

China Precision Steel, Inc.  
Form 10-Q  
November 10, 2008

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended: September 30, 2008

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-23039

**CHINA PRECISION STEEL, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**14-1623047**

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

**18th Floor, Teda Building  
87 Wing Lok Street, Sheungwan, Hong Kong,  
People's Republic of China**

(Address of principal executive offices, Zip Code)

**+1-852-2543-2290**

(Registrant's telephone number, including area code)

\_\_\_\_\_  
(Former name, former address and former fiscal year, if changed since last report)

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

The number of shares outstanding of each of the issuer's classes of common equity, as of November 10, 2008 is as follows:

Class of Securities	Shares Outstanding
Common Stock, \$0.001 par value	46,562,955

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**PART I**  
**FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS.**

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Table of Contents**Item 1. Financial Statements.**

**China Precision Steel, Inc. and Subsidiaries**  
**Condensed Consolidated Balance Sheets**

	Notes	(Unaudited) September 30, 2008	June 30, 2008
<b>Assets</b>			
<b>Current assets</b>			
Cash and equivalents		\$ 10,327,075	\$ 18,568,842
Accounts receivable			
Trade, net of allowances of \$1,034,354 and \$1,033,479 at September 30 and June 30, 2008, respectively		36,535,870	33,783,074
Bills receivables		7,260,878	4,309,703
Other		575,519	571,746
Inventories	5	18,154,946	17,815,087
Prepaid expenses		—	58,105
Advances to suppliers, net of allowance of \$2,524,973 and \$2,522,837 at September 30 and June 30, 2008, respectively		31,082,560	33,027,365
<b>Total current assets</b>		<b>103,936,848</b>	<b>108,133,922</b>
<b>Property and equipment</b>			
Property and equipment, net	6	39,214,849	39,199,305
Construction-in-progress	7	22,930,167	16,476,454
		62,145,016	55,675,759
<b>Intangible assets, net</b>		<b>1,626,393</b>	<b>1,625,690</b>
<b>Goodwill</b>		<b>99,999</b>	<b>99,999</b>
<b>Total assets</b>		<b>\$ 167,808,256</b>	<b>\$ 165,535,370</b>
<b>Liabilities and Stockholders' Equity</b>			
<b>Current liabilities</b>			
Accounts payable and accrued liabilities		\$ 12,873,381	\$ 12,047,981
Advances from customers	8	3,710,279	6,996,996
Other taxes payables		5,561,006	3,976,239
Current income taxes payable		4,746,404	4,742,387
Notes payable	9	17,392,980	17,465,799
<b>Total current liabilities</b>		<b>44,284,050</b>	<b>45,229,402</b>

**Stockholders' equity:**

Preferred stock: \$0.001 per value, 8,000,000 shares authorized, no shares outstanding at September 30, and June 30, 2008	11		
Common stock: \$0.001 par value, 62,000,000 shares authorized, 46,562,955 and 46,472,955 issued and outstanding September 30, and June 30, 2008	11	46,563	46,473
Additional paid-in capital	11	75,642,383	75,372,488
Accumulated other comprehensive income		9,368,177	9,295,658
Retained earnings		38,467,083	35,591,349
<b>Total stockholders' equity</b>		123,524,206	120,305,968
<b>Total liabilities and stockholders' equity</b>		\$ 167,808,256	\$ 165,535,370

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

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**China Precision Steel, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Operations**  
**For the Three Months Ended September 30, 2008 and 2007**  
**(Unaudited)**

	Notes	2008	2007
<b>Revenues</b>			
Sales revenues		\$ 25,350,419	\$ 27,187,235
Cost of goods sold		21,397,761	20,245,135
<b>Gross profit</b>		<b>3,952,658</b>	<b>6,942,100</b>
<b>Operating expenses</b>			
Selling expenses		211,298	100,705
Administrative expenses		462,100	486,376
Provision for bad debts		—	625,998
Depreciation and amortization expense		26,203	13,632
<b>Total operating expenses</b>		<b>699,601</b>	<b>1,226,711</b>
<b>Income from continuing operations</b>		<b>3,253,057</b>	<b>5,715,389</b>
<b>Other income (expense)</b>			
Other revenues		120,703	9,155
Other expenses		—	—
Interest and finance costs		(327,405)	(442,141)
<b>Total other income (expense)</b>		<b>(206,702)</b>	<b>(432,986)</b>
<b>Income from continuing operations before income tax</b>		<b>3,046,355</b>	<b>5,282,403</b>
<b>Provision for (benefit from) income tax</b>	10		
Current		170,621	505,725
Deferred		—	(1,064,028)
Total income tax expense		170,621	(558,303)
<b>Net income</b>		<b>\$ 2,875,734</b>	<b>\$ 5,840,706</b>
<b>Basic earnings per share</b>	12	<b>\$ 0.06</b>	<b>\$ 0.16</b>
<b>Basic weighted average shares outstanding</b>		<b>46,556,107</b>	<b>37,378,143</b>
<b>Diluted earnings per share</b>	12	<b>\$ 0.06</b>	<b>\$ 0.15</b>
<b>Diluted weighted average shares outstanding</b>		<b>46,692,711</b>	<b>38,397,325</b>
<b>The Components of comprehensive income:</b>			

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Net income	\$	2,875,734	\$	5,840,706
Foreign currency translation adjustment		72,519		905,537
<b>Comprehensive income</b>	\$	2,948,253	\$	6,746,243

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



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**China Precision Steel, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Changes in Stockholders' Equity**  
**For the Year Ended June 30, 2008 and the Three Months Ended September 30, 2008**

	Ordinary Shares		Additional	Accumulated	Retained	Total
	Share	Amount	Paid-in	Other	Earnings	Stockholders'
			Capital	Comprehensive		Equity
				Income		
Balance at June 30, 2007	37,378,143	\$ 37,378	\$ 31,867,063	\$ 2,192,160	\$ 17,008,238	\$ 51,104,839
Sale of common stock	7,100,000	7,100	44,498,650	—	—	44,505,750
Syndication fees	—	—	(130,468)	—	—	(130,468)
Make good shares	2,000,000	2,000	(2,000)	—	—	—
Exercise of warrants	765,872	766	1,729,235	—	—	1,730,001
Cancellation of stock	(771,060)	(771)	(2,589,992)	—	—	(2,590,763)
Foreign currency translation Adjustment	—	—	—	7,103,498	—	7,103,498
Net income	—	—	—	—	18,583,111	18,583,111
Balance at June 30, 2008	46,472,955	46,473	75,372,488	9,295,658	35,591,349	120,305,968
Exercise of warrants	90,000	90	269,895	—	—	269,985
Foreign currency translation Adjustment	—	—	—	72,519	—	72,519
Net income	—	—	—	—	2,875,734	2,875,734
Balance at September 30, 2008 (unaudited)	46,562,955	\$ 46,563	\$ 75,642,383	\$ 9,368,177	\$ 38,467,083	\$ 123,524,206

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**China Precision Steel, Inc. and Subsidiaries**  
**Condensed Consolidated Statements of Cash Flows**  
**For the Three Months Ended September 30, 2008 and 2007**  
**(Unaudited)**

