

China Natural Gas, Inc.  
Form 10-Q/A  
October 01, 2010

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q/A  
(Amendment No. 2)

(Mark One)

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

For the quarterly period ended March 31, 2010

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)

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(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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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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 May 6, 2010: 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

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### EXPLANATORY NOTE

This Amendment No. 2 on Form 10-Q/A (the "Amended Filing") amends Amendment No. 1 to the Quarterly Report of China Natural Gas, Inc. (the "Company") (as amended, the "Amended 10-Q"), which in turn had amended the Quarterly Report on Form 10-Q for the quarter ended March 31, 2010, originally filed on May 7, 2010 (the "Original Filing").

As previously disclosed in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, in February 2010, the Company obtained a bank loan in the amount of \$17.7 million (the "Loan") and, in connection with the Loan, Xi'an Xilan Natural Gas Co. Ltd., the Company's variable interest entity, pledged its equipment and vehicles located within China to secure the Loan (the "Pledge") and guaranteed the repayment of the Loan (the "Guarantee").

By August 8, 2010, the Company's former outside counsel determined that the Pledge was prohibited by the indenture (the "Indenture") for the Company's 5% guaranteed senior note issued to Abax Lotus Ltd. ("Abax") dated January 29, 2008 (the "Senior Notes"). As a result, the Company believed that Abax had the right to declare a default under the Indenture and could thereafter accelerate the Senior Notes, which would cause a simultaneous default under the warrant agreement governing the Company's warrants issued in connection with the Senior Notes, thereby entitling the warrant holders to require the Company to redeem their warrants. In view of the potential default under the Indenture and warrant agreement, the Board, in consultation with management and the Audit Committee, determined that the Company was required to restate its annual financial statements for the year ended December 31, 2009 and the quarter ended March 31, 2010 to reclassify from long term liabilities to short term liabilities the Senior Notes and the fair value of the redeemable warrants (the "Reclassification").

Therefore, the Company filed a Current Report on Form 8-K on August 19, 2010 to disclose that its financial statements contained in its Annual Report on Form 10-K for the year ended December 31, 2009 (the "Annual Report") and the Original Filing should not be relied upon, and, on August 20, 2010, the Company filed:

- Amendment No. 1 to the Annual Report (as amended, the "Amended 10-K") to (i) restate the financial statements contained therein to make the Reclassification and disclose as subsequent events the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture, (ii) make other amendments to the Annual Report to give effect to the foregoing and (iii) amend Part II, Item 9A, Controls and Procedures of the Annual Report; and
- the Amended 10-Q to (i) amend Part II, Item 4, Other Information, of the Original Filing to disclose the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture, (ii) restate the financial statements contained therein to make the Reclassification, record the Loan as a long term liability and record an increase in restricted cash as a result of obtaining the proceeds of the Loan; (iii) make other amendments to the Original Filing to give effect to the foregoing; (iv) amend Part I, Item 4, Controls and Procedures, of the Original Filing; and (v) file the Loan, the Pledge and the Guarantee as exhibits to the Amended 10-Q.

Also, in its Quarterly Report on Form 10-Q for the quarter ended June 30, 2010, the Company (i) recorded the Senior Notes and warrants, which were described as redeemable, as current liabilities in the financial statements contained therein; (ii) made other disclosures in such quarterly report to give effect to the foregoing; and (iii) disclosed in Part II, Item 4, Other Information, of such quarterly report the Loan, the Pledge and the Guarantee as well as the initial determination that the Pledge was not permitted under the Indenture.

Subsequent to restating its financial statements and filing the Amended 10-K and Amended 10-Q, management of the Company internally revisited the analysis of whether the Pledge was indeed prohibited by the Indenture and

determined that it was not. In late August 2010, the Company engaged the law firm DLA Piper, which had not previously advised the Company or management on these matters, to review the Company's analysis, and DLA Piper subsequently confirmed the Company's analysis. At the request of the Company's independent auditors, the Company engaged another law firm with no prior relationship to the Company to review the Company's analysis, and that law firm subsequently confirmed the Company's analysis. The Company engaged DLA Piper as its regular outside counsel for SEC reporting and other public company matters in early September 2010. The Board of Directors of the Company, in consultation with management and the Audit Committee, determined on September 15, 2010, that none the Loan, the Pledge or the Guarantee, individually or together, were prohibited by the Indenture.

