

China Natural Gas, Inc.
Form 10-Q
November 09, 2009

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, 2009

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

For the transition period from to

000-31539
(Commission file number)

CHINA NATURAL GAS, INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or
organization)

98-0231607
(IRS Employer of Identification No.)

19th Floor, Building B, Van Metropolis
Tang Yan Road, Hi-Tech Zone
Xi'an, 710065, Shaanxi Province, China
(Address of principal executive offices)

(zip code)

86-29-8832-7391
(registrant 's telephone number, including area code)

N/A
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

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. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Number of shares of Common Stock outstanding as of November 4, 2009: 21,183,904

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

Yes No

China Natural Gas, Inc.

Index

| | | |
|-------------------|---|-----------|
| PART I. | FINANCIAL INFORMATION | |
| Item 1. | Financial Statements | 1 |
| | Notes to Consolidated Financial Statements (unaudited) | 4 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 20 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk | 34 |
| Item 4. | Controls and Procedures | 34 |
| PART II. | OTHER INFORMATION | |
| Item 1. | Legal Proceedings | 35 |
| Item 1A. | Risk Factors | 35 |
| Item 2. | Unregistered Sales of Equity Securities and Use of Proceeds | 35 |
| Item 3. | Defaults Upon Senior Securities | 35 |
| Item 4. | Submission of Matters to a Vote of Security Holders | 35 |
| Item 5. | Other Information | 35 |
| Item 6. | Exhibits | 35 |
| SIGNATURES | | 36 |

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
 CONSOLIDATED BALANCE SHEETS
 AS OF SEPTEMBER 30, 2009 AND DECEMBER 31, 2008

| | September 30, 2009 (Unaudited) | December, 31 2008 |
|---|--------------------------------------|-----------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash & cash equivalents | \$ 55,931,579 | \$ 5,854,383 |
| Accounts receivable | 1,141,615 | 906,042 |
| Other receivable - employee advances | 238,962 | 332,263 |
| Inventories | 1,464,958 | 519,739 |
| Advances to suppliers | 1,809,560 | 837,592 |
| Prepaid expense and other current assets | 455,586 | 838,294 |
| Loan receivable | 293,400 | 293,400 |
| Total current assets | 61,335,660 | 9,581,713 |
| PROPERTY AND EQUIPMENT, NET | 71,840,861 | 76,028,272 |
| CONSTRUCTION IN PROGRESS | 42,124,222 | 22,061,414 |
| DEFERRED FINANCING COSTS | 1,439,456 | 1,746,830 |
| OTHER ASSETS | 13,350,012 | 8,844,062 |
| TOTAL ASSETS | \$ 190,090,211 | \$ 118,262,291 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued liabilities | \$ 1,412,215 | \$ 800,013 |
| Other payables | 245,397 | 124,151 |
| Unearned revenue | 1,741,827 | 944,402 |
| Accrued interest | 274,941 | 861,114 |
| Taxes payable | 1,942,670 | 1,862,585 |
| Total current liabilities | 5,617,050 | 4,592,265 |
| LONG TERM LIABILITIES: | | |
| Notes payable, net of discount of \$13,457,880 and \$15,478,395 as of September 30, 2009 and December 31, 2008, respectively | 26,542,120 | 24,521,605 |
| Redeemable liabilities - warrants | 17,500,000 | 17,500,000 |
| Derivative liabilities - warrants | 2,488,070 | - |
| Total long term liabilities | 46,530,190 | 42,021,605 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, \$0.0001 per share; 5,000,000 shares authorized; none issued | | - |
| Common stock, \$0.0001 per share; 45,000,000 shares authorized, 21,183,904 and 14,600,154 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively | 2,118 | 1,460 |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | |
|---|-----------------------|-----------------------|
| Additional paid-in capital | 79,812,871 | 32,115,043 |
| Cumulative translation adjustment | 8,700,988 | 8,661,060 |
| Statutory reserves | 5,417,413 | 3,730,083 |
| Retained earnings | 44,009,581 | 27,140,775 |
| Total stockholders' equity | 137,942,971 | 71,648,421 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 190,090,211 | \$ 118,262,291 |

The accompanying notes are an integral part of these statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008
(Unaudited)

| | Three months ended September 30 | | Nine months ended September 30 | |
|--|------------------------------------|---------------|-----------------------------------|---------------|
| | 2009 | 2008 | 2009 | 2008 |
| Revenue | | | | |
| Natural gas revenue | \$ 15,454,386 | \$ 15,354,461 | \$ 46,140,884 | \$ 40,494,646 |
| Gasoline revenue | 1,633,478 | 1,187,754 | 4,440,892 | 3,466,601 |
| Installation and other | 3,037,320 | 1,858,985 | 8,813,594 | 5,356,113 |
| Total revenue | 20,125,184 | 18,401,200 | 59,395,370 | 49,317,360 |
| Cost of revenue | | | | |
| Natural gas cost | 7,536,188 | 6,973,035 | 21,773,635 | 20,369,778 |
| Gasoline cost | 1,534,806 | 1,085,311 | 4,194,615 | 3,208,326 |
| Installation and other | 1,336,498 | 850,487 | 3,797,586 | 2,492,650 |
| Total cost of revenue | 10,407,492 | 8,908,833 | 29,765,836 | 26,070,754 |
| Gross profit | 9,717,692 | 9,492,367 | 29,629,534 | 23,246,606 |
| Operating expenses | | | | |
| Selling expenses | 2,406,462 | 2,098,343 | 7,062,429 | 5,008,631 |
| General and administrative expenses | 1,422,300 | 968,169 | 4,286,620 | 2,947,494 |
| Total operating expenses | 3,828,762 | 3,066,512 | 11,349,049 | 7,956,125 |
| Income from operations | 5,888,930 | 6,425,855 | 18,280,485 | 15,290,481 |
| Non-operating income (expense) | | | | |
| Interest income | 7,248 | 13,536 | 23,940 | 120,297 |
| Interest expense | (68,407) | (212,774) | (745,064) | (1,249,003) |
| Other income (expense), net | 178,728 | (6,786) | (137,954) | (17,512) |
| Change in fair value of warrants | (357,979) | | (1,473,762) | |
| Foreign currency exchange income (loss) | 280 | (48,605) | (50,527) | (101,436) |
| Total non-operating expense | (240,130) | (254,629) | (2,383,367) | (1,247,654) |
| Income before income tax | 5,648,800 | 6,171,226 | 15,897,118 | 14,042,827 |
| Provision for income tax | 1,001,281 | 1,034,636 | 3,185,220 | 2,584,774 |
| Net income | 4,647,519 | 5,136,590 | 12,711,898 | 11,458,053 |
| Other comprehensive income | | | | |
| Foreign currency translation gain | 195,040 | 756,316 | 39,928 | 4,554,040 |
| Comprehensive income | \$ 4,842,559 | \$ 5,892,906 | \$ 12,751,826 | \$ 16,012,093 |
| Weighted average shares outstanding | | | | |
| Basic | 15,754,696 | 14,600,154 | 14,985,001 | 14,600,154 |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | | | |
|--------------------|------------|------------|------------|------------|
| Diluted | 16,139,820 | 14,639,795 | 15,035,172 | 14,658,419 |
| Earnings per share | | | | |
| Basic | \$ 0.29 | \$ 0.35 | \$ 0.85 | \$ 0.78 |
| Diluted | \$ 0.29 | \$ 0.35 | \$ 0.85 | \$ 0.78 |

The accompanying notes are an integral part of these statements

CHINA NATURAL GAS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009 AND 2008
(Unaudited)

| | Nine Months Ended September 30, | |
|---|---------------------------------|---------------|
| | 2009 | 2008 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 12,711,898 | \$ 11,458,053 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 4,175,175 | 2,295,534 |
| Loss on disposal of equipment | 21,372 | 12,265 |
| Amortization of discount on senior notes | 280,250 | 555,001 |
| Amortization of financing costs | 63,940 | 147,002 |
| Stock based compensation | 186,672 | 51,861 |
| Change in fair value of warrants | 1,473,762 | - |
| Change in assets and liabilities: | | |
| Accounts receivable | (235,396) | (1,269,832) |
| Other receivable | (31,011) | |
| Other receivable - employee advances | 93,231 | (273,759) |
| Inventories | (754,309) | (194,580) |
| Advances to suppliers | (971,240) | (508,417) |
| Prepaid expense and other current assets | 223,206 | (783,706) |
| Accounts payable and accrued liabilities | 611,924 | 193,212 |
| Other payables | 121,234 | 37,587 |
| Unearned revenue | 796,827 | 34,855 |
| Accrued interest | (586,173) | 350,002 |
| Taxes payable | 80,025 | 606,233 |
| Net cash provided by operating activities | 18,261,387 | 12,711,311 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (47,797) | (21,693,376) |
| Proceeds from sales of equipment | 41,308 | - |
| Proceeds from short term investments | - | 249,464 |
| Additions to construction in progress | (18,064,065) | (16,679,747) |
| Prepayment on long term assets | (4,434,118) | (6,774,616) |
| Proceeds from loan receivable | - | 286,740 |
| Return of acquisition deposit | 449,970 | - |
| Payment for intangible assets | (68,347) | - |
| Payment for land use rights | (455,830) | - |
| Net cash used in investing activities | (22,578,879) | (44,611,535) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Stock issued for cash | 57,607,813 | |
| Proceeds from senior notes | - | 40,000,000 |
| Payment for offering costs | (3,237,452) | (2,122,509) |
| Net cash provided by financing activities | 54,370,361 | 37,877,491 |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | |
|--|----------------------|----------------------|
| Effect of exchange rate changes on cash and cash equivalents | 24,327 | 1,115,706 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 50,077,196 | 7,092,973 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 5,854,383 | 13,291,729 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 55,931,579 | \$ 20,384,702 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | |
| Interest paid, net of capitalized interest | \$ 1,014,956 | \$ |
| Income taxes paid | \$ 3,176,730 | \$ 1,203,048 |

The accompanying notes are an integral part of these statements

Notes to Consolidated Financial Statements
September 30, 2009
(Unaudited)

Note 1 - Organization

Organization and Line of Business

China Natural Gas, Inc. (the “Company” or “CHNG”) was incorporated in the state of Delaware on March 31, 1999. The Company through its wholly-owned subsidiaries and variable interest entities, located in Shaanxi and Henan Province in the People’s Republic of China (“PRC”), engages in sales and distribution of natural gas and gasoline to commercial, industrial and residential customers, construction of pipeline networks, installation of natural gas fittings and parts for end-users, and modification of automobiles services for vehicles to be able to use natural gas.

Recent Developments

On March 18, 2008, Shaanxi Xilan Natural Gas Equipment Co., Ltd (“SXNGE”) increased its registered capital from \$30,000,000 to \$53,929,260. The additional \$14,429,260 of registered capital was contributed by China Natural Gas, Inc. on April 17, 2008 and \$9,500,000 of registered capital was contributed by China Natural Gas, Inc. as a payment to Chemtex International Inc. on January 31, 2008, for the purchase of license, know-how, and design of constructing the Liquefied Natural Gas (“LNG”) processing plant.

On April 22, 2008, Jingbian Liquefied Natural Gas Co., Ltd. (“JBLNG”) increased its registered capital by \$2,862,000. JBLNG is 100% owned by Xi’an Xilan Natural Gas Co., Ltd.

On April 30, 2008, the Industrial and Commercial Administration Bureau approved Xi’an Xilan Natural Gas Co., (“XXNGC”) to increase registered capital from \$8,336,856 to \$43,443,640 as an additional contribution by the shareholders of XXNGC under PRC Law. \$15,513,526 was approved by the Industrial and Commercial Administration Bureau to be transferred out from the surplus reserve and retained earnings as an increase of registered capital. Another \$19,593,258 was contributed by SXNGE cumulatively prior to April 30, 2008, which was previously classified as an intercompany payable in XXNGC and was eliminated in the consolidated financial statements. The increase in registered capital in XXNGC was in compliance with the Addendum to Option Agreement entered by the Company through SXNGE and XXNGC, Mr. Qinan Ji, chairman and shareholder of XXNGC, and each of the shareholders of XXNGC (hereafter collectively referred to as the “Transferor”) on August 8, 2008, and made retroactive to June 30, 2008. See “Consolidation of Variable Interest Entity” section for further detail on the Addendum to Option Agreement.

On July 3, 2008, XXNGC formed Henan Xilan Natural Gas Co., Ltd. (“HXNGC”) as a wholly owned limited liability company, with registered capital of \$4,383,000 in Henan province, PRC. HXNGC was established for the purpose of natural gas city gasification engineering design, construction and technical advisory work services in Henan, PRC.

On October 2, 2008, China Natural Gas, Inc. (the “Company”) through its wholly-owned subsidiary, XXNGC, entered into an Equity Ownership Transfer Agreement (the “Acquisition Agreement”) with Lingbao Yuxi Natural Gas Co., Ltd. (“LBNGC”) and the shareholders of LBNGC (the “Sellers”). Pursuant to the term of the Acquisition Agreement, XXNGC acquired for cash consideration of approximately \$19,604,200 (RMB 134 million), 100% of all outstanding registered equity interest in LBNGC and all assets held by LBNGC, including the land use right to 0.44 acres and all of LBNGC’s local business’ exclusive operating rights. LBNGC owns the exclusive rights to operate CNG fueling stations and pipelines in Lingbao City. In conjunction with this acquisition, XXNGC has also secured an abundant supply of natural gas to support its future expansion in the Henan province. The Acquisition Agreement was fully executed in

November, 2008.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. The Company's functional currency is the Chinese Renminbi ("RMB"); however, the Company's reporting currency is the United States Dollar ("USD"); therefore, the accompanying consolidated financial statements have been translated and presented in USD.

In the opinion of management, the unaudited consolidated financial statements furnished herein include all adjustments, all of which are of a normal recurring nature, necessary for a fair statements of the results for the interim period presented. Operating results for the period ended September 30, 2009 are not necessary indicative of the results that may be expected for the year ended December 31, 2009. The information included in this Form 10-Q should be read in conjunction with information included in the 2008 annual report filed on Form 10-K/A.

Use of 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 and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of China Natural Gas, Inc. and its wholly owned subsidiary, Shaanxi Xilan Natural Gas Equipment Co., Ltd and its 100% variable interest entities (“VIE”), Xi’an Xilan Natural Gas Co. Ltd., Jingbian Liquefied Natural Gas Co., Ltd., Shaanxi Xilan Auto Bodyshop Co., Ltd. (“SXABC”), Henan Xilan Natural Gas Co., Ltd., and Lingbao Yuxi Natural Gas Co., Ltd. All inter-company accounts and transactions have been eliminated in the consolidation.

Consolidation of Variable Interest Entity

In accordance with Financial Accounting Standards Board’s (“FASB”) accounting standard regarding consolidation, VIEs are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders lack adequate decision making ability. All VIEs with which the Company is involved must be evaluated to determine the primary beneficiary of the risks and rewards of the VIE. The primary beneficiary is required to consolidate the VIE for financial reporting purposes.

