

China Natural Gas, Inc.  
Form 10-K/A  
June 14, 2011

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

FORM 10-K/A  
(Amendment No. 1)

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2010

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-34373

CHINA NATURAL GAS, INC.  
(Exact Name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
Incorporation or organization)

98-0231607  
(I.R.S. Employer  
Identification Number)

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

Registrant's telephone number, including area code: 86-29-88323325

Securities registered under Section 12(b) of the Exchange Act: None

Securities registered under Section 12(g) of the Exchange Act:  
Common Stock, \$.0001 par value per share  
(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  
Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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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 (§232.45 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 "

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. "

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):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting and non-voting stock held by non-affiliates of the registrant, as of June 30, 2010, was approximately \$146,361,188. All executive officers and directors of the registrant have been deemed, solely for the purpose of the foregoing calculation, to be "affiliates" of the registrant.

As of February 28, 2011 there were 21,321,904 shares of the issuer's common stock, \$0.0001 par value per share, issued and outstanding.

EX-31.1 (Certifications required under Section 302 of the Sarbanes-Oxley Act of 2002)

EX-31.2 (Certifications required under Section 302 of the Sarbanes-Oxley Act of 2002)

EX-32.1 (Certifications required under Section 906 of the Sarbanes-Oxley Act of 2002)

EX-32.2 (Certifications required under Section 906 of the Sarbanes-Oxley Act of 2002)

Documents Incorporated by Reference

The registrant intends to file a definitive proxy statement pursuant to Regulation 14A within 120 days of the end of the fiscal year ended December 31, 2010. The proxy statement is incorporated herein by reference into the following parts of the Form 10-K:

- Part III, Item 10, Directors, Executive Officers and Corporate Governance;
- Part III, Item 11, Executive Compensation;
- Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters;
- Part III, Item 13, Certain Relationships and Related Transactions, and Director Independence;
- Part III, Item 14, Principal Accountant Fees and Services.

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (this “Amendment No. 1”) of China Natural Gas, Inc. (the “Company”) amends the Annual Report on Form 10-K of the Company for the year ended December 31, 2010, originally filed with the Securities and Exchange Commission (the “SEC”) on March 14, 2011 (the “Original Filing”). We refer to the Original Filing as the “2010 Form 10-K.”

This Amendment No. 1 amends and supplements the disclosure under Item 9A (Disclosure Controls and Procedures) in the 2010 Form 10-K to provide (i) disclosure that the Company did not maintain personnel with a sufficient level of accounting knowledge, experience and training in the application of the accounting principles generally accepted in the United States of America (“U.S. GAAP”) and SEC requirements in the application thereof, which constitutes a material weakness in its internal control over financial reporting (in addition to the material weaknesses previously disclosed in the 2010 Form 10-K) and (ii) the management’s remediation initiatives undertaken with respect thereto.

This Amendment No. 1 also amends Item 8 of the 2010 Form 10-K to provide a reissued Report of Independent Registered Public Accounting Firm of Friedman LLP (contained in the “F” pages hereto), with respect to the additional material weakness in Item 9A.

This Amendment No. 1 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, as well as a consent of our former independent auditors, Frazer Frost, LLP, as Exhibit 23.1 hereto. Except as described above, this Amendment No. 1 does not amend, update or change any items, financial statements or other disclosures in the 2010 Form 10-K, speaks as of the date of the Original Filing and does not update or discuss any other developments affecting the Company subsequent to the date of the Original Filing.

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and notes thereto are included herein beginning at page F-1.

## ITEM 9A CONTROLS AND PROCEDURES

### Disclosure Controls and Procedures

During and subsequent to the reporting period covered by this report, and under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of our disclosure controls and procedures that were in effect at the end of the period covered by this report. Disclosure controls and procedures is defined under Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), as those controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. Our principal executive officer and principal financial officer have concluded that the Company had a material weakness in its internal control over financial reporting as of December 31, 2010 because:

- The Company did not maintain personnel with a sufficient level of accounting knowledge, experience and training in the application of the accounting principles generally accepted in the United States of America ("U.S. GAAP") and SEC requirements in the application thereof.

Based on their evaluation and considering the material weaknesses previously identified in our internal control over financial reporting (Item 9A, Controls and Procedures, Amendment No. 2 to our Annual Report on Form 10-K for the year ended December 31, 2009, (the "2009 Form 10-K") and as discussed below in "Management's Report on Internal Control over Financial Reporting," our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures that were in effect on December 31, 2010 were not effective.

### Management's Report on Internal Control over Financial Reporting

The Company's management is responsible for establishing and maintaining an adequate system of internal control over financial reporting. Internal control over financial reporting is defined under Rule 13a-15(f) as a process designed by, or under the supervision of, an issuer's principal executive officer and principal financial officer, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and include those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.

In connection with this annual report, management has conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Evaluation Framework developed by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on its evaluation under the Internal Control - Evaluation Framework and due to the material weaknesses evidenced by the events described below, management concluded that our internal control over financial reporting was not effective as of December 31, 2010. A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected on a timely basis by employees in the normal course of their work.

As part of management's evaluation of the effectiveness of internal control over financial reporting, management reviewed certain transactions entered into by the Company in 2010. As previously disclosed in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 and in Amendment No. 2 to the 2009 Form 10-K, 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").

During management's evaluation of the effectiveness of internal control over financial reporting in connection with this annual report for the year ended December 31, 2010, management concluded that the Company had the following material weaknesses in its internal control over financial reporting during the year ended December 31, 2010:

- failure to disclose the Loan, the Pledge and the Guarantee as subsequent events in the footnotes to its consolidated financial statements included in the 2009 Form 10-K, and to file a current report on Form 8-K within four business days after entry into the Loan, the Pledge and the Guarantee;
- failure to disclose the Loan, the Pledge and the Guarantee in the quarterly report on Form 10-Q for the quarter ended March 31, 2010, which led to an understatement of restricted cash in the amount of \$13.2 million and the understatement of bank loans in the amount of \$13.2 million in the consolidated balance sheet included therein;
- incorrect determination that the Pledge constituted a breach of the indenture (the "Indenture") governing the Company's 5% guaranteed senior notes issued to Abax Lotus Ltd. dated January 29, 2008 (the "Senior Notes"), which led the Company to erroneously (i) reclassify from long-term liabilities to short-term liabilities the Senior Notes and the fair value of the redeemable warrants (the "Reclassification") and file related amendments to the Annual Report on Form 10-K for the year ended December 31, 2009 (the "Amended 10-K") and the Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 (the "Amended 10-Q"), (ii) disclose in the Amended 10-K, Amended 10-Q and the Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 that the Pledge constituted a breach of the Indenture and (iii) make the Reclassification;
- failure to document and communicate to the Board of Directors and members of management the evaluation of disclosure requirements in connection with acquisitions of four natural gas stations in the second quarter of 2010 and the acquisition of Hanchun Makou Yuntong Compressed Natural Gas Co., Ltd. in the third quarter of 2010.

In addition, management has concluded that the Company had a material weakness in its internal control over financial reporting as of December 31, 2010 because:

- The Company did not maintain personnel with a sufficient level of accounting knowledge, experience and training in the application of U.S. GAAP and SEC requirements in the application thereof.

The management concluded that these events indicated that the Company's policies and procedures in place as of December 31, 2010 were not sufficient to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act was being recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, nor were such policies and procedures sufficient to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act was being accumulated and communicated to the Company's management to allow timely decisions regarding required disclosure.

Friedman, LLP, the independent registered public accounting firm that audited the consolidated financial statements, has issued an attestation report on our internal control over financial reporting which is included in Item 8.

### Management's Remediation Initiatives

In response to the above identified material weaknesses and to strengthen our internal control over financial reporting, we have taken the following remediation initiatives:

- Our Audit Committee and Board of Directors held meetings promptly after being notified of the material weaknesses in internal controls identified above to address such weaknesses, and determined to meet regularly specifically for the purpose of monitoring and discussing with management the remediation of such weaknesses.
- In early September 2010, we engaged a professional internal control consultant through February 2011 to review and test our existing internal controls procedures, evaluate and identify inadequacies with our existing internal control procedures, and recommended changes as necessary and appropriate for the improvement of internal controls.



- Our Audit Committee and Board of Directors adopted a written internal authorization policy establishing approval procedures for various corporate actions. The policy lists various operational, administrative and financial corporate events and actions and for each such event and action, identifies whether prior approval or discussion with particular executive officers, the Board of Directors or legal counsel is required. The policy also sets quantitative limits on specific types of transactions that management may approve without Board approval. After adopting such policy, our Audit Committee and Board of Directors discussed the policy with management.
- We have established an internal audit function, with a Senior Internal Control Auditing Specialist, supported by six other employees. The Senior Internal Control Auditing Specialist, a Certified Internal Auditor (CIA) with ten years of internal audit-related work experience, is responsible for coordinating and evaluating the effectiveness of the Company's internal control over financial reporting, and he works closely with the third-party internal control consultant hired by the Company to establish and improve the internal control system and evaluate its effectiveness.
- We appointed a new Chief Financial Officer at the end of 2010 to improve and enhance our corporate governance and internal control systems.
- We are now developing a comprehensive training and development plan for our accounting personnel, including our Chief Financial Officer, Financial Controller and others, in the knowledge of the principles and rules of U.S. GAAP and the SEC requirements in the application thereof.

In addition, the Company continues to reassess its internal controls and procedures in light of these recent events and is in the process of determining additional appropriate actions to take to remediate these material weaknesses.

#### Changes in Internal Control over Financial Reporting

Other than the remediation measures described above, there was no change in our internal control over financial reporting during the year ended December 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

Exhibits:

| Number | Description of Exhibit  |
|--------|---|
| 1.1    | Underwriting Agreement, dated September 2, 2009 (incorporated by reference to same Exhibit 1.1 filed with the Registrant's Form 8-K filed on September 3, 2009).  |
| 2.1    | Form of Equity Ownership Transfer Agreement (incorporated by reference to same exhibit filed with the Registrant's Form 8-K filed on December 31, 2008).  |
| 3.1    | Articles of Incorporation, dated March 31, 1999 (incorporated by reference to same exhibit filed with the Company's Form 10SB Registration Statement filed September 15, 2000, SEC file no. 000-31539); Certificate of Amendment to the Articles of Incorporation, dated May 25, 2000 (incorporated by reference to same exhibit filed with the Registrant's Form 10SB Registration Statement filed September 15, 2000, SEC file no. 000-31539); Certificate of Amendment to the Articles of Incorporation, dated October 26, 2007 (incorporated by reference to Exhibit 4 to the Registrant's Registration Statement on Form 8-A12B filed June 3, 2009, SEC File No. 001-34373); Certificate of Amendment to the Articles of Incorporation, dated April 20, 2009 (incorporated herein by reference to Exhibit 5 to the Registrant's Registration Statement on Form 8-A12B filed June 3, 2009, SEC File no. 001-34373). |
| 3.2    | Registrant's Amended and Restated By-Laws, dated June 14, 2006 (incorporated by reference to Exhibit 3.1 filed with the Registrant's Form 8-K filed June 16, 2006, SEC file no. 000-31539); Amended and Restated By-Laws, dated September 24, 2008 (incorporated by reference to Exhibit 7 to the Registrant's Registration Statement on Form 8-A12B filed June 3, 2009, SEC File No. 001-34373).   |
| 3.3    | Certificate of Ownership and Merger, dated February 14, 2002 (incorporated by reference to Exhibit 2 to the Registrant's Registration Statement on Form 8-A12B filed June 3, 2009, SEC File No. 001-34373).   |
| 3.4    | Certificate of Ownership, dated December 12, 2005 (incorporated by reference to Exhibit 3 to the Registrant's Registration Statement on Form 8-A12B filed June 3, 2009, SEC File No. 001-34373).  |
| 4.1    | Registrant's 2009 Employee Stock Option and Stock Award Plan (incorporated by reference to Exhibit 4.1 to the Registrant's Registration Statement on Form S-8 (333-166422) filed April 30, 2010); Registrant's 2009 Employee Stock Option and Stock Award Plan – Award Agreement (incorporated by reference to Exhibit 10.2 to the Registrant's Form 10-Q filed July 20, 2009).   |
| 10.1   | Share Purchase Agreement made as of December 6, 2005 among Coventure International Inc., Xi'an Xilan Natural Gas Co., Ltd. and each of Xilan's shareholders (incorporated by reference to the exhibits to Registrant's Form 8-K filed on December 9, 2005).   |
| 10.2   | Return to Treasury Agreement between Coventure International Inc. and John Hromyk, dated December 6, 2005 (incorporated by reference to the exhibits to Registrant's Form 8-K filed on December 9, 2005).   |
| 10.3   | Purchase Agreement made as of December 20, 2005 between China Natural Gas, Inc. and John Hromyk (incorporated by reference to the exhibit to Registrant's Form 8-K filed on December 23, 2005).   |
| 10.4   | Form of Securities Purchase Agreement (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006).   |

