054,008                      | 28,261,529 |
| Net income from continuing operations per common share attributable to parent company Basic                      | \$ 0.70                         | \$ 0.44    |
| Net income from continuing operations per common share attributable to parent company Diluted                    | 0.70                            | 0.44       |

As of September 30, 2013 and 2012, the exercise prices for 50,000 shares and 60,000 shares, respectively, of outstanding stock options were above the weighted average market price of the Company's common stock during the nine months ended September 30, 2013 and 2012, respectively, and these stock options were excluded from the calculation of the diluted income per share for the corresponding periods presented.

For the nine months ended September 30, 2012, 1,775,074 shares issuable upon conversion of convertible notes that were then outstanding have not been included in the computation, because such inclusion would have had an anti-dilutive effect.

**28. Significant concentrations**

A significant portion of the Company's business is conducted in China where the currency is the RMB. Regulations in China permit foreign owned entities to freely convert the RMB into foreign currency for transactions that fall under the "current account," which includes trade related receipts and payments, interest and dividends. Accordingly, the Company's Chinese subsidiaries may use RMB to purchase foreign exchange for settlement of such "current account" transactions without pre-approval. However, in certain cases, the remittance of currencies out of China, and the PRC subsidiaries may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currencies. If China Automotive is unable to receive dividend payments from its subsidiaries, China Automotive may be unable to effectively finance its operations or pay dividends on its shares.

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

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

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

During the nine months ended September 30, 2013, the Company's ten largest customers accounted for 73.2% of its consolidated net sales, with the largest customer individually accounting for more than 10% of consolidated net sales, i.e., 11.8%. As of September 30, 2013, approximately 3.2% of accounts receivable were from trade transactions with the aforementioned one customer, and there was no individual customer with a receivables balance of more than 10% of total accounts receivable.

During the nine months ended September 30, 2012, the Company's ten largest customers accounted for 73.4% of its consolidated net sales, with each of two customers individually accounting for more than 10% of consolidated net sales, i.e., 12.2% and 10.5% individually, or an aggregate of 22.7%. As of September 30, 2012, approximately 20.4% of accounts receivable were from trade transactions with the aforementioned two customers, one of them with a receivables balance of more than 10% of total accounts receivable, i.e., 12.0%.

China Automotive, the parent company, may depend on dividend payments by Genesis and HLUSA, which are mainly generated from their subsidiaries in the PRC after they receive payments from the PRC subsidiaries. Under PRC law, the PRC subsidiaries are required to set aside at least 10% of their respective accumulated profits, up to 50% of their paid-in capital, to fund certain mandated reserve funds that are not payable or distributable as cash dividends. Pursuant to applicable regulations, foreign-invested enterprises in China may pay dividends only out of their accumulated profits, if any, determined in accordance with the PRC law. In calculating accumulated profits, foreign investment enterprises in China are required to allocate at least 10% of their annual net income each year, if any, to fund certain reserve funds, including mandated employee benefits funds, unless these reserves have reached 50% of the registered capital of the enterprises (see Note 19).

## 29. Related party transactions and balances

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

### Related sales

|                                     | Three Months Ended September 30, |          |
|-------------------------------------|----------------------------------|----------|
|                                     | 2013                             | 2012     |
| Merchandise sold to related parties | \$ 9,166                         | \$ 2,939 |
| Equipment sold to related parties   | -                                | 82       |
|                                     | 9,166                            | 3,021    |

Edgar Filing: CHINA AUTOMOTIVE SYSTEMS INC - Form 10-Q

|                                     | Nine Months Ended September 30, |           |
|-------------------------------------|---------------------------------|-----------|
|                                     | 2013                            | 2012      |
| Merchandise sold to related parties | \$ 26,344                       | \$ 19,325 |
| Equipment sold to related parties   | -                               | 82        |
|                                     | 26,344                          | 19,407    |

*Related purchases*

|                                           | Three Months Ended September 30, |          |
|-------------------------------------------|----------------------------------|----------|
|                                           | 2013                             | 2012     |
| Materials purchased from related parties  | \$ 10,500                        | \$ 4,452 |
| Technology purchased from related parties | 58                               | 433      |
| Equipment purchased from related parties  | 777                              | 402      |
| Total                                     | \$ 11,335                        | \$ 5,287 |

|                                           | Nine Months Ended September 30, |           |
|-------------------------------------------|---------------------------------|-----------|
|                                           | 2013                            | 2012      |
| Materials purchased from related parties  | \$ 23,171                       | \$ 14,137 |
| Technology purchased from related parties | 575                             | 433       |
| Equipment purchased from related parties  | 2,160                           | 2,169     |
| Total                                     | \$ 25,906                       | \$ 16,739 |

*Related receivables*

|                     | September<br>30, 2013 | December 31, 2012 |
|---------------------|-----------------------|-------------------|
| Accounts receivable | \$ 17,783             | \$ 12,286         |
| Other receivables   | 67                    | 107               |
| Total               | \$ 17,850             | \$ 12,393         |

*Related advances*

|                                                 | September<br>30, 2013 | December 31, 2012 |
|-------------------------------------------------|-----------------------|-------------------|
| Advanced equipment payment to related parties   | \$ 829                | \$ 4,162          |
| Advanced payments and others to related parties | 1,204                 | 779               |
| Total                                           | \$ 2,033              | \$ 4,941          |

*Related payables*

|                  | September<br>30, 2013 | December 31, 2012 |
|------------------|-----------------------|-------------------|
| Accounts payable | \$ 6,258              | \$ 4,521          |

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

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

As of November 13, 2013, Hanlin Chen, the Company's Chairman, owns 63.65% 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.

### **30. Commitments and contingencies**

*Legal proceedings*

*Securities Action* - Southern District of New York. On October 25, 2011, a purported securities class action (the "Securities Action") was filed in the United States District Court for the Southern District of New York on behalf of all purchasers of the Company's securities between March 25, 2010 and March 17, 2011. On February 24, 2012, the plaintiffs filed an amended complaint, changing the purported class period to between May 12, 2009 and March 17, 2011. The amended complaint alleges that the Company, certain of its present officers and directors and the Company's former independent accounting firm violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and the rules promulgated thereunder, and seeks unspecified damages. The Company filed a motion to dismiss

the amended complaint, which was fully briefed on April 18, 2012. On August 8, 2012, the court denied the Company's motion to dismiss the amended complaint. On September 4, 2012, the Company filed an answer to the amended complaint. On January 15, 2013, plaintiffs filed a motion to certify the purported class, which was fully briefed on April 8, 2013. On May 31, 2013, the court denied plaintiffs' motion to certify the purported class, and, on July 3, 2013, the court issued its order and opinion. On July 17, 2013, plaintiffs filed a petition for permission to appeal the order denying class certification, and, on August 1, 2013, the Company filed an answer in opposition to the petition. On October 23, 2013, the Court of Appeals for the Second Circuit denied plaintiffs' petition for permission to appeal. On December 12, 2013, the district court is scheduled to hold a status conference regarding plaintiffs' remaining individual claims. The Company believes that the allegations in the amended complaint are without merit and intends to defend itself vigorously against the claims.

The above-referenced action does not specify an amount of damages that the plaintiffs seek. Moreover, this matter has not reached the merits of the plaintiffs' claims. With no merits discovery having been commenced, the Company cannot determine whether an adverse outcome is probable, nor can it provide a reasonable estimate of potential losses related to this matter. Although the Company believes that it has meritorious defenses to this action and intends to defend it vigorously, an adverse outcome in this matter could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

*Derivative Action - Delaware Chancery Court.* On December 23, 2011, a purported shareholder derivative action was filed in the Court of Chancery of the State of Delaware (the "Court of Chancery") on behalf of the Company. The complaint alleged that certain of the Company's current officers and directors breached their fiduciary duties to the Company in relation to the Company's accounting of convertible notes issued in February 2008. On January 25, 2012, a second purported shareholder derivative action was filed in the Court of Chancery on behalf of the Company. On February 3, 2012, the Court of Chancery consolidated the two cases, which were stayed pending the outcome of the motion to dismiss in the Securities Action. On October 23, 2012, the derivative plaintiffs filed a consolidated amended complaint on behalf of the Company (the "Derivative Action"). The consolidated complaint alleged that certain of the Company's current officers and directors breached their fiduciary duties to the Company in relation to the Company's accounting of the convertible notes issued in February 2008. The consolidated complaint set forth three causes of action for breach of fiduciary duties, unjust enrichment and insider trading. On January 7, 2013, the Company filed a motion to dismiss the Derivative Action. That motion was fully briefed on February 28, 2013, and oral argument was held before the Court of Chancery on May 6, 2013. On August 30, 2013, the Court of Chancery dismissed all of the derivative plaintiffs' claims with prejudice. The time for the derivative plaintiffs to appeal the Court of Chancery's decision expired on September 30, 2013 and, accordingly, the Derivative Action has terminated.