On February 21, 2006, the Company formed Shaanxi Xilan Natural Gas Equipment Co., Ltd as a wholly-owned foreign enterprise (WFOE). Then through SXNGE, the Company entered into exclusive arrangements with Xi’an Xilan Natural Gas and its shareholders that give the Company the ability to substantially influence Xi’an Xilan Natural Gas’ daily operations and financial affairs, appoint its senior executives and approve all matters requiring shareholder approval. The Company memorialized these arrangements on August 17, 2007 and made retroactive to March 8, 2006. As a result, the Company consolidates the financial results of Xi’an Xilan Natural Gas as variable interest entity. The arrangements consist of the following agreements:

- a. Xi’an Xilan Natural Gas holds the licenses and approvals necessary to operate its natural gas business in China.
- b. SXNGE provides exclusive technology consulting and other general business operation services to Xi’an Xilan Natural Gas in return for a consulting services fee which is equal to Xi’an Xilan Natural Gas’s revenue.
- c. Xi’an Xilan Natural Gas’ shareholders have pledged their equity interests in Xi’an Xilan Natural Gas to the Company.
- d. Irrevocably granted the Company an exclusive option to purchase, to the extent permitted under PRC law, all or part of the equity interests in Xi’an Xilan Natural Gas and agreed to entrust all the rights to exercise their voting power to the person appointed by the Company.

On August 8, 2008, the Company through SXNGE entered into an Addendum to Option Agreement with Mr. Qinan Ji, chairman and shareholder of XXNGC, and each of the shareholders of XXNGC (hereafter collectively referred to as the “Transferor”), and made retroactive to June 30, 2008. According to the Agreement, the Chairman and the Shareholders of XXNGC irrevocably grants to SXNGE an option to purchase each Transferor’s Purchased Equity Interest at \$1.00 or the lowest price permissible under the applicable laws at the time that SXNGE exercises the Option. The Agreement limits XXNGC and the transferors’ right to make all equity interest related decisions.

Foreign Currency Translation

As of September 30, 2009 and December 31, 2008, the accounts of the Company were maintained, and their consolidated financial statements were expressed in RMB. Such consolidated financial statements were translated into USD in accordance with an accounting standard issued by the FASB, with the RMB as the functional currency. All assets and liabilities were translated at the exchange rate as of the balance sheet date, stockholders' equity were translated at the historical rates and statement of income and cash flow items were translated at the weighted average exchange rate for the year. The resulting translation adjustments are reported under other comprehensive income. Cash flows from the Company's operations are calculated based upon the local currencies and translated to USD at average translation rates for the period. As a result, translation adjustments amount related to assets and liabilities reported on the consolidated statement of cash flows will not necessarily agree with changes in the corresponding consolidated balances on the balance sheet.

The balance sheet amounts with the exception of equity at September 30, 2009, were translated 6.82 RMB to \$1.00 as compared to 6.82 RMB at December 31, 2008. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the nine months ended September 30, 2009 and 2008, were 6.82 RMB and 6.98 RMB to \$1.00, respectively.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and demand deposits in accounts maintained with state-owned banks within the PRC and the United States. The Company considers all highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents.

Certain financial instruments, which subject the Company to concentration of credit risk, consist of cash. The Company maintains balances at financial institutions which, from time to time, may exceed Federal Deposit Insurance Corporation insured limits for the banks located in the United States. Balances at financial institutions or state-owned banks within the PRC are not covered by insurance. As of September 30, 2009 and December 31, 2008, the Company had total deposits of \$16,483,752 and \$5,604,383 without insurance coverage. And as of September 30, 2009 and December 31, 2008, the Company had deposits in the United States of \$38,692,760 and \$1,273,639 in excess of federally insured limits, respectively. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant risks on its cash in bank accounts.

Accounts Receivable

Accounts and other receivable are netted against an allowance for uncollectible accounts, as needed. The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Reserves are recorded primarily on a specific identification basis in the period of the related sales. Delinquent account balances are written-off after management has determined that the likelihood of collection is not probable, and known bad debts are written off against allowance for doubtful accounts when identified. The Company's management has determined that all receivables are collectible and there is no need for an allowance for uncollectible accounts as of September 30, 2009, and December 31, 2008.

Other Receivable – Employee Advances

From time to time, the Company advances predetermined amounts based upon internal Company policy to certain employees and internal units to ensure certain transactions are performed in a timely manner. The Company has full oversight and control over the advanced accounts. As of September 30, 2009 and December 31, 2008, no allowance for the uncollectible accounts was deemed necessary.

Inventory

Inventory is stated at the lower of cost, as determined on a first-in, first-out basis, or market. Management compares the cost of inventories with the market value, and an allowance is made for writing down the inventories to their market value, if lower. Inventory consists of material used in the construction of pipelines and material used in repairing and modifying vehicles. Inventory also consists of gasoline.

The following are the details of the inventories:

September 30, 2009
(Unaudited) December 31, 2008

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | | | |
|------------------------|----|-----------|----|---------|
| Materials and supplies | \$ | 838,023 | \$ | 318,069 |
| Gasoline | | 626,935 | | 201,670 |
| | \$ | 1,464,958 | \$ | 519,739 |

Advances to Suppliers

The Company advances to certain vendors for purchase of its materials. The advances are interest-free and unsecured.

Loan Receivable

Loan receivable consists of the following:

| | September 30, 2009 (Unaudited) | | December 31, 2008 |
|---|-----------------------------------|---------|-------------------|
| Shanxi Yuojin Mining Company, due on November 26, 2008, extended to November 30, 2009, annual interest at 6.57% | \$ | 293,400 | \$ 293,400 |

Property and Equipment

Property and equipment are stated at cost. Expenditures for maintenance and repairs are charged to earnings as incurred while additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method for substantially all assets with estimated lives as follows:

| | |
|----------------------------|------------|
| Office equipment | 5 years |
| Operating equipment | 5-20 years |
| Vehicles | 5 years |
| Buildings and improvements | 5-30 years |

The following are the details of the property and equipment:

| | September 30, 2009 (Unaudited) | December 31, 2008 |
|-------------------------------|-----------------------------------|-------------------|
| Office equipment | \$ 415,859 | \$ 412,490 |
| Operating equipment | 59,499,262 | 59,473,283 |
| Vehicles | 2,298,712 | 2,414,756 |
| Buildings and improvements | 21,209,086 | 21,190,599 |
| Total property and equipment | 83,422,919 | 83,491,128 |
| Less accumulated depreciation | (11,582,058) | (7,462,856) |
| Property and equipment, net | \$ 71,840,861 | \$ 76,028,272 |

Depreciation expense for the three months ended September 30, 2009 and 2008 was \$1,390,659 and \$937,156, respectively. Depreciation expense for the nine months ended September 30, 2009 and 2008 was \$4,170,241 and \$2,295,534, respectively.

Construction in Progress

Construction in progress ("CIP") consists of the cost of constructing property and equipment for the Company's gas stations and a new project of processing, distribution and sale of LNG. The major cost of construction in progress relates to technology licensing fees, equipment purchase, land use rights requisition cost, capitalized interest and other construction fees. No depreciation is provided for construction in progress until such time as the assets are completed and placed into service. Interest incurred during construction is capitalized into construction in progress. All other interest is expensed as incurred.

As of September 30, 2009 and December 31, 2008, the Company had construction in progress in the amount of \$42,124,222 and \$22,061,414, respectively. Interest cost capitalized into construction in progress for the three months ended September 30, 2009 and 2008, amounted to \$1,388,870 and \$990,061, respectively. Interest cost capitalized into construction in progress for the nine months ended September 30, 2009 and 2008, amounted to \$3,419,796 and \$1,672,565, respectively.

Construction in progress at September 30, 2009 consisted of the following:

| No. | Project Description | Location | September 30, 2009 (Unaudited) | Commencement date | Expected completion date | Estimated additional cost to complete |
|-----|---------------------|----------|-----------------------------------|----------------------|--------------------------------|--|
|-----|---------------------|----------|-----------------------------------|----------------------|--------------------------------|--|

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | | | | | |
|---|--------------------------------|-------|---------------|---------|--------|---------------|
| 1 | Jingbian LNG – Phase I | JBLNG | \$ 34,735,672 | Dec-06 | May-10 | \$ 14,218,000 |
| 2 | Sa Pu mother station | HXNGC | 769,413 | Jul-08 | Jun-11 | 6,300,000 |
| 3 | Zijing Energy mother station | XXNGC | 4,132,925 | Sep-08 | May-11 | 3,440,000 |
| 4 | Xi'an Cangsheng mother station | XXNGC | 1,855,599 | Sep-08 | May-11 | 3,220,000 |
| 5 | Other CIP projects | XXNGC | 630,613 | Various | Dec-09 | 2,050,000 |
| | | | \$ 42,124,222 | | | \$ 29,228,000 |

Long-Lived Assets

The Company evaluates at least annually, more often when circumstances require, the carrying value of long-lived assets to be held and used. Impairment losses to be recorded on long-lived assets used in operations when indicators of impairment are present and the undiscounted cash flows estimated to be generated by those assets are less than the assets' carrying amounts. In that event, a loss is recognized based on the amount by which the carrying amount exceeds the fair market value of the long-lived assets. Loss on long-lived assets to be disposed of is determined in a similar manner, except that fair market values are reduced for the cost of disposal. Based on its review, the Company believes that, as of September 30, 2009, there were no significant impairments of its long-lived assets.

Unearned Revenue

Unearned revenue represents prepayments by customers for gas purchases and advance payments on installation of pipeline contracts. The Company records such prepayment as unearned revenue when the payments are received.

Fair Value of Financial Instruments

The accounting standards regarding fair value of financial instruments and related fair value measurements define fair value, establish a three-level valuation hierarchy for disclosures of fair value measurement, and enhance disclosure requirements for fair value measures. The carrying amounts reported in the consolidated balance sheets for current receivables and payables qualify as financial instruments. Management concluded the carrying values are a reasonable estimate of fair value because of the short period of time between the origination of such instruments and their expected realization and if applicable, their stated interest rate approximates current rates available. The three levels are defined as follows:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

FASB accounting standard regarding derivatives and hedging specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. This FASB accounting standard also provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the exception.

As a result of adopting this FASB accounting standard, 383,654 warrants previously treated as equity pursuant to the derivative treatment exemption are no longer afforded equity treatment because the strike price of the warrants is denominated in US dollar, a currency other than the Company's functional currency, the Chinese Renminbi. As a result, the warrants are not considered indexed to the Company's own stock, and as such, all future changes in the fair value of these warrants will be recognized currently in earnings until such time as the warrants are exercised or expire.

As such, effective January 1, 2009, the Company reclassified the fair value of these warrants from equity to liability, as if these warrants were treated as a derivative liability since their issuance in October 2007. On January 1, 2009, the Company reclassified from additional paid-in capital, as a cumulative effect adjustment, \$5,844,239 to beginning retained earnings and \$1,014,308 to warrant liabilities to recognize the fair value of such warrants. The fair value of the warrants was \$2,488,070 on September 30, 2009. The Company recognized a \$357,979 loss from the change in fair value of the three months ended September 30, 2009. The Company recognized a \$1,473,762 loss from the change in fair value of warrants for the nine months ended September 30, 2009.

These common stock purchase warrants do not trade in an active securities market, and as such, we estimate the fair value of these warrants using the Black-Scholes Option Pricing Model using the following assumptions:

| | | |
|--|--------------------|-----------------|
| | September 30, 2009 | January 1, 2009 |
| | (Unaudited) | |

| | | |
|-----------------------|---|---|
| Annual dividend yield | - | - |
|-----------------------|---|---|

| | | |
|-------------------------|--------|--------|
| Expected life (years) | 3.07 | 3.82 |
| Risk-free interest rate | 1.45 % | 1.13 % |
| Expected volatility | 90 % | 90 % |

Expected volatility is based on historical volatility. Historical volatility was computed using daily pricing observations for recent periods that correspond to the term of the warrants. The Company believes this method produces an estimate that is representative of our expectations of future volatility over the expected term of these warrants. The Company has no reason to believe future volatility over the expected remaining life of these warrants is likely to differ materially from historical volatility. The expected life is based on the remaining term of the warrants. The risk-free interest rate is based on U.S. Treasury securities according to the remaining term of the warrants.

Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Depending on the product and the terms of the transaction, the fair value of the notes payable and derivative liabilities were modeled using a series of techniques, including closed-form analytic formula, such as the Black-Scholes Option Pricing Model, which does not entail material subjectivity because the methodology employed does not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets.

The following table sets forth by level within the fair value hierarchy of the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of September 30, 2009.

| | Carrying Value at September 30, 2009 (Unaudited) | | Fair Value Measurement at September 30, 2009 (Unaudited) | | |
|--|--|------|--|---------------|---------|
| | | | Level 1 | Level 2 | Level 3 |
| Senior notes | \$ 26,542,120 | \$ - | \$ - | \$ 35,366,413 | |
| Redeemable liability - warrants | 17,500,000 | - | - | 13,475,197 | |
| Derivative liability - warrants | 2,488,070 | - | 2,488,070 | - | |
| Total liability measured at fair value | \$ 46,530,190 | \$ - | \$ 2,488,070 | \$ 48,841,610 | |

Other than the derivative liabilities - warrants carried at fair value, the Company did not identify any other assets and liabilities that are required to be presented on the balance sheet.

Revenue Recognition

Revenue is recognized when services are rendered to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas and gasoline sales is recognized when gas and gasoline is pumped through pipelines to the end users. Revenue from installation of pipelines is recorded when the contract is completed and accepted by the customers. The construction contracts are usually completed within one to two months. Revenue from repairing and modifying vehicles is recorded when services are rendered to and accepted by the customers.

Enterprise Wide Disclosure

The Company's chief operating decision-makers (i.e. chief executive officer and his direct reports) review financial information presented on a consolidated basis, accompanied by disaggregated information about revenues by business lines for purposes of allocating resources and evaluating financial performance. There are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Based on qualitative and quantitative criteria established by the FASB's accounting standard for segment reporting, the Company considers itself to be operating within one reportable segment.

Advertising Costs

The Company expenses the cost of advertising as incurred or, as appropriate, the first time the advertising takes place. Advertising costs for the three and nine months ended September 30, 2009 and 2008, were insignificant.

Stock-Based Compensation

The Company records and reports stock-based compensation pursuant to FASB's accounting standard regarding stock compensation which defines a fair-value-based method of accounting for stock-based employee compensation and

transactions in which an entity issues its equity instruments to acquire goods and services from non-employees. Stock compensation for stock granted to non-employees has been determined in accordance with this accounting standard, as the fair value of the consideration received or the fair value of equity instruments issued, whichever is more reliably measured.

Income Taxes

FASB's accounting standard regarding income taxes, requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of temporary differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. At September 30, 2009 and December 31, 2008, there was no significant book to tax differences. There is no difference between book depreciation and tax depreciation as the Company uses the same method for both book and tax. A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The adoption had no effect on the Company's consolidated financial statements.