	2008	2007
<b>Cash flows from operating activities</b>		
Net Income	\$ 2,875,734	\$ 5,840,706
<b>Adjustments to reconcile net income to net cash provided by operating activities</b>		
Depreciation and amortization	843,290	493,613
Allowance for bad and doubtful debts	—	625,998
<b>Net changes in assets and liabilities:</b>		
Accounts receivable, net	(5,622,477)	(23,095,388)
Inventories	(325,089)	8,039,005
Deposits	—	82,758
Prepayments	—	(14,702)
Advances to suppliers	1,974,708	284,972
Accounts payable and accrued expenses	885,734	(1,362,139)
Advances from customers	(3,295,867)	6,549,629
Other taxes payable	1,582,948	1,230,830
Current income taxes	—	1,013,596
Deferred income taxes	—	(1,064,028)
<b>Net cash (used in) provided by operating activities</b>	<b>(1,081,019)</b>	<b>(1,375,150)</b>
<b>Cash flows from investing activities</b>		
Purchases of property, plant and equipment including construction in progress	(7,263,898)	(1,016,793)
<b>Net cash (used in) investing activities</b>	<b>(7,263,898)</b>	<b>(1,016,793)</b>
<b>Cash flows from financing activities</b>		
Exercise of common stock warrants	269,985	—
Advances from/(to) directors, net	—	3,047,524
Notes payable proceeds	—	16,490,833
Repayments of notes payable	(87,611)	(17,084,041)
<b>Net cash provided by financing activities</b>	<b>182,374</b>	<b>2,454,316</b>
<b>Effect of exchange rate</b>	<b>(79,224)</b>	<b>482,557</b>
<b>Net increase (decrease) in cash</b>	<b>(8,241,767)</b>	<b>544,930</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>18,568,842</b>	<b>5,504,862</b>
<b>Cash and cash equivalents, end of period</b>	<b>\$ 10,327,075</b>	<b>\$ 6,049,792</b>

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

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**China Precision Steel, Inc.**  
Notes to the Consolidated Financial Statements

**1. Description of Business**

On December 28, 2006, China Precision Steel, Inc. (the “Company” or “we”), under our former name, OraLabs Holding Corp., issued 25,363,002 shares of common stock in exchange for 100% of the registered capital of Partner Success Holdings Limited (“PSHL”), a British Virgin Islands Business Company pursuant to a Stock Exchange Agreement, dated March 31, 2006. Subsequent to the closing of that transaction, on December 28, 2006, the Company redeemed 3,629,350 shares of its common stock in exchange for all of the common stock of OraLabs, Inc., a wholly-owned operating subsidiary. The Company issued 100,000 shares of its common stock to OraLabs, Inc. in exchange for \$450,690, and received additional cash payments in the aggregate amount of \$108,107 in payment of an estimated \$558,797 tax liability to be incurred by the Company in connection with the spin off of OraLabs, Inc. and the supplemental payment received. The Company then changed its name to China Precision Steel, Inc.

These transactions were treated for financial reporting purposes as a recapitalization, with prior OraLabs, Inc. operating activities reflected on the statements of operations as income (loss) from discontinued operations. The \$558,797 estimated tax liability incurred in connection with the spin off of OraLabs, Inc. was treated as a transaction cost for financial reporting purposes and was treated as a reduction in additional paid in capital to the extent of the additional cash received which was also \$558,797.

PSHL, registered on April 30, 2002 in the Territory of the British Virgin Islands, had registered capital of \$50,000 as of September 30, 2008 and 2007. It has three wholly-owned subsidiaries, Shanghai Chengtong Precision Strip Company Limited (“Chengtong”), Shanghai Tuorong Precision Strip Company Limited (“Tuorong”), and Blessford International Limited (“Blessford”).

Chengtong was registered on July 2, 2002 in Shanghai, in the People’s Republic of China (“PRC”), with a registered capital of \$3,220,000 and a defined period of existence of 50 years from July 2, 2002 to July 1, 2052. Chengtong was classified as a Sino-foreign joint venture enterprise with limited liabilities. On August 22, 2005, the authorized registered capital was increased to \$15,220,000 and on December 11, 2007, the authorized registered capital was further increased to \$42,440,000. Pursuant to the document issued by the District Council to Xuhang Town Council on June 28, 2004, the equity transfers from China Chengtong Metal Group Limited and Eastreal Holdings Company Limited to PSHL were approved and the transformation of Chengtong from a Sino-foreign joint investment enterprise to a wholly foreign owned enterprise (WFOE) was granted.

In the year ended June 30, 2007, we added three indirect subsidiaries to our corporate structure. On April 9, 2007, we purchased Shanghai Tuorong Precision Strip Company Limited, or Tuorong, through PSHL. The sole activity of Tuorong is the ownership of a land use right with respect to facilities utilized by Chengtong. On April 10, 2007, PSHL purchased for \$100,000 Blessford International Limited, a British Virgin Islands company. Blessford International Limited does not conduct any business, but it owns a single subsidiary, Shanghai Blessford Alloy Company Limited, that is a wholly-foreign owned enterprise with limited liabilities. Shanghai Blessford was registered on February 24, 2006 in Shanghai with a registered capital of \$12,000,000 and a defined period of existence of 50 years from February 24, 2006 to February 23, 2056. On May 27, 2008, the authorized registered capital was increased to \$22,000,000. We intend to hold Blessford International Limited as a shell subsidiary. As used herein, the “Group” refers to the Company, PSHL, Chengtong, Tuorong, Blessford International and Shanghai Blessford on a consolidated basis.

The Company’s principal activities are conducted through its two operating subsidiaries, Chengtong and Shanghai Blessford. Chengtong and Shanghai Blessford are niche precision steel processing companies principally engaged in the manufacture and sales of cold-rolled and hot-rolled precision steel products and plates for down stream

applications in the automobile industry (components and spare parts), kitchen tools and functional parts of electrical appliances. Raw materials, hot-rolled de-scaled (pickled) steel coils, will go through certain cold reduction processing procedures to give steel rolls and plates in different cuts and thickness for deliveries in accordance with customers' specifications. Specialty precision steel offers specific control of thickness, shape, width, surface finish and other special quality features that compliment the emerging need for highly engineered end use applications. Precision steel pertains to the precision of measurements and tolerances of the above factors, especially thickness tolerance.

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**2. Basis of Preparation of Financial Statements**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements and related notes. The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the audited consolidated financial statements of the Company and notes thereto for the year ended June 30, 2008.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (which include only normal recurring adjustments) necessary to present fairly the balance sheets of China Precision Steel, Inc. and subsidiaries as of September 30, 2008 and the results of their operations and cash flows for the three months ended September 30, 2008 and 2007. The results of operations for the three months ended September 30, 2008 are not necessarily indicative of the results to be expected for the entire year ending June 30, 2009.

**3. Summary of Significant Accounting Policies**

The following is a summary of significant accounting policies:

**Cash and Equivalents** - The Company considers all highly liquid debt instruments purchased with maturity period of three months or less to be cash equivalents. The carrying amounts reported in the accompanying consolidated balance sheets for cash and cash equivalents approximate their fair value.

**Accounts Receivable** - The Company provides an allowance for doubtful accounts equal to the estimated uncollectible amounts. It is reasonably possible that the Company's estimate of the allowance will change. At September 30, 2008 and June 30, 2008, the Company had \$1,034,354 and \$1,033,479 of allowances for doubtful accounts, respectively.

**Inventory** - Inventory is stated at the lower of cost or market. Cost is determined using the weighted average method. Market value represents the estimated selling price in the ordinary course of business less the estimated costs necessary to complete the sale.

The cost of inventories comprises all costs of purchases, costs of conversion and other costs incurred in bringing the inventories to their present location and condition. The costs of conversion of inventories include fixed and variable production overheads, taking into account the stage of completion.

**Advances to Suppliers** - In order to insure a steady supply of raw materials, the Company is required from time to time to make cash advances when placing its purchase orders. Cash advances are shown net of allowances for unrecoverable advances of \$2,524,973 and \$2,522,837 at September 30, 2008 and June 30, 2008, respectively.

