CHINA AUTOMOTIVE SYSTEMS INC
Form 10-Q
August 14, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 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 x No ¨

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

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 x

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

Yes ¨ No x

As of August 14, 2013, the Company had 28,043,019 shares of common stock issued and outstanding.

CHINA AUTOMOTIVE SYSTEMS, INC.

INDEX

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. Suc 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 1. FINANCIAL STATEMENTS.

China Automotive Systems, Inc. and Subsidiaries

Condensed Unaudited Consolidated Statements of Operations and Comprehensive Income

(In thousands of USD, except share and per share amounts)

	Three Months Ended June 30,	
	2013	2012
Net product sales		
Unrelated parties	$88,854	$71,886
Related parties (Note 26)	9,035	8,493
	97,889	80,379
Cost of product sold		
Unrelated parties	73,494	61,241
Related parties (Note 26)	6,006	3,506
	79,500	64,747
Gross profit	18,389	15,632
Gain on other sales	1,058	1,810
Less: Operating expenses		
Selling expenses	3,800	2,088
General and administrative expenses	3,217	3,130
Research and development expenses	4,616	3,650
Total operating expenses	11,633	8,868
Income from operations	7,814	8,574
Other income, net	3	7
Financial expenses, net	(108)	(500)
Gain on change in fair value of derivative	-	3,411
Gain on redemption of convertible notes	-	1,421
Income before income tax expenses and equity in earnings of affiliated companies	7,709	12,913
Less: Income taxes	1,571	1,314
Equity in earnings of affiliated companies	68	32
Income from continuing operations	6,206	11,631
Discontinued operations - net of income tax (Note 23)	-	2,620
Net income	6,206	14,251

Net income attributable to non-controlling interests	1,225	1,229
Net income attributable to parent company	$4,981	$13,022
Allocation to convertible notes holders	-	(859)
Net income attributable to parent company's common shareholders	$4,981	$12,163
Comprehensive income:		
Income from continuing operations	$6,206	$11,631
Income from discontinued operations	-	2,620
Net income	6,206	14,251
Other comprehensive income:		
Foreign currency translation gain (loss), net of tax - continuing operations	3,436	(1,131)
Foreign currency translation gain (loss), net of tax - discontinued operations	-	(96)
Foreign currency translation gain (loss), net of tax	3,436	(1,227)
Comprehensive income - continuing operations	9,642	10,500
Comprehensive income - discontinued operations	-	2,524
Comprehensive income	9,642	13,024
Comprehensive income attributable to non-controlling interests	1,808	1,019
Comprehensive income attributable to parent company	$7,834	$12,005
Net income attributable to parent company's common shareholders per share		
Basic –		
Income per share from continuing operations attributable to shareholders	$0.18	$0.35
Income per share from discontinued operations	-	0.08
	$0.18	$0.43
Diluted-		
Income per share from continuing operations attributable to shareholders	$0.18	$0.21
Income per share from discontinued operations	-	0.08
	$0.18	$0.29
Weighted average number of common shares outstanding		
Basic	28,043,019	28,260,302
Diluted	28,048,789	30,257,347

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

4

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)

	Six Months Ended June 30,	
	2013	2012
Net product sales		
Unrelated parties	$177,874	$144,912
Related parties (Note 26)	17,178	16,386
	195,052	161,298
Cost of product sold		
Unrelated parties	144,631	120,603
Related parties (Note 26)	12,671	9,685
	157,302	130,288
Gross profit	37,750	31,010
Gain on other sales	1,732	1,922
Less: Operating expenses		
Selling expenses	6,964	4,268
General and administrative expenses	7,343	6,512
Research and development expenses	8,016	7,242
Total operating expenses	22,323	18,022
Income from operations	17,159	14,910
Other income, net	73	78
Financial expenses, net	(309)	(1,412)
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	16,923	14,548
Less: Income taxes	3,317	2,775
Equity in earnings of affiliated companies	126	112
Income from continuing operations	13,732	11,885
Discontinued operations - net of income tax (Note 23)	-	2,651
Net income	13,732	14,536
Net income attributable to non-controlling interests	2,811	2,283
Net income attributable to parent company	$10,921	$12,253
Allocation to convertible notes holders	-	(1,055)
Net income attributable to parent company’s common shareholders	$10,921	$11,198
Comprehensive income:		
Income from continuing operations	$13,732	$11,885
Income from discontinued operations	-	2,651
Net income	13,732	14,536