Local PRC Income Tax

The Company's subsidiary and VIEs operate in China. Starting January 1, 2008, pursuant to the tax laws of China, general enterprises are subject to income tax at an effective rate of 25% compared to 33% prior to 2008. The Company's VIE, XXNGC, is in the natural gas industry whose development is encouraged by the government. According to the income tax regulation, any company engaged in the natural gas industry enjoys a favorable tax rate. Accordingly, except for income from SXNGE, JBLNG, SXABC, HXNGC and LBNGC which subjects to 25% PRC income tax rate, XXNGC's income is subject to a reduced tax rate of 15%. A reconciliation of tax at the United States federal statutory rate to the provision for income tax recorded in the financial statements is as follows:

| | For the three months ended | | For the nine months ended | |
|--|--------------------------------------|--------------------------------------|--------------------------------------|--------------------------------------|
| | September 30, 2009 (Unaudited) | September 30, 2008 (Unaudited) | September 30, 2009 (Unaudited) | September 30, 2008 (Unaudited) |
| Tax provision (credit) at statutory rate | 34% | 34% | 34% | 34% |
| Foreign tax rate difference | (9)% | (9)% | (9)% | (9)% |
| Effect of favorable tax rate | (9)% | (12)% | (8)% | (10)% |
| Other item (1) | 2% | 5% | 3% | 5% |
| Total provision for income taxes | 18% | 18% | 20% | 20% |

(1) The 2% represents \$649,484 in expenses incurred by CHNG are not deductible in PRC for the three months ended September 30, 2009. The 5% represents \$1,434,740 expenses incurred by CHNG that are not deductible in PRC for the three months ended September 30, 2008. The 3% represents \$3,774,073 in expenses incurred by CHNG that are not deductible in PRC for the nine months ended September 30, 2009. The 5% represents \$4,013,188 expenses incurred by CHNG that are not deductible in PRC for the nine months ended September 30, 2008.

The estimated tax savings for the three months ended September 30, 2009 and 2008, amounted to approximately \$570,006 and \$645,717, respectively. The net effect on earnings per share, had the income tax been applied, would decrease basic and diluted earnings per share for the three months ended September 30, 2009 and 2008, from \$0.29 to \$0.25 and \$0.35 to \$0.31, respectively.

The estimated tax savings for the nine months ended September 30, 2009 and 2008, amounted to approximately \$1,801,782 and \$1,579,140, respectively. The net effect on earnings per share, had the income tax been applied, would decrease basic and diluted earnings per share for the nine months ended September 30, 2009 and 2008, from \$0.85 to

\$0.73 and \$0.78 to \$0.67, respectively.

China Natural Gas, Inc. was incorporated in the United States and has incurred net operating loss for income tax purpose for the period ended September 30, 2009. The estimated net operating loss carry forwards for United States income tax purposes amounted to \$2,278,525 and \$1,657,473 as of September 30, 2009 and December 31, 2008, respectively, which may be available to reduce future years' taxable income. These carry forwards will expire, if not utilized, beginning in 2027 through 2029. Management believes that the realization of the benefits arising from this loss appear to be uncertain due to Company's limited operating history and continuing losses for United States income tax purposes. Accordingly, the Company has provided a 100% valuation allowance at September 30, 2009. Management reviews this valuation allowance periodically and makes adjustments as warranted. The valuation allowances were as follow:

| | Nine months ended September 30, 2009 | Year ended December 31, 2008 |
|------------------------------|---|---------------------------------|
| Valuation allowance | (Unaudited) | |
| Balance, beginning of period | \$ 563,541 | \$ 322,614 |
| Increase | 211,158 | 240,927 |
| Balance, end of period | \$ 774,699 | \$ 563,541 |

The Company has cumulative undistributed earnings of foreign subsidiaries of approximately \$27,431,955 as of September 30, 2009, which is included in consolidated retained earnings and will continue to be indefinitely reinvested in international operations. Accordingly, no provision has been made for U.S. deferred taxes related to future repatriation of these earnings, nor is it practicable to estimate the amount of income taxes that would have to be provided if we concluded that such earnings will be remitted in the future.

Value added tax

Sales revenue represents the invoiced value of goods, net of a value-added tax (“VAT”). All of the Company’s variable interest entity XXNGC’s products that are sold in the PRC are subject to a Chinese value-added tax at a rate of 13% of the gross sales price. This VAT may be offset by VAT paid by the XXNGC on raw materials and other materials included in the cost of producing their finished product. XXNGC recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

All revenues from SXABC are subject to a Chinese VAT at a rate of 6%. This VAT cannot offset with VAT paid for materials included in the cost of revenues.

Basic and Diluted Earnings Per Share

Earnings per share is calculated in accordance with the FASB’s accounting standard regarding earnings per share. Basic net earnings per share is based upon the weighted average number of common shares outstanding. Diluted net earnings per share is based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

All share and per share amounts used in the Company’s consolidated financial statements and notes thereto have been retroactively restated to reflect the 1-for-2 reverse stock split, which were effective on April 28, 2009.

Recently issued accounting pronouncements

In January 2009, the FASB’s accounting standard regarding other investments providing additional guidance which amended the impairment model to remove the exclusive reliance on “market participant” estimates of future cash flows used in determining fair value. Changing the cash flows used to analyze other-than-temporary impairment from the “market participant” view to a holder’s estimate of whether there has been a “probable” adverse change in estimated cash flows allows companies to apply reasonable judgment in assessing whether an other-than-temporary impairment has occurred. The adoption of this guidance did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the FASB’s accounting standard regarding fair value measurements and disclosures providing additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased and also includes guidance on identifying circumstances that indicate a transaction is not orderly for fair value measurements. This guidance shall be applied prospectively with retrospective application not permitted. The adoption of this guidance did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the FASB’s accounting standard regarding debt and equity securities requires to make the other-than-temporary impairments guidance more operational and to improve the presentation of other-than-temporary impairments in the financial statements. This guidance will replace the existing requirement that the entity’s management assert it has both the intent and ability to hold an impaired debt security until recovery with a requirement that management assert it does not have the intent to sell the security, and it is more likely than not it will

not have to sell the security before recovery of its cost basis. This guidance provides increased disclosure about the credit and noncredit components of impaired debt securities that are not expected to be sold and also requires increased and more frequent disclosures regarding expected cash flows, credit losses, and an aging of securities with unrealized losses. Although this guidance does not result in a change in the carrying amount of debt securities, it does require that the portion of an other-than-temporary impairment not related to a credit loss for a held-to-maturity security be recognized in a new category of other comprehensive income and be amortized over the remaining life of the debt security as an increase in the carrying value of the security. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In April 2009 In April 2009, the FASB issued an accounting standard that requires disclosures about fair value of financial instruments not measured on the balance sheet at fair value in interim financial statements as well as in annual financial statements. Prior to this guidance, fair values for these assets and liabilities were only disclosed annually. This guidance applies to all financial instruments and requires all entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In May 2009, the FASB updated an accounting standard regarding subsequent events providing guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This accounting standard requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected. The Company adopted this Standard during the second quarter of 2009. This guidance requires that public entities evaluate subsequent events through the date that the financial statements are issued. The Company has evaluated subsequent events through the time of filing these consolidated financial statements with the SEC on November 9, 2009.

In June 2009, the FASB issued an accounting standard amending the accounting and disclosure requirements for transfers of financial assets. This guidance is effective for the Company beginning in 2010. Should the Company's accounts receivable securitization programs not qualify for sale treatment under the revised rules, future securitization transactions entered into on or after January 1, 2010 would be classified as debt and the related cash flows would be reflected as a financing activity. The Company is currently assessing the impact of the standard on its securitization programs.

In June 2009, the FASB updated an accounting standard regarding consolidation guidance which modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. This guidance clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. This guidance also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. This guidance is effective for fiscal years beginning after November 15, 2009. The Company is currently assessing the impact of the standard on its securitization programs.

In August 2009, the FASB issued an Accounting Standards Update ("ASU") regarding measuring liabilities at fair value. This ASU provides additional guidance clarifying the measurement of liabilities at fair value in circumstances in which a quoted price in an active market for the identical liability is not available; under those circumstances, a reporting entity is required to measure fair value using one or more of valuation techniques, as defined. This ASU is effective for the first reporting period, including interim periods, beginning after the issuance of this ASU. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

In October 2009, the FASB issued an ASU regarding accounting for own-share lending arrangements in contemplation of convertible debt issuance or other financing. This ASU requires that at the date of issuance of the shares in a share-lending arrangement entered into in contemplation of a convertible debt offering or other financing, the shares issued shall be measured at fair value and be recognized as an issuance cost, with an offset to additional paid-in capital. Further, loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs, at which time the loaned shares would be included in the basic and diluted earnings-per-share calculation. This ASU is effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

Note 3 – Other Assets

Other assets consisted of the following:

| | September 30, 2009 | December 31, 2008 |
|-------------------------------------|-----------------------|----------------------|
| | Unaudited | |
| Prepaid rent – natural gas stations | \$ 369,392 | \$ 272,635 |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | |
|---|---------------|--------------|
| Prepayment for acquiring land use right | 1,422,990 | 1,060,675 |
| Advances on purchasing equipment and construction in progress | 10,862,520 | 6,427,974 |
| Refundable security deposits | 530,783 | 981,083 |
| Others | 164,327 | 101,695 |
| Total | \$ 13,350,012 | \$ 8,844,062 |

All land in the PRC is government owned. However, the government grants users land use rights. As of September 30, 2009 and December 31, 2008, the Company prepaid \$1,422,990 and \$1,060,675, respectively, to the PRC local government to purchase land use rights. The Company is in the process of negotiating the final purchase price with the local government and the land use rights have not yet been granted to the Company. Therefore, the Company did not amortize the prepaid land use rights.

Advances on the purchase of equipment and construction in progress are monies deposited or advanced to outside vendors/subcontractors for the purchase of operating equipment or for services to be provided for constructions in progress.

Refundable security deposits are monies deposited with one of the Company's major vendors and gas station landlord. These amounts will be returned to the Company if they terminate the business relationship or at the end of the lease.

Note 4 – Senior Notes Payable

On December 30, 2007, the Company entered into a Securities Purchase Agreement with Abax Lotus Ltd. (the "Investor"). The Purchase Agreement was subsequently amended on January 29, 2008, pursuant to which the Company (i) agreed to issue 5.00% Guaranteed Senior Notes due 2014 (the "Senior Notes") of approximately \$20,000,000, (ii) agreed to issue to the Investor Senior Notes in aggregate principal amount of approximately \$20,000,000 on or before March 3, 2008 subject to the Company meeting certain closing conditions, (iii) granted the Investor an option to purchase up to approximately \$10,000,000 in principal amount of its Senior Notes and (iv) agreed to issue to the Investor seven-year warrants exercisable for up to 1,450,000 shares of the Company's common stock (the "Warrants") at an initial exercise price equal to \$14.7304 per share, subject to certain adjustments, which adjusted to \$7.3652 on January 29, 2009. On January 29, 2008, the Company issued \$20,000,000 Senior Notes and 1,450,000 warrants pursuant to the Purchase Agreement. On March 3, 2008, the Investor exercised its first option for an additional \$20,000,000 of Senior Notes. On March 10, 2008, the Company issued \$20,000,000 in additional Senior Notes resulting in total Senior Notes of \$40,000,000.

At the closing, the Company entered into:

- An indenture for the 5.00% Guaranteed Senior Notes due 2014;
- An investor rights agreement;
- A registration rights agreement covering the shares of common stock issuable upon exercise of the warrants;
- An information rights agreement that grants to the Investor, subject to applicable law, the right to receive certain information regarding the Company;
- A share-pledge agreement whereby the Company granted to the Collateral Agent (on behalf of the holders of the Senior Notes) a pledge on 65% of the Company's equity interest in Shaanxi Xilan Natural Gas Equipment Co., Ltd., a PRC corporation and wholly-owned subsidiary of the Company; and
 - An account pledge and security agreement whereby the Company granted to the Collateral Agent a security interest in the account where the proceeds from the Senior Notes are deposited.

In addition, Qinan Ji, Chief Executive Officer and Chairman of the Board of the Company, executed a non-compete agreement for the benefit of the Investor.

The Senior Notes were issued pursuant to an indenture between the Company and DB Trustees (Hong Kong) Limited, as trustee, at the closing. The Senior Notes will mature on January 30, 2014 and will initially bear interest at the stated interest rate of 5.00% per annum, subject to an increase in the event of certain circumstances. The Company is required to make mandatory prepayments on the Senior Notes on the following dates and in the following amounts, expressed as a percentage of the aggregate principal amount of Notes that will be outstanding on the first such payment date:

| Date | Prepayment Percentage |
|------------------|-----------------------|
| July 30, 2011 | 8.3333% |
| January 30, 2012 | 8.3333% |
| July 30, 2012 | 16.6667% |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | |
|------------------|----------|
| January 30, 2013 | 16.6667% |
| July 30, 2013 | 25.0000% |

During the twelve month period commencing January 30 of the years set forth below, the Company may redeem the Senior Notes at the following principal amount:

| Year | Principal |
|---------------------|------------|
| 2009 | 43,200,000 |
| 2010 | 42,400,000 |
| 2011 | 41,600,000 |
| 2012 | 40,800,000 |
| 2013 and thereafter | 40,000,000 |

Upon the occurrence of certain events defined in the indenture, the Company must offer the holders of the Senior Notes the right to require the Company to purchase the Senior Notes in an amount equal to 105% of the aggregate principal amount purchased plus accrued and unpaid interest on the Senior Notes purchased.

The indenture requires the Company to pay additional interest at the rate of 3.0% per annum of the Senior Notes if the Company has not obtained a listing of its common stock on the Nasdaq Global Market, the Nasdaq Capital Market or the New York Stock Exchange by January 29, 2009 and maintained such listing continuously thereafter as long as the Senior Notes are outstanding. As of January 29, 2009, the Company has not obtained a listing of its common stock on the market stated in the agreement. However, the Company obtained a three-month waiver from ABAX for the additional interest payment. The waiver gives the Company three more months until April 28, 2009 to achieve the uplisting status. By the end of the extended period, if the Company was not able to complete the uplisting, the Company would have to pay additional interest retroactively starting January 30, 2009 in accordance with the terms of the waiver. The Company was approved to be listed on Nasdaq on June 1, 2009 but was in negotiation with ABAX regarding the amount of additional interest to be paid as of June 30, 2009, thus the Company recognized additional interest payment amounted to \$203,334 and \$406,667 for the three months and six months ended June 30, 2009, respectively.

In August 2009, the Company reached an agreement with ABAX that the Company was to pay additional interest accrued for the period from April 29, 2009, the expiration date of previous waiver to June 1, 2009, the date of listing. As such, the Company paid \$113,214 additional interest to ABAX in August 2009 and recorded other income of \$293,453 accordingly.