10.5 Form of Warrant (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006).

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| Number | Description of Exhibit  |
|--------|---|
| 10.6   | Form of Registration Rights Agreement (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 12, 2006).   |
| 10.7   | CNG Product Purchase and Sale Agreement between Xi'an Xilan Natural Gas Co., Ltd. and Zhengzhou Zhongyou Hengran Petroleum Gas Co., Ltd. made as of July 20, 2006, (translated from the original Mandarin) (incorporated by reference to the exhibits to Registrant's Form 10-KSB filed on April 17, 2007). |
| 10.8   | Securities Purchase Agreement, dated August 2, 2007, between the Company and the Investors named therein (incorporated by reference to the exhibits to Registrant's Form 8-K filed on August 8, 2007).  |
| 10.9   | Registration Rights Agreement, dated August 2, 2007, between the Company and the Investors named therein (incorporated by reference to the exhibits to Registrant's Form 8-K filed on August 8, 2007).  |
| 10.10  | Consulting Services Agreement, dated August 17, 2007, between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).   |
| 10.11  | Operating Agreement, dated August 17, 2007, between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).   |
| 10.12  | Equity Pledge Agreement, dated August 17, 2007, between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).   |
| 10.13  | Option Agreement, dated August 17, 2007, between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).  |
| 10.14  | Proxy Agreement, dated August 17, 2007, between Shaanxi Xilan Natural Gas Equipment Co., Ltd. and Xi'an Xilan Natural Gas Co., Ltd. (incorporated by reference to the exhibits to Registrant's Form 10-QSB filed on August 20, 2007).   |
| 10.15  | Securities Purchase Agreement, dated December 30, 2007, between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).   |
| 10.16  | Amendment to Securities Purchase Agreement, dated January 29, 2008, between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).   |
| 10.17  | Indenture, dated January 29, 2008, by and among the Company and DB Trustees (Hong Kong) Limited, as trustee, relating to the 5.00% Guaranteed Senior Notes due 2014 (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).   |
| 10.18  | Warrant Agreement, dated January 29, 2008, by and among the Company, Mr. Qinan Ji, Deutsche Bank AG, Hong Kong Branch as Warrant Agent and Deutsche Bank Luxembourg S.A. as Warrant Agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).                   |

- 10.19 Equity Registration Rights Agreement, dated January 29, 2008, by and between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).

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| Number | Description of Exhibit   |
|--------|--|
| 10.20  | Investor Rights Agreement, dated January 29, 2008, by and among the Company, its subsidiaries, Mr. Qinan Ji, and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).   |
| 10.21  | Information Rights Agreement, dated January 29, 2008, between the Company and Abax Lotus Ltd. (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).  |
| 10.22  | Onshore Share Pledge Agreement, dated January 29, 2008, between the Company and DB Trustees (Hong Kong) Limited, as security agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).                                       |
| 10.23  | Account Pledge and Security Agreement, dated January 29, 2008, by and between the Company and DB Trustees (Hong Kong) Limited as Security Agent (incorporated by reference to the exhibits to Registrant's Form 8-K filed on January 31, 2008).                          |
| 10.24  | Natural Gas Purchase Agreement entered by and between Xi' An Xilan Natural Gas Co., Ltd. and China Petroleum Co., Ltd., Changqing Branch, dated July 30, 2006 (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009). |
| 10.25  | Natural Gas Purchase Agreement entered by and between Jiyuan Yuhai Natural Gas Co., Ltd. and Xi' An Xilan Natural Gas Co., Ltd. dated, February 28, 2008 (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).      |
| 10.26  | Natural Gas Supply Agreement between Jincheng Ming Shi Natural Gas Co., Ltd., Jinan Branch and Xi' An Xilan Natural Gas Co., Ltd. dated March 20, 2008 (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).        |
| 10.27  | Natural Gas Purchase Agreement entered by and between Shaanxi Natural Gas Co., Ltd. and Xi' An Xilan Natural Gas Co., Ltd., dated July 17, 2008 (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).               |
| 10.28  | Independent Director Agreement dated January 1, 2008, by and between China Natural Gas., Inc. and Zhiqiang Wang (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).   |
| 10.29  | Independent Director Agreement dated July 1, 2008, by and between China Natural Gas., Inc. and Carl Yeung (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).   |
| 10.30  | Independent Director Agreement dated August 5, 2008, by and between China Natural Gas., Inc. and Lawrence W. Leighton (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).   |
| 10.31  | Employment Agreement, dated October 10, 2008, by and between China Natural Gas., Inc. and Richard Peidong Wu (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009).  |
| 10.32  |  |

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Employment Agreement, dated May 10, 2005, by and between China Natural Gas., Inc. and Qinan Ji (incorporated herein by reference to the exhibits to the Registrant's Form 10-K/A filed on July 20, 2009); Employment Agreement, dated January 1, 2009, by and between China Natural Gas., Inc. and Qinan Ji (incorporated herein by reference to the Exhibit 10.4 to the Registrant's Form 10-Q/A filed on July 20, 2009); Employment Agreement dated January 1, 2010, by and between the Company and Qinan Ji (incorporated by reference to Exhibit 10.3 to the Registrant's Form 8-K filed on November 9, 2010).

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| Number  | Description of Exhibit   |
|---------|--|
| 10.33   | Equity Ownership Transfer Agreement, dated October 2, 2008, by and between Xi'an Xilan Natural Gas Co., Ltd., Zhihe Zhang and Lingjun Hu (incorporated by reference to the Registrant's Form 8-K filed on December 31, 2008).  |
| 10.34   | Joint Venture Agreement dated July 22, 2009 by and between Xi'an Xilan Natural Gas Co., Ltd. and China National Petroleum Corporation Kunlun Natural Gas Co., Ltd. (incorporated by reference to the Registrant's Form 8-K filed on July 28, 2009).  |
| 10.35   | Strategic Cooperation Framework Agreement dated as of July 6, 2009 by and between Xi'an Xilan Natural Gas Co., Ltd. and China National Petroleum Corporation Kunlun Natural Gas Co., Ltd. (incorporated by reference to the Registrant's Form 8-K filed on July 8, 2009).                          |
| 10.36   | Employment Agreement dated December 20, 2010 between the Company and Shaocheng Xu (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on December 23, 2010).   |
| 10.37   | Independent Director Agreement dated November 25, 2010 between the Company and Frank Waung (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on November 26, 2010).  |
| 10.38   | Waiver dated February 4, 2009, executed by DB Trustees (Hong Kong) Limited, as trustee under the Indenture governing the Company's 5.0% Guaranteed Senior Notes due 2014 (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on November 9, 2010).                       |
| 10.39   | Waiver dated August 14, 2009, by and among the Company and the holders of the Company's 5.0% Guaranteed Senior Notes due 2014 signatory thereto (incorporated by reference to Exhibit 10.2 to the Registrant's Form 8-K filed on November 9, 2010).  |
| 10.40   | Loan Contract of Fixed Asset dated February 26, 2010, by the between Jingbian Xi'an Xilan Liquefied Natural Gas Co. Ltd. and Xi'an Branch Shanghai Pudong Development Bank (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on August 13, 2010). |
| 10.41   | Mortgage Contract of Movables dated February 26, 2010, by and between Xi'an Xilan Natural Gas Co. Ltd. and Xi'an Branch Shanghai Pudong Development Bank (incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q filed on August 13, 2010).                   |
| 10.42   | Contract of Guarantee dated February 26, 2010, by and between Xi'an Xilan Natural Gas Co. Ltd. and Xi'an Branch Shanghai Pudong Development Bank (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q filed on August 13, 2010).                           |
| 10.43   | Employment Agreement of Veronica Chen dated May 1, 2009 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on July 20, 2009).  |
| 10.44   | Supply Agreement between CNP Changqing Oil Field Branch Company dated November 25, 2010 and Jingbian LNG Company (incorporated by reference to Exhibit 99.1 to the Registrant's Form 8-K filed on December 1, 2010).   |
| 10.45** | Coal Bed Methane Purchase Agreement entered by and between Henan Xilan Natural Gas Co., Ltd. and Qinshui Lanyan Coal Bed Methane Co., Ltd. dated January 12, 2009 (English translation attached).  |



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- 10.46\*\* Natural Gas Supply Agreement between Huojia Hualong Petrochemical Co., Ltd., and Xi' An Xilan Natural Gas Co., Ltd. dated November 16, 2009 (English translation attached).
- 14.1 Code of Ethics adopted by the Company on June 14, 2006 (incorporated by reference to the exhibits to Registrant's Form 8-K filed on June 16, 2006).

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| Number | Description of Exhibit   |
|--------|--|
| 16.1   | Letter of Moore Stephens Wurth Frazer and Torbet, LLP dated January 7, 2010 (incorporated by reference to Exhibit 16.1 to Registrant's Form 8-K filed on January 7, 2010). |
| 16.2   | Letter from Frazer Frost, LLP dated December 6, 2010 (incorporated by reference to the exhibits to Exhibit 16.1 to the Registrant's Form 8-K filed on December 7, 2010).   |
| 21.1** | List of Subsidiaries.  |
| 23.1*  | Written consent of Frazer Frost, LLP.  |
| 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.            |
| 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

\*\* Filed with the Original Filing

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: June 14, 2011

CHINA NATURAL GAS, INC.

/s/ Qinan Ji

Name: Qinan Ji

Title: Chief Executive Officer  
(Principal Executive Officer)

/s/ Bode Xu

Name: Bode Xu

Title: Chief Financial Officer  
(Principal Financial and Accounting Officer)

CHINA NATURAL GAS, INC.  
AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have audited the accompanying consolidated balance sheet of China Natural Gas, Inc. as of December 31, 2010, and the related consolidated statements of income and comprehensive income, stockholders' equity, and cash flows for the year then ended. We also have audited China Natural Gas, Inc.'s internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). China Natural Gas, Inc.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weaknesses have been identified and included in management's assessment as of December 31, 2010:

- As previously disclosed in the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 and in Amendment No. 2 to the 2009 Form 10-K/A, 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"). Management failed to disclose the Loan, the Pledge and the Guarantee as subsequent events in the footnotes to its consolidated financial statements included in the annual report on Form 10-K for the year ended December 31, 2009, and to file a current report on Form 8-K within four business days after entry into the Loan, the Pledge and the Guarantee;
- Management failed to disclose the Loan, the Pledge and the Guarantee in the quarterly report on Form 10Q for the quarter ended March 31, 2010, which led to an understatement of restricted cash in the amount of \$13.2 million and the understatement of bank loans in the amount of \$13.2 million in the consolidated balance sheet included therein;
- Management incorrectly determined that the Pledge constituted a breach of the indenture (the "Indenture") governing the Company's 5% guaranteed senior notes issued to Abax Lotus Ltd. dated January 29, 2008 (the "Senior Notes"), which led the Company to erroneously (i) reclassify from long-term liabilities to short-term liabilities the Senior Notes and the fair value of the redeemable warrants (the "Reclassification") and file related amendments to the Annual Report on Form 10-K for the year ended December 31, 2009 (the "Amended 10-K") and the Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 (the "Amended 10-Q"), (ii) disclose in the Amended 10-K, Amended 10-Q and the Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 that the Pledge constituted a breach of the Indenture and (iii) make the Reclassification;
- Management failed to document and communicate to the Board of Directors and members of management the evaluation of disclosure requirements in connection with acquisitions of four natural gas stations in the second quarter of 2010 and the acquisition of Hanchun Makou Yuntong Compressed Natural Gas Co., Ltd. in the third quarter of 2010; and
- The Company did not maintain personnel with a sufficient level of accounting knowledge, experience and training in the application of U.S. GAAP and SEC requirements in the application thereof.

These material weaknesses were considered in determining the nature, timing and extent of audit tests applied in our audit of the 2010 consolidated financial statements, and our opinion regarding the effectiveness of the Company's internal control over financial reporting does not affect our opinion on those consolidated financial statements.

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, China Natural Gas, Inc. has not maintained effective internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of China Natural

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Gas, Inc. as of December 31, 2010, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Friedman LLP

New York, New York

March 14, 2011

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
China Natural Gas, Inc.