The purpose of this Amended Filing is to reverse all disclosure in the Amended 10-Q related to the Reclassification and to further amend Part I, Item 4, Controls and Procedures. With respect to the former, the amendments herein include: (i) reversal of the reclassification of the Company's Senior Notes payable and the fair value of the redeemable warrants from current liabilities back to long term liabilities, (ii) removal of the statements indicating that the Pledge was not permitted under the Indenture, and (iii) other amendments to the Amended 10-Q to give effect to the foregoing. The Company is not restating the Amended 10-Q's restatement of long term liabilities and restricted cash on the Company's consolidated balance sheet as of March 31, 2010 or the restatement of financing activities in consolidated statements of cash flow for the three months ended March 31, 2010, which restatements were made to record the Loan as a long term liability and record an increase in restricted cash as a result of obtaining the proceeds of the Loan, and are described in the Amended 10-Q.

In accordance with Rule 12b-15 under the Exchange Act, each item of the Original Filing, as amended by the Amended 10-Q, that is amended by this Amended Filing is also restated in its entirety, and this Amended Filing is accompanied by currently dated certifications on Exhibits 31.1, 31.2, 32.1 and 32.2 by the Company's Chief Executive Officer and Chief Financial Officer. Except as described above, this Amended Filing does not amend, update, or change any items, financial statements, or other disclosures in the Original Filing, as amended by the Amended 10-Q, and does not reflect events occurring after the filing of the Original Filing, including as to any exhibits to the Original Filing, as amended by the Amended 10-Q, affected by subsequent events. Information not affected by the changes described above is unchanged and reflects the disclosures made at the time of the Original Filing, as amended by the Amended 10-Q. Accordingly, this Amended Filing should be read in conjunction with the Original Filing and our other SEC filings subsequent to the filing of the Original Filing, including the Amended 10-Q and any other amendments to those filings. Capitalized terms not defined in the Amended Filing are as defined by the Original Filing.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## CHINA NATURAL GAS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS  
AS OF MARCH 31, 2010 AND DECEMBER 31, 2009

	March 31, 2010 (Unaudited) (As Restated – See Note 2)	December, 31 2009
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash & cash equivalents	\$ 30,172,391	\$ 48,177,794
Restricted cash	13,203,000	-
Accounts receivable, net of allowance for doubtful accounts of \$196,138 and \$163,280 as of March 31, 2010 and December 31, 2009, respectively.	1,514,070	1,289,116
Other receivables	491,020	709,741
Other receivable - employee advances	190,045	338,689
Inventories	874,678	841,837
Advances to suppliers	1,302,568	596,868
Prepaid expense and other current assets	1,546,556	1,076,915
Loans receivable	14,259,240	293,400
Total current assets	63,553,568	53,324,360
INVESTMENT IN UNCONSOLIDATED JOINT VENTURES	1,467,000	1,467,000
PROPERTY AND EQUIPMENT, NET	75,603,216	72,713,012
CONSTRUCTION IN PROGRESS	57,102,317	52,918,236
DEFERRED FINANCING COSTS	1,234,540	1,336,998
OTHER ASSETS	16,937,089	15,854,910
<b>TOTAL ASSETS</b>	<b>\$ 215,897,730</b>	<b>\$ 197,614,516</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Accounts payable and accrued liabilities	\$ 1,970,228	\$ 2,081,261
Other payables	85,082	80,788
Unearned revenue	2,199,805	1,813,641
Accrued interest	200,509	786,052
Taxes payable	2,888,511	1,901,577
Total current liabilities	7,344,135	6,663,319
<b>LONG TERM LIABILITIES:</b>		
Notes payable, net of discount \$11,946,508 and \$12,707,713 as of March 31, 2010 and December 31, 2009, respectively	28,053,492	27,292,287

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Derivative liabilities - warrants	19,152,570	19,545,638
Long term debt	13,203,000	
Total long term liabilities	60,409,062	46,837,925
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY:</b>		
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 shares issued and outstanding at March 31, 2010 and December 31, 2009	2,118	2,118
Additional paid-in capital	79,926,097	79,851,251
Cumulative other comprehensive gain	8,675,165	8,714,019
Statutory reserves	6,425,074	5,962,695
Retained earnings	53,116,079	49,583,189
Total stockholders' equity	148,144,533	144,113,272
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 215,897,730</b>	<b>\$ 197,614,516</b>

CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME  
FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009  
(Unaudited)