**Intangible assets** - The Company acquired land use rights in August 2004 and December 2006 for 50 years that expire in August 2054 and December 2056 respectively. The land use rights are amortized over a fifty-year term. An amortization amount of approximately \$35,000 is to be recorded each year starting from the current financial year ending June 30, 2009 for the remaining lease period.

Intangible assets of the Company are reviewed annually to determine whether their carrying value has become impaired. The Company also re-evaluates the periods of amortization to determine whether subsequent events and circumstances warrant revised estimates of useful lives. As of September 30, 2008, the Company expects these assets to be fully recoverable.



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**Property, Plant and Equipment** - Property, plant and equipment are stated at cost less accumulated depreciation. The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its present working condition and location for its intended use.

Depreciation is computed on a straight-line basis over the estimated useful lives of the related assets for financial reporting purposes. The estimated useful lives for significant property and equipment are as follows:

	10
Buildings	years
Office equipment	5 years
Motor vehicles	5 years
	10
Plant and machinery	years

Repairs and maintenance costs are normally charged to the statement of operations in the year in which they are incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the asset, the expenditure is capitalized as an additional cost of the asset.

Property, plant and equipment are evaluated annually for any impairment in value. Where the recoverable amount of any property and equipment is determined to have declined below its carrying amount, the carrying amount is reduced to reflect the decline in value. There were no property and equipment impairments recognized during the three months ended September 30, 2008 and 2007.

**Capitalized Interest** - The Company capitalizes interest cost on borrowings incurred during the new construction or upgrade of qualified assets. Capitalized interest is added to the cost of the underlying assets and is amortized over the useful lives of the assets. During the three months ended September 30, 2008 and 2007, the Company capitalized no interest to construction-in-progress.

**Construction-in-Progress** - Plant and production lines currently under development are accounted for as construction-in-progress. Construction-in-progress is recorded at acquisition cost, including land rights cost, development expenditure, professional fees and the interest expenses capitalized during the course of construction for the purpose of financing the project. Upon completion and readiness for use of the project, the cost of construction-in-progress is to be transferred to fixed assets.

**Contingent Liabilities and Contingent Assets** - A contingent liability is a possible obligation that arises from past events and whose existence will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Company. It can also be a present obligation arising from past events that is not recognized because it is not probable that outflow of economic resources will be required or the amount of obligation cannot be measured reliably.

A contingent liability is not recognized but is disclosed in the notes to the financial statements. When a change in the probability of an outflow occurs so that outflow is probable, the contingency is then recognized as a provision.

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain events not wholly within the control of the Company.

Contingent assets are not recognized but are disclosed in the notes to the financial statements when an inflow of economic benefits is probable. When inflow is virtually certain, an asset is recognized.



**Advances from Customers** - Revenue from the sale of goods or services is recognized at the time that goods are delivered or services are rendered. Receipts in advance for goods to be delivered or services to be rendered in a subsequent period are carried forward as deferred revenue.

**Revenue Recognition** - Revenue from the sale of goods and services is recognized on the transfer of risks and rewards of ownership, which generally coincides with the time when the goods are delivered to customers and the title has passed and services have been rendered and invoiced. Revenue is reported net of all VAT taxes. Other income is recognized when it is earned.

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**Foreign Currencies** - The Company's principal country of operations is the PRC. The financial position and results of operations of the Company are determined using the local currency ("Renminbi" or "Yuan") as the functional currency. Transactions not conducted in Renminbi are translated into Renminbi at the exchange rates prevailing at the times of such transactions. The results of operations denominated in foreign currencies are translated at the average rate of exchange during the reporting period. Assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the market rate of exchange ruling at that date. The registered equity capital denominated in the functional currency is translated at the historical rate of exchange at the time of capital contribution. All translation adjustments resulting from the translation of the financial statements into the reporting currency ("US Dollars") are dealt with as an exchange fluctuation reserve in shareholders' equity.

**Taxation** - Taxation on overseas profits has been calculated on the estimated assessable profits for the year at the rates of taxation prevailing in the country in which the Company operates.

United States

China Precision Steel, Inc. is subject to United States federal income tax at a tax rate of 34%. No provision for income taxes in the United States has been made as China Precision Steel, Inc. had no taxable income in fiscal year 2008.

BVI

PSHL and Blessford International were incorporated in the British Virgin Islands and, under the current laws of the British Virgin Islands, are not subject to income taxes.

PRC

Provision for the PRC enterprise income tax is calculated at the prevailing rate based on the estimated assessable profits less available tax relief for losses brought forward. The Company does not accrue taxes on unremitted earnings from foreign operations as it is the Company's intention to invest these earnings in the foreign operations indefinitely.

*Enterprise income tax*

On March 16, 2007, the National People's Congress of China passed The Enterprise Income Tax Law (the "New EIT Law"), and on December 6, 2007, the State Council of China passed the Implementing Rules for the EIT Law ("Implementing Rules") which took effect on January 1, 2008. The New EIT Law and Implementing Rules impose a unified enterprise income tax ("EIT") of 25% on all domestic-invested enterprises and foreign invested entities ("FIEs"), unless they qualify under certain limited exceptions. Therefore, nearly all FIEs are subject to the new tax rate alongside other domestic businesses rather than benefiting from the old FIE tax laws, and its associated preferential tax treatments, beginning January 1, 2008.

Despite these changes, the EIT Law gives the FIEs established before March 16, 2007 ("Old FIEs") a five-year grandfather period during which they can continue to enjoy their existing preferential tax treatments, commonly referred to as "tax holidays", until these holidays expire. As Old FIEs, Chengtong is currently enjoying a 50% reduction in the 25% statutory rates that will expire on December 31, 2008, Shanghai Blessford is currently enjoying a full tax exemption from the enterprise income tax that will expire on December 31, 2009, and is entitled to a 50% reduction for the three subsequent years expiring on December 31, 2012. Subsequent to the expiry of their tax holidays, Chengtong and Shanghai Blessford will be subject to enterprise income taxes at 25% or the prevailing statutory rates. The discontinuation of any such special or preferential tax treatment or other incentives would have an adverse effect on any organization's business, fiscal condition and current operations in China.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets, including tax loss and credit carry forwards, and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

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In 2006, the Financial Accounting Standards Board (“FASB”) issued FIN 48, which clarifies the application of SFAS No. 109 by defining a criterion that an individual income tax position must meet for any part of the benefit of that position to be recognized in an enterprise’s financial statements and provides guidance on measurement, derecognition, classification, accounting for interest and penalties, accounting in interim periods, disclosure and transition. In accordance with the transition provisions, the Company adopted FIN 48 effective January 1, 2007.

The Company recognizes that virtually all tax positions in the PRC are not free of some degree of uncertainty due to tax law and policy changes by the State. However, the Company cannot reasonably quantify political risk factors and thus must depend on guidance issued by current state officials.

Based on all known facts and circumstances and current tax law, the Company believes that the total amount of unrecognized tax benefits as of September 30, 2008, is not material to its results of operations, financial condition or cash flows. The Company also believes that the total amount of unrecognized tax benefits as of September 30, 2008, if recognized, would not have a material effect on its effective tax rate. The Company further believes that there are no tax positions for which it is reasonably possible, based on current Chinese tax law and policy, that the unrecognized tax benefits will significantly increase or decrease over the next 12 months producing, individually or in the aggregate, a material effect on the Company’s results of operations, financial condition or cash flows.