We have audited the accompanying consolidated balance sheets of China Natural Gas, Inc. and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of income and other comprehensive income, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2009. China Natural Gas, Inc.'s management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of China Natural Gas, Inc. and subsidiaries as of December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), China Natural Gas, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2009, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 10, 2010, except for the effects of the material weaknesses described in the six paragraph of that report, as to which the date is September 30, 2010, expressed an adverse opinion on the effectiveness of internal control over financial reporting.

/s/ Frazer Frost, LLP (Successor Entity of Moore Stephens Wurth Frazer and Torbet, LLP, see Form 8-K filed on January 7, 2010)

Brea, California

March 10, 2010, except for the effects on the consolidated financial statements of the restatement described in Note 2 and 15, as to which the date is September 30, 2010



CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

|  | December, 31<br>2010  | December, 31<br>2009  |
|--|-----------------------|-----------------------|
| <b>ASSETS</b>  |                       |                       |
| <b>CURRENT ASSETS:</b>   |                       |                       |
| Cash and cash equivalents  | \$ 10,046,249         | \$ 48,177,794         |
| Accounts receivable, net   | 1,821,595             | 1,289,116             |
| Other receivable   | 188,364               | 709,741               |
| Employee advances  | 302,532               | 338,689               |
| Inventories  | 815,884               | 841,837               |
| Advances to suppliers  | 8,434,995             | 596,868               |
| Prepaid expense and other current assets   | 4,249,353             | 1,076,915             |
| Loan receivable  | -                     | 293,400               |
| <b>Total current assets</b>  | <b>25,858,972</b>     | <b>53,324,360</b>     |
| Investment in unconsolidated joint ventures                                      | 1,517,000             | 1,467,000             |
| Property and equipment, net  | 82,769,171            | 72,713,012            |
| Construction in progress   | 116,569,871           | 52,918,236            |
| Deferred financing cost, net   | 927,166               | 1,336,998             |
| Other assets   | 19,806,375            | 15,854,910            |
| <b>TOTAL ASSETS</b>  | <b>\$ 247,448,555</b> | <b>\$ 197,614,516</b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                      |                       |                       |
| <b>CURRENT LIABILITIES:</b>  |                       |                       |
| Notes payable - current maturities   | 2,551,306             | -                     |
| Accounts payable and accrued liabilities   | \$ 5,428,668          | \$ 2,162,049          |
| Unearned revenue   | 2,376,563             | 1,813,641             |
| Accrued interest   | 646,528               | 786,052               |
| Taxes payable  | 2,377,765             | 1,901,577             |
| <b>Total current liabilities</b>   | <b>13,380,830</b>     | <b>6,663,319</b>      |
| <b>LONG-TERM LIABILITIES:</b>  |                       |                       |
| Notes payable, net of current portion  | 28,064,363            | 27,292,287            |
| Long-term debt   | 18,204,000            |                       |
| Derivative liabilities - warrants  | 17,752,066            | 19,545,638            |
| <b>Total long-term liabilities</b>   | <b>64,020,429</b>     | <b>46,837,925</b>     |
| <b>Total liabilities</b>   | <b>77,401,259</b>     | <b>53,501,244</b>     |
| <b>COMMITMENTS AND CONTINGENCIES</b>   |                       |                       |
| <b>STOCKHOLDERS' EQUITY:</b>   |                       |                       |
| Preferred stock, par value \$0.0001 per share, 5,000,000 authorized, none issued | -                     | -                     |
|  | 2,132                 | 2,118                 |

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|   |                      |                      |
|---|----------------------|----------------------|
| Common stock, par value \$0.0001 per share, 45,000,000 authorized, 21,321,904 and 21,183,904 issued and outstanding at December 31, 2010 and 2009, respectively |                      |                      |
| Additional paid-in capital  | 81,611,763           | 79,851,251           |
| Accumulative other comprehensive income   | 15,667,145           | 8,714,019            |
| Statutory reserves  | 7,918,634            | 5,962,695            |
| Retained earnings   | 64,847,622           | 49,583,189           |
| Total stockholders' equity  | 170,047,296          | 144,113,272          |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>   | <b>\$247,448,555</b> | <b>\$197,614,516</b> |

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

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

|  | Years Ended December 31, |                     |                   |
|--|--------------------------|---------------------|-------------------|
|  | 2010                     | 2009                | 2008              |
| <b>Revenue</b>                             |                          |                     |                   |
| Natural gas                                | \$71,367,502             | \$62,236,342        | \$55,746,893      |
| Gasoline                                   | 7,522,412                | 6,384,172           | 4,616,052         |
| Installation and other                     | 11,063,709               | 12,445,604          | 7,357,714         |
|  | 89,953,623               | 81,066,118          | 67,720,659        |
| <b>Cost of revenue</b>                     |                          |                     |                   |
| Natural gas                                | 38,651,298               | 29,478,854          | 27,234,508        |
| Gasoline                                   | 7,050,003                | 5,993,207           | 4,277,458         |
| Installation and other                     | 4,838,858                | 5,432,978           | 3,469,671         |
|  | 50,540,159               | 40,905,039          | 34,981,637        |
| <b>Gross profit</b>                        | <b>39,413,464</b>        | <b>40,161,079</b>   | <b>32,739,022</b> |
| <b>Operating expenses</b>                  |                          |                     |                   |
| Selling                                    | 13,254,923               | 10,607,596          | 7,651,948         |
| General and administrative                 | 7,131,543                | 4,500,676           | 4,024,882         |
|  | 20,386,466               | 15,108,272          | 11,676,830        |
| <b>Income from operations</b>              | <b>19,026,998</b>        | <b>25,052,807</b>   | <b>21,062,192</b> |
| <b>Other income (expense)</b>              |                          |                     |                   |
| Interest income                            | 418,763                  | 125,287             | 209,502           |
| Interest expense                           | -                        | (747,172 )          | (2,228,244 )      |
| Other income (expense), net                | (137,817 )               | (186,805 )          | 111,859           |
| Change in fair value of warrants           | 1,793,572                | (1,031,330 )        | -                 |
| Foreign currency exchange loss             | (88,613 )                | (69,077 )           | (397,299 )        |
|  | 1,985,905                | (1,909,097 )        | (2,304,182 )      |
| <b>Income before income tax</b>            | <b>21,012,903</b>        | <b>23,143,710</b>   | <b>18,758,010</b> |
| <b>Provision for income tax</b>            | <b>3,792,531</b>         | <b>4,312,923</b>    | <b>3,567,642</b>  |
| <b>Net income</b>                          | <b>17,220,372</b>        | <b>18,830,787</b>   | <b>15,190,368</b> |
| <b>Other comprehensive income</b>          |                          |                     |                   |
| Foreign currency translation gain          | 6,953,126                | 52,959              | 5,184,035         |
| <b>Comprehensive income</b>                | <b>\$24,173,498</b>      | <b>\$18,883,746</b> | <b>20,374,403</b> |
| <b>Weighted average shares outstanding</b> |                          |                     |                   |
| Basic                                      | 21,268,972               | 16,624,294          | 14,600,154        |
| Diluted                                    | 21,430,867               | 16,830,907          | 14,645,070        |

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Earnings per share

|         |        |        |        |
|---------|--------|--------|--------|
| Basic   | \$0.81 | \$1.13 | \$1.04 |
| Diluted | \$0.80 | \$1.12 | \$1.04 |

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

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

|  | Common Stock |          | Additional    | Accumulative  | Retained Earnings |               | Total          |
|--|--------------|----------|---------------|---------------|-------------------|---------------|----------------|
|  | Shares       | Amount   | Paid-in       | Other         | Statutory         | Unrestricted  | Stockholders'  |
|  |              |          | Capital       | Comprehensive | Reserve           |               | Equity         |
|  |              |          |               | Income        |                   |               |                |
| Balance<br>December 31,<br>2007  | 14,600,154   | \$ 1,460 | \$ 32,048,339 | \$ 3,477,025  | \$ 1,802,735      | \$ 13,877,755 | \$ 51,207,314  |
| Options issued<br>for services   |              |          | 66,704        |               |                   |               | 66,704         |
| Cumulative<br>translation<br>adjustment  |              |          |               | 5,184,035     |                   |               | 5,184,035      |
| Net income   |              |          |               |               |                   | 15,190,368    | 15,190,368     |
| Transfer to<br>statutory reserve   |              |          |               |               | 1,927,348         | (1,927,348 )  | -              |
| Balance<br>December 31,<br>2008  | 14,600,154   | \$ 1,460 | \$ 32,115,043 | \$ 8,661,060  | \$ 3,730,083      | \$ 27,140,775 | \$ 71,648,421  |
| Reclassification<br>of warrants from<br>equity to<br>derivative<br>liabilities |              |          | (6,858,547 )  |               |                   | 5,844,239     | (1,014,308 )   |
| Issuance of<br>common stock  | 6,583,750    | 658      | 57,607,155    |               |                   |               | 57,607,813     |
| Offering costs   |              |          | (3,237,452 )  |               |                   |               | (3,237,452 )   |
| Options issued<br>for services   |              |          | 66,535        |               |                   |               | 66,535         |
| Stock based<br>compensation  |              |          | 158,517       |               |                   |               | 158,517        |
| Cumulative<br>translation<br>adjustment  |              |          |               | 52,959        |                   |               | 52,959         |
| Net income   |              |          |               |               |                   | 18,830,787    | 18,830,787     |
| Transfer to<br>statutory reserve   |              |          |               |               | 2,232,612         | (2,232,612 )  | -              |
| Balance<br>December 31,<br>2009  | 21,183,904   | \$ 2,118 | \$ 79,851,251 | \$ 8,714,019  | \$ 5,962,695      | \$ 49,583,189 | \$ 144,113,272 |
|  | 138,000      | 14       | 676,186       |               |                   |               | 676,200        |

|                                   |            |          |               |               |              |               |                |
|-----------------------------------|------------|----------|---------------|---------------|--------------|---------------|----------------|
| Exercise of stock options         |            |          |               |               |              |               |                |
| Options issued for services       |            |          | 66,024        |               |              |               | 66,024         |
| Stock based compensation          |            |          | 1,018,302     |               |              |               | 1,018,302      |
| Cumulative translation adjustment |            |          |               | 6,953,126     |              |               | 6,953,126      |
| Net income                        |            |          |               |               |              | 17,220,372    | 17,220,372     |
| Transfer to statutory reserve     |            |          |               |               | 1,955,939    | (1,955,939 )  | -              |
| Balance December 31, 2010         | 21,321,904 | \$ 2,132 | \$ 81,611,763 | \$ 15,667,145 | \$ 7,918,634 | \$ 64,847,622 | \$ 170,047,296 |

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

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CHINA NATURAL GAS, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | For the Years ended December 31, |               |              |
|---|----------------------------------|---------------|--------------|
|   | 2010                             | 2009          | 2008         |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                  |               |              |
| Net income  | \$ 17,220,372                    | \$ 18,830,787 | 15,190,368   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                  |               |              |
| Depreciation and amortization   | 6,644,843                        | 5,571,772     | 3,474,905    |
| Recovery of doubtful accounts   | (149,859 )                       | -             | -            |
| Loss on disposal of equipment   | 123,553                          | 21,373        | 24,806       |
| Amortization of discount on senior notes  | -                                | 280,250       | 1,004,677    |
| Amortization of financing costs   | -                                | 63,940        | 227,989      |
| Options issued for services   | 66,024                           | 66,535        | 66,704       |
| Stock-based compensation  | 1,018,302                        | 158,517       | -            |
| Change in fair value of warrants  | (1,793,572 )                     | 1,031,330     | -            |
| Change in assets and liabilities:   |                                  |               |              |
| Accounts receivable   | (326,573 )                       | (387,948 )    | (568,370 )   |
| Other receivables   | 531,970                          | (644,083 )    | 247,349      |
| Employee advances   | 46,174                           | (6,425 )      | (55,747 )    |
| Inventories   | 53,292                           | (322,099 )    | (267,470 )   |
| Advances to suppliers   | (7,624,015 )                     | 240,724       | (125,896 )   |
| Prepaid expense and other current assets  | (2,973,865 )                     | (306,445 )    | (642,857 )   |
| Accounts payable and accrued liabilities  | 3,144,057                        | 2,526         | 339,168      |
| Unearned revenue  | 488,687                          | 869,239       | 583,940      |
| Accrued interest  | (139,524 )                       | (75,062 )     | 861,114      |
| Taxes payable   | 372,136                          | 38,991        | 556,121      |
| Net cash provided by operating activities   | 16,702,002                       | 25,433,922    | 20,916,801   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                  |               |              |
| Payment on investment in unconsolidated joint ventures                            | -                                | (1,467,000 )  | -            |
| Purchase of property and equipment  | (6,060,287 )                     | (1,074,066 )  | (43,225,673) |
| Proceeds from sales of property and equipment                                     | 96,141                           | 41,325        | 194,891      |
| Loan receivable   | (14,379,768)                     | -             | -            |
| Proceeds from loan receivable   | 14,675,648                       | -             | -            |
| Proceeds from short term investments  | -                                | -             | 250,821      |
| Additions to construction in progress   | (44,830,638)                     | (28,020,498)  | (19,012,750) |
| Return (payment) of acquisition deposit   | 1,627,340                        | (283,200 )    | -            |
| Prepayment on long-term assets  | (10,274,357)                     | (6,139,766 )  | (5,729,833 ) |
| Payment for acquisition of business   | (3,077,031 )                     | -             | -            |
| Payment for intangible assets   | (6,159,474 )                     | (161,486 )    | (53,826 )    |
| Payment for land use rights   | (4,283,789 )                     | (432,566 )    | (30,354 )    |
| Excess of cost over fair value of net assets acquired                             | (505,225 )                       | -             | -            |
| Net cash used in investing activities   | (73,171,440)                     | (37,537,257)  | (67,606,724) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                  |               |              |
| Proceeds from the issuance of common stock  | -                                | 57,607,813    | -            |