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

#### *Other commitments and contingencies*

In addition to the bank loans, notes payables and the related interest, the following table summarizes the Company's major commitments and contingencies as of September 30, 2013 (figures are in thousands of USD):

|                                       | Payment obligations by period |          |        |      |            |           |
|---------------------------------------|-------------------------------|----------|--------|------|------------|-----------|
|                                       | 2013 <sup>(1)</sup>           | 2014     | 2015   | 2016 | Thereafter | Total     |
| Interest on short-term bank loan      | \$ 294                        | \$ 464   | \$ -   | \$ - | \$ -       | \$ 758    |
| Obligations for purchasing agreements | 6,883                         | 2,302    | 260    | -    | -          | 9,445     |
| Total                                 | \$ 7,177                      | \$ 2,766 | \$ 260 | \$ - | \$ -       | \$ 10,203 |

(1) Remaining 3 months in 2013.

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

As of September 30, 2013 and 2012, the Company did not have any significant transactions, obligations or relationships that could be considered off-balance sheet arrangements.

### **32. Segment reporting**

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

As of September 30, 2013 and 2012, the Company had eleven product sectors, five of which were principal profit makers and were reported as separate sectors and engaged in the production and sales of power steering (Henglong, Jiulong, Shenyang, Wuhu and Hubei Henglong). The other nine sectors were engaged in the production and sale of sensor modular (USAI), EPS (Jielong), provision of after sales and R&D services (HLUSA), production and sale of power steering (Chongqing Henglong), trade (Brazil Henglong), and the holding company (Genesis). Since the revenues, net income and net assets of these nine sectors are less than 10% of its segment in the condensed unaudited consolidated financial statements, the Company incorporated these nine sectors into “Other Sectors.”

As discussed in Discontinued Operations - Zhejiang (see Note 26) above, Zhejiang was identified as a product sector for the sales of power steering pumps of the Group prior to disposal on May 21, 2012. After the Company sold its 51% equity interest in Zhejiang on May 21, 2012 and presented it as a discontinued operation, the Company has adjusted the information for Zhejiang's business in segment reporting for the same period in 2012.

The Company's product sector information from continuing operations for the three months ended September 30, 2013 and 2012, is as follows (figures are in thousands of USD):

|                                               | Net Sales                        |           | Income from Continuing Operations |          |
|-----------------------------------------------|----------------------------------|-----------|-----------------------------------|----------|
|                                               | Three Months Ended September 30, |           | Three Months Ended September 30,  |          |
|                                               | 2013                             | 2012      | 2013                              | 2012     |
| Henglong                                      | \$ 55,846                        | \$ 39,062 | \$ 8,368                          | \$ 4,117 |
| Jiulong                                       | 16,692                           | 15,377    | 279                               | 284      |
| Shenyang                                      | 9,095                            | 7,314     | 603                               | 402      |
| Wuhu                                          | 4,948                            | 7,414     | (145)                             | 729      |
| Hubei Henglong                                | 11,783                           | 9,982     | 6,092 (1)                         | 613      |
| Other Sectors                                 | 7,558                            | 6,635     | 522                               | (1,105)  |
| Total Segments                                | 105,922                          | 85,784    | 15,719                            | 5,040    |
| Corporate                                     | -                                | -         | 309                               | (687)    |
| Eliminations                                  | (15,003)                         | (12,600)  | (5,599)                           | 47       |
| Total consolidated from continuing operations | \$ 90,919                        | \$ 73,184 | \$ 10,429                         | \$ 4,400 |

(1) \$5.2 million included in the balance was income from investment in Henglong, which has been eliminated at the consolidation level.

The Company's product sector information from continuing operations for the nine months ended September 30, 2013 and 2012, is as follows (figures are in thousands of USD):

|                                               | Net Sales                       |            | Income from Continuing Operations |           |
|-----------------------------------------------|---------------------------------|------------|-----------------------------------|-----------|
|                                               | Nine Months Ended September 30, |            | Nine Months Ended September 30,   |           |
|                                               | 2013                            | 2012       | 2013                              | 2012      |
| Henglong                                      | \$ 177,836                      | \$ 123,713 | \$ 19,751                         | \$ 14,248 |
| Jiulong                                       | 56,735                          | 54,572     | 1,516                             | 1,276     |
| Shenyang                                      | 28,164                          | 21,090     | 1,119                             | 628       |
| Wuhu                                          | 17,113                          | 24,208     | (312)                             | 581       |
| Hubei Henglong                                | 34,610                          | 29,653     | 7,550 (1)                         | 8,946 (1) |
| Other Sectors                                 | 24,866                          | 28,160     | 1,416                             | 390       |
| Total Segments                                | 339,324                         | 281,396    | 31,040                            | 26,069    |
| Corporate                                     | -                               | -          | (2,203)                           | 3,424     |
| Eliminations                                  | (53,353)                        | (46,914)   | (4,677)                           | (13,207)  |
| Total consolidated from continuing operations | \$ 285,971                      | \$ 234,482 | \$ 24,160                         | \$ 16,285 |

(1) \$5.2 million and \$7.0 million included in the respective balances of \$7.6 million and \$8.9 million was income from investment in Henglong in 2013 and 2012, respectively, which has been eliminated at the consolidation level.



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

The following discussion and analysis should be read in conjunction with the Company's condensed unaudited consolidated financial statements and the related notes thereto and the other financial information contained elsewhere in this Report. This information excludes Zhejiang as discontinued operations (see Note 26 to the consolidated financial statements in this Report) unless otherwise noted.

### **General Overview**

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

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

### **Corporate Structure**

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

For more information on the Company's corporate structure, including the recently completed reorganization of certain PRC-based subsidiaries and the Zhejiang Sale, please see Note 1, "Organization and Business" and Note 26, "Discontinued operations - Zhejiang" to the consolidated financial statements in this Report.

### **Critical Accounting Estimates**

The Company prepares its condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amount of revenues and expenses during the reporting periods. Management periodically evaluates the estimates and judgments made. Management bases its

estimates and judgments on historical experience and on various factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates as a result of different assumptions or conditions. The following critical accounting policies affect the more significant judgments and estimates used in the preparation of the Company's condensed consolidated financial statements.

The Company considers an accounting estimate to be critical if:

- It requires the Company to make assumptions about matters that were uncertain at the time it was making the estimate, and
- Changes in the estimate or different estimates that the Company could have selected would have had a material impact on the Company's financial condition or results of operations.

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

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

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

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

### Recent Accounting Pronouncements

Please see Note 2 to the consolidated financial statements under Item 1 of Part I of this Report.