The indenture limits the Company's ability to incur debt and liens, make dividend payments and stock repurchases, make investments, reinvest proceeds from asset sales and enter into transactions with affiliates, among other things. The indenture also requires the Company to maintain certain financial ratios.

The Company also entered into an investor rights agreement, pursuant to which, as long as an investor holds at least 10% of the aggregate principal amount of the Senior Notes issued and outstanding or at least 3% of the Company's issued and outstanding common stock pursuant to the warrants on an as-exercised basis ("Minimum Holding"), the Company has agreed not to undertake certain corporate actions without prior Investor approval. In addition, so long as an Investor owns the Minimum Holding, such Investor shall have a right of first refusal for future debt securities offerings by the Company and the Company is subject to certain transfer restrictions on its securities and certain other properties.

From the Closing Date and as long as the Investor continues to hold more than 10% of the outstanding shares of common stock on an as-converted, fully-diluted basis, the Investor shall be entitled to appoint one of the Company's board of directors (the "Investor Director"). The Investor Director shall be entitled to serve on each committee of the board, except that, the Investor Director shall not serve on the audit committee unless it is an independent director. Mr. Ji has agreed to vote his shares for the election of the Investor Director.

The Company was required to prepare and file a registration statement covering the sales of all of the shares of common stock issuable upon exercise of the warrants or incur additional interest of 1% on the Notes. The Company's registration statement was declared effective on May 6, 2008; therefore, no penalties were incurred.

In connection with the issuance of the Securities Purchase Agreement, the Company paid \$2,122,509 in debt issuance costs which is being amortized over the life of the Senior Notes. For the three months ended September 30, 2009 and 2008, the Company amortized \$11,505 and \$24,410 of the aforesaid issuance costs, net of capitalized interest. For the nine months ended September 30, 2009 and 2008, the Company amortized \$63,940 and \$147,002 of the aforesaid issuance costs, net of capitalized interest.

In connection with the Securities Purchase Agreement, the Company agreed to issue to the Investor seven-year warrants exercisable for up to 1,450,000 shares of the Company's common stock at an initial exercise price equal to \$14.7304 per share, subject to certain adjustments. The exercise price of the Warrants is adjusted on the first anniversary of issuance and thereafter, at every six month anniversary beginning in the fiscal year 2009 if the volume weighted average price, or VWAP, (as defined therein) for the 15 trading days prior to the applicable reset date is less than the then applicable exercise price, in which case the exercise price shall be adjusted downward to the then current VWAP; provided, however, that in no event shall the exercise price be adjusted below \$7.3652 per share. The exercise price was adjusted to \$7.3652 on January 29, 2009. No further adjustments of the exercise price will be required (as that is the floor price).

The warrants granted to the Investor on January 29, 2008 are considered derivative instruments that need to be bifurcated from the original security. If the Warrants have not been exercised within the seven year period, then the Investor can have the Company purchase the Warrants for \$17,500,000. This amount is shown as a debt discount and is being amortized over the term of the Senior Notes. For the three months ended September 30, 2009 and 2008, the Company amortized \$63,054 and \$95,528 of the aforesaid discounts, net of capitalized interest. For the nine months ended September 30, 2009 and 2008, the Company amortized \$280,250 and \$555,001 of the aforesaid discounts, net of capitalized interest.

The warrants have been determined to be derivative liabilities instruments because there is a required redemption requirement if the holder does not exercise the Warrants. However, the warrants are not required to be valued at fair value, rather, to be at its undiscounted redemption amount of \$17.5 million.

Note 5 – Warrants

Following is a summary of the warrant activity:

| | Warrants Outstanding | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|---|----------------------|---------------------------------|---------------------------|
| Outstanding, December 31, 2007 | 544,242 | \$ 13.10 | 376,977 |
| Granted | 1,450,000 | 14.74 | - |
| Forfeited | - | - | - |
| Exercised | - | - | - |
| Outstanding, December 31, 2008 | 1,994,242 | \$ 14.28 | - |
| Granted | - | - | - |
| Forfeited | (160,588) | \$ 7.20 | - |
| Exercised | - | - | - |
| Outstanding, September 30, 2009 (Unaudited) | 1,833,654 | \$ 8.93 | 5,842,088 |

Following is a summary of the status of warrants outstanding at September 30, 2009 (Unaudited):

| Outstanding Warrants | | |
|----------------------|-----------|------------------------------------|
| Exercise Price | Number | Average Remaining Contractual Life |
| \$ 7.37 | 1,450,000 | 5.33 |
| \$ 14.86 | 383,654 | 2.84 |
| \$ 8.93 | 1,833,654 | 4.81 |

Note 6 – Defined Contribution Plan

The Company is required to participate in a defined contribution plan operated by the local municipal government in accordance with Chinese law and regulations. The Company contributes 100RMB per employee per month to the plan. Starting from 2008, no minimum contribution is required but the maximum contribution cannot be more than 14% of the current salary expense. The total contribution for the above plan was \$53,128 and \$0 for the three months ended September 30, 2009 and 2008, respectively. The total contribution for the above plan was \$134,207 and \$0 for the nine months ended September 30, 2009 and 2008, respectively.

Note 7 – Secondary Public Offering

On September 9, 2009, the Company completed an underwritten public offering for 5,725,000 shares of its common stock at a price of \$8.75 per share. China Natural Gas also granted the underwriters a 30-day option to purchase up to an additional 858,750 shares to cover over-allotments at the public offering price.

On September 21, 2009, the Company closed the sale of an additional 858,750 shares of common stock at the public offering price of \$8.75 per share, pursuant to the over-allotment option exercised in full by the underwriter in connection with its public offering that closed on September 9, 2009.

The net proceeds, after deducting underwriting discounts and commissions and the relevant expenses, is approximately \$54.4 million.

The net proceeds from the offering was intended to be used for the construction of the Company's liquefied natural gas facility, the acquisition of CNG fueling stations, the purchase of CNG trucks and the establishment of a joint venture company with China National Petroleum Corporation Kunlun Natural Gas Co., Ltd., as well as for general working capital purposes.

Note 8 – Statutory Reserve

As stipulated by the Company Law of the People's Republic of China (PRC) as applicable to Chinese companies with foreign ownership, net income after taxation can only be distributed as dividends after appropriation has been made for the following:

15

- i. Making up cumulative prior years' losses, if any;
- ii. Allocations to the "Statutory surplus reserve" of at least 10% of income after tax, as determined under PRC accounting rules and regulations, until the fund amounts to 50% of the Company's registered capital;
- iii. Allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

As of September 30, 2009, the remaining reserve needed to fulfill the 50% registered capital requirement totaled \$53,257,563.

Note 9 – Accounting for stock-based compensation

1) Options from CEO to pay for certain Company's legal expenses

On September 22, 2007, Mr. Qinan Ji, chairman and shareholder of the Company, transferred 50,000 of his personally-owned options to the Company's attorney to cover certain Company legal expenses. 30% of the options vested on September 22, 2008, 30% vest on September 22, 2009, and the remaining 40% vest on September 22, 2010. Upon termination of service to the Company, the attorney is required to return all unvested options. These options expire June 1, 2012.

The Company used the Black-Sholes Option Pricing Model to value the options at the time they were issued, based on the stock price on its grant date, the stated exercise prices and expiration dates of the instruments and using a risk-free rate of 4.10%. The estimated life is based on one half of the sum of the vesting period and the contractual life of the option. This is the same as assuming that the options are exercised at the mid-point between the vesting date and expiration date. \$14,842 and \$12,965 of compensation expense was recorded during the three months ended September 30, 2009 and 2008, respectively. \$44,527 and \$38,896 of compensation expense were recorded during the nine months ended September 30, 2009 and 2008, respectively.

As of September 30, 2009, approximately \$88,032 of estimated expense with respect to non-vested stock-based compensation has yet to be recognized and will be recognized in expense over the optionee's remaining weighted average service period of approximately one year.

2) 2009 stock option plan

On March 11, 2009, the board of directors approved by written consent the Company's stock option plan for its employees, directors and consultants. Pursuant to the plan, the total stock option pool will equal to 10% of the Company's total shares outstanding as of March 11, 2009. Among the option pool approved, 4% shall be awarded in 2009 and another 4% shall be awarded in 2010, and 2% reserved for future awards. For the 2009 stock option award, the CEO and CFO were granted total options of 1% and 0.6% of the common shares outstanding respectively, 50% as Non-qualified Stock Options (NSO) and 50% as Incentive Stock Awards (ISA), for a vesting period of four years. As Richard Wu has resigned as CFO, the Company granted to his successor, Veronica Chen, options to purchase 75,000 shares (post-split) of the Company's common stock, representing approximately 0.5% of the Company's outstanding shares as of March 11, 2009, with the same terms and conditions as specified in the stock options plan. 5,000 option shares per year will be granted to each non-executive board member and 6,000 option shares per year granted to the Audit Committee Chairman. Other senior management and employees will be granted total options of 2.11% of the Company's common shares. On April 1, 2009 and May 1, 2009, the Company issued 243,850 and 75,000 stock options, respectively, pursuant to the Company's 2009 employee stock option and stock award plan. The strike price for the options was \$4.90 per share. The stock option has a term of six years and vests evenly over four years starting one year from the issuance date on an annually basis.

The Company used the Black-Sholes Option Pricing Model to value the options at the time they were issued, based on the stock price on its grant date, the stated exercise prices and expiration dates of the instruments and using risk-free rates. The estimated life is based on one half of the sum of the vesting period and the contractual life of the option. This is the same as assuming that the options are exercised at the mid-point between the vesting date and expiration date. \$71,073 and \$142,146 of compensation expense was recorded during three months and nine months ended September 30, 2009, respectively.

As of September 30, 2009, approximately \$995,021 of estimated expense with respect to non-vested stock-based compensation has yet to be recognized and will be recognized in expense over the optionee's remaining weighted average service period of approximately 3.50 years.

Following is a summary of the Stock option activity:

| | Options Outstanding | Weighted Average Exercise Price | Aggregate Intrinsic Value |
|---|---------------------|---------------------------------|---------------------------|
| Outstanding, December 31, 2007 | - | - | - |
| Granted | - | - | - |
| Forfeited | - | - | - |
| Exercised | - | - | - |
| Outstanding, December 31, 2008 | - | - | - |
| Granted | 318,850 | \$ 4.9 | 95,655 |
| Forfeited | - | - | - |
| Exercised | - | - | - |
| Outstanding, September 30, 2009 (Unaudited) | 318,850 | \$ 4.9 | 2,302,097 |

Following is a summary of the status of stock options outstanding at September 30, 2009 (unaudited):

| Outstanding Options | | | Exercisable Options | | |
|---------------------|---------|------------------------------------|---------------------|--------|------------------------------------|
| Exercise Price | Number | Average Remaining Contractual Life | Exercise Price | Number | Average Remaining Contractual Life |
| \$ 4.90 | 243,850 | 5.50 | - | - | - |
| \$ 4.90 | 75,000 | 5.59 | - | - | - |

Note 10 – Earnings per Share

Earnings per share for the periods ended September 30, 2009 and 2008 is determined by dividing net income for the periods by the weighted average number of both basic and diluted shares of common stock and common stock equivalents outstanding. The following is an analysis of the differences between basic and diluted earnings per common share in accordance with FASB's accounting standard.

The following demonstrates the calculation for earnings per share for the periods ended September 30, 2009 and 2008:

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---------------------------------------|--|-------------|---|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |
| Basic earning per share | | | | |
| Net income | 4,647,519 | 5,136,590 | 12,711,898 | 11,458,053 |
| Weighted shares outstanding-Basic | 15,754,696 | 14,600,152 | 14,985,001 | 14,600,152 |
| Earnings per share-Basic | \$ 0.29 | \$ 0.35 | \$ 0.85 | \$ 0.78 |
| Diluted earning per share | | | | |
| Net income | 4,647,519 | 5,136,590 | 12,711,898 | 11,458,053 |
| Weighted shares outstanding-Basic | 15,754,696 | 14,600,154 | 14,985,001 | 14,600,154 |
| Effect of diluted securities-Warrants | 385,124 | 39,641 | 50,171 | 58,265 |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | | | |
|-------------------------------------|------------|------------|------------|------------|
| Weighted shares outstanding-Diluted | 16,139,820 | 14,639,795 | 15,035,172 | 14,658,419 |
| Earnings per share –Diluted | \$ 0.29 | \$ 0.35 | \$ 0.85 | \$ 0.78 |

17

At September 30, 2009 and 2008, the Company had outstanding warrants of 1,833,654 and 1,994,242, respectively. For the three months ended September 30, 2009, the average stock price was greater than the exercise prices of the 1,450,000 warrants which resulted in additional weighted average common stock equivalents of 385,124; 383,654 outstanding warrants were excluded from the diluted earnings per share calculation as they are anti-dilutive. For the three months ended September 30, 2008, the average stock price was greater than the exercise prices of the 160,588 warrants which resulted in additional weighted average common stock equivalents of 39,641; 1,833,654 outstanding warrants were excluded from the diluted earnings per share calculation as they are anti-dilutive. For the nine months ended September 30, 2009, the average stock price was greater than the exercise prices of the 1,450,000 warrants which resulted in additional weighted average common stock equivalents of 50,171; 383,654 outstanding warrants were excluded from the diluted earnings per share calculation as they are anti-dilutive. For the nine months ended September 30, 2008, the average stock price was greater than the exercise prices of the 160,588 warrants which resulted in additional weighted average common stock equivalents of 58,265; 1,833,654 outstanding warrants were excluded from the diluted earnings per share calculation as they are anti-dilutive.

Note 11 – Current Vulnerability Due to Certain Concentrations

Concentration of natural gas vendors:

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|-------------|--|-------------|
| | 2009 | 2008 | 2009 | 2008 |
| | (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |
| Numbers of natural gas vendors | 4 | 4 | 4 | 4 |
| Percentage of total natural gas purchases | 99% | 97% | 99% | 98% |

As of September 30, 2009 and December 31, 2008, the Company has \$106,078 and \$206,811, respectively, payable due to its major suppliers.

The Company maintains long-term natural gas minimum purchase agreements with one of its vendors as of September 30, 2009. There are no minimum purchase requirements by the Company. Contracts are renewed on an annual basis. The Company's management reports that it does not expect any issues or difficulty in continuing to renew the supply contracts with these vendors going forward. Price points for natural gas are strictly controlled by the government and have remained stable over the past three years.