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|  |                     |                     |                     |
|--|---------------------|---------------------|---------------------|
| Proceeds from exercise of stock options  | 676,200             | -                   | -                   |
| Proceeds from long-term debt   | 17,752,800          | -                   | 40,000,000          |
| Debt issuance costs  | -                   | -                   | (2,122,509 )        |
| Stock issuance costs   | -                   | (3,237,454 )        | -                   |
| Net cash provided by financing activities  | 18,429,000          | 54,370,359          | 37,877,491          |
| Effect of exchange rate changes on cash and cash equivalents                       | (91,107 )           | 56,387              | 1,375,086           |
| <b>NET (DECREASE) INCREASE IN CASH &amp; CASH EQUIVALENTS</b>                      | <b>(38,131,545)</b> | <b>42,323,411</b>   | <b>(7,437,346 )</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>                                | <b>48,177,794</b>   | <b>5,854,383</b>    | <b>13,291,729</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>                                      | <b>\$10,046,249</b> | <b>\$48,177,794</b> | <b>5,854,383</b>    |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>                           |                     |                     |                     |
| Interest paid, including capitalized interest                                      | \$2,908,661         | \$503,845           | \$902,777           |
| Income taxes paid  | \$3,863,788         | \$4,178,066         | \$2,998,627         |
| <b>Non-cash transactions for investing and financing activities:</b>               |                     |                     |                     |
| Construction in progress transferred to property and equipment                     | \$5,057,958         | \$-                 | \$823,464           |
| Prepayment on long-term assets transferred to property and equipment               | \$18,431,526        | \$-                 | \$405,630           |
| Purchase of equipment through accounts payable                                     | \$-                 | \$1,234,603         | \$-                 |
| Capitalized interest - amortization of discount of notes payable and issuance cost | \$3,733,214         | \$2,836,324         | \$1,164,618         |

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



China Natural Gas, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements

Note 1 - Organization

Organization and Line of Business

China Natural Gas, Inc. (the “Company”) was incorporated in the State of Delaware on March 31, 1999. The Company through its wholly owned subsidiaries and variable interest entity (“VIE”), Xi’an Xilan Natural Gas Co., Ltd. (“XXNGC”) and subsidiaries of its VIE, located in Hong Kong, Shaanxi Province, Henan Province 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 through fueling stations and pipelines, construction of pipeline networks, installation of natural gas fittings and parts for end-users, and conversions of gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles at automobile conversion sites. The consolidated balance sheets as of December 31, 2010 and 2009 and the consolidated statements of income and comprehensive income, stockholder’s equity and cash flows for the years ended December 31, 2010, 2009 and 2008 include the accounts of China Natural Gas, Inc. and Subsidiaries and variable interest entities (“China Natural Gas,” the “Company,” “our,” “us” or “we”). Our subsidiaries and variable interest entities are: Xilan Energy Co. Ltd. (“XEC”), Xi’an Xilan Natural Gas Co, Ltd. (“XXNGC”), Shaanxi Xilan Natural Gas Equipment Co. Ltd (“SXNGE”), Hubei Xian Natural Gas Co., Ltd (“HBXNG”), Lingbao Yuxi Natural Gas Co. Ltd. (“LYNG”), Shaanxi Jingbian Liquefied Natural Gas Co. Ltd (“JBLNG”), Henan Xilan Natural Gas Co. Ltd (“HXNGC”), Xi’an Xilan Auto Body Shop Co, Ltd. (“SXABC”), Henan CNPC Kunlun Xilan Compressed Natural Gas Co., Ltd ( “JV”) and Hanchuan Makou Yuntong Compressed Natural Gas Co., Ltd (Makou”).

During the second quarter of 2010, the Company’s VIE, XXNGC, effectively acquired 100% of the assets and operating rights of four natural gas stations in Xi’an, PRC, for aggregate cash consideration of \$10,502,490.

On May 29, 2010, Hubei Xilan Natural Gas Co., Ltd., a wholly owned limited liability company in Hubei Province, PRC, formed by XXNGC (“HBXNGC”), agreed to purchase 100% of the equity interests of Makou, a limited liability company formed under the laws of the PRC, from eight individuals for a purchase price of \$3,648,080. Makou owns and operates a compressed natural gas (“CNG”) compressor station in Hanchuan City, Hubei Province, and purchases natural gas from pipelines, conducts compressing and sells natural gas on a wholesale basis through tankers to fueling stations in Hubei Province. In July 2010, HBXNGC obtained full control of Makou’s assets and operations.

On February 5, 2010 and April 23, 2010, JBLNG, an entity wholly owned by XXNGC, increased its registered capital by \$6,026,343 and \$11,668,376, respectively, which was invested by XXNGC in the form of equipment and cash.

On December 17, 2009, the Company through its VIE, XXNGC, formed HBXNGC as a wholly owned limited liability company, with registered capital of \$1,467,000 in Hubei Province, PRC. HBXNGC was established to construct harbor liquid natural gas (“LNG”) fueling stations and ships in Hubei, PRC.

On October 27, 2009, the Company formed XEC as a wholly owned limited liability company, with authorized capital of \$5,000,000 in Hong Kong. XEC was established for the purpose of importing LNG into the PRC.

On October 27, 2009, the Company through its VIE, XXNGC, formed Henan CNPC Kunlun Xilan Compressed Natural Gas Co., Ltd. (the “JV”) as a joint venture with China National Petroleum Corporation Kunlun Natural Gas Co., Ltd. (“CNPC Kunlun”), with registered capital of \$7,335,000 in Henan Province, PRC. The JV was established to build and CNG compressor stations and fueling stations, sell CNG, provide vehicle conversion services from gasoline-fueled vehicles to hybrid (natural gas/gasoline) powered vehicles and provide technical advisory work services in Henan, PRC. CNPC Kunlun holds 51% ownership of the JV and XXNGC holds 49% ownership.

On September 8, 2009, SXNGE, the Company's wholly owned foreign entity, increased its registered capital by \$26,000,000 from \$53,929,260 to \$79,929,260. The Company contributed \$10,000,000 and \$16,000,000 in registered capital to SXNGE on September 29, 2009 and January 13, 2010, respectively.

Note 2 – Summary of Significant Accounting Policies

Basis of Presentation

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The accompanying consolidated financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America (“U.S. GAAP”).

#### Use of Estimates

The preparation of the consolidated financial statements in conformity with U.S. GAAP 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. Significant accounting estimates reflected in the Company’s consolidated financial statements include revenue recognition, allowance for doubtful accounts, inventory obsolescence, warrants liability and useful lives of property and equipment. Actual results could differ from those estimates.

#### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries and its 100% VIE, XXNGC, and XXNGC’s wholly owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation.

#### Consolidation of Variable Interest Entity

In accordance with Financial Accounting Standards Board’s (“FASB”) accounting standard regarding consolidation, VIEs are 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. Any VIE 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 SXNGE as a wholly foreign owned enterprise (“WFOE”) under the laws of the PRC. Through SXNGE, the Company entered into exclusive arrangements with XXNGC and its shareholders that give the Company the ability to substantially influence XXNGC’s daily operations and financial affairs and appoint its senior executives. The Company is considered the primary beneficiary of XXNGC and it consolidates its accounts as a VIE. The Company’s arrangements with XXNGC consist of the following agreements:

- Consulting Service Agreement, dated August 17, 2007. Under this agreement entered into between SXNGE and XXNGC, SXNGE provides XXNGC exclusive consulting services with respect to XXNGC’s general business operations, human resources and research and development. In return, XXNGC pays a quarterly service fee to SXNGE, which is equal to XXNGC’s revenue for such quarter. The term of this agreement is indefinite unless SXNGE notifies XXNGC of its intention to terminate this agreement. XXNGC may not terminate this agreement during its term. This agreement is retroactive to March 8, 2006.
- Operating Agreement, dated August 17, 2007. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, SXNGE agrees to fully guarantee XXNGC’s performance of all operations-related contracts, agreements or transactions with third parties and, in return, XXNGC agrees to pledge all of its assets, including accounts receivable, to SXNGE. The XXNGC shareholders party to this operating agreement agree to, among other things, appoint as XXNGC’s directors, individuals recommended by XXNGC, and appoint SXNGE’s senior officers as XXNGC’s general manager, chief financial officer and other senior officers. The term of this agreement is indefinite unless SXNGE notifies XXNGC of its intention to terminate this agreement with 30 days prior notice. XXNGC may not terminate this agreement during its term. This agreement is retroactive to March 8, 2006.

- Equity Pledge Agreement, dated August 17, 2007. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, to secure the payment obligations of XXNGC under the consulting service agreement described above, the XXNGC shareholders party to this equity pledge agreement have pledged to SXNGE all of their equity ownership interests in XXNGC. Upon the occurrence of certain events of default specified in this agreement, SXNGE may exercise its rights and foreclose on the pledged equity interest. Under this agreement, the pledgors may not transfer the pledged equity interest without SXNGE's prior written consent. This agreement will also be binding upon successors of the pledgor and transferees of the pledged equity interest. The term of the pledge is two years after the obligations under the Consulting Service Agreement have been fulfilled. This agreement is retroactive to March 8, 2006.

- Option Agreement, dated August 17, 2007. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders party to this option agreement irrevocably granted to SXNGE, or any third party designated by SXNGE, the right to acquire, in whole or in part, the respective equity interests in XXNGC of these XXNGC shareholders. The option agreement can be terminated by SXNGE by notifying XXNGC of its intention to terminate this agreement with 30 days prior notice. The option agreement is retroactive to March 8, 2006.
- Addendum to the Option Agreement, dated August 8, 2008. Under this addendum to the option agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders irrevocably granted to SXNGE an option to purchase the XXNGC shareholders' additional equity interests in XXNGC (the "Additional Equity Interest") in connection with any increase in XXNGC's registered capital subsequent to the execution of the option agreement described above, at \$1.00 or the lowest price permissible under applicable law at the time that SXNGE exercises the option to purchase the Additional Equity Interest. The option agreement can be terminated by SXNGE by notifying XXNGC of its intention to terminate this agreement with 30 days prior notice. This addendum is retroactive to June 30, 2008.
- Proxy Agreement, dated August 17, 2007. Under this agreement entered into between SXNGE, on the one hand, and XXNGC and certain shareholders of XXNGC, on the other hand, the XXNGC shareholders irrevocably granted to SXNGE the right to exercise their shareholder voting rights, including attendance at and voting of their shares at shareholders meetings in accordance with the applicable laws and XXNGC's articles of association. This agreement is retroactive to March 8, 2006.

#### Foreign Currency Translation

The Company's reporting currency is the U.S. dollar. The functional currency of XXNGC and the Company's and XXNGC's PRC subsidiaries, and, therefore, the functional currency of the Company, is the RMB. The results of operations and financial position of XXNGC and the Company's and XXNGC's PRC subsidiaries are translated to U.S. dollars using the period end exchange rates as to assets and liabilities and weighted average exchange rates as to revenues, expenses and cash flows. Capital accounts are translated at their historical exchange rates when the capital transaction occurred. The resulting currency translation adjustments are recorded as a component of accumulated other comprehensive income (loss) within stockholders' equity. As a result, translation adjustment 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. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

The balance sheet amounts, with the exception of equity, were translated at the December 31, 2010 exchange rate of RMB 6.59 to \$1.00 as compared to RMB 6.82 to \$1.00 at December 31, 2009. The equity accounts were stated at their historical rate. The average translation rates applied to income and cash flow statement amounts for the years ended December 31, 2010, 2009 and 2008 were 6.76, 6.82 RMB and 6.94 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 private sector banks in Hong Kong 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.

