

CHINA AUTOMOTIVE SYSTEMS INC
Form 10-Q
August 13, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2007

Or

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

For the transition period from _____ to _____

China Automotive Systems, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State or Other Jurisdiction of Incorporation or Organization)

33-0885775

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

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

(Address of Principal Executive Offices)

Registrant's telephone number, including Area Code: (86) 716- 832- 9196

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

Not Applicable

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report.)

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

Yes x No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

Yes o No x

As of June 30, 2007, the Company had 23,959,702 shares of common stock issued and outstanding.

CHINA AUTOMOTIVE SYSTEMS, INC.
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PART 1 — FINANCIAL INFORMATION**ITEM 1. FINANCIAL STATEMENTS**

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

| | Three Months Ended June 30 | |
|---|----------------------------|---------------|
| | 2007 | 2006 |
| Net product sales, including \$1,173,244 and \$794,200 to related parties in 2007 and 2006, respectively | \$ 36,312,338 | \$ 24,747,912 |
| Cost of product sold, including \$1,414,954 and \$674,207 purchased from related parties in 2007 and 2006, respectively | 24,218,532 | 15,476,767 |
| Gross profit | 12,093,806 | 9,271,145 |
| Add: Gain on other sales | 147,993 | 117,887 |
| Less: Operating expenses- | | |
| Selling expenses | 2,813,166 | 2,386,901 |
| General and administrative expenses | 2,080,578 | 2,352,153 |
| Research and development expenses | 468,517 | 251,394 |
| Depreciation and amortization | 935,173 | 1,253,604 |
| Total Operating expenses | 6,297,434 | 6,244,052 |
| Income from operations | 5,944,365 | 3,144,980 |
| Add: Other income, net | — | — |
| Financial (expenses) | (16,495) | (177,477) |
| Income before income taxes | 5,927,870 | 2,967,503 |
| Less: Income taxes | 1,067,535 | 850,739 |
| Income before minority interests | 4,860,335 | 2,116,764 |
| Less: Minority interests | 2,405,181 | 1,365,128 |
| Net income | \$ 2,455,154 | \$ 751,636 |
| Net income per common share | | |
| Basic and diluted | \$ 0.10 | \$ 0.03 |
| Weighted average number of common shares outstanding | | |
| Basic | 23,959,702 | 23,254,121 |
| Diluted | 23,962,153 | 23,267,235 |

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

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

| | Three Months Ended June 30 | |
|-----------------------------------|----------------------------|------------|
| | 2007 | 2006 |
| Net income | \$ 2,455,154 | \$ 751,636 |
| Other comprehensive income: | | |
| Foreign currency translation gain | 1,265,553 | — |
| Comprehensive income | \$ 3,720,707 | \$ 751,636 |

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

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

| | Six Months Ended June 30 | |
|---|--------------------------|---------------------|
| | 2007 | 2006 |
| Net product sales, including \$2,075,828 and \$1,377,739 to related parties in 2007 and 2006, respectively | \$ 64,695,730 | \$ 45,712,364 |
| Cost of product sold, including \$2,466,434 and \$1,330,202 purchased from related parties in 2007 and 2006, respectively | 43,410,018 | 29,496,022 |
| Gross profit | 21,285,712 | 16,216,342 |
| Add: Gain on other sales | 260,087 | 200,602 |
| Less: Operating expenses- | | |
| Selling expenses | 4,406,812 | 3,879,390 |
| General and administrative expenses | 3,589,605 | 4,389,690 |
| Research and development expenses | 587,982 | 441,141 |
| Depreciation and amortization | 1,828,424 | 1,942,094 |
| Total Operating expenses | 10,412,823 | 10,652,315 |
| Income from operations | 11,132,976 | 5,764,629 |
| Add: Other income, net | 38,462 | 625 |
| Financial (expenses) | (411,492) | (511,863) |
| Income before income taxes | 10,759,946 | 5,253,391 |
| Less: Income taxes | 2,361,615 | 1,051,450 |
| Income before minority interests | 8,398,331 | 4,201,941 |
| Less: Minority interests | 4,300,076 | 2,355,907 |
| Net income | \$ 4,098,255 | \$ 1,846,034 |
| Net income per common share | | |
| Basic and diluted | \$ 0.17 | \$ 0.08 |
| Weighted average number of common shares outstanding | | |
| Basic | 23,948,950 | 22,969,051 |
| Diluted | 23,956,740 | 22,987,095 |