The Company's operations are carried out in the People's Republic of China. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the People's Republic of China, by the general state of the People's Republic of China's economy. The Company's business may be influenced by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

Note 12 – Commitments and Contingencies

(a) Lease Commitments

The Company recognizes lease expense on a straight-line basis over the term of the lease in accordance to FASB's accounting standard regarding leases. The Company entered into a series of long-term lease agreements with outside parties to lease land use rights to the self-built Natural Gas filling stations located in the PRC. The agreements have terms ranging from 10 to 30 years. The Company makes annual prepayments for most lease agreements. The

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

Company also entered into two office leases in Xi'an, PRC and New York, NY. The minimum future payment for leasing land use rights and offices is as follows:

| | |
|-------------------------------|---------------|
| Year ending December 31, 2009 | \$ 86,758 |
| Year ending December 31, 2010 | 1,458,518 |
| Year ending December 31, 2011 | 1,577,171 |
| Year ending December 31, 2012 | 1,391,916 |
| Year ending December 31, 2013 | 1,280,490 |
| Thereafter | 21,923,923 |
| Total | \$ 27,718,776 |

18

For the three months ended September 30, 2009 and 2008, the land use right and office lease expenses were \$411,452 and \$256,876, respectively. For the nine months ended September 30, 2009 and 2008, the land use right and office lease expenses were \$1,209,549 and \$630,821 respectively.

(b) Property and Equipment

In January 2008, the Company entered into a contract with Chemtex International Inc. to purchase equipment supply for the LNG plant and storage tank located in Jingbian County, Shannxi Province China, in the total amount of \$13,700,000. On May 16, 2008, JBLNG entered into an agreement with Hebei Tongchan Import and Export Co. Ltd. (Hebei) and agreed that Hebei will act as the trade agency for JBLNG. On June 16, 2008, the Company entered into an equipment supply contract with Chemtex International Inc. to supply imported equipment for a LNG plant and a storage tank to be built by Jingbian Xilan LNG Co. Ltd. On September 8, 2008, the total contract value was reduced from \$13,700,000 to \$13,100,000. As of September 30, 2009, the Company advanced \$6,140,000 to the trade agency and the future commitment for equipment is \$6,960,000.

(c) Natural Gas Purchase Commitments

The Company has existing long-term natural gas purchase agreements with its major suppliers. However, none of those agreements stipulate any specific purchase amount or quota each year, thus giving the Company enough flexibility to constantly look for lower-cost sources of supply. Therefore, the Company is not legally bound in purchase commitments by those agreements.

(d) Capital Commitments

In July 2009, the Company, through its variable interest entity, Xi'an Xilan Natural Gas Co., Ltd. ("Xi'an Xilan"), has entered into a joint venture agreement with China National Petroleum Corporation Kunlun Natural Gas Co., Ltd. and a Joint Venture Company will be established. The Joint Venture Company will have an initial registered capital of RMB50,000,000 (approximately \$7,350,000) and Xi'an Xilan has a capital commitment of RMB24,500,000, representing 49% of the Joint Venture Company's total registered capital. As of September 30, 2009, Xi'an Xilan has not yet made any capital contribution.

(e) Legal Proceedings

A former member of the board of directors filed a lawsuit against the Company in the New York State Supreme Court, Nassau County, in which he has sought, among other things to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that the plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an options agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, the Company believes that any liability it would incur will not have a materially adverse effect on its financial condition or its results of operations, and, accordingly, this matter has not been reflected on the Company's consolidated financial statements.

Note 13 – Subsequent event

The Company has performed an evaluation of subsequent events through November 9, 2009, which is the date the financial statements were issued.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

CAUTIONARY STATEMENT

FORWARD-LOOKING STATEMENT

The information in this report contains forward-looking statements. All statements other than statements of historical fact made in this report are forward looking. In particular, the statements herein regarding industry prospects and future results of operations or financial position are forward-looking statements. These forward-looking statements can be identified by the use of words such as "believes," "estimates," "could," "possibly," "probably," "anticipates," "projects," "expects," "may," "will," or "should" or other variations or similar words. No assurances can be given that the future results anticipated by the forward-looking statements will be achieved. Forward-looking statements reflect management's current expectations and are inherently uncertain. Our actual results may differ significantly from management's expectations.

The following discussion and analysis should be read in conjunction with our financial statements, included herewith. This discussion should not be construed to imply that the results discussed herein will necessarily continue into the future, or that any conclusion reached herein will necessarily be indicative of actual operating results in the future. Such discussion represents only the best present assessment of our management.

Overview

We are a distributor of compressed natural gas ("CNG") in China.. As of September 30, 2009, we operated 24 CNG fueling stations in Shaanxi province and 12 CNG fueling stations in Henan province. We own our CNG fueling stations while we lease the land upon which our CNG fueling stations operate. For the three and nine months ended September 30, 2009, we sold CNG of 40,420,123 and 120,866,756 cubic meters respectively through our fueling stations, compared to 40,547,584 and 107,226,877 cubic meters for the three and nine months ended September 30, 2008. We also transport, distribute and sell piped natural gas to residential and commercial customers in the Xi'an area, including Lantian County, and the districts of Lintong and Baqiao, in Shaanxi province through a high pressure pipeline network of approximately 120 kilometers.

We operate four main business lines:

- Distribution and sale of compressed natural gas through our variable interest entity (VIE) owned CNG fueling stations for hybrid (natural gas/gasoline) powered vehicles (36 stations as of September 30, 2009);
- Installation, distribution and sale of piped natural gas to residential and commercial customers. We distributed and sold piped natural gas to 118,973 residential customers as of September 30, 2009;
- Distribution and sale of gasoline through our VIE owned CNG fueling stations for gasoline and hybrid (natural gas/gasoline) powered vehicles (7 of our VIE owned CNG fueling stations sold gasoline as of September 30, 2009); and
- Conversion of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at our auto conversion sites.

We buy all of the natural gas that we sell and distribute to our customers. We do not mine or produce any of our own natural gas and have no plans to do so during the next 12 months. We currently sell our natural gas in two forms: (i) CNG and (ii) piped natural gas.

On October 24, 2006, our variable interest entity, Xi'an Xilan Natural Gas Co., Ltd. ("XXNGC"), formed a wholly-owned subsidiary, Shaanxi Jingbian Liquefied Natural Gas Co., Ltd. ("SJLNG"), for the purpose of constructing a liquefied natural gas ("LNG") facility to be located in Jingbian, Shaanxi province. We planned to invest approximately \$45 million to construct this facility but are anticipating now that the total investment increase to approximately \$49.0 million primarily attributed to significant increase in material and labor costs incurred due to additional engineering reinforcement needs to ensure project safety, excluding \$2.7 million additional payment of land use right for phase I, phase II and phase III because soaring local land price due to recent energy resource explorations as well as the cost of \$4.5 million to purchase an additional 8.3 acres of land for the Yulin government's construction of an electricity substation, phase II and phase III of the LNG plant.

The LNG plant was funded through the sale of senior notes to Abax Lotus Ltd. in January 2008 as well as the underwritten public offering in September 2009. When completed, the plant is expected to have LNG processing capacity of 500,000 cubic meters per day, or approximately 150 million cubic meters on an annual basis. Phase I of the LNG plant is under construction and is expected to be completed by May 2010, later than originally planned because of delays mainly due to macro tariff exemption policy changes and additional document requirements at Shaanxi Province customs; engineering reinforcement of plant basis; ocean shipment route change to avoid pirates in Somali area.

We had total revenues of 20,125,184 and 18,401,200 for the three months ended September 30, 2009 and 2008 respectively and revenues of 59,395,370 and 49,317,360 for the nine months ended September 30, 2009 and 2008, respectively. We had net income of 4,647,519 and 5,136,590 for the three months ended September 30, 2009 and 2008 respectively and net income of 12,711,898 and 11,458,053 for the nine months ended September 30, 2009 and 2008 respectively.

Factors Affecting Our Results of Operations

Significant factors affecting our results of operations are:

Successful expansion of our CNG fueling station business in our target markets. Our revenue increased by 9.37% during the three months ended September 30, 2009 from the three months ended September 30, 2008 and by 20.44% during the nine months ended September 30, 2009 from the nine months ended September 30, 2008 largely because of the addition of 3 new fueling stations added since the third quarter of 2008, as well as the increase of pipeline natural gas customers. As of September 30, 2009, we operated 36 CNG fueling stations in total and, in Shaanxi alone, we operated 24 CNG fueling stations. We believe we are the largest provider of CNG fueling stations in Xi'an, one of our core target markets for CNG. As of September 30, 2009, we operated 12 CNG fueling stations in Henan province, another of our core target markets. The successful expansion of our CNG fueling station business in Xi'an and Henan province has been a significant factor driving our revenue growth and results of operations for the period reviewed. While we intend to expand into different provinces, we anticipate the growth of our CNG fueling business in Xi'an and Henan province will continue to significantly affect our results of operations as we intend to continue to increase the number of CNG fueling stations we operate in these areas.

Regulation of natural gas prices in the PRC. The prices at which we purchase our natural gas supplies and sell CNG and pipeline natural gas products are strictly regulated by the PRC central government, including the National Development and Reform Commission ("NDRC"), and the local state price bureaus who have the discretion to set natural gas prices within the boundaries set by the PRC central government. In addition, natural gas procurement and sale prices are not uniform across China and can vary across provinces. For example, the prices at which we procure and sell CNG and piped natural gas are lower in Shaanxi than in Henan. Accordingly, our results of operations and, in particular, our revenue, cost of revenue and gross profit and gross margin are affected significantly by factors which are outside of our control. As we expand our natural gas business into other provinces, we expect our results of operations to continue to be affected significantly by the regulation of natural gas prices in the PRC.

Government policies encouraging the adoption of cleaner burning fuels. Our results of operations for the periods reviewed have benefited from environmental regulations and programs in the PRC that promote the use of cleaner burning fuels, including natural gas for vehicles. As an enterprise engaged in the natural gas industry, our VIE benefits from a reduced income tax rate of 15% compared to the standard 25% enterprise income tax rate in the PRC. In addition, the PRC government has encouraged companies to invest in and build the necessary transportation, distribution and sale infrastructure for natural gas in various policy pronouncements such as by officially including CNG/gasoline hybrid vehicles in the country's "encouraged development" category. These policies have benefited our results of operations by encouraging the demand for our natural gas products and also by lowering our expenses. As we expand into the LNG business, we anticipate that our results of operations will continue to be affected by government policies encouraging the adoption of cleaner burning fuels and the increased adoption of CNG and LNG technology.

Taxation

United States

We are incorporated in the State of Delaware and are subject to the tax laws of the United States. Since we do not have any revenue generating activities in the United States, we incurred a net operating loss for income tax purposes for the period ended September 30, 2009. The estimated net operating loss carry forwards for United States income tax purposes amounted to \$2,278,525 and \$1,657,473 as of September, 2009 and December 31, 2008, respectively, which may be available to reduce future years' taxable income. These carry forwards will expire, if not utilized, beginning in 2027 through 2029. Our management believes that the realization of the benefits arising from this loss appear to be uncertain due to our Company's limited operating history and continuing losses for United States income tax purposes. Accordingly, we have provided a 100% valuation allowance at September 30, 2009.

The PRC

Our subsidiary, VIE and its subsidiaries operate in China. Starting January 1, 2008, pursuant to the tax laws of China, general enterprises are subject to income tax at an effective rate of 25% compared to 33% prior to 2008. Based on certain income tax regulations adopted in 2001 to encourage the development of certain industries, including the natural gas industry, in the western portions of China such as Shaanxi Province, XXNGC is subject to a reduced tax rate of 15%. Accordingly, except for income from XXNGC, which is subject to the reduced tax rate of 15%, income from Xilan Equipment, SJLNG, XXABC, HXNGC and LBNGC are subject to the 25% PRC income tax rate. Our effective income tax rate for the three months ended September 30, 2009 and 2008 were approximately 17.7% and 16.8%, respectively.

Value Added Tax

Sales revenue represents the invoiced value of goods, net of a value-added tax ("VAT"). All of our variable interest entity XXNGC's products that are sold in the PRC are subject to a Chinese VAT at a rate of 13% of the gross sales price. This VAT may be offset by VAT paid by XXNGC on raw materials and other materials included in the cost of producing their finished products. XXNGC records VAT payable and VAT receivable net of payments in its financial statements. VAT tax returns are filed offsetting the payables against the receivables.

All revenues from XXABC are subject to a Chinese VAT at a rate of 6%. This VAT cannot be offset with VAT paid for materials included in the cost of revenues.

Internal Control Over Financial Reporting

We are subject to reporting obligations under the U.S. securities laws. The SEC, as required by Section 404 of the Sarbanes-Oxley Act, adopted rules requiring every public company to include a management report on such company's internal control over financial reporting in its annual report, which contains management's assessment of the effectiveness of the company's internal control over financial reporting. In addition, an independent registered public accounting firm must report on our internal control over financial reporting. Based on the Company's evaluation, management concluded that, due to the identification of a material weakness in relation to inadequate US GAAP expertise, as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2008, as amended, and the fact that the company is still in the process of remediating such material weakness, as of September 30, 2009, the Company's disclosure controls and procedures remained ineffective.

CONSOLIDATED RESULTS OF OPERATIONS

Three Months Ended September 30, 2009 Compared to Three Months Ended September 30, 2008

The following table represents the consolidated operating results for the three month period ended September 30, 2009 and 2008:

Sales Revenues

The following table sets forth a breakdown of our revenues for the period indicated:

| | September 30, 2009 | September 30, 2008 | Increase in dollar amount | Increase in percentage |
|-----------------------------------|-----------------------|-----------------------|---------------------------------|---------------------------|
| Natural gas from fueling stations | \$ 14,789,924 | \$ 14,756,929 | \$ 32,995 | 0.2% |
| Natural gas from pipelines | 664,462 | 597,532 | 66,930 | 11.2% |
| Gasoline | 1,633,478 | 1,187,754 | 445,724 | 37.5% |
| Installation | 2,415,550 | 1,197,051 | 1,218,499 | 101.8% |
| Auto conversion | 621,770 | 661,934 | (40,164) | -6.1% |
| Total | \$ 20,125,184 | \$ 18,401,200 | \$ 1,723,984 | 9.4% |

Overall. Total revenue for the three months ended September 30, 2009 increased to 20,125,184 from 18,401,200 for the three months ended September 30, 2008, an increase of 1,723,984 or 9.4 %. This increase was mainly due to the addition of 3 new fueling stations added since the third quarter of 2008, and an increase in the number of residential and commercial pipeline customers to 118,973 as of September 30, 2009 from 92,984 as of September 30, 2008. We sold natural gas of 43,209,817 cubic meters during the three months ended September 30, 2009, compared to 43,213,532 cubic meters during the three months ended September 30, 2008. For the three months ended September 30, 2009, 84.9% of our revenue was generated from the sale of natural gas and gasoline, and the other 15.1% was generated from our installation and auto conversion services.

Natural Gas from Fueling Stations. Natural gas revenue from our fueling stations increased by 0.2% or \$32,995, to \$14,789,924 during the three months ended September 30, 2009, from \$14,756,929 during the three months ended September 30, 2008, and contributed to 73.5% of our total revenue, which was the largest among our four major business lines. During the three months ended September 30, 2009, we sold compressed natural gas of 40,420,123 cubic meters, compared to 40,547,584 cubic meters during the three months ended September 30, 2008 through our fueling stations. In terms of average station sales value and volume, in the three months ended September 30, 2009, we sold approximately \$418,622 and 1,144,074 cubic meters of compressed natural gas per station, compared to approximately \$423,000 and 1,180,000 cubic meters in the three months ended September 30, 2008. The reason for the decline in per station sales by 3% in quantity was due to the construction of main subway lines in Xi'an, which caused certain bus routes to deviate from our stations as well as enhanced competition in Henan Province. Unit selling price was relatively stable at \$0.37 (RMB 2.5).