*Value added tax*

The Provisional Regulations of the People’s Republic of China Concerning Value Added Tax promulgated by the State Council came into effect on January 1, 1994. Under these regulations and the Implementing Rules of the Provisional Regulations of the People’s Republic of China Concerning Value Added Tax, value added tax is imposed on goods sold in or imported into the PRC and on processing, repair and replacement services provided within the PRC.

Value added tax payable in the PRC is charged on an aggregated basis at a rate of 13% or 17% (depending on the type of goods involved) on the full price collected for the goods sold or, in the case of taxable services provided, at a rate of 17% on the charges for the taxable services provided, but excluding, in respect of both goods and services, any amount paid in respect of value added tax included in the price or charges, and less any deductible value added tax already paid by the taxpayer on purchases of goods and services in the same financial year.

**Retirement Benefit Costs** - According to the PRC regulations on pension, Chengtong and Shanghai Blessford contribute to a defined contribution retirement scheme organized by municipal government in the province in which Chengtong and Shanghai Blessford were registered and all qualified employees are eligible to participate in the scheme. Contributions to the scheme are calculated at 23.5% of the employees’ salaries above a fixed threshold amount and the employees contribute 2% to 8%, while Chengtong and Shanghai Blessford contribute the balance contribution of 15.5% to 21.5%. The Group has no other material obligation for the payment of retirement benefits beyond the annual contributions under this scheme.

For the three months ended September 30, 2008 and 2007, the Company’s pension cost charged to the statements of operations under the plan amounted to \$97,399 and \$60,599, respectively, all of which have been paid to the National Social Security Fund.

**Fair Value of Financial Instruments** - The carrying amounts of certain financial instruments, including cash, accounts receivable, other receivables, accounts payable, accrued expenses, and other payables approximate their fair values as at September 30, 2008 and June 30, 2008 because of the relatively short-term maturity of these instruments.

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**Use of Estimates** - The preparation of financial statements in accordance with generally accepted accounting principles require management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Reclassifications** - Certain reclassifications have been made to the prior years' financial statements to conform to the current year presentation. These reclassifications had no effect on previously reported results of operations or retained earnings.

**Recent Accounting Pronouncements** -

The Financial Accounting Standards Board ("FASB") recently issued the following standards which the Company reviewed to determine the potential impact on our financial statements upon adoption.

In September 2006, the FASB issued Statement No. 157, "Fair Value Measurements" ("SFAS No. 157"). SFAS No. 157 addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands the required disclosures about fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. Management is assessing the impact of the adoption of SFAS No. 157. The adoption of SFAS No. 157 did not impact our consolidated financial statements in any material respect.

In September 2006, the FASB issued Statement No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS No. 158"), an amendment of FASB Statements No. 87, 88, 106 and 132(R). SFAS No. 158 requires (a) recognition of the funded status (measured as the difference between the fair value of the plan assets and the benefit obligation) of a benefit plan as an asset or liability in the employer's statement of financial position, (b) measurement of the funded status as of the employer's fiscal year-end with limited exceptions, and (c) recognition of changes in the funded status in the year in which the changes occur through comprehensive income. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. The requirement to measure the plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. SFAS No. 158 has no current applicability to the Company's financial statements.

In February 2007, the FASB issued Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"), an amendment of FASB Statement No. 115. SFAS No. 159 addresses how companies should measure many financial instruments and certain other items at fair value. The objective is to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The adoption of SFAS No. 159 did not impact our consolidated financial statements in any material respect.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "Business Combinations" ("SFAS 141(R)"). SFAS 141(R) will change the accounting for business combinations. Under SFAS No. 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No. 141(R) will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141(R) will impact the Company in the event of any future acquisition.

In December 2007, the FASB issued SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51” (“SFAS 160”). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008. The Company does not believe that SFAS 160 will have a material impact on its consolidated financial statements.

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In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133 (“SFAS 161”). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. The guidance in SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company is currently assessing the impact of SFAS 161.

**4. Concentrations of Business and Credit Risk**

The Company provides credit in the normal course of business. The Company performs ongoing credit evaluations of its customers and clients and maintains allowances for doubtful accounts based on factors surrounding the credit risk of specific customers and clients, historical trends, and other information. Trade accounts receivable, net totaled \$36,535,870 and \$33,783,074 as of September 30, 2008 and June 30, 2008, respectively.

The Company’s list of customers whose purchases exceeded 10% of total sales during the three months ended September 30, 2008 and 2007 is as follows:

<i>Customers</i>	<i>2008</i>	<i>% to sales</i>	<i>2007</i>	<i>% to sales</i>
Shanghai Ruixuefeng Metals Co., Limited	—	—	8,648,752	32
Shanghai Changshuo Stainless Steel Co., Ltd.	3,414,685	13	—	—
Shanghai Bayou Industrial Co. Ltd.	2,961,211	12	—	—
Shanghai Shengdeji Metal Co. Ltd.	—	—	3,288,926	12

The Company’s list of suppliers whose sales exceeded 10% of total consumption during the three months ended September 30, 2008 and 2007 is as follows:

<i>Suppliers</i>	<i>2008</i>	<i>% to consumption</i>	<i>2007</i>	<i>% to consumption</i>
BaoSteel Steel Products Trading Co. Ltd.	7,571,158	40	1,257,169	7
Shanghai Pinyun Steel Co., Ltd	3,630,582	19	3,262,936	18
Hangzhou Relian Company Limited	—*	—*	2,291,248	12

Table of Contents**5. Inventories**

As of September 30, 2008 and June 30, 2008 inventories consisted of the following:

<b>At cost:-</b>	<b>September 30, 2008</b>	<b>June 30, 2008</b>
Raw materials	\$ 8,091,779	\$ 8,376,173
Work in progress	1,332,217	3,247,093
Finished goods	6,428,527	3,918,801
Consumable items	2,302,423	2,273,020
	<b>\$ 18,154,946</b>	<b>\$ 17,815,087</b>

**6. Property, Plant and Equipment**

Property, plant and equipment, stated at cost less accumulated depreciation, consisted of the following:

	<b>September 30, 2008</b>	<b>June 30, 2008</b>
Plant and machinery	\$ 23,399,238	\$ 22,725,528
Buildings	21,716,056	21,685,208
Motor vehicles	525,406	379,885
Office equipment	197,309	185,161
	45,838,009	44,975,782
Less: Accumulated depreciation	(6,623,160)	(5,776,477)
	<b>\$ 39,214,849</b>	<b>\$ 39,199,305</b>

Depreciation expense related to manufacturing is included as a component of cost of goods sold. During the three months ended September 30, 2008 and 2007, depreciation totaling \$824,032 and \$477,980, respectively, was included as a component of cost of goods sold.

Plant and machinery amounting to \$18,950,135 (June 30, 2008: \$18,972,430) and land use right amounting to \$553,873 (June 30, 2008: \$553,404) were pledged for notes payable totaling \$17,392,980.

**7. Construction-In-Progress**

As of September 30, 2008 and June 30, 2008, construction-in-progress consisted of the following:

	<b>September 30, 2008</b>	<b>June 30, 2008</b>
Construction costs	\$ 22,930,167	\$ 16,476,454

Construction-in-progress represents construction and installations of the new plant and machinery and administration and factory buildings.



Table of Contents**8. Advances from Customers**

Advances from customers represent advance cash receipts from new customers and for which goods have not been delivered or services rendered as of the balance sheets dates. Advances from customers for goods to be delivered or services to be rendered in the subsequent period are carried forward as deferred revenue. As of September 30, 2008 and June 30, 2008, there were advances from customers of \$3,710,279 and \$6,996,996, respectively.