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

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

| | Six Months Ended June 30 | |
|-----------------------------------|--------------------------|--------------|
| | 2007 | 2006 |
| Net income | \$ 4,098,255 | \$ 1,846,034 |
| Other comprehensive income: | | |
| Foreign currency translation gain | 1,265,553 | 601,399 |
| Comprehensive income | \$ 5,363,808 | \$ 2,447,433 |

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

China Automotive Systems, Inc.
Condensed Consolidated Balance Sheets

| | June 30, 2007 (Unaudited) | December 31, 2006 |
|---|------------------------------|-------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 19,627,606 | \$ 27,418,500 |
| Pledged cash deposits | 2,828,672 | 3,484,335 |
| Accounts and notes receivable, net, including \$1,850,422 and \$1,770,933 from related parties at 2007 and 2006, respectively | 69,919,862 | 57,234,383 |
| Advance payments and other, including \$223,684 and \$487,333 to related parties at 2007 and 2006, respectively | 1,141,534 | 837,014 |
| Inventories | 17,364,810 | 15,464,571 |
| Total current assets | \$ 110,882,484 | \$ 104,438,803 |
| Long-term Assets: | | |
| Property, plant and equipment, net | \$ 41,656,104 | \$ 40,848,046 |
| Intangible assets, net | 418,593 | 3,140,548 |
| Other receivables, net, including \$811,653 and \$738,510 from related parties at 2007 and 2006, respectively | 1,145,384 | 966,715 |
| Advance payment for property, plant and equipment, including \$1,315,243 and \$488,873 to related parties at 2007 and 2006, respectively | 5,633,146 | 2,640,708 |
| Long-term investments | 72,368 | 73,718 |
| Total assets | \$ 159,808,079 | \$ 152,108,538 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Bank loans | \$ 11,447,368 | \$ 15,384,615 |
| Accounts and notes payable, including \$987,473 and \$640,405 to related parties at 2007 and 2006, respectively | 42,487,454 | 37,647,913 |
| Customer deposits | 265,730 | 146,171 |
| Accrued payroll and related costs | 2,006,378 | 1,506,251 |
| Accrued expenses and other payables | 8,979,953 | 11,078,186 |
| Accrued pension costs | 3,421,258 | 3,266,867 |
| Taxes payable | 7,622,569 | 5,914,362 |
| Amounts due to shareholders/directors | 370,080 | 358,065 |
| Total current liabilities | \$ 76,600,790 | \$ 75,302,430 |
| Long-term liabilities: | | |
| Advances payable | 321,392 | 313,151 |
| Total liabilities | \$ 76,922,182 | \$ 75,615,581 |
| Minority interests | \$ 22,798,874 | \$ 23,112,667 |
| Stockholders' equity: | | |
| Preferred stock, \$0.0001 par value - Authorized - 20,000,000 Shares issued and outstanding - None | \$ — | — |
| Common stock, \$0.0001 par value - Authorized - 80,000,000 Shares Issued and Outstanding - 23,959,702 shares and 23,851,581 shares at June 30, 2007 and December 31, 2006, respectively | 2,396 | 2,385 |
| Additional paid-in capital | 29,994,873 | 28,651,959 |
| Retained earnings- | | |
| Appropriated | 6,078,613 | 6,209,909 |