### Results of Operations

#### Results of Operations Three Months Ended September 30, 2013 and 2012

*The Company disposed of its 51% equity interest in Zhejiang in May 2012. Pursuant to ASC Topic 205-20, the business of Zhejiang is considered as discontinued operations. Previously reported condensed unaudited consolidated statements of operations and comprehensive income for the three months ended September 30, 2012 presented have been adjusted to reflect the discontinued operations. Please refer to Note 26 to the condensed unaudited consolidated financial statements in this Report.*

|                | Net Sales<br>(in thousands of USD,<br>except percentages) |           |           |       | Cost of Product Sold<br>(in thousands of USD,<br>except percentages) |           |           |       |   |
|----------------|-----------------------------------------------------------|-----------|-----------|-------|----------------------------------------------------------------------|-----------|-----------|-------|---|
|                | 2013                                                      | 2012      | Change    |       | 2013                                                                 | 2012      | Change    |       |   |
| Henglong       | \$ 55,846                                                 | \$ 39,062 | 16,784    | 43.0  | % \$ 45,726                                                          | \$ 30,855 | \$ 14,871 | 48.2  | % |
| Jiulong        | 16,692                                                    | 15,377    | 1,315     | 8.6   | 14,760                                                               | 13,776    | 984       | 7.1   |   |
| Shenyang       | 9,095                                                     | 7,314     | 1,781     | 24.4  | 7,789                                                                | 6,254     | 1,535     | 24.5  |   |
| Wuhu           | 4,948                                                     | 7,414     | (2,466)   | -33.3 | 4,725                                                                | 6,802     | (2,077)   | -30.5 |   |
| Hubei Henglong | 11,783                                                    | 9,982     | 1,801     | 18.0  | 9,812                                                                | 9,033     | 779       | 8.6   |   |
| Other Sectors  | 7,558                                                     | 6,635     | 923       | 13.9  | 6,192                                                                | 6,614     | (422)     | -6.4  |   |
| Total Segments | 105,922                                                   | 85,784    | 20,138    | 23.5  | 89,004                                                               | 73,334    | 15,670    | 21.4  |   |
| Elimination    | (15,003)                                                  | (12,600)  | (2,403)   | 19.1  | (14,610)                                                             | (12,651)  | (1,959)   | 15.5  |   |
| Total          | \$ 90,919                                                 | \$ 73,184 | \$ 17,735 | 24.2  | % \$ 74,394                                                          | \$ 60,683 | \$ 13,711 | 22.6  | % |

#### Net Sales

Net sales were \$90.9 million for the three months ended September 30, 2013, compared to \$73.2 million for the same period in 2012, representing an increase of \$17.7 million, or 24.2%. The increase was mainly due to the continuing growth of automotive market demand in China and the increased sales of newly developed products to North America.

The main market for the Company's products is China. The Chinese government issued an incentive policy relating to purchase of low-emission cars and fuel-efficient cars in May 2012. Encouraged by such incentive policy, the sales volume of passenger vehicles in the China market continues to increase. The Company's sales of steering gears for passenger vehicles, one of the main products of the Company, also increased.

In the third quarter of 2013, the Chinese government increased investment in infrastructure industries, such as railways and highways, which led to an increase in the sales of commercial vehicles in the China market. The Company's sales of steering gears for commercial vehicles, one of the main products of the Company, also increased.

To compete with joint-brands' cars and address the over capacity issue, the domestic brands' car manufacturers, which are the Company's main customers, had to lower their products' price to a certain level to attract end customers. The price pressure was passed on from the car manufacturers to the Company, which led to continuing price decreases for the Company's main products.

In summary, the Company had an increase in sales volume leading to a sales increase of \$15.6 million, a decrease in selling price leading to a sales decrease of \$0.6 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$2.7 million.

Further analysis is as follows:

- Net sales for Henglong were \$55.8 million for the three months ended September 30, 2013, compared to \$39.1 million for the same period in 2012, representing an increase of \$16.7 million, or 42.7%, which was mainly due to an increase in sales volume for passenger vehicles in the China market. An increase in sales volume led to a sales increase of \$16.5 million, a decrease in selling price led to a sales decrease of \$0.9 million and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$1.2 million.
- Net sales for Jiulong were \$16.7 million for the three months ended September 30, 2013, compared to \$15.4 million for the same period in 2012, representing an increase of \$1.3 million, or 8.4%, which was mainly due to an increase in sales volume for commercial vehicles in the China market. An increase in sales volume led to a sales increase of \$2.0 million, a decrease in selling price led to a sales decrease of \$1.2 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.5 million.
- Net sales for Shenyang were \$9.1 million for the three months ended September 30, 2013, compared to \$7.3 million for the same period in 2012, representing an increase of \$1.8 million, or 24.7%, which was mainly due to an increase in sales volume for passenger vehicles in the China market. An increase in sales volumes led to a sales increase of \$0.8 million, an increase in selling price led to a sales increase of \$0.8 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.2 million.
- Net sales for Wuhu were \$4.9 million for the three months ended September 30, 2013, compared to \$7.4 million for the same period in 2012, representing a decrease of \$2.5 million, or 33.8%. The decrease of revenue from Wuhu was mainly due to Wuhu's main customer adjusting its product mix in 2013 due to the shift in market demand and lower purchases from the Company.
- Net sales for Hubei Henglong were \$11.8 million for the three months ended September 30, 2013, compared to \$10.0 million for the same period in 2012, representing an increase of \$1.8 million, or 18.0%. Hubei Henglong's products were all sold to the United States. The net sales increase was mainly due to sales of the newly developed products to a United States customer. An increase in sales volumes led to a sales increase of \$1.3 million, an increase in selling price led to a sales increase of \$0.2 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.3 million.
- Net sales for Other Sectors were \$7.6 million for the three months ended September 30, 2013, compared to \$6.6 million for the same period in 2012, representing an increase of \$1 million, or 15.2%, primarily due to sales of the new products, which quantity has initially reached a considerable size during the three months ended September 30, 2013.

#### *Cost of Sales*

For the three months ended September 30, 2013, the cost of sales was \$74.4 million, compared to \$60.7 million for the same period of 2012, representing an increase of \$13.7 million, or 22.6%. The increase in the cost of sales was mainly due to the net effect of a net increase in sales volumes which led to a cost of sales increase of \$14.4 million, a decrease in unit cost which led to a cost of sales decrease of \$3.0 million, and the appreciation of the RMB against the U.S. dollar which led to a cost of sales increase of \$2.3 million. The decrease in the unit cost of sales was primarily due to a decrease in the cost of raw materials, including steel, enhanced production efficiency and strengthened cost-control. Further analysis is as follows:

- Cost of sales for Henglong was \$45.7 million for the three months ended September 30, 2013, compared to \$30.9 million for the same period of 2012, representing an increase of \$14.8 million, or 47.9%. This increase was mainly due to an increase in sales volumes which led to a cost of sales increase of \$14.4 million, which was offset by a decrease in cost of sales of \$0.5 million due to the decrease in unit material costs resulting from the adoption of technical innovations in the production processes in 2013, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$1.0 million.
- Cost of sales for Jiulong was \$14.8 million for the three months ended September 30, 2013, compared to \$13.8 million for the same period of 2012, representing an increase of \$1.0 million, or 7.2%. The increase in cost of sales was mainly due to an increase in sales volumes which led to a cost of sales increase of \$1.0 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.4 million, which was offset by a decrease in unit cost which led to a cost of sales decrease of \$0.4 million.

- Cost of sales for Shenyang was \$7.8 million for the three months ended September 30, 2013, compared to \$6.3 million for the same period of 2012, representing an increase of \$1.5 million, or 23.8%. The increase in cost of sales was mainly due to an increase in sales volumes which led to a cost of sales increase of \$1.5 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.2 million, offset by a decrease in unit cost which led to a cost of sales decrease of \$0.2 million.
- Cost of sales for Wuhu was \$4.7 million for the three months ended September 30, 2013, compared to \$6.8 million for the same period of 2012, representing a decrease of \$2.1 million, or 30.9%. The decrease in cost of sales was mainly due to a decrease in sales volumes and an increase in unit cost.
- Cost of sales for Hubei Henglong was \$9.8 million for the three months ended September 30, 2013, compared to \$9.0 million for the same period of 2012, representing an increase of \$0.8 million, or 8.9%. The increase in cost of sales was mainly due to an increase in sales volumes and a decrease in unit cost.
- Cost of sales for Other Sectors was \$6.2 million for the three months ended September 30, 2013, compared to \$6.6 million for the same period of 2012, representing a decrease of \$0.4 million, or 6.1%. The decrease in cost of sales was mainly due to an increase in sales volumes and a decrease in unit cost.

Gross margin was 18.2% for the three months ended September 30, 2013, representing a 1.1% increase from 17.1% for the same period of 2012, which was primarily due to greater sales volume, and lower unit cost mainly as a result of reduced costs of raw materials and technical improvements which enhanced production efficiency.