The Company maintains balances at financial institutions which, from time to time, may exceed Hong Kong Deposit Protection Board ("HKDPB") insured limits for the banks located in Hong Kong or may exceed Federal Deposit

Insurance Corporation (“FDIC”) 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 December 31, 2010 and 2009, the Company had total deposits of \$9,106,073 and \$47,459,560, respectively, without insurance coverage or in excess of HKDPB or FDIC insured limits. The Company has not experienced any losses to date as a result of this policy.

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#### Accounts Receivable

Accounts receivable are presented net of an allowance for doubtful accounts. The Company estimates an allowance for potential credit losses on accounts receivable. Management periodically 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 the allowance.

Management considers accounts past due after three months. 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 recorded allowances for doubtful accounts in the amount of \$15,177 and \$163,280 as of December 31, 2010 and 2009, respectively.

#### Other Receivable

Other receivable mainly include security deposit paid to government or landlord for certain contracts in our normal course of business. The security deposit will be refunded to the Company after the contract is completed.

#### Employee Advances

From time to time, the Company advances predetermined amounts based upon internal Company policy to certain employees and internal units. As of December 31, 2010 and 2009, the Company had employee advances in the amount of \$302,532 and \$338,689, respectively.

#### Inventories

Inventories are stated at the lower of cost or market, as determined on a first-in, first-out basis. 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. Inventories consist 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:

|                        | December 31, 2010 | December 31, 2009 |
|------------------------|-------------------|-------------------|
| Materials and supplies | \$ 524,934        | \$ 345,611        |
| Gasoline               | 290,950           | 496,226           |
|                        | \$ 815,884        | \$ 841,837        |

#### Advances to Suppliers

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

#### Prepaid expense and other current assets

Prepaid expenses and other current assets include the incoming value-added-tax, generated by purchasing of production facilities in the Jingbian LNG factory and prepaid rent for the land and premises. The incoming value-added-tax generated by purchasing of production facilities will grant the Company tax credits after the LNG factory becomes operational. The rent is recognized as a deferred expense and is amortized during the renting periods.





## Loan Receivable

Loan receivable consists of the following:

|  | December<br>31,<br>2010 | December<br>31,<br>2009 |
|--|-------------------------|-------------------------|
| Shanxi Tuojin Mining Company, due on November 30, 2009, extended to November 30, 2010, annual interest at 5.84%(1) | -                       | \$293,400               |
| Total  | -                       | \$293,400               |

(1) Shanxi Tuojin Mining Company paid off this loan on March 11, 2010.

## Investments in Unconsolidated Joint Ventures

Investee companies that are not required to be consolidated, but over which the Company exercises significant influence, are accounted for under the equity method of accounting. Whether or not the Company exercises significant influence with respect to an investee depends on an evaluation of several factors including, among others, representation on the investee company's board of directors and ownership level, which is generally a 20% to 50% interest in the voting securities of the investee company. Under the equity method of accounting, the Company's share of the earnings or losses of the investee company is reflected in the caption "other income (expense), net" in the consolidated statements of income and other comprehensive income. The Company's carrying value in an equity method investee company is its cost increased or decreased by its share of earnings or losses of the investee.

When the Company's carrying value in an equity method investee company is reduced to zero, no further losses are recorded in the Company's consolidated financial statements unless the Company has guaranteed obligations of the investee company or has committed additional funding. If the investee company subsequently reports income, the Company will not record its share of such income until it equals the amount of its share of losses not previously recognized.

The Company's investment in unconsolidated joint ventures that are accounted for on the equity method of accounting represents the Company's 49% interest in the JV. The investment in the JV amounted to \$1,517,000 and \$1,467,000 at December 31, 2010 and December 31, 2009, respectively. The JV has not had any operations to date.

The financial position of the JV as of December 31, 2010 is summarized below:

|                              | December 31,<br>2010 | December 31,<br>2009 |
|------------------------------|----------------------|----------------------|
| Current assets               | \$ 3,095,918         | \$ 2,993,878         |
| Noncurrent assets            | -                    | -                    |
| Total assets                 | \$ 3,095,918         | \$ 2,993,878         |
| Current liabilities          | -                    | -                    |
| Noncurrent liabilities       | -                    | -                    |
| Equity                       | \$ 3,095,918         | \$ 2,993,878         |
| Total liabilities and equity | \$ 3,095,918         | \$ 2,993,878         |

## 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:

|                               | December 31, 2010 | December 31, 2009 |
|-------------------------------|-------------------|-------------------|
| Office equipment              | \$ 580,688        | \$ 439,055        |
| Operating equipment           | 71,163,466        | 61,350,503        |
| Vehicles                      | 3,308,624         | 2,486,614         |
| Buildings and improvements    | 27,861,655        | 21,414,553        |
| Total property and equipment  | 102,914,433       | 85,690,725        |
| Less accumulated depreciation | (20,145,262)      | (12,977,713)      |
| Property and equipment, net   | \$ 82,769,171     | \$ 72,713,012     |

Depreciation expense for the years ended December 31, 2010, 2009 and 2008 was \$6,591,008, \$5,565,608 and \$3,473,429, respectively.

## Construction in Progress

Construction in progress consists of the cost of constructing property and equipment for CNG fueling stations and LNG projects, a natural gas infrastructure project in the Xi'an International Port District and other projects, including technology licensing fees, equipment purchases, 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 December 31, 2010 and December 31, 2009, the Company had construction in progress in the amount of \$116,569,871 and \$52,918,236, respectively. Interest cost capitalized into construction in progress for the years ended December 31, 2010, 2009 and 2008 amounted to \$6,492,529, \$4,597,544 and \$1,932,931, respectively.

Construction in progress at December 31, 2010 and 2009 is set forth in the table below. The column of "estimated additional cost to complete" reflects the amounts currently estimated by management to be necessary to complete the relevant project. As of December 31, 2010, the Company was not contractually or legally obligated to expend the estimated additional cost to complete these projects, except to the extent reflected in Note 13 to the consolidated financial statements.

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| Project Description              | Location                                | December 31,<br>2010 | Commencement<br>date | Expected<br>completion<br>date | Estimated<br>additional cost to<br>complete |
|----------------------------------|---|----------------------|----------------------|--------------------------------|---|
| Phase I of LNG Project           | Jingbian County, Shaanxi Province, PRC  | \$ 65,309,335(1)     | December 2006        | June 2011(2)                   | \$ 1,760,278(3)                             |
| Phases II and III of LNG Project | Jingbian County, Shaanxi Province, PRC  | 35,860,914(4)        | December 2006        | December 2015                  | 206,840,695(5)                              |
| Sa Pu Mother Station             | Henan Province, PRC                     | 925,328              | July 2008            | June 2011                      | 6,300,000                                   |
| International port(6)            | International Port District, Xi'an, PRC | 5,440,515            | May 2009             | December 2020                  | 299,400,000                                 |
| Other projects                   | PRC                                     | 9,033,779            | Various              | Various                        | 9,447,266                                   |
|                                  |   | \$ 116,569,871       |                      |                                | \$ 523,748,239                              |

| Project Description            | Location                               | December 31, 2009 | Commencement<br>Date | Expected<br>completion<br>date | Estimated<br>additional<br>cost to<br>complete |
|--------------------------------|--|-------------------|----------------------|--------------------------------|--|
| Jingbian LNG                   | Jingbian County, Shaanxi Province, PRC | \$ 44,411,503     | December 2006        | June 2010                      | \$ 11,150,000                                  |
| Sa Pu mother station           | Henan Province, PRC                    | 814,822           | July 2008            | June 2011                      | 6,300,000                                      |
| Zijing Energy mother station   | Sanyuan County, Shaanxi Province, PRC  | 4,213,074         | September 2008       | March 2010                     | 513,450  |
| Xi'an Cangsheng mother station | Xi'an, Shaanxi Province, PRC           | 1,891,584         | September 2008       | May 2011                       | 3,227,400                                      |
| Other CIP projects             | PRC                                    | 1,587,253         | Various              | Various                        | 450,000  |
|                                |  | \$ 52,918,236     |                      |                                | \$ 21,640,850                                  |

(1) Includes \$57,844,070 of construction cost and \$7,465,265 of capitalized interest for phase I of the LNG Project.

(2) The Company has completed the trial run in December 2010. Currently we are in the production preparation period.

(3) Includes \$717,602 of construction cost and \$1,042,676 of capitalized interest that the Company currently expects to expend to complete test runs and make installment payments to contractors. The total expected cost of \$67.07 million exceeds the amount originally anticipated by the Company. The increased costs to build a LNG processing capacity of 500,000 cubic meters are attributable to unforeseen cost overruns and escalations, including increases in material and labor costs incurred to reinforce pilings based upon modified engineering analyses, as well as rising land use rights prices, which the Company believes resulted from recent energy resource exploration activities in nearby areas. Phase I construction has also experienced delays due to changes in government policies with respect to tariff exemptions for core equipment imported by the Company and related additional document requirements of

the customs agency of Shaanxi Province, and increased international shipment times for ordered equipment due to the modification by international shipping companies of traditional shipment routes to avoid pirates along the Coast of Somalia.

- (4) Includes \$31,761,788 of construction cost and \$4,099,126 of capitalized interest for phase II and phase III of the LNG project.
- (5) This amount reflects management's current estimate that an investment in phases II and III through December 15, 2015, including an estimated \$186.8 million of construction cost and \$20 million of capitalized interest, may be able to finance the construction of a facility capable of processing 3,000,000 cubic meters of LNG per day, or approximately 900 million cubic meters per year.

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(6) Xi'an International Port District Committee, a local government agency in the PRC, has appointed XXNGC pursuant to a conditional non-binding agreement to be the developer of natural gas infrastructure for Xi'an International Port District, a former agricultural area that has been zoned for urbanization. If XXNGC chooses to proceed with the project, it will be responsible for constructing, and all costs related to the construction of, a natural gas pipeline network that will service residential, commercial and industrial buildings and users, as well as fueling stations and related infrastructure. The estimated cost to complete the project of \$299,400,000 is based upon a third-party feasibility study and management's current estimates. The Company is currently the only natural gas provider in the surrounding area and expects that it would supply natural gas to the International Port District once construction is completed. If the Company determines not to proceed further with this project, it expects to be able to obtain a refund from subcontractors of the \$5,440,515 invested as of December 31, 2010 or transfer the construction-in-progress assets.

### Goodwill

The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis in the fourth quarter or more frequently if indicators of impairment exist. The Company uses a two-step goodwill impairment test to identify the potential impairment and to measure the amount of goodwill impairment, if any. The first step is to compare the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill is considered not impaired. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. Under step two, the impairment loss is measured by comparing the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss is recognized in an amount equal to that excess. Goodwill is included in other assets on the consolidated balance sheet.

### Long-Lived Assets

The Company evaluates the carrying value of long-lived assets to be held and used at least annually and whenever events or changes in circumstances indicate that the assets might be impaired. Impairment losses are 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 December 31, 2010, 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 provide 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.

The 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 to 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 U.S. dollars, a currency other than the Company's functional currency, the RMB. 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 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 had been 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 at the beginning of the period and \$1,014,308 to warrant liabilities to recognize the fair value of such warrants. The fair value of the warrants was \$252,066 and \$2,045,638 as of December 31, 2010 and 2009, respectively. The Company recognized a gain of \$1,793,572 and a loss of \$1,031,330 for the years ended December 31, 2010 and 2009, respectively, to reflect the change in fair value of the warrants.