Natural Gas from Pipelines. Natural gas revenue from our pipelines increased by 11.2%, or \$66,930, to \$664,462 during the three months ended September 30, 2009, from \$597,532 during the three months ended September 30, 2008, and contributed to 3.3% of our total revenue. As of September 30, 2009, the Company had 118,973 pipeline customers, an increase of 25,989 customers comparing to as of September 30, 2008. We also sold 2,789,694 cubic meters of natural gas through our pipelines during the three months ended September 30, 2009, compared to 2,665,948 cubic meters during the three months ended September 30, 2008.

Gasoline. Revenue from gasoline sales increased by 37.5%, or \$445,724, to \$1,633,478 during the three months ended September 30, 2009, from \$1,187,754 during the three months ended September 30, 2008, and contributed 8.1% to our total revenue. The gasoline revenue increase was due to the sales volume increased 41.7% from 1,667,783 liters to 2,357,490 liters, offset by 2.67% decrease of unit sales price from \$ 0.6500 (RMB4.86) per liter in the three months ended September 30, 2008 to \$0.6934 (RMB 4.73) per liter in the three months ended September 30, 2009, affected by the decrease of international oil price. The increased sales volumes were due to our two stations, Xianning and Kaiyuan, began operation in the third quarter of 2008.

Installation Services. Revenue from installation services increased by 101.8%, or \$1,218,499, to \$ 2,415,550 during the three months ended September 30, 2009, from \$1,197,051 during the three months ended September 30, 2008, and contributed 12.0% to our total revenue. The increase of installation sales was mainly due to the increase of pipeline customers in the newly acquired subsidiary, Lingbao Natural Gas, Co., since October 2008. Installation services to our top four customers contributed to 19.2%, 12.6%, 11.6% and 11.3% of our installation revenue for the three months ended September 30, 2009.

Auto Conversion Services. Revenue from our auto conversion division decreased by 6.1%, or \$40,164, to \$621,770 during the three months ended September 30, 2009, from \$661,934 during the three months ended September 30, 2008, and contributed 3.1% to our total revenue.

Cost of Revenue

The following table sets forth a breakdown of our cost of revenue for the periods indicated:

| | September 30, 2009 | September 30, 2008 | Increase / (Decrease) in dollar amount | Increase / (Decrease) in percentage |
|-----------------------------------|-----------------------|-----------------------|---|---|
| Natural gas from fueling stations | \$ 7,075,387 | \$ 6,538,493 | \$ 536,894 | 8.2% |
| Natural gas from pipelines | 460,801 | 434,542 | 26,259 | 6.0% |

| | | | | |
|-----------------|---------------|--------------|--------------|--------|
| Gasoline | 1,534,806 | 1,085,311 | 449,495 | 41.4% |
| Installation | 972,146 | 448,900 | 523,246 | 116.6% |
| Auto conversion | 364,352 | 401,587 | (37,235) | (9.3%) |
| Total | \$ 10,407,492 | \$ 8,908,833 | \$ 1,498,659 | 16.8% |

Overall. Our cost of revenue consists of the cost of natural gas and gasoline sold, installation and other costs. Cost of natural gas and gasoline sold consists of the cost for purchase from our suppliers. Cost of installation and other costs include certain expenditures for the connection of customers to our pipeline system, and the cost for converting gasoline-fueled vehicles into natural gas hybrid vehicles.

Our cost of revenue for the three months ended September 30, 2009 was \$10,407,492, an increase of \$1,498,659, or 16.8%, from \$8,908,833 for the three months ended September 30, 2008, while our revenue increased by 9.4% during the same period.

Natural Gas from Fueling Stations. Cost of revenue of our natural gas for our fueling stations increased by 8.2%, or \$536,894, to \$7,075,387 during the three months ended September 30, 2009, as compared to \$6,538,493 for the three months ended September 30, 2008, mainly due to increased coal bed methane procurement price in Henan Province from \$0.1466 (RMB 1.0) to \$0.1906 (RMB 1.3) in June 2009 reflecting enhanced coal bed methane demand brought by newly opened fueling stations in Henan Province.

Natural Gas from Pipelines. Cost of revenue of our natural gas sold through our pipelines increased by 6.0%, or \$26,259 to \$460,801 during the three months ended September 30, 2009, as compared to \$434,542 during the three months ended September 30, 2008, which was in line with the sales growth.

Gasoline. Cost of our gasoline revenue increased by 41.4%, to \$1,534,086 during the three months ended September 30, 2009, from \$1,085,311 for the three months ended September 30, 2008. The increase of cost of gasoline revenue was due to the increase in sales volume, and the effect of the increase of average unit cost from \$0.6361 (RMB 4.44) per liter during the three months ended September 30, 2008 to \$0.6523 (RMB 4.45) per liter during the three months ended September 30, 2009 due to the increasing price of the international fuel market.

Installation Services. Cost of revenue from our installation services increased by 116.6%, or \$523,246, to \$972,146 during the three months ended September 30, 2009, as compared to \$448,900 during the three months ended September 30, 2008, as a result of the increase of pipeline customers.

Auto Conversion Services. Cost of our auto conversion revenue decreased by 9.3%, or \$37,235, to \$364,352 during the three months ended September 30, 2009, as compared to \$401,587 during the three months ended September 30, 2008.

Gross profit

The following table sets forth a breakdown of our gross profit for the periods indicated:

| | September 30, 2009 | September 30, 2008 | Increase in dollar amount | Increase in percentage |
|-----------------------------------|-----------------------|-----------------------|------------------------------|---------------------------|
| Natural gas from fueling stations | \$ 7,714,537 | \$ 8,218,436 | \$ (503,899) | -6.1% |
| Natural gas from pipelines | 203,661 | 162,990 | 40,671 | 25.0% |
| Gasoline | 98,672 | 102,443 | (3,771) | -3.7% |
| Installation | 1,443,404 | 748,151 | 695,253 | 92.9% |
| Auto conversion | 257,418 | 260,347 | (2,929) | -1.1% |
| Total | \$ 9,717,692 | \$ 9,492,367 | \$ 225,325 | 2.4% |

We earned a gross profit of \$9,717,692 for the three months ended September 30, 2009, an increase of \$225,325 or 2.4%, compared to \$9,492,367 for the three months ended September 30, 2008. In summary, gross profit increase was mainly due to the increased sales volume of pipeline natural gas with stable unit price and cost; and the increased installation revenue from new pipeline customers.

Gross margin

Gross margin for natural gas sold through our fueling stations decreased from 55.7% in the three months ended September 30, 2008 to 52.2% in the three months ended September 30, 2009 due to increased coal bed methane procurement price in Henan Province from RMB 1.0 to RMB 1.3 in June 2009 reflecting enhanced coal bed methane demand brought by newly opened fueling stations in Henan Province.

Gross margin for natural gas sold through pipelines was 30.7% during the three months ended September 30, 2009, and increased slightly as compared to 27.3% during the three months ended September 30, 2008.

Gross margin for gasoline sales decreased from 8.6% during the three months ended September 30, 2008 to 6.0% during the three months ended September 30, 2009, due to the decrease of gasoline retail price and increase of gasoline purchase cost.

Gross margin for our installation business decreased to 59.8% in the three months ended September 30, 2009 from 62.5% in the three months ended September 30, 2008 due to increase of material costs.

Gross margin for our auto conversion business increased from 39.3% in the three months ended September 30, 2008 to 41.4% in the three months ended September 30, 2009 due to improved efficiency. Due to higher coal bed methane procurement cost, our total gross margin decreased from 51.6% for the three months ended September 30, 2008 to 48.3% for the three months ended September 30, 2009.

Operating expenses

We incurred operating expenses of \$3,828,762 for the three months ended September 30, 2009, an increase of \$762,250 or 24.9%, compared to \$3,066,512 for the three months ended September 30, 2008. Sales and marketing costs increased 14.7 % from \$2,098,343 for the three months ended September 30, 2008 to \$2,406,462 for the three months ended September 30, 2009, primarily due to the \$200,190 increase in depreciation expense and \$101,678 increase in leasing expense, as well as \$83,997 and \$42,286 increase in utility and marketing expense, respectively, mainly related to the acquisition of Lingbao Natural Gas, Co. in October 2008 as well as the addition of 3 new fueling stations added since the third quarter of 2008. In addition, we also increased our efforts to obtain new residential and commercial customers and attract customers to our fueling stations. General and administrative expenses increased 46.9% from \$968,169 for the three months ended September 30, 2008 to \$1,422,300 for the three months ended September 30, 2009 mainly due to increase of \$252,485 in depreciation expense, and \$130,181 in legal expense, as well as \$59,948 in travel expense,. The transportation cost per million cubic meters of natural gas during the three months ended September 30, 2009 was approximately \$2,669.

Income from Operations and Operating Margin

For the foregoing reasons, income from operations decreased by \$536,925, or 8.4%, to \$5,888,930 for the three months ended September 30, 2009, from \$6,425,855 for the three months ended September 30, 2008. Our operating margin for the three months ended September 30, 2009 was 29.3%, compared to 34.9% for the three months ended September 30, 2008.

Non-Operating Income (Expense)

Our non-operating expense decreased by \$14,499, or 5.7%, to \$240,130 for the three months ended September 30, 2009, from \$254,629 for the three months ended September 30, 2008, primarily due to the reversal of excessive interest expense of \$293,453 previously recognized as penalty interest due to delayed Nasdaq listing pursuant to the indenture with Abax Lotus, Ltd.

Provision for Income Tax

Income tax was \$1,001,281 for the three months ended September 30, 2009, as compared to \$1,034,636 for the three months ended September 30, 2008.

Net Income

Based on the foregoing, net income decreased to \$4,647,519 for the three months ended September 30, 2009, a decrease of \$489,071, or 9.5%, from \$5,136,590 for the three months ended September 30, 2008. Net margin decreased from 27.9% during the three months ended September 30, 2008 to 23.1% during the three months ended September 30, 2009. The reduced net margin reflects increased coal bed methane procurement price as well as increase in operating expenses.

Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008

The following table represents the consolidated operating results for the nine month period ended September 30, 2009 and 2008:

Sales Revenues

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

The following table sets forth a breakdown of our revenues for the period indicated:

| | September 30, 2009 | September 30, 2008 | Increase in dollar Amount | Increase in percentage |
|-----------------------------------|-----------------------|-----------------------|------------------------------|---------------------------|
| Natural gas from fueling stations | \$ 44,099,167 | \$ 38,697,495 | \$ 5,401,672 | 14.0% |
| Natural gas from pipelines | 2,041,717 | 1,797,151 | 244,566 | 13.6% |
| Gasoline | 4,440,892 | 3,466,601 | 974,291 | 28.1% |
| Installation | 7,019,593 | 3,549,621 | 3,469,972 | 97.8% |
| Auto conversion | 1,794,001 | 1,806,492 | (12,491) | -0.7% |
| Total | \$ 59,395,370 | \$ 49,317,360 | \$ 10,078,010 | 20.4% |

Overall. Total revenue for the nine months ended September 30, 2009 increased to \$59,395,370 from \$49,317,360 for the nine months ended September 30, 2008, an increase of \$10,078,010 or 20.4%. This increase was mainly due to the addition of 10 new fueling stations added since the first quarter of 2008, and an increase in the number of residential and commercial pipeline customers to 118,973 as of September 30, 2009 from 92,984 as of September 30, 2008. We sold natural gas of 129,583,633 cubic meters during the nine months ended September 30, 2009, compared to 115,303,300 cubic meters during the nine months ended September 30, 2008. For the nine months ended September 30, 2009, 85.2% of our revenue was generated from the sale of natural gas and gasoline, and the other 14.8% was generated from our installation and auto conversion services.

Natural Gas from Fueling Stations. Natural gas revenue from our fueling stations increased by 14.0% or \$5,401,672, to \$44,099,167 during the nine months ended September 30, 2009, from \$38,697,495 during the nine months ended September 30, 2008, and contributed to 74.2% of our total revenue, which was the largest among our four major business lines. The increase of natural gas revenue was mainly due to the increase of sales volume generated from our newly added fueling stations. During the nine months ended September 30, 2009, we sold compressed natural gas of 120,866,756 cubic meters, compared to 107,226,877 cubic meters during the nine months ended September 30, 2008 through our fueling stations. In terms of average station sales value and volume, in the nine months ended September 30, 2009, we sold approximately \$1,256,029 and 3,442,517 cubic meters of compressed natural gas per station, compared to approximately \$1,292,000 and 3,650,000 cubic meters in the nine months ended September 30, 2008. The reason for the decline in per station sales by 6% in quantity was due to the construction of main subway lines in Xi'an, which caused certain bus routes to deviate from our stations and the new competition in Henan Province. Unit selling price was relatively stable at \$0.37 (RMB 2.5).

Natural Gas from Pipelines. Natural gas revenue from our pipelines increased by 13.6%, or \$244,566, to \$2,041,717 during the nine months ended September 30, 2009, from \$1,797,151 during the nine months ended September 30, 2008, and contributed to 3.4 % of our total revenue. As of September 30, 2009, the Company had 118,973 pipeline customers, an increase of 25,989 customers comparing to as of September 30, 2008. We also sold 8,716,877 cubic meters of natural gas through our pipelines during the nine months ended September 30, 2009, compared to 8,076,422 cubic meters during the nine months ended September 30, 2008.

Gasoline. Revenue from gasoline sales increased by 28.1%, or \$974,291, to \$4,440,892 during the nine months ended September 30, 2009, from \$3,466,601 during the nine months ended September 30, 2008, and contributed 7.5% to our total revenue. The gasoline revenue increase was due to the sales volume increased 39.9% from 5,170,860 liters to 7,236,253 liters, offset by 10.5% decrease of unit sales price from \$0.6705 (RMB4.68) per liter in the nine months ended September 30, 2008 to RMB \$0.6142 (RMB 4.19) per liter in the nine months ended September 30, 2009, affected by the decrease of international oil price. The increased sales volume was due to our two stations, Xianning and Kaiyuan, began operation in September 30, 2008.

Installation Services. Revenue from installation services increased by 97.8%, or \$3,469,972, to \$ 7,019,593 during the nine months ended September 30, 2009, from \$3,549,621 during the nine months ended September 30, 2008, and contributed 11.8% to our total revenue. The increase of installation sales was mainly due to the increase of pipeline customers in the newly acquired subsidiary, Lingbao Natural Gas, Co., since January 2009. Installation services to our top four customers contributed to 12.2%, 8.7%, 7.3% and 6.9% of our installation revenue for the nine months ended September 30, 2009.