#### *Gain on Other Sales*

Gain on other sales mainly consisted of net amount retained from sales of materials, property, plant and equipment and scraps. For the three months ended September 30, 2013, gain on other sales amounted to \$5.0 million, while it amounted to \$0.7 million for the same period of 2012, representing an increase of \$4.3 million. The increase was mainly due to the gain of \$4.1 million (before tax) for selling an idle land use right during the three months ended September 30, 2013, which represents the difference between the total selling price of \$4.6 million and the net book value of \$0.5 million of the land use right and plants.

#### *Selling Expenses*

Selling expenses were \$2.6 million for the three months ended September 30, 2013, compared to \$2.4 million for the same period of 2012, representing an increase of \$0.2 million, or 8.3%, mainly due to an increase in sales volumes which led to an increase in warehouse rental fees of \$0.1 million, and an increase in other expenses, such as transportation expenses and salaries and wages expenses of \$0.1 million.

#### *General and Administrative Expenses*

General and administrative expenses were \$2.8 million for the three months ended September 30, 2013, compared to \$2.5 million for the same period of 2012, representing an increase of \$0.3 million, or 12.0%, which was mainly due to an increase in property tax.

#### *Research and Development Expenses*

Research and development expenses were \$5.1 million for the three months ended September 30, 2013, compared to \$2.8 million for the three months ended September 30, 2012, representing an increase of \$2.3 million, or 82.1%. The Company's research and development expenses were mainly used for the development and trial production of EPS and other new products. Research and development expenditures have continued to be significant in the past three years.

In summary, expenses for mold improvement increased by \$0.7 million, external technical support fees increased by \$0.4 million and the salaries and wages expenses of research and development related staff increased by \$1.2 million.

The global automotive parts industry is highly competitive; winning and maintaining new business requires suppliers to rapidly produce innovative products on a cost-competitive basis. In the past three years, the Company has continued to purchase advanced manufacturing equipment for newly developed products and hiring senior technicians, and give bonuses to technical personnel who make an outstanding contribution to product research and development.

*Income from Operations*

Income from operations was \$11.0 million for the three months ended September 30, 2013, compared to \$5.5 million for the three months ended September 30, 2012, representing an increase of \$5.5 million, or 100.0%, including an increase of \$4.0 million, or 32.0%, in gross profit, an increase of \$4.3 million, in gain on other sales, and an increase of \$2.9 million, or 37.7%, in operating expenses.

*Other Income, Net*

Other income was \$0.5 million for the three months ended September 30, 2013, compared to \$0.2 million for the three months ended September 30, 2012, an increase of \$0.3 million, primarily as a result of increased government subsidies.

*Financial Expenses / Income, Net*

Financial income, net, was \$0.7 million for the three months ended September 30, 2013, compared to financial expenses, net of \$0.4 million for the three months ended September 30, 2012, representing a decrease of \$1.1 million, which was mainly due to a decrease in bank loans which led a decrease in interest charges and an increase in time deposits which generated more interest income for the Company.

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

Income before income tax expenses and equity in earnings of affiliated companies was \$12.2 million for the three months ended September 30, 2013, compared to \$5.2 million for the three months ended September 30, 2012, representing an increase of \$7.0 million, which was mainly due to an increase in operating income of \$5.5 million, an increase in other income of \$0.3 million, and a decrease in financial expenses of \$1.1 million.

*Income Taxes*

Income tax expense was 1.9 million for the three months ended September 30, 2013, compared to \$0.9 million of income tax expense for the three months ended September 30, 2012, representing an increase of \$1.0 million, which was mainly due to an increase in income before income tax. The income before income tax increased to \$19.6 million for the three months ended September 30, 2013 from \$5.2 million for the same period in 2012, offset by a decreased effective tax rate from 16.9% to 15.3% as a result of the increase of the weight of the pretax income of lower tax rate subsidiaries in the Company's consolidated pretax income.

*Net Income*

Net income was \$10.4 million for the three months ended September 30, 2013, compared to net income of \$4.4 million for the three months ended September 30, 2012, representing an increase of \$6.0 million, which was mainly due to an increase in income before income tax expenses and equity in earnings of affiliated companies of \$7.0 million, offset by an increase in income tax expenses of \$1.0 million.

*Net Income Attributable to Non-controlling Interests*

Net income attributable to non-controlling interests amounted to \$1.8 million and \$1.0 million for the three months ended September 30, 2013 and 2012, respectively.

The Company owns equity interests in ten non-wholly owned subsidiaries established in the PRC and Brazil, through which it conducts its operations. Except for Beijing Henglong, which is accounted for under the equity method, all the operating results of these non-wholly owned subsidiaries were consolidated in the Company's financial statements as of September 30, 2013 and 2012. For the three months ended September 30, 2013 and 2012, the Company recorded \$1.8 million and \$1.0 million, respectively, for the non-controlling interests' share in the earnings of the consolidated non-wholly owned subsidiaries.

*Net Income Attributable to Parent Company*

Net income attributable to parent company was \$8.6 million for the three months ended September 30, 2013, compared to net income attributable to parent company of \$3.4 million for the three months ended September 30, 2012, representing an increase of \$5.2 million, reflecting an increase in net income.

**Results of Operations Nine Months Ended September 30, 2013 and 2012**

*The Company disposed of its 51% equity interest in Zhejiang in May 2012. Pursuant to ASC Topic 205-20, the business of Zhejiang is considered as discontinued operations. Previously reported condensed unaudited consolidated statements of operations and comprehensive income for the nine months ended September 30, 2012 presented have been adjusted to reflect the discontinued operations. Please refer to Note 26 to the condensed unaudited consolidated financial statements in this Report.*

|               | Net Sales<br>(in thousands of USD,<br>except percentages) |            |           |       |   | Cost of Product Sold<br>(in thousands of USD,<br>except percentages) |            |           |       |   |
|---------------|-----------------------------------------------------------|------------|-----------|-------|---|----------------------------------------------------------------------|------------|-----------|-------|---|
|               | 2013                                                      | 2012       | Change    |       |   | 2013                                                                 | 2012       | Change    |       |   |
| Henglong      | \$ 177,836                                                | \$ 123,713 | 54,123    | 43.7  | % | \$ 145,763                                                           | \$ 97,062  | \$ 48,701 | 50.2  | % |
| Giulong       | 56,735                                                    | 54,572     | 2,163     | 4.0   |   | 49,519                                                               | 47,457     | 2,062     | 4.3   |   |
| Shenyang      | 28,164                                                    | 21,090     | 7,074     | 33.5  |   | 24,888                                                               | 18,456     | 6,432     | 34.9  |   |
| Wuhu          | 17,113                                                    | 24,208     | (7,095)   | -29.3 |   | 16,007                                                               | 22,626     | (6,619)   | -29.3 |   |
| Hubei         | 34,610                                                    | 29,653     | 4,957     | 16.7  |   | 28,559                                                               | 26,362     | 2,197     | 8.3   |   |
| Henglong      |                                                           |            |           |       |   |                                                                      |            |           |       |   |
| Other Sectors | 24,866                                                    | 28,160     | (3,294)   | -11.7 |   | 20,841                                                               | 25,828     | (4,987)   | -19.3 |   |
| Total         | 339,324                                                   | 281,396    | 57,928    | 20.6  |   | 285,577                                                              | 237,791    | 47,786    | 20.1  |   |
| Segments      |                                                           |            |           |       |   |                                                                      |            |           |       |   |
| Elimination   | (53,353)                                                  | (46,914)   | (6,439)   | 13.7  |   | (53,881)                                                             | (46,820)   | (7,061)   | 15.1  |   |
| Total         | \$ 285,971                                                | \$ 234,482 | \$ 51,489 | 22.0  | % | \$ 231,696                                                           | \$ 190,971 | \$ 40,725 | 21.3  | % |

*Net Sales*

Net sales were \$286.0 million for the nine months ended September 30, 2013, compared to \$234.5 million for the same period in 2012, representing an increase of \$51.5 million, or 22.0%. The increase was mainly due to the continuing growth of automotive market demand in China and the increased sales of newly developed products to North America.

Under the pressure of over-production, the competition among various auto sellers and manufacturers in China has intensified, which resulted in a continued decrease in the sale price of cars in China in 2013. The decrease in sale price for single-brands' cars was more significant than joint-brands' cars. In order to preserve the market share of the Company among its single-brands' cars customers, the Company correspondingly lowered the sale price of one of its main products, the steering gears.