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

|                         | December 31, 2010 |   | December 31, 2009 |   | December 31, 2008 |   |
|-------------------------|-------------------|---|-------------------|---|-------------------|---|
| Annual dividend yield   | -                 |   | -                 |   | -                 |   |
| Expected life (years)   | 1.59              |   | 2.82              |   | 3.82              |   |
| Risk-free interest rate | 0.48              | % | 1.49              | % | 1.13              | % |
| Expected volatility     | 84                | % | 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 that this method produces an estimate that is representative of the Company's 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 United States Treasury securities with a term equal 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 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 the Company's financial assets and liabilities that were accounted for at fair value on a recurring basis as of December 31, 2010.

|  | Carrying Value at<br>December | Fair Value Measurement at<br>December 31, 2010 |
|--|-------------------------------|--|
|--|-------------------------------|--|

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|  | 31, 2010      | Level 1 | Level 2    | Level 3       |
|--|---------------|---------|------------|---------------|
| Senior notes                           | 30,615,669    | -       | -          | 30,615,669    |
| Redeemable liability – warrants        | 17,500,000    | -       | -          | 17,500,000    |
| Derivative liability – warrants        | 252,066       | -       | 252,066    | -             |
| Total liability measured at fair value | \$ 48,367,735 | \$ -    | \$ 252,066 | \$ 48,115,669 |

Other than the assets and liabilities set forth in the table above, the Company did not identify any other assets or liabilities that are required to be accounted for at fair value on the balance sheet. The carrying value of long-term debt with variable interest rate approximates its fair value.

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The following is a reconciliation of the beginning and ending balance of warrants and liability measured at fair value on a recurring basis using significant observable inputs (Level 2) as of December 31, 2010:

|                      |             |
|----------------------|-------------|
| Beginning balance    | \$2,045,638 |
| Change in fair value | (1,793,572) |
| Ending balance       | \$252,066   |

#### Revenue Recognition

Revenue is recognized when services are rendered to customers and 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. 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.

#### Stock-Based Compensations

The Company records and reports stock-based compensation based on 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. Compensation for stock granted to non-employees is determined 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. As at December 31, 2010 and 2009, there were no significant book to tax differences except for warrants liability and stock based compensation. There was no difference between book depreciation and tax depreciation as the Company uses the same depreciation method for both book depreciation and tax depreciation. An uncertain 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. Penalties and interest incurred related to underpayment of income tax are classified as income tax expense in the year incurred. No significant penalties or interest relating to income taxes have been incurred during the years ended December 31, 2010, 2009 and 2008.

Income tax returns for the years prior to 2007 are no longer subject to examination by tax authorities.

A reconciliation of tax at the U.S. federal statutory rate to the effective tax rate for income tax recorded in the financial statements is as follows:



|                               | For the years ended<br>December 31 |      |      |
|-------------------------------|------------------------------------|------|------|
|                               | 2010                               | 2009 | 2008 |
| US federal statutory tax rate | 34%                                | 34%  | 34%  |
| Foreign tax rate difference   | (9)%                               | (9)% | (9)% |
| Effect of favorable tax rate  | (9)%                               | (9)% | (9)% |
| Other item (1)                | 2%                                 | 3%   | 3%   |
| Effective tax rate            | 18%                                | 19%  | 19%  |

(1) The 2%, 3% and 3% represents \$1,525,674, \$3,444,173 and \$3,661,932 in expenses incurred by the Company that are not deductible in the PRC for the years ended December 31, 2010, 2009 and 2008, respectively.

The estimated tax savings for the years ended December 31, 2010, 2009 and 2008 amounted to approximately \$2,095,808, \$2,410,928 and \$2,195,871, respectively. The net effect on earnings per share, had the U.S. federal income tax been applied, would be a decrease in basic earnings per share for the years ended December 31, 2010, 2009 and 2008, from \$0.81 to \$0.71, \$1.13 to \$0.99 and \$1.04 to \$0.86, respectively. The net effect on earnings per share, had the U.S. federal income tax been applied, would be a decrease in diluted earnings per share for the years ended December 31, 2010, 2009 and 2008, from \$0.80 to \$0.71, \$1.12 to \$0.98, and \$1.04 to \$0.86, respectively.

The Company is incorporated in the United States and has incurred a net operating loss for U.S. income tax purpose for the period ended December 31, 2010. The estimated net operating loss carry-forwards for U.S. income tax purposes amounted to \$4,934,195 and \$2,699,276 as of December 31, 2010 and 2009, respectively, which may be available to reduce future years' taxable income. These carry-forwards will expire, if not utilized, beginning in 2027 through 2030. Management believes that the realization of the benefits arising from this loss appear to be uncertain due to the Company's limited operating history and continuing losses for U.S. income tax purposes. Accordingly, the Company has provided a 100% valuation allowance at December 31, 2010 and 2009. Management reviews this valuation allowance periodically and makes adjustments as warranted. The change in the valuation allowances were as follow:

| Valuation allowance          | For the years ended December 31, |            |            |
|------------------------------|----------------------------------|------------|------------|
|                              | 2010                             | 2009       | 2008       |
| Balance, beginning of period | \$ 917,754                       | \$ 563,541 | \$ 322,614 |
| Increase (decrease)          | (157,882)                        | 354,213    | 240,927    |
| Balance, end of period       | \$ 759,872                       | \$ 917,754 | \$ 563,541 |

The Company has cumulative undistributed earnings of foreign subsidiaries of approximately \$45,697,066 as of December 31, 2010, 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 the Company concluded that such earnings will be remitted in the future.

#### Local PRC Income Tax

The Company's PRC subsidiary, XXNGC and XXNGC's subsidiaries operate in the PRC. Starting January 1, 2008, pursuant to the tax laws of PRC, general enterprises are subject to income tax at an effective rate of 25% compared to 33% prior to 2008. However, under PRC income tax regulation, any company deemed to be engaged in the natural gas industry under such regulation enjoys a favorable income tax rate. Thus, XXNGC's income is subject to a reduced tax rate of 15%. The Company's PRC subsidiary and all of XXNGC's subsidiaries are not deemed to be engaged in the natural gas industry under PRC income tax regulation and, accordingly, are subject to a 25% income tax rate.



### Value-Added Tax

Sales revenue represents the invoiced value of goods, net of a value-added tax (“VAT”). The products of the Company’s VIE, XXNGC, and two of XXNGC’s subsidiaries, Lingbao Yuxi Natural Gas Co., Ltd. (“Lingbao Yuxi”) and Makou, that are sold in the PRC are subject to a PRC VAT at a rate of 13% of the gross sales price. This VAT may be offset by VAT paid by XXNGC or its subsidiaries, as applicable, 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 PRC VAT at a rate of 6%. This VAT cannot offset with VAT paid for materials included in the cost of revenues.

### Taxes Payable

Taxes payable at December 31, 2010 and 2009 consisted of the following:

|                               | December 31, 2010   | December 31, 2009   |
|-------------------------------|---------------------|---------------------|
| Value-added tax payable       | \$ 1,207,453        | \$ 740,772          |
| Business tax payable          | 252                 | 1,540               |
| Income tax payable            | 1,084,338           | 1,127,961           |
| Urban maintenance tax payable | 45,492              | 27,442              |
| Withholding tax payable       | 4,813               | 3,862               |
| Other tax payable             | 35,417              |                     |
| <b>Total tax payable</b>      | <b>\$ 2,377,765</b> | <b>\$ 1,901,577</b> |

### Basic and Diluted Earnings Per Share

Basic net earnings per share are based upon the weighted average number of common shares outstanding. Diluted net earnings per share are based on the assumption that all dilutive convertible shares and stock options were converted or exercised, unless this results in anti-dilution. 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 was effective on April 28, 2009.

### Reclassifications

Certain reclassifications have been made to the prior years’ financial statements to conform to the current year presentation. We reclassified \$1,041,209 from general and administrative expenses to selling expenses in the consolidated statements of income and other comprehensive income for year ended December 31, 2009.

### Recently issued accounting pronouncements

In January 2010, the FASB issued Accounting Standards Update (“ASU”) No. 2010-01, Accounting for Distributions to Shareholders with Components of Stock and Cash, which clarifies that the stock portion of a distribution to shareholders that allows them to elect to receive cash or stock with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate is considered a share issuance that is reflected in earnings per

share prospectively and is not a stock dividend for purposes of applying Topics 505 and 260 (Equity and Earnings Per Share). The amendments in this update are effective for interim and annual periods ending on or after December 15, 2009, and should be applied on a retrospective basis. The Company's adoption of this ASU did not have a material impact on its consolidated financial statements.

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In January 2010, the FASB issued ASU No. 2010-02, Accounting and Reporting for Decreases in Ownership of a Subsidiary – a Scope Clarification, which affects accounting and reporting by an entity that experiences a decrease in ownership in a subsidiary that is a business or nonprofit activity. This ASU also affects accounting and reporting by an entity that exchanges a group of assets that constitutes a business or nonprofit activity for an equity interest in another entity. The amendments in this update are effective beginning in the period that an entity adopts ASU 810-10, Consolidations. If an entity has previously adopted ASU 810-10 as of the date the amendments in this update are included in the Accounting Standards Codification, the amendments in this update are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this update should be applied retrospectively to the first period that an entity adopted ASU 810-10. The Company's adoption of this ASU did not have a material impact on its consolidated financial statements.

In January 2010, the FASB issued ASU No. 2010-06, Improving Disclosures about Fair Value Measurements. This update provides amendments to Subtopic 820-10 that requires new disclosure as follows: (1) transfers in and out of Levels 1 and 2: a reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers; (2) activity in Level 3 fair value measurements in the reconciliation for fair value measurements using significant unobservable inputs (Level 3) a reporting entity should present separately information about purchases, sales, issuances and settlements (that is, on a gross basis rather than as one net number). This update provides amendments to Subtopic 820-10 that clarifies existing disclosures as follows: (1) level of disaggregation: a reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities; (2) Disclosures about inputs and valuation techniques: A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The Company is currently evaluating the impact of this ASU, however, the Company's adoption of this ASU did not have a material impact on its consolidated financial statements.

In April 2010, the FASB issued ASU 2010-13, Compensation -Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades. This update provides amendments to Topic 718 to clarify that an employee share-based payment award with an exercise price denominated in currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The Company's adoption of this ASU did not have a material impact on its consolidated financial statements.

In September 2010, the FASB issued Accounting Standard Update 2010-25, Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans. This ASU clarifies how loans to participants should be classified and measured by defined contribution plans and how International Financial Reporting Standards compare to these provisions. The amendments in this update are effective for fiscal years ending after December 15 2010. The Company's adoption of this ASU did not have a material impact on its consolidated financial statements.

In December 2010, the FASB issued Accounting Standard Update 2010-28, Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts. This ASU modified Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. For public entities, the amendments in the ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. The Company's adoption of this ASU is not expected to have a material impact on its consolidated financial statements.

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In December 2010, the FASB issued Accounting Standard Update 2010-29, Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations. This ASU specifies that, if a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 is effective prospectively for business combinations where the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. The Company's adoption of this ASU is not expected to have a material impact on its consolidated financial statements.

### Note 3 –Business Combinations

Effective January 1, 2009, the Company adopted the accounting standard related to business combinations, which requires the acquisition method of accounting to be used for all business combinations and for an acquirer to be identified for each business combination. This accounting standard requires an acquirer to recognize the assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at the acquisition date, measured at their fair values as of that date, with limited exceptions. It also requires the acquirer in a business combination achieved in stages (sometimes referred to as a step acquisition) to recognize the identifiable assets and liabilities, as well as the non-controlling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with the standard).

The Company's acquisition of Makou was accounted for in accordance with this standard and the Company has allocated the purchase price of Makou based upon the fair value of the net assets acquired and liabilities assumed at the acquisition date. The Company estimated the fair values of the assets acquired and liabilities assumed at the acquisition date in accordance with the business combination standard and, except for cash and cash equivalents, fair value was estimated using Level 3 inputs under the accounting standards related to fair value measurements. Level 3 inputs for the nonfinancial assets included a valuation report (prepared by a third-party appraisal firm) that primarily utilized a cost approach valuation technique.

In accordance with the accounting standards related to goodwill and other intangible assets, indefinite lived intangibles and goodwill are not being amortized.

The following table summarizes the net book value and the fair value of the assets acquired at the date of acquisition, which represents the purchase price allocation at the date of the acquisition of Makou. No liabilities were assumed.

|                                    | Net Book Value | Fair Value   |
|------------------------------------|----------------|--------------|
| Property, plant and equipment, net | 1,241,992      | 1,241,992    |
| Land use rights                    | 1,817,567      | 1,817,567    |
| Goodwill                           | -              | 598,800      |
| Total assets                       | 3,059,559      | 3,658,359    |
| Net assets                         | \$ 3,059,559   | \$ 3,658,359 |

The Company determined the \$3.6 million fair value of the acquired assets of Makou based on an evaluation by an independent appraisal firm and the final asset evaluation by management. The excess of the purchase price of an acquired entity over the net of the amounts assigned to assets acquired is recognized as goodwill, and represents intangible values that Makou has built over its existing profitable business, which do not qualify for separate recognitions, or other factors. These values include but are not limited to:

expected synergies from expanding our market share in the natural gas industry;

the existing reputation of the current management team;

the experience of the work force;

the stable relationship with its existing suppliers;

the existing operating licenses of shortening our time of starting up a brand new mother station.