**9. Short-Term Loans**

Short-term loans consisted of the following:

	September 30, 2008	June 30, 2008
Bank loan dated August 1, 2008, due in one year with an interest rate of the Singapore Interbank Offered Rate ("SIBOR") plus 3% (6.9% at September 30, 2008) (Note 6)	5,300,000	5,300,000
Bank loan dated August 1, 2008, due in one year with an interest rate at 115% of the standard market rate set by the People's Bank of China for Renminbi loans, secured by land use rights, buildings, plant and machinery (8.59% at September 30, 2008) (Note 6)	2,893,885	2,886,952
Bank loan dated July 26, 2008, due in one year with an interest rate at 115% of the standard market rate set by the People's Bank of China for Renminbi loans, secured by land use rights, buildings, plant and machinery (8.59% at September 30, 2008) (Note 6)	9,199,095	9,278,847
	\$ 17,392,980	\$ 17,465,799

The weighted average interest rate on short-term loans at September 30, 2008 and June 30, 2008 was 8.08% and 7.72%, respectively.

**10. Income Taxes**

For enterprise income tax reporting purposes, the Company reports income and expenses on an accrual basis and is required to compute a 10% salvage value when computing depreciation expense. For financial reporting purposes, the Company reports income and expenses on the accrual basis and does not take into account a 10% salvage value when computing depreciation expenses.

The tax holiday resulted in tax savings as follows:

	Three months ended September 30,	
	2008	2007
Tax savings	\$ 645,170	\$ 676,656
Benefit per share		

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Basic	\$	0.01	\$	0.06
Diluted	\$	0.01	\$	0.05

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Significant components of the Group's deferred tax assets and liabilities as of September 30, 2008 and June 30, 2008 are as follows:

<b>Deferred tax assets and liabilities:</b>	<b>September 30, 2008</b>	<b>June 30, 2008</b>
Book depreciation in excess of tax depreciation	\$ 199,043	\$ 169,962
Temporary differences resulting from provision for bad debts	—	573,324
Net deferred income tax asset	\$ 199,043	\$ 743,286
Valuation allowance	(199,043)	(743,286)
	\$ —	\$ —

A reconciliation of the provision for income taxes with amounts determined by the U.S. federal income tax rate to income before income taxes is as follows.

	<b>Three months ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Computed tax at the federal statutory rate of 34%	\$ 1,035,761	\$ 1,796,017
Less adjustment to EIT statutory rate of 25% in 2008 and 27% in 2007	(290,468)	(369,768)
Tax effect of US losses not deductible in PRC	54,616	86,493
Income not subject to tax	—	(330,361)
Expenses not deductible for tax	6,945	—
Understated taxation for FY2009	8,937	—
Deferred taxes	—	(1,064,028)
Benefit of tax holiday	(645,170)	(676,656)
Income tax expense per books	\$ 170,621	\$ (558,303)

Income tax expense (benefit) consists of:

	<b>Three months ended September 30,</b>	
	<b>2008</b>	<b>2007</b>
Income tax expense for the year PRC	\$ 170,621	\$ 505,725
Deferred income tax expense (benefit) – PRC	—	(1,064,028)
Income tax expense per books	\$ 170,621	\$ (558,303)



Table of Contents**11. Equity**

On November 6, 2007, in connection with a Subscription Agreement, dated November 1, 2007 (the “Subscription Agreement”), the Company issued to certain institutional accredited investors warrants to purchase 1,420,000 shares of Common Stock valued at \$5,374,748. In connection with the transaction, Roth Capital Partners, LLC, as placement agent, received warrants to purchase 225,600 shares of Common Stock valued at \$887,504.

Information with respect to stock warrants outstanding is as follows:

<b>Exercise Price</b>	<b>Outstanding June 30, 2008</b>	<b>Granted</b>	<b>Expired or Exercised</b>	<b>Outstanding June 30, 2008</b>	<b>Expiration Date</b>
\$ 3.00	448,392	-0-	(90,000)	358,392	February 22, 2011
\$ 3.60	100,000	-0-	-0-	100,000	February 22, 2010
\$ 8.45	1,420,000	-0-	-0-	1,420,000	November 6, 2010
\$ 7.38	225,600	-0-	-0-	225,600	November 6, 2010

Pursuant to Section 5.1 of the Stock Purchase Agreement, the Company agreed to reserve for issuance to investors in the private placement an aggregate of 2,000,000 shares of Common Stock if the Company’s net income for the fiscal year ended June 30, 2007 was less than US\$10.4 million, as set forth in the Company’s audited financial statements as filed with the SEC in the Company’s Annual Report on Form 10-K for that fiscal year. As the Company’s net income as set forth in its audited financial statements for the year ended June 30, 2007 was less than US\$10.4 million, the Company was required to issue the 2,000,000 shares of Common Stock to such investors. Such issuance was effected on October 15, 2007. No additional consideration was received by the Company in connection with this issuance of shares of Common Stock.

In conjunction with the Company’s final audit of the Tuorong acquisition, certain post-closing adjustments were required. In light of such adjustments and consistent with the purposes and intentions of the Debt Reduction Agreement, dated February 13, 2007, as amended February 20, 2007, it was determined that 771,060 shares of the Company’s Common Stock issued to directors pursuant to such Agreement would be required to be cancelled in order to eliminate the \$2,590,763 reflected on the June 30, 2007 audited financial statements as amounts due from directors. Such cancellation was effected on November 8, 2007.

Pursuant to the Subscription Agreement, on November 6, 2007, the Company agreed to issue and sell in a registered direct offering (the “Offering”) an aggregate of 7,100,000 shares of its common stock (“Common Stock”) at a price of \$6.75 per share (the “Purchase Price”) and an aggregate of 1,420,000 warrants to purchase shares of its Common Stock (“Warrants” and, together with the Common Stock, the “Securities”). The Warrants have an exercise price of \$8.45 per share. The Warrants may not be exercised prior to May 6, 2008. The Securities (including the shares issuable upon exercise of the Warrants) are registered under the Securities Act of 1933, as amended (the “Act”), pursuant to the Company’s existing effective shelf Registration Statement on Form S-3. In connection with the offer and sale of the Securities, the Company filed on November 1, 2007, a Registration Statement on Form S-3 pursuant to Rule 462(b) promulgated under the Act to register an additional \$10 million of its securities relating to its shelf Registration Statement.

The Company closed the Offering on November 6, 2007 (the “Closing Date”). The net proceeds of the offering were approximately \$44 million, after deducting underwriting commissions and discounts and other fees and expenses relating to the offering. The warrants were valued at \$5.3 million and were recorded to additional paid-in capital. The intended usage of the net proceeds was for repayment of certain bank debt, capital expenditure, and general corporate purposes. During the year ended June 30, 2008, long-term bank loans of \$13,042,159 were paid off, and a progress

payment of \$7,016,729 was made in relation to the third cold rolling mill. During the three months ended September 30, 2008, we invested an additional \$7,709,434 in construction in progress and property, production plants and equipment in relation to the third cold rolling mill and expansion of the Shanghai Blessford production facilities.

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On the Closing Date, pursuant to a Placement Agency Agreement entered into between the Company and Roth Capital Partners LLC on October 31, 2007, Roth Capital received an amount in cash equal to 7.0% of the gross proceeds of the Offering and warrants to purchase an amount of Common Stock equal to 3.0% of the total number of shares of Common Stock sold in the Offering (the "Placement Warrants"), or 225,600 shares of Common Stock valued at \$887,504, and this amount was recorded as syndication fees offsetting additional paid-in capital. Such Placement Warrants have an exercise price per share of 120% of the closing price per share of the Company's Common Stock on the Closing Date, or \$7.38, and were not exercisable prior to May 6, 2008. Thereafter, the Placement Warrants are exercisable at any time until the third anniversary of the date of issue.