Other comprehensive income:		
Foreign currency translation gain (loss), net of tax - continuing operations	4,048	(650)
Foreign currency translation gain (loss), net of tax - discontinued operations	-	(75)
Foreign currency translation gain (loss), net of tax	4,048	(725)
Comprehensive income - continuing operations	17,780	11,235
Comprehensive income - discontinued operations	-	2,576
Comprehensive income	17,780	13,811
Comprehensive income attributable to non-controlling interests	3,497	2,118
Comprehensive income attributable to parent company	$14,283	$11,693
Net income attributable to parent company's common shareholders per share		
Basic –		
Income per share from continuing operations attributable to shareholders	$0.39	$0.31
Income per share from discontinued operations	-	0.09
	$0.39	$0.40
Diluted-		
Income per share from continuing operations attributable to shareholders	$0.39	$0.31
Income per share from discontinued operations	-	0.09
	$0.39	$0.40
Weighted average number of common shares outstanding		
Basic	28,043,019	28,260,302
Diluted	28,049,863	28,261,854

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)

	June 30, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 75,270	$ 87,649
Pledged cash deposits	22,628	26,481
Short-term investments	15,376	-
Accounts and notes receivable, net - unrelated parties	244,216	211,306
Accounts and notes receivable, net - related parties	15,197	12,286
Advance payments and others - unrelated parties	2,805	3,127
Advance payments and others - related parties	1,402	779
Inventories	48,251	43,542
Current deferred tax assets	4,551	4,392
Total current assets	429,696	389,562
Non-current assets:		
Property, plant and equipment, net	83,361	81,691
Intangible assets, net	662	676
Other receivables, net - unrelated parties	1,134	849
Other receivables, net - related parties	64	107
Advance payment for property, plant and equipment - unrelated parties	1,995	1,001
Advance payment for property, plant and equipment - related parties	1,209	4,162
Long-term investments	3,855	3,665
Non-current deferred tax assets	4,258	4,112
Total assets	$ 526,234	$ 485,825
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Bank and government loans	$ 47,175	$ 40,284
Accounts and notes payable - unrelated parties	179,185	166,380
Accounts and notes payable - related parties	4,522	4,521
Customer deposits	771	870
Accrued payroll and related costs	5,642	5,472
Accrued expenses and other payables	26,170	23,063
Accrued pension costs	4,370	4,255
Taxes payable	5,629	5,593
Amounts due to shareholders/directors	300	332
Deferred tax liabilities	73	46
Advances payable	2,622	-
Total current liabilities	276,459	250,816

Long-term liabilities:		
Advances payable	-	2,609
Total liabilities	276,459	253,425
Commitments and Contingencies (Note 27)		
Stockholders’ equity-		
Common stock, $0.0001 par value - Authorized - 80,000,000 shares; Issued– 28,260,302 and 28,260,302 shares at June 30, 2013 and December 31, 2012, respectively	3	3
Additional paid-in capital	39,371	39,371
Retained earnings-		
Appropriated	10,048	9,953
Unappropriated	130,155	119,329
Accumulated other comprehensive income	29,259	25,898
Treasury stock – 217,283 and 217,283 shares at June 30, 2013 and December 31, 2012, respectively	(1,000)	(1,000)
Total parent company stockholders' equity	207,836	193,554
Non-controlling interests	41,939	38,846
Total stockholders' equity	249,775	232,400
Total liabilities and stockholders' equity	$ 526,234	$ 485,825

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

6

China Automotive Systems, Inc. and Subsidiaries

Condensed Unaudited Consolidated Statements of Cash Flows

(In thousands of USD unless otherwise indicated)

	Six Months Ended June 30, 2013	2012
Cash flows from operating activities:		
Net income	$ 13,732	$ 14,536
Adjustments to reconcile net income from operations to net cash provided by operating activities:		
Depreciation and amortization	7,218	7,310
Increase (decrease) in allowance for doubtful accounts	(106)	67
Inventory write downs	277	-
Deferred income taxes	(143)	(476)
Equity in earnings of affiliated companies	(126)	(112)
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	57	27
Loss (gain) on fixed assets disposals	(165)	67
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Pledged deposits	4,306	(1,756)
Accounts and notes receivable	(32,734)	1,224
Advance payments and others	(219)	1,208
Inventories	(4,211)	(2,543)
Increase (decrease) in:		
Accounts and notes payable	9,689	(4,517)
Customer deposits	(106)	207
Accrued payroll and related costs	73	(314)
Accrued expenses and other payables	2,679	(6,688)
Accrued pension costs	44	193
Taxes payable	(66)	1,635
Advances payable	(32)	634
Net cash provided by operating activities	167	6,882
Cash flows from investing activities:		
Increase in other receivables	(212)	(936)
Cash received from property, plant and equipment sales	1,557	492
Payments to acquire property, plant and equipment	(5,565)	(8,880)
Payments to acquire intangible assets	(60)	(4)
Purchase of short-term investments	(15,376)	-