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As a result, the \$0.6 million of goodwill was due to the acquisition purchase price over the fair value of the assets acquired. As of December 31, 2010, the Company did not record any impairment charge from write-downs of purchased intangible assets since the Company did not identify any trends that caused a reduction in expected future cash flows.

#### Note 4 – Other Assets

Other assets consisted of the following:

|   | December 31,<br>2010 | December 31,<br>2009 |
|---|----------------------|----------------------|
| Prepaid rent – natural gas stations                           | \$ 2,317,270         | \$ 340,211           |
| Goodwill  | 606,924              | -                    |
| Prepayment for acquiring land use right                       | 3,822,840            | 1,936,440            |
| Advances on purchasing equipment and construction in progress | 3,358,008            | 12,056,964           |
| Refundable security deposits                                  | 2,654,379            | 1,264,283            |
| Intangible assets   | 7,046,954            | 257,012              |
| <b>Total</b>  | <b>\$ 19,806,375</b> | <b>\$ 15,854,910</b> |

The goodwill amount is the excess of the cost the Company paid to acquire 100% of the equity interests of Makou over the fair value of Makou's net assets. Annual impairment testing is performed during the fourth quarter of each year unless events or circumstances indicate earlier impairment testing is required. No impairment loss was recognized during the year ended December 31, 2010.

All land in the PRC is government owned. However, the government grants users land use rights. As of December 31, 2010 and 2009, the Company prepaid \$3,822,840 and \$1,936,440, respectively, to PRC local government authorities 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 amounts prepaid for land use rights.

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

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

|                   |                        |
|-------------------|------------------------|
| Intangible assets | Estimated useful lives |
| Land use rights   | 30 years               |

Intangible assets represent operating rights acquired during acquisition of four natural gas stations, consisting of following:

|                  | December 31,<br>2010 | December 31,<br>2009 |
|------------------|----------------------|----------------------|
| Operating rights | \$ 5,032,541         | \$ -                 |
| Land use rights  | 2,014,413            | 257,012              |

|       |              |            |
|-------|--------------|------------|
| Total | \$ 7,046,954 | \$ 257,012 |
|-------|--------------|------------|

The operating rights are deemed to have an indefinite useful life as cash flows are expected to continue indefinitely. The operating rights will not be amortized until their useful life is deemed to be no longer indefinite. The Company evaluates intangible assets for impairment at least annually and whenever events or changes in circumstances indicate that the assets might be impaired.

The land use rights included in intangible assets have been granted to the Company by the government of the PRC and are being amortized over their estimated useful life of 30 years.

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Note 5 –Notes Payable

The Company’s securities purchase agreement with Abax Lotus Ltd. (“Abax”) was amended on January 29, 2008 (as amended, the “Purchase Agreement”). Under the Purchase Agreement, on January 29, 2008, the Company sold to Abax \$20,000,000 in principal amount of its 5.0% Guaranteed Senior Notes due January 30, 2014 (the “Senior Notes”) and warrants to purchase 1,450,000 shares of its common stock (the “Abax Warrants”) and, on March 3, 2008, the Company issued to Abax an additional \$20,000,000 in principal amount of Senior Notes.

In connection with the Purchase Agreement, on January 29, 2008, the Company also entered into the following:

- indenture with DB Trustees (Hong Kong) Limited, as trustee (the “Trustee”), pursuant to which the Senior Notes were issued (the “Indenture”);
- warrant agreement with Deutsche Bank AG, Hong Kong Branch, as warrant agent, pursuant to which the Abax Warrants were issued;
- investor rights agreement with Abax, pursuant to which, among other things, Abax had the right to nominate a director for election to the Company’s board of directors so long as Abax held at least 10% of the outstanding shares of common stock on an as-converted, fully diluted basis. Abax no longer holds such amount of the Company’s common stock and therefore no longer has a director nomination right;
- registration rights agreement with Abax, pursuant to which the Company agreed to file a registration statement to register the resale of the shares of common stock issuable upon exercise of the Abax Warrants. The Company filed a registration statement on Form S-1 (File No. 149719), which was declared effective by the Securities and Exchange Commission on May 6, 2008, to register the resale of the shares of common stock issuable upon exercise of the Abax Warrants;
- information rights agreement with Abax, pursuant to which Abax has the right to receive certain information regarding the Company;
- onshore share pledge agreement with DB Trustees (Hong Kong) Limited, as pledgee, pursuant to which the Company granted to DB Trustees (Hong Kong) Limited, on behalf of the holders of the Senior Notes, a pledge on 65% of the Company’s equity interests in its PRC subsidiary; and
- account pledge and security agreement with DB Trustees (Hong Kong) Limited, as collateral agent, pursuant to which the Company granted to DB Trustees (Hong Kong) Limited a security interest in the account where the proceeds from the Company’s sale of the Senior Notes were deposited.

On the dates set forth in the table below, the Company will be required to make repayments of the corresponding percentage of the principal amount (or such lesser principal amount as shall be outstanding then) in respect of the aggregate outstanding principal amount of the Senior Notes as of July 30, 2011:

| Date             | Repayment Percentage |
|------------------|----------------------|
| July 30, 2011    | 8.3333%              |
| January 30, 2012 | 8.3333%              |
| July 30, 2012    | 16.6667%             |
| January 30, 2013 | 16.6667%             |
| July 30, 2013    | 25.0000%             |
| January 30, 2014 | 25.0000%             |

Notes payable at December 31, 2010 consists of the following:

|                      |              |
|----------------------|--------------|
| Notes payable        | \$40,000,000 |
| Less discount        | (9,384,331 ) |
|                      | 30,615,669   |
| Less current portion | (2,551,306 ) |
|                      | \$28,064,363 |

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The Company has the option to redeem all, but not less than all, of the Senior Notes at the redemption prices set forth below (in each case expressed as a percentage of the outstanding unpaid principal amount), plus accrued and unpaid interest, if redeemed during the twelve-month period commencing on January 29 of the years set forth below:

| Year                | Principal  |
|---------------------|------------|
| 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 Company had the option to redeem \$42,400,000 and \$43,200,000 of the Senior Notes in 2010 and 2009, respectively, but has not made any payments of principal or interest on the Senior Notes, except as described below.

The terms of the Indenture obligated the Company to complete a qualifying listing, as defined therein, by January 29, 2009. As the Company did not complete a qualifying listing by such date, the Company was obligated to pay to Abax an additional interest at the rate of 3.0% per annum, calculated from and including January 29, 2009 to the date of its qualifying listing. However, Abax caused the Trustee to waive the Company's obligation to pay such additional interest in February 2009. The waiver extended the deadline for a qualifying listing to May 4, 2009, but provided that if a qualifying listing were not completed by such date, additional interest of 3.0% per annum would be payable from January 29, 2009 to the date of the Company's qualifying listing. The Company completed its NASDAQ listing, which constituted a qualifying listing, on June 1, 2009, after the extended deadline of May 4, 2009. Therefore, under the terms of the initial waiver, the Company was required to pay additional interest at a rate of 3.0% per annum for the period from January 29, 2009 to June 1, 2009, or \$406,667. However, in August 2009, the Company reached an agreement with Abax whereby the Company agreed to pay Abax \$113,214, which reflected additional interest at the rate of 3.0% per annum for the period from April 30, 2009 to May 31, 2009, and \$50,000, which reflected out-of-pocket expenses incurred by Abax in connection with a financing transaction proposed in 2008, but never consummated.

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.

In connection with the issuance of the Senior Notes, the Company paid \$2,122,509 in debt issuance costs, which are being amortized over the life of the Senior Notes. For the years ended December 31, 2010, 2009 and 2008, the Company amortized \$0, \$63,940, and \$227,989, respectively, of the aforesaid issuance costs, net of capitalized interest.

The Abax Warrants are presently exercisable and have an exercise price of \$7.3652 per share, although Abax has not exercised any of the Abax Warrants.

The Abax Warrants are considered derivative instruments required to be bifurcated from the original security because there is a redemption requirement if the holder does not exercise the Warrants. If Abax does not exercise the Abax Warrants prior to their expiration date, January 29, 2015, Abax can require the Company to repurchase the Abax 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 years ended December 31, 2010, 2009 and 2008, the Company amortized \$3,323,382, \$2,770,682 and \$2,021,605, respectively, of the aforesaid discounts, of which \$3,323,382, \$2,490,432 and \$1,016,928, respectively,

were capitalized into construction in progress.

Note 6 – Long-term Loan

The Company's long-term debt as of December 31, 2010 consists of:

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December 31,  
2010

A loan from Pudong Development Bank Xi'an Branch, due various dates from 2012 to 2014. With interest at 5.76% for the first year and subject to adjustment after the second year.

\$ 18,204,000

The loan was secured by XXNGC's equipment and vehicles located within the PRC. The carrying net value of the assets pledged is \$12,150,759 as of December 31, 2010. Interest expense for the year ended December 31 2010 was \$760,199, all of which was capitalized into construction in progress. XXNGC also entered into a guaranty with the lender to guarantee the repayment of the loans. As the People's Bank of China adjusted the standard interest rate two times on October and December, 2010, beginning January 1, 2011 the interest rate of these loans is 6.22%. The Company is required to make mandatory repayments on the long term loan as follows:

|                  | Repayment<br>Percentage | Repayment<br>Amount |
|------------------|-------------------------|---------------------|
| March 5, 2012    | 25%                     | \$ 4,551,000        |
| March 5, 2013    | 25%                     | 4,551,000           |
| March 5, 2014    | 25%                     | 4,551,000           |
| December 5, 2014 | 25%                     | 4,551,000           |
|                  |                         | \$ 18,204,000       |

## Note 7 – Warrants

The following is a summary of the warrant activity:

|                                | Warrants<br>Outstanding | Warrants<br>Exercisable | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|-------------------------|-------------------------|---------------------------------------|---------------------------------|
| Outstanding, December 31, 2007 | 544,242                 | 544,242                 | \$ 13.10                              | \$376,977                       |
| Granted                        | 1,450,000               |                         | 14.74                                 | -                               |
| Forfeited                      | -                       |                         | -                                     | -                               |
| Exercised                      | -                       |                         | -                                     | -                               |
| Outstanding, December 31, 2008 | 1,994,242               | 544,242                 | \$ 14.28                              | \$-                             |
| Granted                        | -                       |                         | -                                     | -                               |
| Forfeited                      | (160,588 )              | (160,588 )              | 7.20                                  | -                               |
| Exercised                      | -                       |                         | -                                     | -                               |
| Outstanding, December 31, 2009 | 1,833,654               | 383,654                 | \$ 8.93                               | \$4,008,434                     |
| Granted                        | -                       |                         | -                                     | -                               |
| Forfeited                      | -                       |                         | -                                     | -                               |
| Exercised                      | -                       |                         | -                                     | -                               |
| Outstanding, December 31, 2010 | 1,833,654               | 383,654                 | 8.93                                  | -                               |

The following is a summary of the status of warrants outstanding and exercisable as of December 31, 2010:

## Warrants Outstanding

| Exercise Price | Number    | Average Remaining Contractual Life |
|----------------|-----------|------------------------------------|
| \$ 7.37        | 1,450,000 | 4.08                               |
| 14.86          | 383,654   | 1.59                               |
| \$ 8.93        | 1,833,654 | 3.56                               |

## Warrants Exercisable

| Exercise Price | Number  | Average Remaining Contractual Life |
|----------------|---------|------------------------------------|
| \$ 14.86       | 383,654 | 1.59                               |

## Note 8 – 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 RMB 100 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 \$389,219, \$224,949 and \$112,233 for the years ended December 31, 2010, 2009 and 2008, respectively.

## Note 9 – Stockholders' Equity

## a) Secondary Public Offering

On September 9, 2009, the Company completed a public offering of 5,725,000 shares of its common stock at a price of \$8.75 per share. The Company 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, following the underwriters' exercise of the over-allotment option in full.

The net proceeds, after deducting underwriting discounts and commissions and other expenses, was approximately \$54.4 million.

## b) Statutory Reserve

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

- 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; and
- iii. allocations to the discretionary surplus reserve, if approved in the shareholders' general meeting.

As of December 31, 2010 and 2009, the remaining amount needed to fulfill the 50% registered capital requirement was approximately \$65,408,874 and \$62,649,581, respectively.