**12. Earnings Per Share**

SFAS 128 requires a reconciliation of the numerator and denominator of the basic and diluted earnings per share (EPS) computations.

For the three months ended September 30, 2008, dilutive shares include outstanding warrants to purchase 358,392 shares of common stock at an exercise price of \$3.00 and 100,000 shares at an exercise price of \$3.60. Warrants to purchase 1,420,000 shares at an exercise price of \$8.45 and 225,600 shares at an exercise price of \$7.38 were not included as their effect would have been anti-dilutive, however, these securities could potentially dilute basic earnings per share in the future. For the three months ended September 30, 2007, dilutive shares include outstanding warrants to purchase 1,300,059 shares of common stock at an exercise price of \$3.00 and 100,000 shares at an exercise price of \$3.60.

The following reconciles the components of the EPS computation:

	<b>Income (Numerator)</b>	<b>Shares (Denominator)</b>	<b>Per Share Amount</b>
<b>For the three months ended September 30, 2008:</b>			
Net income	\$ 2,875,734		
Basic EPS income available to common shareholders	\$ 2,875,734	46,556,107	\$ 0.06
Effect of dilutive securities:			
Warrants		136,604	
Diluted EPS income available to common shareholders	\$ 2,875,734	46,692,711	\$ 0.06
<b>For the three months ended September 30, 2007:</b>			
Net income	\$ 5,840,706		
Basic EPS income available to common shareholders	\$ 5,840,706	37,378,143	\$ 0.16
Effect of dilutive securities:			
Warrants		1,019,182	
Diluted EPS income available to common shareholders	\$ 5,840,706	38,397,325	\$ 0.15

**13. Commitments**

As of September 30, 2008, the Company had \$5,481,492 in commitments for capital expenditures for contractual commitments of the construction projects related to expansion of Shanghai Blessford's production facilities.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

**Special Note Regarding Forward Looking Statements**

This Quarterly Report on Form 10-Q, including the following "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements include, among others, those concerning our expected financial performance and strategic and operational plans, as well as all assumptions, expectations, predictions, intentions or beliefs about future events. You are cautioned that any such forward-looking statements are not guarantees of future performance and that a number of risks and uncertainties could cause actual results of the Company to differ materially from those anticipated, expressed or implied in the forward-looking statements. The words "believe," "expect," "anticipate," "project," "targets," "optimistic," "aim," "will" or similar expressions are intended to identify forward-looking statements. All statements other than statements of historical fact are statements that could be deemed forward-looking statements. Risks and uncertainties that could cause actual results to differ materially from those anticipated include risks related to new and existing products; any projections of sales, earnings, revenue, margins or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements regarding future economic conditions or performance; uncertainties related to conducting business in China; any of the factors and risks mentioned in the "Risk Factors" sections of our Annual Report on Form 10-K for the year ended June 30, 2008 and subsequent SEC filings. The Company assumes no obligation and does not intend to update any forward-looking statements, except as required by law.

**Use of Terms**

Except as otherwise indicated by the context, all references in this Quarterly Report to (i) the "Group," the "Company," "we," "us" or "our" are to China Precision Steel, Inc., a Delaware corporation, and its direct and indirect subsidiaries; (ii) "PSHL" are to our subsidiary Partner Success Holdings Limited, a BVI company; (iii) "Blessford International" are to PSHL's subsidiary Blessford International Limited, a BVI company; (iv) "Shanghai Blessford" are to Blessford International's subsidiary Shanghai Blessford Alloy Company Limited, a PRC company; (v) "Chengtong" are to PSHL's subsidiary Shanghai Chengtong Precision Strip Co., Limited, a PRC company; (vi) "Tuorong" are to PSHL's subsidiary Shanghai Tuorong Precision Strip Company Limited, a PRC company; (vii) "Securities Act" are to the Securities Act of 1933, as amended; (viii) "Exchange Act" means the Securities Exchange Act of 1934, as amended; (ix) "RMB" are to Renminbi, the legal currency of China; (x) "U.S. dollar," "\$" and "US\$" are to the legal currency of the United States; (xi) "BVI" are to the British Virgin Islands; and (xii) "China" and "PRC" are to the People's Republic of China.

**Overview of the Company's Business**

We are a niche and high value-added steel processing company principally engaged in the manufacture and sale of high precision cold-rolled steel products, in the provision of heat treatment and in the cutting and slitting of medium and high-carbon hot-rolled steel strips. We use commodity steel to create a high value-added specialty premium steel. Specialty precision steel pertains to the precision of measurements and tolerances of thickness, shape, width, surface finish and other special quality features of highly-engineered end-use applications.

We produce and sell precision ultra-thin and high strength cold-rolled steel products ranging from 7.5 mm to 0.03 mm. We also provide heat treatment and cutting and slitting of medium and high-carbon hot-rolled steel strips not exceeding 7.5 mm thickness. Our process puts hot-rolled de-scaled (pickled) steel coils through a cold-rolling mill, utilizing our patented systems and high technology reduction processing procedures, to make steel coils and sheets in customized thicknesses according to customer specifications. Currently, our specialty precision products are mainly



used in the manufacture of automobile parts and components, steel roofing, plane friction discs, appliances, food packaging materials, saw blades, textile needles, and microelectronics.

We conduct our operations principally in China through our wholly-owned operating subsidiaries, Chengtong and Shanghai Blessford, which are wholly owned subsidiaries of our direct subsidiary, PSHL. Most of our sales are made domestically in China; however, we began exporting during fiscal 2007 and our overseas market currently covers Indonesia, Thailand, the Philippines, Nigeria and Ethiopia. We intend to further expand into additional overseas markets in the future, subject to suitable market conditions and favorable regulatory controls.

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In the year ended June 30, 2007, we added three indirect subsidiaries to our corporate structure. On April 9, 2007, we purchased or Tuorong through PSHL. The sole activity of Tuorong is the ownership of a land use right with respect to facilities leased to Chengtong. On April 10, 2007, PSHL purchased Blessford International for nominal consideration. Blessford International does not conduct any business, but it owns a single subsidiary, Shanghai Blessford, that is a wholly-foreign owned enterprise chartered in China. We intend to hold Blessford International as a shell subsidiary.

We strive to find an appropriate sales mix that provides us with the stability and cash flows, along with the higher margin provided by high precision and individually customized cold-rolled steel products. To meet market demands in our primary market, China, as well as overseas market, there were increased capital requirements as we sought to construct additional rolling mills to accommodate our planned growth. In addition, our workforce has increased and, in particular, we have faced a growing need for experienced executive and technical staff.

Our market is highly competitive, although we have focused on a niche market that we consider allows us to compete effectively as we continue to grow our business. We also face significant price volatility for raw materials, the hot-rolled steel coils, and our financial results may be impacted by changes in the market prices for these materials. Given our size, we do not have the ability to influence the prices at which we must purchase raw materials. However, the nature of our high value-add products enables us to pass on all or part of the price fluctuations in raw materials to our customers.