In summary, the Company had an increase in sales volume leading to a sales increase of \$55.0 million, a decrease in selling price leading to a sales decrease of \$8.9 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a sales increase of \$5.4 million.

Further analysis is as follows:

- Net sales for Henglong were \$177.8 million for the nine months ended September 30, 2013, compared to \$123.7 million for the same period in 2012, representing an increase of \$54.1 million, or 43.7%, which was mainly due to an increase in sales volume for passenger vehicles in the China market. An increase in sales volume led to a sales increase of \$58.7 million, a decrease in selling price led to a sales decrease of \$7.0 million and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$2.4 million.

- Net sales for Jiulong were \$56.7 million for the nine months ended September 30, 2013, compared to \$54.6 million for the same period in 2012, representing an increase of \$2.1 million, or 3.8%, which was mainly due to an increase in sales volume for commercial vehicles in the China market. An increase in sales volume led to a sales increase of \$3.4 million, a decrease in selling price led to a sales decrease of \$2.3 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$1.0 million.
- Net sales for Shenyang were \$28.2 million for the nine months ended September 30, 2013, compared to \$21.1 million for the same period in 2012, representing an increase of \$7.1 million, or 33.5%, which was mainly due to an increase in sales volume for passenger vehicles in the China market. An increase in sales volumes led to a sales increase of \$7.2 million, a decrease in selling price led to a sales decrease of \$0.5 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.4 million.
- Net sales for Wuhu were \$17.1 million for the nine months ended September 30, 2013, compared to \$24.2 million for the same period in 2012, representing a decrease of \$7.1 million, or 29.3%. Since the majority of the products of Wuhu was sold to local Chinese brand auto manufacturers, the decreased demand for local Chinese brand autos from end-customers due to the aggressive pricing strategies adopted by Sino-foreign joint brand auto manufacturers led to the decrease in sales volumes and prices for Wuhu's products.

- Net sales for Hubei Henglong were \$34.6 million for the nine months ended September 30, 2013, compared to \$29.7 million for the same period in 2012, representing an increase of \$4.9 million, or 16.7%. Hubei Henglong's products were all sold to the United States. The net sales increase was mainly due to sales of the newly developed products to a United States customer. An increase in sales volumes led to a sales increase of \$3.3 million, an increase in selling price led to a sales increase of \$1.0 million, and the effect of foreign currency translation of the RMB against the U.S. dollar resulted in a sales increase of \$0.6 million.
- Net sales for Other Sectors were \$24.9 million for the nine months ended September 30, 2013, compared to \$28.1 million for the same period in 2012, representing a decrease of \$3.2 million, or 11.7%, mainly due to lower sales volume of the new products launched in 2013 as compared to that of the old products sold in 2012.

### *Cost of Sales*

For the nine months ended September 30, 2013, the cost of sales was \$231.7 million, compared to \$191.0 million for the same period of 2012, representing an increase of \$40.7 million, or 21.3%. The increase in the cost of sales was mainly due to the net effect of a net increase in sales volumes which led to a cost of sales increase of \$47.9 million, and the appreciation of the RMB against the U.S. dollar which led to a cost of sales increase of \$4.6 million, offset by a decrease in unit cost which led to a cost of sales decrease of \$11.8 million. The decrease in the unit cost of sales was primarily due to a decrease in the cost of raw materials, including steel, and enhanced production efficiency. Further analysis is as follows:

- Cost of sales for Henglong was \$145.8 million for the nine months ended September 30, 2013, compared to \$97.1 million for the same period of 2012, representing an increase of \$48.7 million, or 50.2%. This was mainly due to an increase in sales volumes which led to a cost of sales increase of \$52.0 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$1.9 million, which were offset by the adoption of technical innovations in the production processes in 2013, and a decrease in unit material costs which led to a cost of sales decrease of \$5.2 million.
- Cost of sales for Jiulong was \$49.5 million for the nine months ended September 30, 2013, compared to \$47.5 million for the same period of 2012, representing an increase of \$2.0 million, or 4.3%. The increase in cost of sales was mainly due to an increase in sales volumes which led to a cost of sales increase of \$2.5 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.8 million, offset by a decrease in unit cost which led to a cost of sales decrease of \$1.3 million.
- Cost of sales for Shenyang was \$24.9 million for the nine months ended September 30, 2013, compared to \$18.5 million for the same period of 2012, representing an increase of \$6.4 million, or 34.6%. The increase in cost of sales was mainly due to an increase in sales volumes which led to a cost of sales increase of \$7.3 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.3 million, offset by a decrease in unit cost which led to a cost of sales decrease of \$1.2 million.
- Cost of sales for Wuhu was \$16.0 million for the nine months ended September 30, 2013, compared to \$22.6 million for the same period of 2012, representing a decrease of \$6.6 million, or 29.3%. The decrease in cost of sales was mainly due to a decrease in sales volumes.
- Cost of sales for Hubei Henglong was \$28.6 million for the nine months ended September 30, 2013, compared to \$26.4 million for the same period of 2012, representing an increase of \$2.2 million, or 8.3%. The increase in cost of sales was mainly due to an increase in sales volumes which led to a cost of sales increase of \$3.0 million, and the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.5 million, offset by a decrease in unit cost which led to a cost of sales decrease of

\$1.3 million.

- Cost of sales for Other Sectors was \$20.8 million for the nine months ended September 30, 2013, compared to \$25.8 million for the same period of 2012, representing a decrease of \$5.0 million, or 19.3%. The decrease in cost of sales was mainly due to a decrease in sales volume which led to a cost of sales decrease of \$1.7 million, and a decrease in unit cost which led to a cost of sales decrease of \$3.8 million, offset by the effect of foreign currency translation of the RMB against the U.S. dollar which resulted in a cost of sales increase of \$0.5 million.

Gross margin was 19.0% for the nine months ended September 30, 2013, representing a 0.4% increase from 18.6% for the same period of 2012, which was primarily due to a magnitude of decreases in unit cost that was greater than the magnitude of decreases in sales price.

#### *Gain on Other Sales*

Gain on other sales mainly consisted of net amount retained from sales of materials, property, plant and equipment and scraps. For the nine months ended September 30, 2013, gain on other sales amounted to \$6.8 million, while it amounted to \$2.6 million for the same period of 2012, representing an increase of \$4.2 million. The increase was mainly due to the gain of \$4.1 million (before tax) for selling an idle land use right during the nine months ended September 30, 2013, which represents the difference between the total selling price of \$4.6 million and the land use right's and plant's net value of \$0.5 million.

### *Selling Expenses*

Selling expenses were \$9.6 million for the nine months ended September 30, 2013, compared to \$6.7 million for the same period of 2012, representing an increase of \$2.9 million, or 43.3%, mainly due to an increase in salaries and wages expenses of salesmen of \$0.9 million, an increase in warehouse rental fees of \$0.8 million, an increase in transportation expenses of \$0.6 million, and an increase in other selling expenses of \$0.6 million.

### *General and Administrative Expenses*

General and administrative expenses were \$10.2 million for the nine months ended September 30, 2013, compared to \$9.0 million for the same period of 2012, representing an increase of \$1.2 million, or 13.3%, which was mainly due to an increase in property tax.

### *Research and Development Expenses*

Research and development expenses were \$13.1 million for the nine months ended September 30, 2013, compared to \$10.0 million for the nine months ended September 30, 2012, representing an increase of \$3.1 million, or 31.0%. The Company's research and development expenses were mainly used for the development and trial production of EPS and other new products. Research and development expenditures have continued to be significant in the past three years. In summary, expenses for mold improvement increased by \$0.5 million, external technical support fees increased by \$0.9 million and the salaries and wages expenses of research and development related staff increased by \$1.7 million.

### *Income from Operations*

Income from operations was \$28.1 million for the nine months ended September 30, 2013, compared to \$20.4 million for the nine months ended September 30, 2012, representing an increase of \$7.7 million, or 37.7%, including an increase of \$10.8 million, or 24.7%, in gross profit, an increase of \$4.2 million, in gain on other sales, and an increase of \$7.1 million, or 27.7%, in operating expenses.