Cash decrease relating to the subsidiary sold	-	(300)
Net cash used in investing activities	(19,656)	(9,628)
Cash flows from financing activities:		
Proceeds from government and bank loan	14,111	33,960
Repayments of bank loan	(8,069)	-
Debt issuance costs paid for bank loan	-	(230)
Dividends paid to the non-controlling interests	(405)	(2,387)
Redemption of convertible notes	-	(23,571)
Decrease in amounts due to shareholders/directors	(40)	-
Net cash provided by financing activities	5,597	7,772
Effects of exchange rate on cash and cash equivalents	1,513	(295)
Net increase (decrease) in cash and cash equivalents	(12,379)	4,731
Cash and cash equivalents at beginning of period	87,649	72,961
Cash and cash equivalents at end of period	$ 75,270	$ 77,692

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:

	Six Months Ended June 30,	
	2013	2012
Cash paid for interest	$ 739	$ 9,578
Cash paid for income taxes	$ 2,029	$ 3,670

SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

	Six Months Ended June 30,	
	2013	2012
Advance payments for acquiring property, plant and equipment	$ 3,204	$ 9,677
Dividends payable to non-controlling interests	167	707
Non-controlling interests contribution of capital with property, plant and equipment	-	2,846
Accounts receivable from sale of a subsidiary	$ -	$ 8,221

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 Six Months Ended June 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, "PRC," and Brazil as of June 30, 2013 and December 31, 2012.

Name of Entity	Percentage Interest June 30, 2013		December 31, 2012	
Shashi Jiulong Power Steering Gears Co., Ltd., "Jiulong"[1]	81.00	%	81.00	%
Jingzhou Henglong Automotive Parts Co., Ltd., "Henglong"[2]	80.00	%	80.00	%
Shenyang Jinbei Henglong Automotive Steering System Co., Ltd., "Shenyang"[3]	70.00	%	70.00	%
Universal Sensor Application Inc., "USAI"[4]	83.34	%	83.34	%
Wuhan Jielong Electric Power Steering Co., Ltd., "Jielong"[5]	85.00	%	85.00	%
Wuhu HengLong Automotive Steering System Co., Ltd., "Wuhu"[6]	77.33	%	77.33	%

Hubei Henglong Automotive System Group Co., Ltd, “Hubei Henglong”[7]	100.00	%	100.00	%
Jingzhou Henglong Automotive Technology (Testing) Center, “Testing Center”[8]	80.00	%	80.00	%
Beijing Henglong Automotive System Co., Ltd., “Beijing Henglong”[9]	50.00	%	50.00	%
Chongqing Henglong Hongyan Automotive System Co., Ltd, “Chongqing Henglong”[10]	70.00	%	70.00	%
CAAS Brazil’s Imports And Trade In Automotive Parts Ltd., “Brazil Henglong”[11]	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.

10

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. As of June 30, 2013, Hubei Henglong, Mr. Ozias Gaia Da Silva and Mr. Ademir Dal'Evedove have completed their capital contributions.

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 six months ended June 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 501,350 stock options, and 1,698,650 stock options remain issuable in the future. As of June 30, 2013, the Company had 90,000 stock options outstanding.

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

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

Financial Instruments – The Company adopted the provisions of *ASC Topic 815, "Derivatives and Hedging Activities,"* that address the determination of whether an instrument meets the definition of a derivative being indexed to a company's own stock for purposes of applying the scope exception as provided for in accordance with *ASC 815-15*. Upon adoption of the standard on the effective date, the Company bifurcated the conversion feature embedded in the convertible notes, 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 21).

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 June 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 June 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 six months ended June 30, 2013 and 2012, please see Note 21.

(d) Classification of the Decrease of Inventory Provision in the Condensed Unaudited Consolidated Statements of Cash Flows

For the six months ended June 30, 2012, the Company has classified the decrease of inventory provision of $0.05 million resulting from disposal of obsolescent inventories during the six months ended June 30, 2012 to the changes in inventories in the condensed unaudited consolidated statements of cash flows for the six months ended June 30, 2012. There was no impact on the net cash provided by operating activities and total cash flow.

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

	June 30, 2013	December 31, 2012
Accounts receivable - unrelated parties (1)	$ 131,226	$ 117,136
Notes receivable - unrelated parties (2) (3)	114,229	95,436
	245,455	212,572
Less: allowance for doubtful accounts - unrelated parties	(1,239)	(1,266)
Accounts and notes receivable- unrelated parties	244,216	211,306
Accounts and notes receivable - related parties	15,197	12,286
	$ 259,413	$ 223,592

(1) As of June 30, 2013, the Company has pledged $20.4 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 RMB267.0 million (equivalent to approximately $43.2 million) as security for the credit facility with banks in China and the Chinese government, including RMB227.0 million (equivalent to approximately $36.8 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 12) 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 12) ; and RMB40.0 million (equivalent to approximately $6.5 million) in favor of the Chinese government as security for the RMB40.0 million interest-free government loan (see Note 12) .