**Results of Operations***Comparison of Three Months Ended September 30, 2008 and September 30, 2007*

	Three Months Ended		Variance	
	September 30,			
	2008	2007	\$	%
<b>SALES REVENUE</b>	\$ 25,350,419	\$ 27,187,235	(1,836,816)	(7)
Cost of Sales	21,397,761	20,245,135	1,152,626	6
<b>GROSS PROFIT</b>	<b>3,952,658</b>	<b>6,942,100</b>	<b>(2,989,442)</b>	<b>(43)</b>
Administrative expenses	462,100	486,376	(24,276)	(5)
Selling expenses	211,298	100,705	110,593	110
<b>INCOME FROM</b>	<b>3,253,057</b>	<b>5,715,389</b>	<b>(2,462,332)</b>	<b>(43)</b>
Other income (expense)	(206,702)	(432,986)	226,284	52
Income tax expense	170,621	(558,303)	728,924	*
<b>NET INCOME</b>	<b>2,875,734</b>	<b>5,840,706</b>	<b>(2,964,972)</b>	<b>(51)</b>
Basic earnings per share	\$ 0.06	\$ 0.16	(0.10)	(61)
Diluted earnings per share	\$ 0.06	\$ 0.15	(0.09)	(59)

\*

*Not meaningful*

Income from continuing operations before tax decreased by \$2,236,048, or 42%, period-on-period to \$3,046,355 for the three months ended September 30, 2008, from \$5,282,403 for the three months ended September 30, 2007 and gross profit decreased by \$2,989,442, or 43%, period-on-period.

Net income decreased by \$2,964,972, or 51%, period-on-period to \$2,875,734 for the three months ended September 30, 2008, from \$5,840,706 for the three months ended September 30, 2007.

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For the period ended September 30, 2007, there was a one-time write back of impairment for consumable items in the amount of \$1,644,123, and a one-time write back of deferred income tax in the amount of \$1,064,028, which increased net income for the three months ended September 30, 2007 from \$3,132,555 to \$5,840,706. Excluding these one-time write backs, there was a slight decrease in net income by \$256,821, or 8%, period-on-period to \$2,875,734 for the three months ended September 30, 2008 from \$3,132,555 for the three months ended September 30, 2007.

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**Gross Profit.** Gross profits in absolute terms decreased by \$2,989,442, or 43%, period-on-period to \$3,952,658 for the three months ended September 30, 2008, from \$6,942,100 for the three months ended September 30, 2007, while gross profit margin decreased to 15.6% for the three months ended September 30, 2008, from 25.5% for the three months ended September 30, 2007. The decrease in gross profit margin principally resulted from two direct sales transactions of raw materials in the amount of \$2,685,419, or 11% of sales revenues, as a move to lower our inventory level in view of decreasing raw material prices during the three months ended September 30, 2008. Excluding the abovementioned direct raw material sales, gross profit margin for the three months ended September 30, 2008 would have been 17.1%.

**Sales Revenues.** Sales volume decreased by 4,467 tons, or 15.6%, period-on-period to 24,216 tons for the three months ended September 30, 2008 from 28,683 tons for the three months ended September 30, 2007. As a result, sales revenues decreased by \$1,836,816, or 6.8%, period-on-period to \$25,350,419 for the three months ended September 30, 2008 from \$27,187,235 for the three months ended September 30, 2007. We believe that the decreases in sales and sales revenues are a result of reduced orders from existing customers in view of a slower economy, and the cancellation of an export order of 500 tons of hard-rolled steel coils due to decreasing steel prices during the period. The decrease in volume produced and shipped during the quarter ended September 30, 2008 was mainly in the high carbon cold-rolled category used in auto components manufacturing, as well as the low carbon cold-rolled steel category.

Our average cost per unit sold increased to \$884 for the three months ended September 30, 2008 compared to average cost per unit sold of \$706 for the three months ended September 30, 2007, representing an increase of \$178 per ton, or 25.2%, period-on-period, due to the combined effect of a significant increase in cost of raw materials per unit sold and an increase in factory overhead per unit sold. The 1400 mm cold-roll mill which became operational at the beginning of October 2006 is now operating at approximately 50% of design capacity and will likely take another two years to reach its maximum production speed and capacity.

**Sales by Product Line.** A break-down of our sales by product line for the three months ended September 30, 2008 and 2007 is as follows:

Product category	Three Months Ended September 30, 2008		2007		Period-on-period		
	Quantity (tons)	\$ Amount	% of sales	Quantity (tons)	\$ Amount	% of sales	Qty. Variance
Low carbon cold-rolled	10,809	10,983,414	43.3	14,321	9,082,234	33.4	(3,512)
Low carbon hard rolled	3,621	4,152,532	16.4	2,387	1,645,333	6.0	1,234
High-carbon cold-rolled	2,600	3,445,509	13.6	8,936	14,646,426	53.9	(6,336)
High-carbon hot-rolled	1,412	1,918,278	7.6	1,897	1,455,863	5.4	(485)
Sales of scrap metal	—	171,867	0.7	—	277,953	1.0	—
Subcontracting income	5,774	4,678,819	18.4	1,142	79,426	0.3	4,632
<b>Total</b>	<b>24,216</b>	<b>25,350,419</b>	<b>100.0</b>	<b>28,683</b>	<b>27,187,235</b>	<b>100</b>	

There were various changes in the break-down of sales among our product lines over the three months ended September 30, 2008 due to the current economic and business environment we operate in and the slowdown across various markets. The low-carbon cold-rolled steel products accounted for 43.3% of the current sales mix at an average selling price of \$1,016 per ton for the three months ended September 30, 2008 compared to 33.4% of the sales mix at an average selling price per ton of \$634 for the three months ended September 30, 2007 as a result of production of higher precision products in this category. Low carbon hard-rolled steel, which is also our exported precision steel product, was 6.0% of sales during the three months ended September 30, 2007, and accounted for \$4,152,532, or

16.4%, of the current sales mix at an average selling price of \$1,147 per ton for the three months ended September 30, 2008. High-carbon cold-rolled steel products accounted for 13.6% of the current sales mix at an average selling price of \$1,326 per ton for the three months ended September 30, 2008 compared to 53.9% of the sales mix at an average selling price per ton of \$1,639 for the three months ended September 30, 2007. Subcontracting income increased to 18.4% of the current sales mix at an average selling price of \$810 for the three months ended September 30, 2008 compared to 0.3% of the sales mix for the three months ended September 30, 2007 at an average selling price of \$70.

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While we are experiencing some reduction in orders of certain products from existing customers, especially the high-carbon cold-rolled steel coils due to slowdown of the auto industry, and exports to the South East Asian markets, we continue to negotiate new contracts with manufacturers who are switching from higher cost imports and our overall business remains healthy with a broad and diversified customer base. Management continues to take appropriate action to develop new products and optimize our product mix without adversely affecting overall sales volume and margins amid current market conditions. Management believes that there are high barriers to entry in the Chinese domestic precision cold-rolled steel industry because of the level of technology expertise required for operation and that our unique capabilities and know-how give us a competitive advantage to grow sales of higher margin products as we continuously carry out R&D and strive to launch new products that could potentially lead to new segments, customers and markets.

Average selling prices	Three Months Ended September 30,		Variance	
	2008 \$	2007 \$	\$	%
Low-carbon cold-rolled	1,016	634	382	60
Low-carbon hard rolled	1,147	689	457	66
High-carbon cold-rolled	1,326	1,639	(313)	(19)
High-carbon hot-rolled	1,358	767	591	77
Subcontracting income	810	70	741	>100

The average unit selling price per ton generated increased to \$1047 per ton for the three months ended September 30, 2008 compared to the corresponding period in 2007 of \$948, representing an increase of \$99, or 10.4%, period-on-period. This increase was due to changes in our sales mix during the quarter to focus on high quality high margin products and subcontracting work. Sales of high-carbon cold-rolled steel products have decreased by 6,336 tons, or 70.9%, period-on-period to 2,600 tons for the three months ended September 30, 2008 compared to 8,936 tons for the three months ended September 30, 2007. While the volume of high-carbon cold-rolled steel decreased, the average sales price declined \$313, or 19%, to \$1,326 in the three months ended September 30, 2008 as compared to an average selling of \$1,639 in the three months ended September 30, 2007. This product accounted for \$3,445,509, or 13.6%, of the total sales mix for the three months ended September 30, 2008 compared to \$14,646,426, or 53.9%, of the sales mix for the three months ended September 30, 2007.