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| | | |
|--|----------------|----------------|
| Unappropriated | 20,276,788 | 16,047,237 |
| Accumulated other comprehensive income | 3,734,353 | 2,468,800 |
| Total stockholders' equity | \$ 60,087,023 | \$ 53,380,290 |
| Total liabilities and stockholders' equity | \$ 159,808,079 | \$ 152,108,538 |

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

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China Automotive Systems, Inc.
Consolidated Statements of Stockholders' Equity
Six months ended June 30, 2007 (unaudited) and year ended December 31, 2006

| | Common Stock | | Additional | Retained Earnings | | Accumulated | Total |
|--|--------------|-----------|-----------------|-------------------|----------------|-----------------------------------|---------------|
| | Shares | Par Value | Paid-in Capital | Appropriated | Unappropriated | Other Comprehensive Income (Loss) | |
| Balance, December 31, 2005 | 22,574,543 | \$ 2,257 | \$ 18,146,722 | \$ 4,923,262 | \$ 12,522,180 | \$ 1,332,684 | \$ 36,927,798 |
| Foreign currency translation gain | — | — | — | — | — | 1,136,116 | 1,136,116 |
| Sale of common stock | 1,216,675 | 122 | 10,899,872 | — | — | — | —10,899,872 |
| Exercise of stock options by independent directors | 22,500 | 2 | 101,248 | — | — | — | 101,250 |
| Cash paid for retaining fee, commissions and placement agent fee in connection with offering | — | — | (627,504) | — | — | — | (627,504) |
| Issuance of common stock related to financing services | 37,863 | 4 | 449,996 | — | — | — | 450,000 |
| Payment of financing services by issuance of common stock in accordance with Cornell Partners, LP | — | — | (450,000) | — | — | — | (450,000) |
| Issuance of a warrant to purchase common stock | — | — | 832,639 | — | — | — | 832,639 |
| Payment of commission and placement agent fee by issuance of common stock warrants in accordance with Cornell Partners, LP | — | — | (832,639) | — | — | — | (832,639) |
| Issuance of stock options to independent directors | — | — | 131,625 | — | — | — | 131,625 |
| Net income for the year ended December 31, 2006 | — | — | — | — | 4,811,704 | — | 4,811,704 |
| Appropriation of retained earnings | — | — | — | 1,286,647 | (1,286,647) | — | — |
| Balance, December 31, 2006 | 23,851,581 | \$ 2,385 | \$ 28,651,959 | \$ 6,209,909 | \$ 16,047,237 | \$ 2,468,800 | \$ 53,380,486 |
| Foreign currency translation gain | — | — | — | — | — | 1,265,553 | 1,265,553 |
| Sale of common stock | 108,121 | 11 | 1,199,989 | — | — | — | 1,200,000 |
| Cash paid for retaining fee, commissions and placement agent fee in connection with offering | — | — | (54,500) | — | — | — | (54,500) |

| | | | | | | | |
|---|------------|----------|---------------|--------------|---------------|--------------|---------------|
| Increase in connection with minority shareholders' abandonment of all its right and interest in Joint-venture | — | — | 197,425 | — | — | — | 197,425 |
| Net income for six months ended June, 30, 2007 | — | — | — | — | 4,098,255 | — | 4,098,255 |
| Appropriation of retained earnings | — | — | — | (131,296) | 131,296 | — | — |
| Balance, June 30, 2007 | 23,959,702 | \$ 2,396 | \$ 29,994,873 | \$ 6,078,613 | \$ 20,276,788 | \$ 3,734,353 | \$ 60,087,715 |