	Three Months Ended March 31,	
	2010	2009
<b>Revenues</b>		
Natural gas revenue	\$ 15,483,629	\$ 14,965,819
Gasoline revenue	1,468,816	1,174,398
Installation and others	2,414,378	2,387,449
<b>Total revenues</b>	<b>19,366,823</b>	<b>18,527,666</b>
<b>Cost of revenues</b>		
Natural gas cost	7,864,654	6,746,929
Gasoline cost	1,367,278	1,130,057
Installation and others	1,039,923	1,017,028
<b>Total cost of revenues</b>	<b>10,271,855</b>	<b>8,894,014</b>
<b>Gross profit</b>	<b>9,094,968</b>	<b>9,633,652</b>
<b>Operating expenses</b>		
Selling expenses	2,891,790	2,580,825
General and administrative expenses	1,817,656	1,425,324
<b>Total operating expenses</b>	<b>4,709,446</b>	<b>4,006,149</b>
<b>Income from operations</b>	<b>4,385,522</b>	<b>5,627,503</b>
<b>Non-operating income (expense):</b>		
Interest income	89,366	8,908
Interest expense	-	(581,492)
Other income (expense), net	46,569	(2,303)
Change in fair value of warrants	393,068	197,051
Foreign currency exchange loss	(8,110)	(50,788)
<b>Total non-operating income (expense)</b>	<b>520,893</b>	<b>(428,624)</b>
<b>Income before income tax</b>	<b>4,906,415</b>	<b>5,198,879</b>
<b>Provision for income tax</b>	<b>911,145</b>	<b>997,256</b>
<b>Net income</b>	<b>3,995,270</b>	<b>4,201,623</b>
<b>Other comprehensive income</b>		
Foreign currency translation loss	(38,854)	(152,115)
<b>Comprehensive income</b>	<b>\$ 3,956,416</b>	<b>\$ 4,049,508</b>
<b>Weighted average shares outstanding</b>		
Basic	21,183,904	14,600,152



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Diluted	21,595,038	14,600,152
Earnings per share		
Basic	\$ 0.19	\$ 0.29
Diluted	\$ 0.19	\$ 0.29

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009  
(Unaudited)

	Three Months Ended March 31,	
	2010	2009
	(As Restated – See Note 2)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 3,995,270	\$ 4,201,623
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,472,595	1,389,565
Provision for bad debt	32,847	-
Amortization of discount on senior notes	-	170,712
Amortization of financing costs	-	38,578
Stock based compensation	74,847	14,842
Change in fair value of warrants	(393,068)	(197,051)
Change in assets and liabilities:		
Accounts receivable	(257,812)	(41,244)
Other receivable - employee advances	148,593	151,617
Inventories	(32,830)	30,812
Advances to suppliers	(705,460)	151,828
Prepaid expense and other current assets	(167,213)	(100,912)
Accounts payable and accrued liabilities	(111,007)	304,860
Other payables	4,296	212,961
Unearned revenue	386,032	195,435
Accrued interest	(585,543)	(330,003)
Taxes payable	986,599	44,898
Net cash provided by operating activities	4,848,146	6,238,521
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Loans to third parties	(14,259,140)	-
Repayment of loans receivable	293,300	-
Purchase of property and equipment	(253,844)	(13,484)
Additions to construction in progress	(7,425,192)	(2,552,098)
Prepayment on long term assets	(1,047,327)	(426,913)
Return of acquisition deposit	(124,653)	-
Payment for intangible assets	-	(35,822)
Payment for land use rights	4,722	-
Net cash used in investing activities	(22,812,134)	(3,028,317)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from long term loan	13,198,500	-
Increase in restricted cash	(13,198,500)	-
Net cash provided by financing activities	-	-
Effect of exchange rate changes on cash and cash equivalents	(41,415)	(6,226)

NET (DECREASE) INCREASE IN CASH & CASH EQUIVALENTS	(18,005,403)	3,203,978
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD	48,177,794	5,854,383
CASH & CASH EQUIVALENTS, END OF PERIOD	\$ 30,172,391	\$ 9,058,361
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Interest paid	\$ 1,085,543	\$ 1,084,130
Income taxes paid	\$ -	\$ 997,257
Non-cash transactions for investing and financing activities:		
Construction in progress transferred to property and equipment	\$ 4,106,200	\$ -
Capitalized interest - amortization of discount of notes payable and issuance cost	\$ 863,662	\$ -

China Natural Gas, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
March 31, 2010  
(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 HongKong, Shaanxi ,Henan and Hubei 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 February 5, 2010, Jingbian Liquefied Natural Gas Co., Ltd. (“JBLNG”) increased the registered capital by \$6,026,343 which was invested by Xi’an Xilan Natural Gas Co., Ltd. (“XXNGC”) in the form of equipment.

On September 8, 2009, Shaanxi Xilan Natural Gas Equipment Co., Ltd (“SXNGE”) increased its registered capital by \$26,000,000 from \$53,929,260 to \$79,929,260. CHNG contributed \$10,000,000 and \$16,000,000 registered capital to SXNGE on September 29, 2009 and January 13, 2010, respectively.