Auto Conversion Services. Revenue from our auto conversion division decreased by 0.7%, or \$12,491, to \$1,794,001 during the nine months ended September 30, 2009, from \$1,806,492 during the nine months ended September 30, 2008, and contributed 3.0% to our total revenue.

Cost of Revenue

The following table sets forth a breakdown of our cost of revenue for the periods indicated:

| | September 30, 2009 | September 30, 2008 | Increase / (Decrease) in dollar amount | Increase / (Decrease) in percentage |
|-----------------------------------|-----------------------|-----------------------|---|---|
| Natural gas from fueling stations | \$ 20,343,004 | \$ 19,078,470 | \$ 1,264,534 | 6.6% |
| Natural gas from pipelines | 1,430,631 | 1,291,308 | 139,323 | 10.8% |
| Gasoline | 4,194,615 | 3,208,326 | 986,289 | 30.7% |
| Installation | 2,734,125 | 1,389,067 | 1,345,058 | 96.8% |
| Auto conversion | 1,063,461 | 1,103,583 | (40,122) | -3.6% |
| Total | \$ 29,765,836 | \$ 26,070,754 | \$ 3,695,082 | 14.2% |

Overall. Our cost of revenue consists of the cost of natural gas and gasoline sold, installation and other costs. Cost of natural gas and gasoline sold consists of the cost for purchase from our suppliers. Cost of installation and other costs include certain expenditures for the connection of customers to our pipeline system, and the cost for converting gasoline-fueled vehicles into natural gas hybrid vehicles.

Our cost of revenue for the nine months ended September 30, 2009 was \$29,765,836, an increase of \$3,695,082, or 14.2%, from \$26,070,754 for the nine months ended September 30, 2008, while our revenue increased by 20.4 % during the same period.

Natural Gas from Fueling Stations. Cost of revenue of our natural gas for our fueling stations increased by 6.6%, or \$1,264,534, to \$20,343,004 during the nine months ended September 30, 2009, as compared to \$19,078,470 for the nine months ended September 30, 2008. The low growth rate for cost of natural gas for our fueling stations was primarily due to the low procurement price in coal bed methane we obtained from July 2008 to May 2009 in Henan province that reduced our unit cost from one of our major supplier by approximately 35%, from \$0.2221(RMB1.55) to \$0.1433(RMB1.00), offset by the increase of natural gas procurement price starting June 2009, from \$0.1466(RMB1.00) to \$0.1906(RMB1.30). Our overall average unit cost was reduced by 3.3% during the nine months ended September 30, 2009.

Natural Gas from Pipelines. Cost of revenue of our natural gas sold through our pipelines increased by 10.8%, or \$139,323 to \$1,430,631 during the nine months ended September 30, 2009, as compared to \$1,291,308 during the nine months ended September 30, 2008, which was in line with the sales growth.

Gasoline. Cost of our gasoline revenue increased by 30.7%, or \$986,289, to \$4,194,615 during the nine months ended September 30, 2009, from \$3,208,326 for the nine months ended September 30, 2008. The increase of cost of gasoline revenue was due to the increase in sales volume, offset by the effect of the decrease of average unit cost from \$0.6189 (RMB 4.32) per liter during the nine months ended September 30, 2008 to \$0.5790 (RMB 3.95) per liter during the nine months ended September 30, 2009 due to the decreasing price of the international fuel market.

Installation Services. Cost of revenue from our installation services increased by 96.8%, or \$1,345,058, to \$2,734,125 during the nine months ended September 30, 2009, as compared to \$1,389,067 during the nine months ended September 30, 2008, as a result of the increase of pipeline customers.

Auto Conversion Services. Cost of our auto conversion revenue decreased by 3.6%, or \$40,122, to \$1,063,461 during the nine months ended September 30, 2009, as compared to \$1,103,583 during the nine months ended September 30, 2008.

Gross profit

The following table sets forth a breakdown of our gross profit for the periods indicated:

| | September 30, 2009 | September 30, 2008 | Increase in dollar amount | Increase in percentage |
|-----------------------------------|-----------------------|-----------------------|------------------------------|---------------------------|
| Natural gas from fueling stations | \$ 23,756,163 | \$ 19,619,025 | \$ 4,137,138 | 21.1% |
| Natural gas from pipelines | 611,086 | 505,843 | 105,243 | 20.8% |
| Gasoline | 246,277 | 258,275 | (11,998) | -4.6% |
| Installation | 4,285,468 | 2,160,554 | 2,124,914 | 98.4% |

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

| | | | | |
|-----------------|---------------|---------------|--------------|-------|
| Auto conversion | 730,540 | 702,909 | 27,631 | 3.9% |
| Total | \$ 29,629,534 | \$ 23,246,606 | \$ 6,382,928 | 27.5% |

27

We earned a gross profit of \$29,629,534 for the nine months ended September 30, 2009, an increase of \$6,382,928 or 27.5%, compared to \$23,246,606 for the nine months ended September 30, 2008. In summary, gross profit increase was mainly due to the increased sales volume of natural gas from fueling stations with low procurement price in coal bed methane from July 2008 to May 2009 in Henan; the increased sales volume of pipeline natural gas with stable unit price and cost; and the increased installation revenue from new pipeline customers.

Gross margin

Gross margin for natural gas sold through our fueling stations increased from 50.7% in the nine months ended September 30, 2008 to 53.9% in the nine months ended September 30, 2009, due to lower coal bed methane procurement cost in Henan Province.

Gross margin for natural gas sold through pipelines was 29.9% during the nine months ended September 30, 2009, and increased slightly as compared to 28.2% during the nine months ended September 30, 2008.

Gross margin for gasoline sales decreased from 7.5% during the nine months ended September 30, 2008 to 5.6% during the nine months ended September 30, 2009, due to the decrease of gasoline retail price exceeded the decrease of gasoline purchase cost.

Gross margin for our installation and auto conversion businesses were 61.1% and 40.7% during the nine months ended September 30, 2009, respectively, and remained flat compared to 60.9% and 38.9% during the nine months ended September 30, 2008. Due to the low procurement price in coal bed methane from July 2008 to May 2009 in Henan, our total gross margin increased from 47.1% for the nine months ended September 30, 2008 to 49.9% for the nine months ended September 30, 2009.

Operating expenses

We incurred operating expenses of \$11,349,049 for the nine months ended September 30, 2009, an increase of \$3,392,924 or 42.6%, compared to \$7,956,125 for the nine months ended September 30, 2008. Sales and marketing costs increased 41.0% from \$5,008,631 for the nine months ended September 30, 2008 to \$7,062,429 for the nine months ended September 30, 2009, primarily due to the \$1,061,006 increase in depreciation expense as well as \$537,884 and \$304,085 increase in leasing and utility expense, respectively, mainly related to the acquisition of Lingbao Natural Gas, Co. in October 2008 as well as the addition of 10 new fueling stations added since the first quarter of 2008. In addition, we also increased our efforts to obtain new residential and commercial customers and attract customers to our fueling stations. General and administrative expenses increased 45.4% from \$2,947,494 for the nine months ended September 30, 2008 to \$4,286,620 for the nine months ended September 30, 2009 mainly due to increase of \$813,701 in depreciation expense and \$276,832 increase in salary expense primarily reflecting the growth of employees, the recruiting of qualified Chief Financial Officer as well as adjustment of compensation for our Chief Executive Officer to market rate. The transportation cost per million cubic meters of natural gas during the nine months ended September 30, 2009 was approximately \$2,536.

Income from Operations and Operating Margin

For the foregoing reasons, income from operations increased by \$2,990,004, or 19.6%, to \$18,280,485 for the nine months ended September 30, 2009, from \$15,290,481 for the nine months ended September 30, 2008. Our operating margin for the nine months ended September 30, 2009 was 30.8%, compared to 31.00% for the nine months ended September 30, 2008.

Non-Operating Income (Expense)

Our non-operating expense increased by \$1,135,713, or 91.0%, to \$2,383,367 for the nine months ended September 30, 2009, from \$1,247,654 for the nine months ended September 30, 2008, primarily due to the recognition of \$1,473,762 non-operating expense related to change in fair value of the Company's outstanding warrants.

Provision for Income Tax

Income tax was \$3,185,220 for the nine months ended September 30, 2009, as compared to \$2,584,774 for the nine months ended September 30, 2008 which is in line with the sales growth.

Net Income

Based on the foregoing, net income increased to \$12,711,898 for the nine months ended September 30, 2009, an increase of \$1,253,845, or 10.9%, from \$11,458,053 for the nine months ended September 30, 2008. Net margin decreased from 23.2% during the nine months ended September 30, 2008 to 21.4% during the nine months ended September 30, 2009. The reduced net margin reflects the non-operating expenses related to fair value change of the Company's outstanding warrants.

LIQUIDITY AND CAPITAL RESOURCES

Historically, our primary sources of liquidity have consisted of cash generated from our operations and debt financing. In 2008, we sold senior notes with a face value of \$40 million to Abax Lotus Ltd. Our principal uses of cash have been, and are expected to continue to be, for operational purposes as well as for constructing our LNG plant.

As of September 30, 2009, the Company had \$55,931,579 of cash and cash equivalents on hand compared to \$5,854,383 of cash and cash equivalents as of December 31, 2008. The increase was primarily attributable to the underwritten public offering in September 2009, the net proceeds of which is approximately \$54.4 million.

Net cash provided by operating activities was \$18,262,387 for the nine months ended September 30, 2009 compared to net cash provided by operations of \$12,711,311 for the nine months ended September 30, 2008. The primary reason for the change was due to the increase in net income, adjusted for non-cash expenses items of \$6,201,171 and change in working capital of \$651,682.

Net cash used in investing activities decreased from \$44,611,535 during the nine months ended September 30, 2008 to \$22,578,879 for the same period in 2009 primarily because of prepayment to equipment suppliers and construction of the LNG plant, and construction addition of fueling stations during the nine months ended September 30, 2008. For the nine months ended September 30, 2009, major cash outflow were primarily to our construction in progress for the LNG Plant.

We had net cash of \$54,370,361 provided by financing activities for the nine months ended September 30, 2009, due to the secondary public offering, compared to net cash provided by financing activities of \$37,877,491 during the nine months ended September 30, 2008.

The Company paid \$18,064,065 to the LNG processing plant as a prepayment on equipment as well as addition to construction in progress during the nine months ended September 30, 2009.

Based on past performance and current expectations, we believe our cash and cash equivalents, cash generated from operations, as well as future possible cash from financing activities, will satisfy our working capital needs, capital expenditures and other liquidity requirements associated with our operations.

The majority of our revenues and expenses were denominated primarily in RMB, the currency of the People's Republic of China. There is no assurance that exchange rates between the RMB and the USD will remain stable. Inflation has not had a material impact on our business.

OFF-BALANCE SHEET ARRANGEMENTS

None.

CAPITAL EXPENDITURES

Our planned capital expenditures as of September 30, 2009 were \$59 million, which we expect to be incurred in connection with the construction of our LNG facility joint-venture cooperation with CNPC Kunlun and the acquisition of additional fueling stations. We planned to invest approximately \$45 million to construct this facility but are anticipating now that the total investment increase to approximately \$49 million primarily attributed to significant increase in material and labor costs incurred due to additional engineering reinforcement needs to ensure project safety, excluding \$2.7 million additional payment of land use right for phase I, phase II and phase III because soaring local land price due to recent energy resource explorations as well as the cost of \$4.5 million to purchase an additional

8.3 acres of land use right for the Yulin government's construction of an electricity substation, phase II and phase III of the LNG plant.

Phase I of the LNG plant is under construction and is expected to be completed by May 2010, later than originally planned because of delays mainly due to macro tariff exemption changes and additional document requirements at Shaanxi Province customs; engineering reinforcement of plant basis; ocean shipment route changes to avoid pirates in Somali area.

CONTRACTUAL OBLIGATIONS

Our contractual obligations are as follows:

| Contractual obligations | Total | Less than 1 year | Payments due by period | | |
|--|---------------|---------------------|------------------------|---------------|----------------------|
| | | | 1-3 Years | 3-5 years | More than 5 years |
| | | | (in thousands) | | |
| Long-Term Debt Obligations | 40,000 | - | 13,333 | 26,667 | \$ - |
| Other Long-Term Liabilities Reflected on Company's Balance Sheet | 17,500 | - | - | - | 17,500(1) |
| Total | 57,500 | - | 13,333 | 26,667 | \$ 17,500 |

Note:

(1) The \$17,500,000 reflects derivative liability related to the embedded put option in the 1,450,000 warrants we issued to Abax in January 2008. If Abax does not exercise the warrants by January 29, 2015, Abax will be entitled to require that we purchase the warrants for \$17,500,000 at that time.

COMMITMENTS AND CONTINGENCIES

Lease Commitments

We recognize lease expense on a straight-line basis over the term of the lease in accordance to FAS 13, "Accounting for leases." We entered into series of long-term lease agreements with outside parties to lease land use right to the self-built natural gas fueling stations located in the PRC. The agreements have terms ranging from 10 to 30 years. We make annual prepayment for most lease agreements. We also entered into two office leases in Xian, PRC and New York, NY. The minimum future payment for leasing land use rights and offices is as follows:

| | |
|-------------------------------|----------------------|
| Year ending December 31, 2009 | \$ 86,758 |
| Year ending December 31, 2010 | 1,458,518 |
| Year ending December 31, 2011 | 1,577,171 |
| Year ending December 31, 2012 | 1,391,916 |
| Year ending December 31, 2013 | 1,280,490 |
| Thereafter | 21,923,923 |
| Total | \$ 27,718,776 |

For the three months ended September 30, 2009 and 2008, the land use right and office lease expenses were \$411,452 and \$256,876, respectively. For the nine months ended September 30, 2009 and 2008, the land use right and office lease expenses were \$1,209,549 and \$630,821 respectively.

Property and Equipment

On January 25, 2008, we entered into a contract with Chemtex International Inc. ("Chemtex") to acquire certain exclusive rights relating to the technical know-how and designing of our LNG plant and LNG storage tank in Jingbian county, Shaanxi province, China, in the total amount of \$9,500,000. On April 13, 2008, our subsidiary, XXNGC, entered into a contract with Chemtex to purchase equipment supply for the LNG plant and LNG storage tank in the total amount of \$13,700,000 (the "Chemtex Purchase Agreement"). The \$13,700,000 purchase price was reduced to

\$13,100,000 under an amendment to the Chemtex Purchase Agreement with Chemtex in September 2008. On May 16, 2008, SJLNG entered into an agreement with Hebei Tongchan Import and Export Co. Ltd. ("Hebei") and agreed that Hebei will act as the trade agency for SJLNG. On June 18, 2008, XXNGC amended the April 13, 2008 with Chemtex and assigned Hebei to purchase the LNG equipment for the LNG plant and LNG storage tank and Hebei succeeded the rights and obligations of XXNGC under Chemtex Purchase Agreement.

As of September 30, 2009, we advanced \$6,140,000 to Hebei and the future commitment for equipment is \$6,960,000.