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

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

| | Six Months Ended June 30 | |
|--|--------------------------|---------------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 4,098,255 | \$ 1,846,034 |
| Adjustments to reconcile net income from continuing operations to net cash provided by operating activities: | | |
| Minority interests | 4,300,076 | 2,355,907 |
| Depreciation and amortization | 3,440,985 | 3,334,319 |
| Allowance for doubtful accounts (Recovered) | (107,765) | 1,263,545 |
| Other operating adjustments | 5,622 | — |
| Changes in operating assets and liabilities: | | |
| (Increase) decrease in: | | |
| Pledged deposits | 734,198 | (661,757) |
| Accounts and notes receivable | (11,092,496) | (11,818,049) |
| Advance payments and other | (280,899) | (1,067,535) |
| Inventories | (1,425,194) | (2,366,961) |
| Increase (decrease) in: | | |
| Accounts and notes payable | 3,825,270 | 4,120,931 |
| Customer deposits | 116,009 | 609,049 |
| Accrued payroll and related costs | 457,740 | 48,500 |
| Accrued expenses and other payables | (537,559) | 2,282,869 |
| Accrued pension costs | 68,177 | 180,874 |
| Taxes payable | 1,520,988 | 1,076,165 |
| Advances payable | — | (62) |
| Net cash provided by operating activities | \$ 5,123,407 | \$ 1,203,829 |
| Cash flows from investing activities: | | |
| (Increase) decrease in other receivables | (34,753) | 94,383 |
| Cash received from equipment sales | 146,412 | — |
| Cash paid to acquire property, plant and equipment | (6,064,201) | (952,502) |
| Cash paid to acquire intangible assets | (28,717) | (139,462) |
| Cash received from other investing activities | — | 3,920 |
| Net cash (used in) investing activities | \$ (5,981,259) | \$ (993,661) |
| Cash flows from financing activities: | | |
| (Decrease) increase in proceeds from bank loans | (4,156,545) | 1,414,898 |
| Dividends paid to the minority interest holders of Joint-venture companies | (4,377,448) | (739,586) |
| Increase (decrease) in amounts due to shareholders/directors | 100 | (451,138) |
| Proceeds from issuance of common stock | 1,145,500 | 4,959,740 |
| Capital Contribution from the minority interest holders of Joint-venture companies | — | 1,422,075 |
| Net cash provided by (used in) financing activities | \$ (7,388,393) | \$ 6,605,989 |
| Cash and cash equivalents effected by foreign currency | \$ 455,351 | \$ 601,399 |
| Net (decrease) increase in cash and cash equivalents | (7,790,894) | 7,417,556 |
| Cash and cash equivalents at beginning of period | 27,418,500 | 12,374,944 |
| Cash and cash equivalents at end of period | \$ 19,627,606 | \$ 19,792,500 |

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

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

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | Six Months Ended June 30 | |
|----------------------------|--------------------------|------------|
| | 2007 | 2006 |
| Cash paid for interest | \$ 422,902 | \$ 347,886 |
| Cash paid for income taxes | \$ 366,832 | \$ 686,927 |

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

| | Six Months Ended June 30 | |
|---|--------------------------|-----------|
| | 2007 | 2006 |
| Issuance of common shares on a non-cash basis | \$ — | \$ 4 |
| Financing services fee related to issuance of common shares | — | (4) |
| Increase in capital by minority shareholders of Joint-venture companies on a non-cash basis | — | 921,785 |
| Dividends payable to minority shareholders of Joint-venture companies being converted into capital | — | (921,785) |
| Decrease in minority interests as a result of minority shareholder's withdrawal from Joint-venture. | (2,830,545) | — |
| Withdrawal of invested intangible assets by minority shareholder of Joint-venture | 2,600,204 | — |
| Increase in equity in connection with minority shareholder's withdrawal from Joint-venture | \$ 230,341 | \$ — |

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

China Automotive Systems, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)

1. ORGANIZATION AND BUSINESS

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

Great Genesis Holding Limited, a company incorporated on January 3, 2003 under The Companies Ordinance in Hong Kong as a limited liability company, “Great Genesis”, is a wholly-owned subsidiary of the Company. Ji Long Enterprise Investment Limited was incorporated on October 8, 1992 under the Companies Ordinance in Hong Kong as a limited liability company, “Ji Long”. Ji Long is an investment holding company. Effective March 4, 2003, all of the shareholders of Ji Long exchanged their 100% shareholder interest for a 100% shareholder interest in Great Genesis, as a result of which Ji Long became a wholly-owned subsidiary of Great Genesis.