Note 2 – Restatement of Previously Reported Consolidated Financial Statement

On August 20, 2010, the Company restated its quarterly consolidated financial statements as of March 31, 2010. The Company is hereby restating the August 20, 2010 restatement of its quarterly consolidated financial statements as of March 31, 2010 to reverse all disclosure related to the reported violation of the Indenture for the Company’s 5% Guaranteed Senior Notes (the “Senior Notes”) issued to Abax Lotus Ltd. (“Abax”).

The Company’s Audit Committee made a decision to restate the consolidated financial statements upon the recommendation of the board of directors and management following the confirmation by two different independent law firms that the opinion on which the Company had previously relied – the basis of its conclusion that it had violated the Indenture – was incorrect. The general nature and scope of the adjustments are summarized as follows:

- (1) Reverse of reclassification of senior notes payable— on February 26, 2010, the Company entered into a bank loan of \$17.7 million with Pudong Development Bank Xi’an Branch (“SPDB”) (the “Bank Loan”). The loan is secured by the Company’s variable interest entity Xi’an Xilan Natural Gas Co., Ltd.’s (“XXNGC”) equipment and vehicles located within the PRC. The Company was entitled to borrow amounts under the loan between March 1, 2010 to June 30, 2010. In connection with the Bank Loan, XXNGC pledged its equipment and vehicles located in PRC to secure the Bank Loan (the “Pledge”) and guaranteed the repayment of the Bank Loan. The original opinion on which the Company relied indicated that the Pledge was prohibited by the Indenture for the Company’s 5% Guaranteed Senior Note issued to Abax Lotus Ltd., (“Abax”) dated January 26, 2008 (the “Senior Notes”). As a result, the Company believed that Abax had the right to declare a default under the Indenture and could thereafter accelerate the Senior Notes, and consequently, that the Company was required to reclassify from long term liabilities to short term liabilities the Senior Notes. Subsequent to the August

20, 2010 restatement, management of the Company internally revisited the analysis of whether the Pledge was indeed prohibited by the Indenture and determined that it was not. The Company engaged two additional independent law firms who reviewed and confirmed this determination. As a result, the Company reverses the August 20, 2010 reclassification of the Senior Notes in an amount of \$28 million from long term liabilities to short term liabilities.

(2) Reverse of reclassification of fair value of the redeemable warrants— in connection with the Senior Notes, the Company issued certain warrants to purchase the Company's common stock pursuant to a Warrant Agreement and Warrant Certificates. Under the terms of the Warrant Agreement, in the event of a default under the Indenture for the Senior Notes, the warrant holders are entitled to require the Company to redeem the warrants for a price equal to the pro rata portion of the aggregate redemption price of \$17,500,000 applicable to the warrants tendered by such holders. As described above, in connection with the August 20, 2010 restatement, the Company believed the Pledge was prohibited by the Indenture and that Abax had a right to declare an event of default under the Indenture. Accordingly, the Company also believed that the warrant holders were entitled to require the Company to redeem their warrants and, consequently, that the Company was required to reclassify from long term liabilities to short term liabilities the fair value of the redeemable warrants. As a result of the Company's conclusion that the Pledge was not prohibited by the Indenture, the Company reverses the August 20, 2010 reclassification of the warrants in an amount of \$17.5 million from long term liabilities to short term liabilities.

The Company is not restating the August 20, 2010 restatement of long term liabilities and restricted cash on the Company's consolidated balance sheet as of March 31, 2010 or the restatement of financing activities in consolidated statements of cash flow for the three months ended March 31, 2010, which restatements were made to record the Loan as a long term liability and record an increase in restricted cash as a result of obtaining the proceeds of the Loan, and are described in Amendment No. 1 to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2010.

The following tables present the adjustments due to the restatements made herein of the Company's previously issued consolidated balance sheet as of March 31, 2010.

Consolidated Balance Sheet			
March 31, 2010			
(Unaudited)			
	Previously Reported	Adjustments	As Restated
<b>ASSETS</b>			
<b>CURRENT ASSETS:</b>			
Cash & cash equivalents	\$ 30,172,391	\$ -	\$ 30,172,391
Restricted cash	13,203,000	-	13,203,000
Accounts receivable	1,514,070	-	1,514,070
Other receivables	491,020	-	491,020
Other receivable - employee advances	190,045	-	190,045
Inventories	874,678	-	874,678
Advances to suppliers	1,302,568	-	1,302,568
Prepaid expense and other current assets	1,546,556	-	1,546,556
Loans receivable	14,259,240	-	14,259,240
Total current assets	63,553,568	-	63,553,568
INVESTMENT IN UNCONSOLIDATED JOINT VENTURES	1,467,000	-	1,467,000
PROPERTY AND EQUIPMENT, NET			