Natural Gas Purchase Commitments

We have certain effective natural gas purchase agreements with our major suppliers. The natural gas purchase agreement with Shaanxi Provincial Natural Gas Co., Ltd. has been renewed annually to date and specifies a maximum amount that can be purchased but does not specify a minimum amount that must be purchased. Our natural gas purchase agreements with certain suppliers of coal-bed methane are of indefinite terms and do not contain either maximum or minimum amounts of purchase. Without minimum purchase requirements under any of our natural gas purchase agreements, we have the flexibility to constantly look for lower-cost sources of supply.

Capital Commitments

In July 2009, the Company, through its variable interest entity, Xi'an Xilan Natural Gas Co., Ltd. ("Xi'an Xilan"), has entered into a joint venture agreement with China National Petroleum Corporation Kunlun Natural Gas Co., Ltd. and a Joint Venture Company will be established. The Joint Venture Company will have an initial registered capital of RMB50,000,000 (approximately \$7,350,000) and Xi'an Xilan has a capital commitment of RMB24,500,000, representing 49% of the Joint Venture Company's total registered capital. As of September 30, 2009, Xi'an Xilan has not yet made any capital contribution.

Legal Proceedings

A former member of the board of directors filed a lawsuit on June 16, 2008 against the Company in New York State Supreme Court, Nassau County, in which he has sought, among other things, to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an option agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, we believe that any liability we would incur will not have a materially adverse effect on our financial condition or our results of operations.

FOREIGN CURRENCY TRANSLATIONS

As of September 30, 2009 and December 31, 2008, our accounts were maintained, and our consolidated financial statements were expressed in RMB. Such consolidated financial statements were translated into USD with the RMB as the functional currency. All assets and liabilities were translated at the exchange rate as of the balance sheet date, stockholders' equity were translated at the historical rates and statement of income and cash flow items were translated at the weighted average exchange rate for the year. The resulting translation adjustments are reported under other comprehensive income. Cash flows from the Company's operations is calculated based upon the local currencies and translated to USD at average translation rates for the period. As a result, translation adjustments amounts related to assets and liabilities reported on the consolidated statement of cash flows will not necessarily agree with changes in the corresponding consolidated balances on the balance sheet.

The balance sheet amounts with the exception of equity at September 30, 2009 were translated RMB6.82 to \$1.00 as compared to RMB6.82 at December 31, 2008. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the nine months ended September 30, 2009 and 2008, were RMB 6.82 and RMB 6.98 to \$1.00, respectively.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial position and results of operations contained in this Quarterly Report on Form 10-Q is based on our condensed consolidated unaudited financial statements, contained elsewhere herein. The preparation of these financial statements in conformity with GAAP requires that we make estimates. There have been no material changes in the development of our accounting estimates or the assumptions underlying those estimates, or the accounting policies that we disclosed as our Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2008.

Revenue Recognition

Revenue is recognized when services are rendered to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are satisfied are recorded as unearned revenue. Revenue from gas and gasoline sales is recognized when gas and gasoline is pumped through pipelines to the end users. Revenue from installation of pipelines is recorded when the contract is completed and accepted by the customers. The construction contracts are usually completed within one to two months. Revenue from repairing and modifying vehicles is recorded when service are rendered to and accepted by the customers.

Accounts Receivables

Accounts and other receivables are recorded at net realizable value consisting of the carrying amount less an allowance for uncollectible accounts, as needed. The Company allowance for uncollectible accounts is not significant.

We maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Reserves are recorded primarily on a specific identification basis. Our management determined that all receivables are good and there is no need for a bad debt reserve as of September 30, 2009.

Other Receivable – Employee Advances

From time to time, we advance predetermined amounts based upon internal Company policy to certain employees and internal units to ensure certain transactions to be performed in a timely manner. We have full oversight and control over the advanced accounts. Therefore, no allowance for the uncollectible accounts is needed.

Inventory

Inventory is stated at the lower of cost, as determined on a first-in, first-out basis, or market. Management compares the cost of inventories with the market value, and allowance is made for writing down the inventories to their market value, if lower. Inventory consists of material used in the installation of pipelines and material used in repairing and modifying of vehicles. Inventory also consists of gasoline.

Fair Value of Financial Instruments

The accounting standards regarding fair value of financial instruments and related fair value measurements defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosure requirements for fair value measures. The carrying amounts reported in the consolidated balance sheets for current receivables and payables qualify as financial instruments. Management concluded the carrying values are a reasonable estimate of fair value because of the short period of time between the origination of such instruments and their expected realization and if applicable, their stated interest rate approximates current rates available. The three levels are defined as follows:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. Depending on the product and the terms of the transaction, the fair value of our notes payable and derivative liabilities were modeled using a series of techniques, including closed-form analytic formula, such as the Black-Scholes option-pricing model, which does not entail material subjectivity because the methodology employed does not necessitate significant judgment, and the pricing inputs are observed from actively quoted markets.

FASB accounting standard regarding derivatives and hedging specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. This FASB accounting standard also provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the exception.

Unearned Revenue

Unearned revenue represents prepayments by customers for gas purchases and advance payments on installation of pipeline contracts. We record such prepayment as unearned revenue when the payments are received.

RECENT ACCOUNTING PRONOUNCEMENTS

See “Note 2. Summary of Significant Accounting Policies” in “Item 1. Financial Statements” herein for a discussion of the new accounting pronouncements adopted in this Quarterly Report on Form 10-Q.

In January 2009, the FASB’s accounting standard regarding other investments providing additional guidance which amended the impairment model to remove the exclusive reliance on “market participant” estimates of future cash flows used in determining fair value. Changing the cash flows used to analyze other-than-temporary impairment from the “market participant” view to a holder’s estimate of whether there has been a “probable” adverse change in estimated cash flows allows companies to apply reasonable judgment in assessing whether an other-than-temporary impairment has occurred. The adoption of this guidance did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the FASB’s accounting standard regarding fair value measurements and disclosures providing additional guidance for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased and also includes guidance on identifying circumstances that indicate a transaction is not orderly for fair value measurements. This guidance shall be applied prospectively with retrospective application not permitted. The adoption of this guidance did not have a material impact on the Company’s consolidated financial statements.

In April 2009, the FASB's accounting standard regarding debt and equity securities requires to make the other-than-temporary impairments guidance more operational and to improve the presentation of other-than-temporary impairments in the financial statements. This guidance will replace the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired debt security until recovery with a requirement that management assert it does not have the intent to sell the security, and it is more likely than not it will not have to sell the security before recovery of its cost basis. This guidance provides increased disclosure about the credit and noncredit components of impaired debt securities that are not expected to be sold and also requires increased and more frequent disclosures regarding expected cash flows, credit losses, and an aging of securities with unrealized losses. Although this guidance does not result in a change in the carrying amount of debt securities, it does require that the portion of an other-than-temporary impairment not related to a credit loss for a held-to-maturity security be recognized in a new category of other comprehensive income and be amortized over the remaining life of the debt security as an increase in the carrying value of the security. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In April 2009 In April 2009, the FASB issued an accounting standard that requires disclosures about fair value of financial instruments not measured on the balance sheet at fair value in interim financial statements as well as in annual financial statements. Prior to this guidance, fair values for these assets and liabilities were only disclosed annually. This guidance applies to all financial instruments and requires all entities to disclose the method(s) and significant assumptions used to estimate the fair value of financial instruments. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

In May 2009, the FASB updated an accounting standard regarding subsequent events providing guidance to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This accounting standard requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected. The Company adopted this Standard during the second quarter of 2009. This guidance requires that public entities evaluate subsequent events through the date that the financial statements are issued. The Company has evaluated subsequent events through the time of filing these consolidated financial statements with the SEC on November 9, 2009.

In June 2009, the FASB issued an accounting standard amending the accounting and disclosure requirements for transfers of financial assets. This guidance is effective for the Company beginning in 2010. Should the Company's accounts receivable securitization programs not qualify for sale treatment under the revised rules, future securitization transactions entered into on or after January 1, 2010 would be classified as debt and the related cash flows would be reflected as a financing activity. The Company is currently assessing the impact of the standard on its securitization programs.

In June 2009, the FASB updated an accounting standard regarding consolidation guidance which modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. This guidance clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. This guidance also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. This guidance is effective for fiscal years beginning after November 15, 2009. The Company is currently assessing the impact of the standard on its securitization programs.

In August 2009, the FASB issued an Accounting Standards Update ("ASU") regarding measuring liabilities at fair value. This ASU provides additional guidance clarifying the measurement of liabilities at fair value in circumstances in which a quoted price in an active market for the identical liability is not available; under those circumstances, a

reporting entity is required to measure fair value using one or more of valuation techniques, as defined. This ASU is effective for the first reporting period, including interim periods, beginning after the issuance of this ASU. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

In October 2009, the FASB issued an ASU regarding accounting for own-share lending arrangements in contemplation of convertible debt issuance or other financing. This ASU requires that at the date of issuance of the shares in a share-lending arrangement entered into in contemplation of a convertible debt offering or other financing, the shares issued shall be measured at fair value and be recognized as an issuance cost, with an offset to additional paid-in capital. Further, loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs, at which time the loaned shares would be included in the basic and diluted earnings-per-share calculation. This ASU is effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Natural Gas Price Risk

Our major market risk exposure continues to be the pricing applicable to our purchases and value-added reselling of CNG. Our revenues and profitability depend substantially upon the applicable prices of natural gas, which in China are regulated and fixed by central and local governments and doesn't fluctuate much at all. Such a price involatility situation is expected to continue for operations in China. We currently don't have any hedge positions in place to reduce our exposure to changes in natural gas whole sale and retail prices.

Interest Rate Risk

We are subject to interest rate risk on our long-term fixed-interest rate debt. Fixed rate debt, where the interest rate is fixed over the life of the instrument, exposes us to changes in market interest rates reflected in the fair value of the debt and to the risk that we may need to refinance maturing debt with new debt at a higher rate. All other things being equal, the fair value of our fixed rate debt will increase or decrease as interest rates change. We had long-term debt outstanding of \$40 million at September 30, 2009, all of which bears interest at fixed rates. The \$40 million of fixed-rate debt is due on 2014. We currently have no interest rate hedge positions in place to reduce our exposure to changes in interest rates.

Foreign Currency Exchange Rates Risk

We operate in China local currency and the effects of foreign currency fluctuations are largely mitigated because local expenses in China are also denominated in the same currency.

Our assets and liabilities of which the functional currency is the China local currency are translated into U.S. dollars using the exchange rates in effect at the balance sheet date, resulting in translation adjustments that are reflected as Cumulative Translation Adjustment in the shareholders' equity section on our Consolidated Balance Sheets. A portion of our net assets are impacted by changes in foreign currencies in relation to the U.S. dollar. We recorded a \$195,040 adjustment to decrease our equity account for the quarter ended September 30, 2009 to reflect the net impact of the fluctuating of Chinese currency against the U.S. dollar.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company's management has evaluated, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operations of the Company's disclosure controls and procedures, as of the end of the period covered by this quarterly report. Based on this evaluation, management concluded that, due to the identification of a material weakness in relation to inadequate US GAAP expertise, as disclosed in our Annual Report on Form 10-K for the year ended December 31, 2008, as amended, and the fact that the company is still in the process of remediating such material weakness, as of September 30, 2009, the Company's disclosure controls and procedures remained ineffective.

Changes in internal control over financial reporting

There have been no changes in our internal control over financial reporting during the most recently completed fiscal quarter that have materially affected or are reasonably likely to materially affect, our internal control over financial reporting. From the second quarter of 2009, the Company has started to independently completing the consolidation of

its financial statements in accordance with U.S. GAAP through recruiting of U.S. GAAP proficient accounting personnel. We are also allocating additional resources to train our existing accounting staff and will continue this effort in the future. Most of the policies, procedures and practices are already in place and being implemented. These initiatives include the following:

- Identifying and hiring additional personnel with U.S. GAAP and SEC reporting experience, including our new CFO Veronica Jing Chen and one ACCA (Association of Chartered Certified Accountants) affiliate, and starting to independently completing the U.S. GAAP based reporting in the second quarter of 2009;
 - Recruiting of additional qualified accounting personnel to form a competent SEC reporting team;
 - Hiring outside consultant to provide training to our finance personnel;
- Based on COSO framework, developing the scope of the Company's internal control system and enhancing the internal control function by establishing the Company's internal audit team containing one corporate control director and two full time employees;
- Introducing and implementing policies and procedures to effectively control daily cash transactions and recording;

The resulting changes in our internal control over financial reporting were evaluated and determined to not have materially affected our control structure for the quarter ended September 30, 2009.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

A former member of the board of directors filed a lawsuit against the Company in New York State Supreme Court, Nassau County, in which he has sought, among other things; to recover a portion of his monthly compensation plus 20,000 options that he alleges are due to him pursuant to a written agreement. After the plaintiff rejected an offer by the Company that included the options that plaintiff alleged were due to him, the Company moved to dismiss the complaint. The judge ordered the Company to issue the 20,000 options to the plaintiff subject to any restrictions required by applicable securities laws, which was essentially what the Company had previously offered, and dismissed all of the plaintiff's remaining claims against the Company. The current board of directors has complied with the court's decision by tendering an options agreement to the plaintiff consistent with the court's decision, but the plaintiff has refused to execute the agreement, and instead has filed an appeal. Regardless of the outcome of the appeal, the Company believes that any liability it would incur will not have a materially adverse effect on its financial condition or its results of operations.

Item 1A. Risk Factors

As of the date of this filing, there have been no material changes from the risk factors disclosed in the Company's Annual Report on Form 10-K/A filed on July 20, 2009. We operate in a changing environment that involves numerous known and unknown risks and uncertainties that could materially affect our operations. The risks, uncertainties and other factors set forth in our Annual Report on Form 10-K/A may cause our actual results, performances and achievements to be materially different from those expressed or implied by our forward-looking statements. If any of these risks or events occur, our business, financial condition or results of operations may be adversely affected.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None

Item 6. Exhibits

(a) Exhibits

| Exhibit Number | Description of Exhibit |
|----------------|------------------------|
|----------------|------------------------|

| | |
|-------|--|
| 31.1* | Certification of Principal Executive Officer pursuant to Rule 13a-14 and Rule 15d-14(a), promulgated under the Securities and Exchange Act of 1934, as amended |
|-------|--|

Edgar Filing: China Natural Gas, Inc. - Form 10-Q

- 31.2* Certification of Principal Financial Officer pursuant to Rule 13a-14 and Rule 15d 14(a), promulgated under the Securities and Exchange Act of 1934, as amended
- 32.1* Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 32.2* Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)

*Filed herewith

SIGNATURES

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

China Natural Gas, Inc.

November 9, 2009

By: /s/ Qinan Ji

Qinan Ji
Chief Executive Officer
(Principal Executive Officer)

November 9, 2009

By: /s/ Veronica Chen

Veronica Chen
Chief Financial Officer
(Principal Financial and Accounting Officer)