### *Other Income, Net*

Other income, net, was \$0.6 million for the nine months ended September 30, 2013, compared to \$0.3 million for the nine months ended September 30, 2012, an increase of \$0.3 million, or 100.0%, primarily as a result of increased government subsidies.

### *Financial Income /Expenses, Net*

Financial income, net was \$0.4 million for the nine months ended September 30, 2013; compared to financial expenses, net of \$1.9 million for the nine months ended September 30, 2012, representing a decrease of \$2.3 million, which was mainly due to the fact that the Company had redeemed all convertible notes by May 2012. Therefore, there were no financial expenses associated with convertible notes for the nine months ended September 30, 2013.

### *Loss on Change in Fair Value of Derivative*

Loss on change in fair value of derivative was \$0.5 million for the nine months ended September 30, 2012. The Company had redeemed all outstanding convertible notes on May 25, 2012. Therefore, there was no gain or loss on change of fair value of derivative associated with convertible notes for the nine months ended September 30, 2013.

Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and

external market factors. In addition, option-based techniques are highly volatile and sensitive to changes in the trading market price of the Company's common stock, which has a high estimated volatility. Derivative financial instruments are initially and subsequently carried at fair values and gain or loss on change in fair value of derivative liabilities is equal to the difference between the beginning and ending balances of the Company's derivative liabilities (see Note 24). As of January 1, 2012 and September 30, 2012, the Company calculated the fair value of derivative liabilities to be \$0.6 million and \$nil, respectively. Therefore the Company recorded a loss on change in fair value of derivative of \$0.5 million for the nine months ended September 30, 2012.

*Gain on Redemption of Convertible Notes*

For the nine months ended September 30, 2012, the Company recorded a gain of \$1.4 million for the redemption of all the outstanding convertible notes on May 25, 2012. As all convertible notes were redeemed in 2012, there was no gain on redemption of convertible notes for the nine months ended September 30, 2013.

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

Income before income tax expenses and equity in earnings of affiliated companies was \$29.1 million for the nine months ended September 30, 2013, compared to \$19.8 million for the nine months ended September 30, 2012, representing an increase of \$9.3 million, which was mainly due to an increase in operating income of \$7.7 million, a decrease in financial expenses of \$0.3 million, a decrease in loss on change in fair value of derivative of \$0.5 million, and a decrease in gain on redemption of convertible notes of \$1.4 million.

*Income Taxes*

Income tax expense was \$5.2 million for the nine months ended September 30, 2013, compared to \$3.7 million of income tax expense for the nine months ended September 30, 2012, representing an increase of \$1.5 million, or 40.5%, which was mainly due to an increase in income before income tax. The income before income tax increased to \$36.6 million for the nine months ended September 30, 2013 from \$19.8 million for the same period in 2012, offset by a decrease in the effective tax rate from 18.5% to 17.8%, mainly due to an increase in the weight of the pretax income of lower tax rate subsidiaries in the Company's consolidated pretax income.

*Income From Continuing Operations*

Net income from continuing operations was \$24.2 million for the nine months ended September 30, 2013, compared to \$16.3 million for the nine months ended September 30, 2012, representing an increase of \$7.9 million, which was mainly due to an increase in income before income tax expenses and equity in earnings of affiliated companies of \$9.3 million and an increase in income tax expenses of \$1.5 million.

*Income From Discontinued Operations*

The Company sold its 51% equity interest in Zhejiang in May 2012 (see Note 26). The net income from the discontinued operations was \$2.6 million for the nine months ended September 30, 2012, which included a gain on such sale of \$2.5 million (after tax) and net operating income of \$0.1 million.

*Net Income*

Net income was \$24.2 million for the nine months ended September 30, 2013, compared to net income of \$18.9 million for the nine months ended September 30, 2012, representing an increase of \$5.3 million, which was mainly due to an increase in income from continuing operations of \$7.9 million, offset by a decrease in income from discontinued operations of \$2.6 million.

*Net Income Attributable to Non-controlling Interests*

Net income attributable to non-controlling interests amounted to \$4.6 million for the nine months ended September 30, 2013, compared to \$3.3 million for the nine months ended September 30, 2012, representing an increase of \$1.3 million, or 39.4%, primarily due to the increase in non-wholly owned subsidiaries' net income.

The Company owns equity interests in ten non-wholly owned subsidiaries established in the PRC and Brazil, through which it conducts its operations. Except for Beijing Henglong, which is accounted for under the equity method, all the operating results of these non-wholly owned subsidiaries were consolidated in the Company's financial statements as of September 30, 2013 and 2012. For the nine months ended September 30, 2013 and 2012, the Company recorded \$4.6 million and \$3.2 million, respectively, for the non-controlling interests' share in the earnings of the consolidated non-wholly owned subsidiaries.

*Net Income Attributable to Parent Company*

Net income attributable to parent company was \$19.5 million for the nine months ended September 30, 2013, compared to net income attributable to parent company of \$15.7 million for the nine months ended September 30, 2012, representing an increase of \$3.8 million, reflecting an increase in 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' acceptances, issuances of capital stock and notes and internally generated cash. As of September 30, 2013, the Company had cash and cash equivalents of \$54.7 million, compared to \$87.6 million as of December 31, 2012, representing a decrease of \$32.9 million, or 37.6%.

The Company had working capital of \$164.4 million as of September 30, 2013, compared to \$138.7 million as of December 31, 2012, representing an increase of \$25.7 million, or 18.5%.

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

The Company believes that, in view of its current cash position as of September 30, 2013, the cash expected to be generated from the operations and funds available from bank borrowings as detailed in subsequent paragraphs will be sufficient to meet its working capital and capital expenditure requirements (including the repayment of bank loans) for at least twelve months commencing from September 30, 2013.

### *Capital Source*

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

The Company had short-term bank and government loans of \$42.2 million, including bank loans of \$35.7 million and a government loan of \$6.5 million (see Note 13); and bankers' acceptances of \$70.5 million (see Note 14) as of September 30, 2013.

The Company currently expects to be able to obtain similar bank loans (i.e., RMB loans) and bankers' acceptance facilities in the future if it can provide adequate mortgage security following the termination of the above-mentioned agreements (see the table under "Bank Arrangements" below for more information). If the Company is not able to do so, it will have to refinance such debt as it becomes due or repay that debt to the extent it has cash available from operations or from the proceeds of additional issuances of capital stock. Owing to depreciation, the value of the mortgages securing the above-mentioned bank loans and banker's acceptances will be lowered by approximately \$14.5 million over the next 12 months. If the Company wishes to obtain the same amount of bank loans and banker's acceptances, it will have to provide additional mortgages of \$14.5 million as of the maturity date of such line of credit agreements (see the table under "Bank Arrangements" below for more information). The Company can still obtain a reduced line of credit with a reduction of \$8.4 million, which is 57.8% (the mortgage rate) of \$14.5 million, if it cannot provide additional mortgages. The Company expects that the reduction in bank loans will not have a material adverse effect on its liquidity.

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

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

As security for the Credit Facility, the Company was required to provide ICBC Macau with the Henglong Standby Letter of Credit for a total amount of not less than \$31.6 million if the Credit Facility is to be fully drawn.

On May 22, 2012, the Company drew down the full amount of \$30.0 million under the Credit Facility and provided the Henglong Standby Letter of Credit for an amount of \$31.6 million in favor of ICBC Macau. The Henglong Standby Letter of Credit issued by ICBC Jingzhou is collateralized by Henglong's notes receivable of RMB216.1 million (equivalent to approximately \$35.1 million). The Company also paid an arrangement fee of \$0.1 million to ICBC Macau and \$0.1 million to ICBC Jingzhou. The original maturity date of the Credit Facility was May 22, 2013. On May 7, 2013, ICBC Macau agreed to extend the maturity date of the Credit Facility to May 13, 2014. The interest rate of the Credit Facility under the extended term is calculated based on the three-month LIBOR plus 2.0% per annum. Except for the above, all other terms and conditions as stipulated in the Credit Agreement remain unchanged. As of September 30, 2013, the interest rate of the Credit Facility was 2.25%.