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

The Company owns the following aggregate net interests in eight Sino-foreign joint ventures organized in the PRC as of June 30, 2007 and 2006.

| Name of Entity | Percentage Interest | |
|---|---------------------|---------------|
| | June 30, 2007 | June 30, 2006 |
| Shashi Jiulong Power Steering Gears Co., Ltd., "Jiulong" | 81.00% | 81.00% |
| Jingzhou Henglong Automotive Parts Co., Ltd., "Henglong" | 44.50% | 44.50% |
| Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., "Shenyang" | 70.00% | 70.00% |
| Zhejiang Henglong & Vie Pump-Manu Co., Ltd., "Zhejiang" | 51.00% | 51.00% |
| Universal Sensor Application Inc., "USAI" | 85.71% | 60.00% |
| Wuhan Jielong Electric Power Steering Co., Ltd., "Jielong" | 85.00% | 85.00% |
| Wuhu HengLong Automotive Steering System Co., Ltd., "Wuhu" | 77.33% | 77.33% |
| Jingzhou Hengsheng Automotive System Co., Ltd, "Hengsheng" | 100.00% | — |

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

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

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

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

On April 12, 2005, Great Genesis entered into a Joint-venture agreement with Shanghai Hongxi Investment Inc., "Hongxi", a company controlled by Mr. Hanlin Chen, the Company's Chairman, and Sensor System Solution Inc., "Sensor", to establish a joint venture, Universal Sensor Application Inc., "USAI", in the Wuhan East Lake development zone to engage in production and sales of sensor modulars. The registered capital of the Joint-venture is \$10 million. Great Genesis and Hongxi intended to invest \$6 million and \$1 million, respectively, including cash and land and building, which would account for 60% and 10% of the total registered capital, respectively. Sensor would invest \$3 million in technology, accounting for 30% of the total registered capital. As of March 20, 2007, the three parties of USAI, Great Genesis, Hongxi, Sensor, entered into an agreement, which led to Sensor's withdrawal from USAI and abandonment of all its rights and interests in USAI. The registered capital of the Joint-venture has changed to \$7,000,000, with 85.71% owned by the Company, 14.29% owned by Hongxi. Since the withdrawal of intangible assets, another technology supplier is being sought.

On April 14, 2006, Great Genesis entered into a Joint-venture agreement with Hong Kong Tongda, "Tongda", to establish a joint venture, Wuhan Jielong Electric Power Steering Co., Ltd., "Jielong", in the Wuhan East Lake development zone. Jielong is mainly engaged in the production and sales of electric power steering, "EPS". The registered capital of the Joint-venture is \$6 million. Great Genesis and Tongda will invest \$5,100,000 and \$900,000, respectively, amounting to 85% and 15% of the total registered capital, respectively.

On March 31, 2006, as amended on May 2, 2006, Great Genesis, entered into a Joint-venture agreement with Wuhu Chery Technology Co., Ltd., "Chery Technology", to establish a Joint-venture, Wuhu Henglong Automotive Steering System Co., Ltd., "Wuhu", in the Wuhu Technological Development Zone. Wuhu is mainly engaged in the production and sales of automobile steering system. The registered capital of the Joint-venture is \$3,750,387, the equivalent of RMB 30,000,000. Great Genesis and Chery Technology invested \$2,900,300, the equivalent of RMB 23,200,000, and \$848,938, the equivalent of RMB 6,800,000, respectively, which accounts for 77.33% and 22.67% of the total registered capital, respectively.

On March 7, 2007, Great Genesis established a wholly-owned subsidiary, Jingzhou Hengsheng Automotive Systems Co., Ltd, "Hengsheng", to engage in production and sales of automotive steering systems. The registered capital of Hengsheng is \$10,000,000.

2. BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - For the six months ended June 30, 2007 and 2006, the accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and Sino-foreign joint ventures, including eight Sino-foreign Joint-ventures disclosed in Note 1. Significant inter-company balances and transactions have been eliminated upon consolidation. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America.

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

In translating the financial statements of the Company from its functional currency into its reporting currency in United States dollars, balance sheet accounts are translated using the closing exchange rate in effect at the balance sheet date and income and expense accounts are translated using an average exchange rate prevailing during the

reporting period. Adjustments resulting from the translation, if any, are included in cumulative other comprehensive income (loss) in stockholders' equity.

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

Actual weighted average shares outstanding used in calculating basic and diluted income per share were:

| | Three Months Ended June 30, | |
|-------------------------------------|-----------------------------|------------|
| | 2007 | 2006 |
| Weighted average shares outstanding | 23,959,702 | 23,254,121 |
| Effect of dilutive securities | 2,451 | 13,114 |
| Diluted shares outstanding | 23,962,153 | 23,267,235 |

| | Six Months Ended June 30, | |
|-------------------------------------|---------------------------|------------|
| | 2007 | 2006 |
| Weighted average shares outstanding | 23,948,950 | 22,969,051 |
| Effect of dilutive securities | 7,790 | 18,044 |
| Diluted shares outstanding | 23,956,740 | 22,987,095 |

The 156,250 shares underlying warrants issued to Cornell Capital Partners, LP on March 20, 2006, and 22,500 options issued to independent directors on July 16, 2006 have not been included in the computation of diluted income per share because such inclusion would have had an anti-dilutive effect.

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

In July 2004, the Company adopted a stock incentive plan. The maximum number of common shares for issuance under this plan is 2,200,000 with a period of 10 years. The stock incentive plan provides for the issuance, to the Company's officers, directors, management and employees, of options to purchase shares of the Company's common stock. As of June 30, 2007, the Company has issued 67,500 stock options under this plan and there remain 2,132,500 stock options issuable in future.

The Company has adopted Statement of Financial Accounting Standards ("SFAS") No. 123R, "Accounting for Stock-Based Compensation", which establishes a fair value method of accounting for stock-based compensation plans. In accordance with SFAS No. 123R, the cost of stock options and warrants issued to employees and non-employees is measured at 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 the provisions of Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS No. 130"). SFAS No. 130 establishes standards for the reporting and display of comprehensive income, its components and accumulated balances in a full set of general purpose financial statements. SFAS No. 130 defines comprehensive income to include all changes in equity except those resulting from investments by owners and distributions to owners, including adjustments to minimum pension liabilities, accumulated foreign currency translation, and unrealized gains or losses on marketable securities.

Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates include allowance for doubtful accounts and notes receivables, valuation and costing of inventory, depreciation of property, plant and equivalent, impairment of long-lived assets and accrued liabilities. Actual results could differ from those estimates.

Reclassifications - Certain comparative amounts have been reclassified to conform to the current year's presentation.

Comments - The accompanying interim condensed consolidated financial statements are unaudited, but in the opinion of management of the Company, contain all adjustments, which include normal recurring adjustments, necessary to present fairly the financial position, the results of operations and cash flows for the three months and six months ended June 30, 2007 and 2006.

The consolidated balance sheet as of December 31, 2006 is derived from the Company's audited financial statements.

Certain information and footnote disclosures normally included in financial statements that have been prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission, although the Company's management believes that the disclosures contained in these financial statements are adequate to make the information presented therein not misleading. For further information, refer to the financial statements and the notes thereto included in the Company's 2006 Annual Report on Form 10-K, as filed with the Securities and Exchange Commission.

The results of operations for the three months and six months ended June 30, 2007 are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2007.

3. ACCOUNTS AND NOTES RECEIVABLE

The Company's accounts receivable at June 30, 2007 (unaudited) and December 31, 2006 are summarized as follows:

| | June 30, 2007 | December 31, 2006 |
|---------------------|---------------|----------------------|
| Accounts receivable | | |