15

6. Inventories

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

	June 30, 2013	December 31, 2012
Raw materials	$ 13,000	$ 11,144
Work in process	7,836	7,094
Finished goods	27,415	25,304
	$ 48,251	$ 43,542

Provision for inventories valuation amounted to $0.3 million and $0 million for the six months ended June 30, 2013 and 2012, respectively.

7. Other receivables, net

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

	June 30, 2013	December 31, 2012
Other receivables - unrelated parties (1)	$ 1,195	$ 905
Less: allowance for doubtful accounts- unrelated parties	(61)	(56)
	$ 1,134	$ 849

	June 30, 2013	December 31, 2012
Other receivables - related parties (1)	$ 668	$ 715
Less: allowance for doubtful accounts- related parties	(604)	(608)
	$ 64	$ 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. Long term investments

As of June 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 June 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 $0.07 million and $0.03 million for the three months ended June 30, 2013 and 2012, respectively, and the equity earnings of non-consolidated affiliates of $0.13 million and $0.11 million for the six months ended June 30, 2013 and 2012, respectively.

9. Property, plant and equipment, net

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

	June 30, 2013	December 31, 2012
Land use rights and buildings	$ 37,388	$ 36,881
Machinery and equipment	108,334	96,368
Electronic equipment	6,384	6,174
Motor vehicles	3,102	2,942
Construction in progress	10,106	13,280
	165,314	155,645
Less: Accumulated depreciation	(81,953)	(73,954)
	$ 83,361	$ 81,691

Depreciation charges were $3.7 million and $3.7 million for the three months ended June 30, 2013 and 2012, respectively, and $7.1 million and $7.2 million for the six months ended June 30, 2013 and 2012, respectively.

As of June 30, 2013, the Company had pledged property, plant and equipment with net book value of $54.4 million for its comprehensive credit facilities with banks in China.

10. Intangible assets

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

	June 30, 2013	December 31, 2012
Costs:		
Patent technology	$ 1,990	$ 1,901
Management software license	637	622
	2,627	2,523
Less: Amortization	(1,965)	(1,847)
	$ 662	$ 676

Amortization expenses were $0.04 million and $0.06 million for the three months ended June 30, 2013 and 2012, respectively, and $0.09 million and $0.11 million for the six months ended June 30, 2013 and 2012, respectively.

11. Deferred income tax assets

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

The components of estimated deferred income tax assets as of June 30, 2013 and December 31, 2012 are as follows (figures are in thousands of USD):

	June 30, 2013	December 31, 2012
Losses carry forward (U.S.) [1]	$7,763	$ 7,004
Losses carry forward (PRC) [1]	1,921	1,887
Product warranties and other reserves	3,572	3,253

Property, plant and equipment	4,061	3,774
Share-based compensation	240	240
Bonus accrual	224	196
Other accruals	1,124	696
Others	636	839
Total deferred tax assets	19,541	17,889
Less: taxable temporary difference related to revenue recognition	(480)	(397)
Total deferred tax assets, net	19,061	17,492
Less: Valuation allowance	(10,252)	(8,988)
Total deferred tax assets, net of valuation allowance [(2)]	$ 8,809	$ 8,504

18

(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 June 30, 2013, valuation allowance was $10.3 million, including $8.6 million allowance for the Company’s deferred tax assets in the United States and $1.7 million allowance for the Company’s non-U.S. deferred tax assets. Based on the Company’s current operations in the United States, management believes that the deferred tax assets in the United States are not likely to be realized in the future. For the non-U.S. deferred tax assets, pursuant to certain tax laws and regulations in China, the management believes such amount will not be used to offset future taxable income.

(2) Approximately $4.3 million and $4.1 million of deferred income tax asset as of June 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 $4.5 million and $4.4 million of deferred income tax assets as of June 30, 2013 and December 31, 2012, respectively, are included in current deferred tax assets.

12. Bank and government loans, net

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

	June 30, 2013	December 31, 2012
Short-term bank loan (1) (2)	$ 10,701	$ 10,341
Short-term bank loan (3)	30,000	30,000
Short-term government loan (4)	6,474	-
Subtotal	47,175	40,341
Debt issue cost	(57)	(230)
Amortization	57	173
	$ 47,175	$ 40,284

(1) These loans are secured by property, plant and equipment of the Company and are repayable within one year. Please see Note 9. At June 30, 2013 and December 31, 2012, the weighted average interest rate was 5.61% and 6.46% per annum, respectively. Interest is paid on the twentieth day of each month and the principal repayment is at maturity.