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c) Stock-based Compensation

Options to pay for certain Company legal expenses

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

The Company used the Black-Scholes Option Pricing Model to value the options at the time they were issued, based on the stock price on the 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. \$66,024, \$66,535 and \$66,704 of compensation expense was recorded during the years ended December 31, 2010, 2009 and 2008, respectively.

2009 Stock Option and Stock Award Plan

On March 11, 2009, the Board approved by written consent the China Natural Gas, Inc. 2009 Employee Stock Option and Stock Award Plan (the "Plan"). Pursuant to the Plan, there are currently 1,460,000 shares of Company common stock authorized for issuance and the Company has granted 638,000 stock options as of December 31, 2010, of which 138,000 have been exercised and 140,700 have been cancelled and are available for reissuance. Thus, there are currently 962,700 shares of Company common stock available for future issuance under the Plan and 359,300 options outstanding. The exercise price for all of the outstanding options is \$4.90 per share.

The Company used the Black-Scholes 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 volatility of the Company's common stock was estimated by management based on the historical volatility of the Company's common stock, the risk free interest rate was based on Treasury Constant Maturity Rates published by the United States Federal Reserve for periods applicable to the estimated life of the options, and the expected dividend yield was based on the current and expected dividend policy. The Company currently uses the "simplified" method to estimate the expected term for share option grants as it does not have sufficient historical experience to provide a reasonable estimate. The Company will continue to use the "simplified" method until management it feels that it has sufficient historical experience to provide a reasonable estimate of expected terms. 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. Compensation expense of \$1,018,303 and \$158,517 was recorded during the years ended December 31, 2010 and 2009, respectively.

During the year ended December 31, 2010, stock options exercisable into 138,000 shares of common stock have been exercised, resulting in \$676,200 of proceeds.

As of December 31, 2010, \$1,448,075 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 2.25 years.



The following is a summary of the stock option activity during all years presented:

|                                | Options<br>Outstanding | Warrants<br>Exercisable | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value |
|--------------------------------|------------------------|-------------------------|--|---------------------------------|
| Outstanding, December 31, 2007 | -                      | -                       | \$-                                      | \$ -                            |
| Granted                        | -                      | -                       | -  | -                               |
| Forfeited                      | -                      | -                       | -  | -                               |
| Exercised                      | -                      | -                       | -  | -                               |
| Outstanding, December 31, 2008 | -                      | -                       | \$-                                      | \$ -                            |
| Granted                        | 318,850                | -                       | 4.90                                     | -                               |
| Forfeited                      | (75,000 )              | -                       | 4.90                                     | -                               |
| Exercised                      | -                      | -                       | -  | -                               |
| Outstanding, December 31, 2009 | 243,850                | -                       | \$4.90                                   | \$ -                            |
| Granted                        | 380,850                | -                       | -  | -                               |
| Forfeited                      | (127,400 )             | -                       | -  | -                               |
| Exercised                      | (138,000 )             | -                       | -  | -                               |
| Outstanding, December 31, 2010 | 359,300                | 2,750                   | \$4.90                                   | \$ 219,173                      |

The following is a summary of the status of stock options outstanding and exercisable at December 31, 2010:

| Outstanding Options |         |  | Exercisable Options |        |  |
|---------------------|---------|--|---------------------|--------|--|
| Exercise Price      | Number  | Average<br>Remaining<br>Contractual Life | Exercise Price      | Number | Average<br>Remaining<br>Contractual Life |
| \$ 4.90             | 359,300 | 4.25years                                | \$ 4.90             | 2,750  | 4.25 years                               |

#### Note 10 – Earnings per Share

The following is a calculation of basic and diluted earnings per common share for the years ended December 31, 2010, 2009 and 2008:

|                                    | For the years ended December 31, |               |               |
|------------------------------------|----------------------------------|---------------|---------------|
|                                    | 2010                             | 2009          | 2008          |
| <b>Basic earnings per share</b>    |                                  |               |               |
| Net income                         | \$ 17,220,372                    | \$ 18,830,787 | \$ 15,190,368 |
| Weighted shares outstanding-Basic  | 21,268,972                       | 16,624,294    | 14,600,154    |
| Earnings per share-Basic           | \$ 0.81                          | \$ 1.13       | \$ 1.04       |
| <b>Diluted earnings per share</b>  |                                  |               |               |
| Net income                         | \$ 17,220,372                    | \$ 18,830,787 | \$ 15,190,368 |
| Weighted shares outstanding -Basic | 21,268,972                       | 16,624,294    | 14,600,154    |

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|                                       |            |            |            |
|---------------------------------------|------------|------------|------------|
| Effect of diluted securities-Warrants | 46,644     | 206,613    | 44,916     |
| Effect of diluted securities-Options  | 115,251    | -          | -          |
| Weighted shares outstanding-Diluted   | 21,430,867 | 16,830,907 | 14,645,070 |
| Earnings per share-Diluted            | \$ 0.80    | \$ 1.12    | \$ 1.04    |

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The Company had 1,833,654, 1,833,654 and 1,994,242 outstanding warrants at December 31, 2010, 2009 and 2008, respectively. For the year ended December 31, 2010, 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 46,644; 383,654 outstanding warrants that were excluded from the diluted earnings per share calculation as they are anti-dilutive. For the year ended December 31, 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 206,613; 383,654 outstanding warrants that were excluded from the diluted earnings per share calculation as they are anti-dilutive. For the year ended December 31, 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 44,916; 1,833,654 outstanding warrants that were excluded from the diluted earnings per share calculation as they are anti-dilutive.

The Company had 395,300 outstanding employee stock options at December 31, 2010. For the year ended December 31, 2010, the average stock price was greater than the exercise price of the options which resulted in additional weighted average common stock equivalents of 115,251.

#### Note 11 – Related Party Transactions

On August 31, 2010, the Company temporarily borrowed \$1,347,300 from the JV for working capital purpose. The borrowing does not have an explicit term, interest or collateral pledged. The Company repaid the borrowing in full on November 8, 2010.

#### Note 12 – Concentrations

Concentration of natural gas vendors:

|   | For the years ended December 31, |      |      |
|---|----------------------------------|------|------|
|   | 2010                             | 2009 | 2008 |
| Numbers of natural gas vendors            | 4                                | 4    | 4    |
| Percentage of total natural gas purchases | 86%                              | 98%  | 98%  |

As of December 31, 2010 and 2009, the Company had \$159,513 and \$82,146 payable to its major suppliers.

The Company maintains long-term natural gas purchase agreements with one of our vendors, Huojia Hualong Petrochemical Co., Ltd., as of December 31, 2010. 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.

The Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC and by the general state of the PRC 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 13 – Commitments and Contingencies

##### Lease Commitments



The Company entered into a series of long-term lease agreements with outside parties to lease land use rights for the Company's CNG fueling 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 Company also entered into five office leases in Xi'an, PRC, one office lease in Wuhan, PRC, one office lease in Yichang, PRC, one office lease in Huangshi, PRC and one office lease in New York, NY. The minimum future payment for leasing land use rights and offices is as follows:

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|                               |               |
|-------------------------------|---------------|
| Year ending December 31, 2011 | \$ 2,012,740  |
| Year ending December 31, 2012 | 2,035,048     |
| Year ending December 31, 2013 | 1,874,914     |
| Year ending December 31, 2014 | 2,237,697     |
| Year ending December 31, 2015 | 1,961,313     |
| Thereafter                    | 32,688,037    |
| Total                         | \$ 42,809,749 |

For the years ended December 31, 2010, 2009 and 2008, the land use right and office lease expenses were \$2,083,039, \$1,623,127 and \$1,127,558, respectively.

#### Property and Equipment Purchase Commitments

The Company has purchase commitments for materials, supplies, services and property and equipment for constructing the LNG plant and other construction projects. The Company has future commitments as followings:

|                               |               |
|-------------------------------|---------------|
| Year ending December 31, 2011 | 11,178,038    |
| Thereafter                    | -             |
| Total                         | \$ 11,178,038 |

#### 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 sufficient flexibility to constantly look for lower-cost sources of supply. Therefore, the Company is not legally bound in purchase commitments by those agreements.

#### Legal Proceedings

a) The Company and certain of its officers and directors have been named as defendants in a putative class action lawsuit alleging violations of the federal securities laws. That action, captioned Vandeveld v. China Natural Gas, Inc., et al., C.A. No. 10-728, was filed on August 26, 2010 in the United States District Court for the District of Delaware. The plaintiff in Vandeveld asserts that the Company, Qinan Ji, Zhiqiang Wang, Donald Yang, David She, Carl Yeung and Lawrence Leighton violated Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, when it failed to disclose and properly account for the Loan in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2010. The complaint alleges that the Pledge to secure the Loan violated the Indenture for the Senior Notes and the warrant agreement relating to the warrants issued to Abax, giving the holder of those notes and warrants the right to declare a default under the Indenture. The complaint further alleges that, on August 20, 2010, the Company amended its Annual Report on Form 10-K for the year ended December 31, 2009 and Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 to disclose the Loan and restate its financial statements in light of the note and warrant holder's right to declare a default under the Indenture, and that the announcement of this news caused the price of our stock to drop by twenty percent. The plaintiff seeks damages in an unspecified amount to recover the losses purportedly suffered by the putative class as a result of that decline. The complaint also asserts claims against the individual defendants as controlling persons of the Company for violations of Section 20(a) of the Securities Exchange Act of 1934.

A second action, captioned Baranowski v. China Natural Gas, Inc., et al., Case No. 10-6572, was filed on September 3, 2010 in the United States District Court for the Southern District of New York. The plaintiff in that action, which

was based on the same claims as those asserted by the plaintiff in Vandavelde and on substantially similar allegations, voluntarily dismissed the action without prejudice on November 23, 2010.

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Two putative class members in the Vandavelde action have moved for appointment as lead plaintiff. After the Court decides those motions, the putative class member who is appointed lead plaintiff will have an opportunity to file an amended complaint. The defendants will not be required to answer or otherwise respond to the complaint until after the lead plaintiff either decides to proceed on the basis of the original complaint or files an amended complaint.

The Company intends to defend this case vigorously. The Company currently cannot estimate the outcome of this litigation as of the date of this report.

b)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, the Company believes that any liability it might incur will not have a material adverse effect on its financial condition or our results of operations.

Note 14 – Quarterly Financial Information

For the years ended December 31, 2010, 2009, and 2008, unaudited quarterly financial data information is as follows:

| Year Ended December 31, 2010 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year     |
|------------------------------|---------------|----------------|---------------|----------------|---------------|
| Revenues                     | \$ 19,366,823 | \$ 21,135,599  | \$ 22,326,474 | \$ 27,124,727  | \$ 89,953,623 |
| Gross profit                 | 9,094,968     | 9,615,532      | 9,389,195     | 11,313,769     | 39,413,464    |
| Net income                   | 3,995,270     | 4,560,503      | 3,584,842     | 5,079,757      | 17,220,372    |
| Basic EPS                    | 0.19          | 0.21           | 0.17          | 0.24           | 0.81          |
| Diluted EPS                  | 0.19          | 0.21           | 0.17          | 0.23           | 0.80          |

| Year Ended December 31, 2009 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year     |
|------------------------------|---------------|----------------|---------------|----------------|---------------|
| Revenues                     | \$ 18,527,666 | \$ 20,742,520  | \$ 20,125,184 | \$ 21,670,748  | \$ 81,066,118 |
| Gross profit                 | 9,633,652     | 10,278,190     | 9,717,692     | 10,531,545     | 40,161,079    |
| Net income                   | 4,201,623     | 3,862,756      | 4,647,519     | 6,118,889      | 18,830,787    |
| Basic EPS                    | 0.29          | 0.26           | 0.29          | 0.29           | 1.13          |
| Diluted EPS                  | 0.29          | 0.26           | 0.29          | 0.28           | 1.12          |

| Year Ended December 31, 2008 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter | Full Year     |
|------------------------------|---------------|----------------|---------------|----------------|---------------|
| Revenues                     | \$ 14,025,674 | \$ 16,890,486  | \$ 18,401,200 | \$ 18,403,299  | \$ 67,720,659 |
| Gross profit                 | 6,088,476     | 7,665,763      | 9,492,367     | 9,492,416      | 32,739,022    |
| Net income                   | 2,808,571     | 3,512,892      | 5,136,590     | 3,732,315      | 15,190,368    |
| Basic EPS                    | 0.20          | 0.24           | 0.35          | 0.25           | 1.04          |
| Diluted EPS                  | 0.20          | 0.24           | 0.35          | 0.25           | 1.04          |