*Bank Arrangements*

As of September 30, 2013, the principal outstanding under the Company's credit facilities and lines of credit was as follows (figures are in thousands of USD):

|                                                   | Bank                             | Due Date | Amount Available<br>(4) | Amount Used | Assessed Mortgage Value<br>(6) |
|---------------------------------------------------|----------------------------------|----------|-------------------------|-------------|--------------------------------|
| 1. Comprehensive credit facilities                | Bank of China                    | Mar 2014 | \$ 22,934               | \$ 9,706    | \$ 15,662                      |
| 2. Comprehensive credit facilities                | Jingzhou Commercial Bank         | Jun 2014 | 32,531                  | 18,452      | 62,563                         |
| 3. Comprehensive credit facilities <sup>(5)</sup> | China Construction Bank          | Sep 2013 | 11,386                  | 1,627       | 30,782                         |
| 4. Comprehensive credit facilities <sup>(1)</sup> | Shanghai Pudong Development Bank | Dec 2013 | 16,265                  | 12,077      | 13,187                         |
| 5. Comprehensive credit facilities <sup>(1)</sup> | China CITIC Bank                 | Nov 2013 | 16,916                  | 11,257      | 15,135                         |
| 6. Comprehensive credit facilities                | China Everbright Bank            | Aug 2014 | 4,880                   | 4,106       | 8,329                          |
| 7. Comprehensive credit facilities                | ICBC Macau                       | May 2014 | 30,000                  | 30,000      | 35,149                         |
| Total                                             |                                  |          | \$ 134,912              | \$ 87,225   | (2) \$ 180,807 (3)             |

(1) Henglong's comprehensive credit facility provided by China CITIC Bank and each of Henglong and Jielong's comprehensive credit facilities provided by Shanghai Pudong Development Bank, are required to be guaranteed by Jiulong, another subsidiary of the Company, in addition to the above pledged assets.

(2) The amount used includes bank loans of \$35.7 million and notes payable of \$51.5 million as of September 30, 2013. The remainder of \$19.0 million of notes payable was 100% secured by bank notes without utilization of credit lines.

(3) As of September 30, 2013, the pledged assets included \$50.8 million accounts and notes receivable and other pledged assets with assessed value of \$130.0 million.

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

(5) As at the date of this report, the comprehensive credit facilities with China Construction Bank have expired. The Company is negotiating the renewal of the credit facilities with the bank and expects to obtain the renewal

in late November 2013. As the Company has obtained sufficient comprehensive lines of credit from other banks, the Company does not anticipate any significant adverse impact on its financial position if the Company fails to renew the same.

- (6) The pledged cash deposits, which are disclosed in Note 3 to the consolidated financial statements in this Report, were not included in the assessed mortgage value.

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

The Company renewed its existing short-term bank loans and borrowed new bank loans during 2013 at annual interest rates of 2.25% to 7.20 %, and maturity terms of twelve months. Pursuant to the comprehensive credit line arrangement the Company pledged: (1) accounts receivable of \$15.7 million as security for its comprehensive credit facility with the Bank of China; (2) equipment with an assessed value of approximately \$62.6 million as security for its revolving comprehensive credit facility with Jingzhou Commercial Bank; (3) equipment, land use rights and buildings with an assessed value of approximately \$30.8 million as security for its comprehensive credit facility with China Construction Bank; (4) land use rights and buildings with an assessed value of approximately \$13.2 million as security for its comprehensive credit facility with Shanghai Pudong Development Bank; (5) land use rights and buildings with an assessed value of approximately \$15.1 million as security for its comprehensive credit facility with China CITIC Bank; (6) land use rights and buildings with an assessed value of approximately \$8.3 million as security for its comprehensive credit facility with China Everbright Bank; and (7) \$35.1 million of notes receivable held by Henglong.

*Cash Requirements*

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

|                                                                      | Total      | Payment Due Dates |           |           |                   |
|----------------------------------------------------------------------|------------|-------------------|-----------|-----------|-------------------|
|                                                                      |            | Less than 1 year  | 1-3 years | 3-5 years | More than 5 Years |
| Short-term loan including interest payable                           | \$ 42,957  | \$ 42,957         | \$ -      | \$ -      | \$ -              |
| Notes payable <sup>(1)</sup>                                         | 70,483     | 70,483            | -         | -         | -                 |
| Other contractual purchase commitments, including service agreements | 9,445      | 6,883             | 2,562     | -         | -                 |
| Total                                                                | \$ 122,885 | \$ 120,323        | \$ 2,562  | \$ -      | \$ -              |

(1) Notes payable do not bear interest.

*Short-term Loans*

The following table summarizes the contract information of short-term borrowings among the banks and the government of the PRC and the Company as of September 30, 2013 (figures are in thousands of USD):

| Bank / PRC Government                         | Purpose         | Borrowing Date | Borrowing Term (Months) | Annual Percentage Rate | Date of Interest Payment | Due Date    | Amount Payable on Due Date |
|-----------------------------------------------|-----------------|----------------|-------------------------|------------------------|--------------------------|-------------|----------------------------|
| ICBC Macau                                    | Working Capital | 13 May 2013    | 12                      | 2.25                   | % Pay quarterly          | 13 May 2014 | 30,000                     |
| China CITIC Bank                              | Working Capital | 7 Aug 2013     | 12                      | 7.20                   | % Pay monthly            | 7 Aug 2014  | 2,440                      |
| Jingzhou Commercial Bank                      | Working Capital | 26 Jun 2013    | 6                       | 5.04                   | % Pay monthly            | 26 Dec 2013 | 1,627                      |
| China Construction Bank                       | Working Capital | 18 Jul 2013    | 12                      | 6.00                   | % Pay monthly            | 18 Jul 2014 | 1,626                      |
| Financial Bureau of Jingzhou Development Zone | Working Capital | 31 Jan 2013    | 11                      | 0.00                   | % -                      | 31 Dec 2013 | 6,506                      |
| Total                                         |                 |                |                         |                        |                          |             | \$ 42,199                  |

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

Management believes that the Company had complied with such financial covenants as of September 30, 2013, and will continue to comply with them.

*Notes Payable*

The following table summarizes the contract information of issuing notes payable between the banks and the Company as of September 30, 2013 (figures are in thousands of USD):

| Purpose                        | Term<br>(Month) | Due Date | Amount Payable on<br>Due Date |
|--------------------------------|-----------------|----------|-------------------------------|
| Working Capital <sup>(1)</sup> | 3-6             | Oct -13  | \$ 12,069                     |
| Working Capital                | 3-6             | Nov -13  | 9,455                         |
| Working Capital                | 3-6             | Dec -13  | 8,594                         |
| Working Capital                | 3-6             | Jan -14  | 16,102                        |
| Working Capital                | 3-6             | Feb -14  | 11,947                        |
| Working Capital                | 3-6             | Mar -14  | 12,316                        |
| Total (Note 14)                |                 |          | \$ 70,483                     |

(1) The notes payable was repaid in full in October 2013.

The Company must use notes payable for the purpose described in the table. If it fails to do so, the banks will no longer issue the notes payable, and it may have an adverse effect on the Company's liquidity and capital resources. The Company has to deposit sufficient cash in the designated account of the bank on the due date of notes payable for payment to the suppliers. If the bank has advanced payment for the Company, it will be charged a penalty interest at 50% of the loan rate that is published by the People's Bank of China for the same period. The Company complied with such financial covenants as of September 30, 2013, and believes it will continue to comply with them.

*Cash Flows*

## (a) Operating activities

Net cash provided by operations during the nine months ended September 30, 2013 was \$0.6 million, compared to net cash provided by operations of \$11.4 million for the same period of 2012, representing a decrease of \$10.8 million.

During the nine months ended September 30, 2013, the decrease in net cash provided by operations was mainly due to the net effect of: (1) the increase in net income (excluding non-cash items) by \$4.4 million; (2) the change in balance of pledge deposits which led to an increase in net cash provided by operations of \$6.5 million; (3) the change in balance of accounts and notes receivable which led to a decrease in net cash provided by operations of \$32.1 million, which was mainly due to the sales of the Company's goods generally on credit terms which range from 4 to 6 months, and the fact that, during the nine months ended September 30, 2013, there was a significant rise in sales revenue of the Company's products which led to an increase in the ending balance of accounts receivable; (4) the change in balance of inventories which led to a decrease in net cash provided by operations of \$4.8 million, which was mainly due to the increase in inventory as a result of an increase in sales; (5) the change in balance of accounts and notes payable which led to an increase in net cash provided by operations of \$6.7 million, which was mainly due to an increase in purchases of raw materials by the Company for the nine months ended September 30, 2013. The credit terms for the Company's suppliers generally range from 4 to 6 months, and as a result, the ending balance of account payable significantly increased; and (6) the change of balance of accrued expenses and other accounts payable, which led to an increase in net cash provided by operation of \$10.2 million.

## (b) Investing activities

The Company used net cash of \$34.9 million in investment activities during the nine months ended September 30, 2013, compared to \$14.5 million during the same period of 2012, representing an increase of \$20.4 million, which was

mainly due to an increase in receipt of cash from sale of property, plant and equipment of \$5.7 million, a decrease in the payment for the acquisition of equipment of \$7.9 million, an increase in bank deposit with original maturities of over three months of \$32.2 million (see Note 4) and a net cash increase of \$3.6 million pursuant to the Company's sale of its 51% equity interest in Zhejing (see Note 25) in May 2012.

(c) Financing activities

During the nine months ended September 30, 2013, the Company used net cash of \$0.6 million in financing activities, compared to net cash of \$3.1 million provided by financing activities for the same period of 2012, representing a decrease of \$3.7 million, which was mainly due to the net effect of: (1) the proceeds from government and bank loan having decreased by \$20.8 million and the repayment of bank loan having increased by \$7.7 million; (2) the dividends paid to the non-controlling interests having decreased by \$1.0 million; and (3) during the nine months ended September 30, 2012, the Company redeemed all of its convertible notes which resulted in a \$23.6 million cash outflow.

*Off-Balance Sheet Arrangements*

As of September 30, 2013 and 2012, the Company did not have any significant transactions, obligations or relationships that could be considered off-balance sheet arrangements.

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

There were no material changes to the disclosure made in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 regarding this matter.

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

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

The Company's management, under the supervision and with the participation of its chief executive officer and chief financial officer, Messrs. Wu Qizhou and Li Jie, respectively, evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2013, the end of the period covered by this Report. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports, such as this Form 10-Q, that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management evaluated the effectiveness of the Company's disclosure controls and procedures as of September 30, 2013. Based on that evaluation, Messrs. Wu and Li concluded that the Company's disclosure controls and procedures were effective as of September 30, 2013.

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

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

There have been no changes in the Company's internal control over financial reporting during the three months ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS.**

*Securities Action* - Southern District of New York. On October 25, 2011, a purported securities class action (the "Securities Action") was filed in the United States District Court for the Southern District of New York on behalf of all purchasers of the Company's securities between March 25, 2010 and March 17, 2011. On February 24, 2012, the plaintiffs filed an amended complaint, changing the purported class period to between May 12, 2009 and March 17, 2011. The amended complaint alleges that the Company, certain of its present officers and directors and the Company's former independent accounting firm violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and the rules promulgated thereunder, and seeks unspecified damages. The Company filed a motion to dismiss the amended complaint, which was fully briefed on April 18, 2012. On August 8, 2012, the court denied the Company's motion to dismiss the amended complaint. On September 4, 2012, the Company filed an answer to the amended complaint. On January 15, 2013, Plaintiffs filed a motion to certify the purported class, which was fully briefed on April 8, 2013. On May 31, 2013, the court denied plaintiffs' motion to certify the purported class, and, on

July 3, 2013, the court issued its order and opinion. On July 17, 2013, plaintiffs filed a petition for permission to appeal the order denying class certification, and, on August 1, 2013, the Company filed an answer in opposition to the petition. On October 23, 2013, the Court of Appeals for the Second Circuit denied plaintiffs' petition for permission to appeal. On December 12, 2013, the district court is scheduled to hold a status conference regarding plaintiffs' remaining individual claims. The Company believes that the allegations in the amended complaint are without merit and intends to defend itself vigorously against the claims.

The above-referenced action does not specify an amount of damages that the plaintiffs seek. Moreover, this matter has not reached the merits of the plaintiffs' claims. With no merits discovery having been commenced, the Company cannot determine whether an adverse outcome is probable, nor can it provide a reasonable estimate of potential losses related to this matter. Although the Company believes that it has meritorious defenses to this action and intends to defend it vigorously, an adverse outcome in this matter could have a material adverse effect on the Company's business, financial condition, results of operations or liquidity.

*Derivative Action* - Delaware Chancery Court. On December 23, 2011, a purported shareholder derivative action was filed in the Court of Chancery of the State of Delaware (the “Court of Chancery”) on behalf of the Company. The complaint alleged that certain of the Company’s current officers and directors breached their fiduciary duties to the Company in relation to the Company’s accounting of convertible notes issued in February 2008. On January 25, 2012, a second purported shareholder derivative action was filed in the Court of Chancery on behalf of the Company. On February 3, 2012, the Court of Chancery consolidated the two cases, which were stayed pending the outcome of the motion to dismiss in the Securities Action. On October 23, 2012, the derivative plaintiffs filed a consolidated amended complaint on behalf of the Company (the “Derivative Action”). The consolidated complaint alleged that certain of the Company’s current officers and directors breached their fiduciary duties to the Company in relation to the Company’s accounting of the convertible notes issued in February 2008. The consolidated complaint sets forth three causes of action for breach of fiduciary duties, unjust enrichment and insider trading. On January 7, 2013, the Company filed a motion to dismiss the Derivative Action. That motion was fully briefed on February 28, 2013, and oral argument was held before the Court of Chancery on May 6, 2013. On August 30, 2013, the Court of Chancery dismissed all of the derivative plaintiffs’ claims with prejudice. The time for the derivative plaintiffs to appeal the Court of Chancery’s decision expired on September 30, 2013 and, accordingly, the Derivative Action has terminated.

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

#### ITEM 1A. RISK FACTORS.

There have been no material changes from the risk factors previously disclosed in Item 1A of the Company’s 2012 Annual Report on Form 10-K.

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

##### (c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The following table provides information about the Company’s share repurchase activity for the three months ended September 30, 2013 (in thousands of USD):

##### Issuer Purchases of Equity Securities

| Period                                  | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced programs <sup>(1)</sup> | Approximate dollar value of shares that may yet be purchased as part of publicly announced program |
|-----------------------------------------|----------------------------------|------------------------------|----------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------|
| July 1, 2013 to July 31, 2013           | -                                | \$ -                         | -                                                                                      | \$ -                                                                                               |
| August 1, 2013 to August 31, 2013       | -                                | \$ -                         | -                                                                                      | \$ -                                                                                               |
| September 1, 2013 to September 30, 2013 | -                                | \$ -                         | -                                                                                      | \$ -                                                                                               |

|       |   |    |   |   |    |   |
|-------|---|----|---|---|----|---|
| Total | - | \$ | - | - | \$ | - |
|-------|---|----|---|---|----|---|

- (1) On August 15, 2012, the Board of Directors of the Company approved a share repurchase program under which the Company may repurchase up to \$5.0 million of its common stock for a period from August 13, 2012 to August 12, 2013. The repurchase program does not obligate the Company to repurchase a minimum number of shares, and the program may be suspended or canceled without prior notice. As at September 30, 2013, the share repurchase program has expired.

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

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION.**

None.

**ITEM 6. EXHIBITS.**

**INDEX TO EXHIBITS**

| Exhibit<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.)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 31.1              | Rule 13a-14(a) Certification*                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 31.2              | Rule 13a-14(a) Certification*                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 32.1              | Section 1350 Certification*                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 32.2              | Section 1350 Certification*                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 101+              | <p>The following materials from the China Automotive Systems, Inc. Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, were filed on November 13, 2013 formatted in Extensible Business Reporting Language (XBRL):</p> <ul style="list-style-type: none"> <li>(i) Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income,</li> <li>(ii) Condensed Unaudited Consolidated Balance Sheets,</li> <li>(iii) Condensed Unaudited Consolidated Statements of Cash Flows, and</li> <li>(iv) related notes</li> </ul> <p>* filed herewith</p> <p>+ XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.</p> |



**SIGNATURES**

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

CHINA AUTOMOTIVE SYSTEMS, INC.  
(Registrant)

Date: November 13, 2013

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

Date: November 13, 2013

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