Sales Breakdown by Major Customer.

Customers	Three Months Ended September 30			
	2008 (\$)	% to sales	2007 (\$)	% to sales
Shanghai Changshuo Stainless Steel Processing Co. Ltd.	3,414,685	13	8,648,752	32
Shanghai Bayou Industrial Limited	2,961,211	12	*	*
Salzgitter Mannesmann	2,392,869	9	*	*
Jiangsu Sumec International Trading Co., Ltd.	1,667,454	7	*	*
Zhangjiagang Gangxing Innovative Construction Material Co., Ltd.	1,527,211	6	*	*
Shanghai Shengdejia Metal Products Limited	*	*	3,288,926	12
Beijing Beimo Aircraft Material Technology Co., Ltd.	*	*	1,746,538	6

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Hangzhou Relian Company Limited	*	*	1,393,982	5
Shandong Province Boxing County				
Longhua Material Ltd.	*	*	1,277,358	5
	13,429,250	47	16,355,556	60
Others	11,921,169	53	10,831,679	40
<b>Total</b>	25,350,419	100	27,187,235	100

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*\* Not major customers for the relevant periods*

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Sales revenues generated from the top five major customers as a percentage of total sales decreased to 47% for the three months ended September 30, 2008 as compared to 60% for the three months ended September 30, 2007. The top five major customers were different period-on-period with the exception of Shanghai Changshuo Stainless Steel Processing Co., Ltd.. The change in customer mix reflects our shift in product focus during the course of the period.

**Cost of Sales.** Cost of sales increased by \$1,152,626, or 5.7%, period-on-period to \$21,397,761 for the three months ended September 30, 2008 from \$20,245,135 for the three months ended September 30, 2007. Cost of sales represented 84.4% of sales revenues for the three months ended September 30, 2008 compared to 74.5% for the three months ended September 30, 2007. Average cost per ton sold increased by \$178, or 25.2%, period-on-period to \$884 per ton for the three months ended September 30, 2008 from \$706 per ton for the three months ended September 30, 2007. Meanwhile, the average selling price per ton increased by \$99 per ton, or 10.4%, period-on-period to \$1,047 per ton for the three months ended September 30, 2008 from \$948 per ton for the three months ended September 30, 2007.

	<b>Three Months Ended September 30,</b>			
	<b>2008</b>	<b>2007</b>	<b>Variance</b>	
	\$	\$	\$	%
<b>Cost of sales</b>				
- Raw materials	18,767,711	18,487,907	279,804	2
- Direct labor	142,214	176,906	(34,692)	(20)
- Factory overhead	2,487,836	1,580,322	907,514	57
	21,397,761	20,245,135	1,152,626	5.7
<b>Cost per unit sold</b>				
Total units sold (tons)	24,216	28,683	(4,467)	(16)
Average cost per unit sold (\$/ton)	884	706	178	25.2

Management believes that the increase in cost of sales is represented by the combined effect of:

- a significant increase in cost of raw materials per unit sold of \$130, or 20%, from \$645 per ton for the three months ended September 30, 2007 compared to \$775 per ton for the three months ended September 30, 2008;
- an increase in factory overhead per unit sold of \$47 or 86% from \$55 per ton for three months ended September 30, 2007 compared to \$102 per ton for the three months ended September 30, 2008.

The cost of raw materials consumed increased by \$279,804, or 2%, period-on-period to \$18,767,711, for the three months ended September 30, 2008 from \$18,487,907 for the three months ended September 30, 2007. This increase was due to increases in raw material prices period-on-period.

Manufacturing overhead costs increased by \$907,514, or 57%, period-on-period to \$2,487,836 for the three months ended September 30, 2008 from \$1,580,322 for the three months ended September 30, 2007. The increase was mainly attributable to the combined effect of an increase in utilities of \$331,268, or 95%, period-on-period to \$678,262 for the three months ended September 30, 2008 from \$346,994 for the three months ended September 30, 2007, an increase in consumables of \$197,402, or 40%, period-on-period to \$685,640 for the three months ended September 30, 2008 from \$488,238 for the three months ended September 30, 2007, and an increase in depreciation allocated to cost of goods sold of \$279,481, or 58%, period-on-period to \$757,461 for the three months ended September 30, 2008 from \$477,980 for the three months ended September 30, 2007.





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**Expenses.**

**Selling Expenses.** Selling expenses increased by \$110,593, or 110%, period-on-period, to \$211,298 for the three months ended September 30, 2008 compared to the corresponding period in 2007 of \$100,705. The increase was mainly attributable to increases in transportation, which rose by 80% period-on-period, due to our increased delivery charges of precision steel resulting from a broader customer base, especially exports where our standard contract terms are F.O.B. and we incur transportation costs to the port of shipment, plus loading costs, as well as an increase in the frequency of deliveries.

**Administrative Expenses.** Administrative expenses decreased by \$24,276, or 5%, period-on-period, to \$462,100 for the three months ended September 30, 2008 compared to the comparable period in 2007. This decrease was chiefly associated with lower SEC compliance costs and professional fees as there was no financing activity during the quarter and we become more familiar with the rules and regulations as a listed company. There were increases in salaries and wages which were principally due to increases in the monthly salaries of the management staff as well as increase in average number of Chengtong staff.

**Finance Costs.** Net finance cost decreased 26% period-on-period as a result of the decrease in total interest expense to \$327,405 for 2008 compared to \$442,141 for 2007 due to lower loan balances and a lower weighted average interest rate during 2008 as compared to 2007.

**Liquidity and Capital Resources**

Our business is capital intensive and requires substantial expenditures for, among other things, the purchase and maintenance of equipment used in our operations. Our short-term and long-term liquidity needs arise primarily from capital expenditures, working capital requirements and principal and interest payments related to our outstanding indebtedness. We have met these liquidity requirements with cash provided by operations, equity financing, and bank debt.

Net cash flows used in operating activities for the three months ended September 30, 2008 was \$1,081,019 as compared with \$1,375,150 used in operating activities for the three months ended September 30, 2007, for a net increase of \$294,131. This increase was due to an increase in accounts receivable, and a decrease in advances from customers offset by a decrease in advances to suppliers during the three months ended September 30, 2008.

Net cash flows used in investing activities for the three months ended September 30, 2008 was \$7,263,898 as compared with \$1,016,793 for the three months ended September 30, 2007. The increase in investing activity was due to increased construction during the three months ended September 30, 2008 as compared to the same period in 2007.

Net cash flows provided by financing activities for the three months ended September 30, 2008, was \$182,374 as compared with \$2,454,316 provided by financing activities for the three months ended September 30, 2007. During the three months ended September 30, 2008, the Company received \$269,985 in net proceeds from the exercise of warrants, which was partially offset by repayment of notes payable of the amount \$87,611. The three months ended September 30, 2007 reflect repayment and renewing of notes payable which offset each other, as well as advances from directors of the amount \$3,047,524.

**Current Assets.** Current assets decreased by \$4,197,074, or 4%, period-on-period to \$103,936,848 as of September 30, 2008 from \$108,133,922 as of June 30, 2008, principally as a result of decreases in cash and equivalents by \$8,241,767, or 44%, period-on-period. During the three months ended September 30, 2008, there were also increases in accounts receivable of \$2,752,796, or 8%, period-on-period, bills receivable of \$2,951,175, or 68%, period on period, and inventories of \$339,859, period on period. The decrease in cash and cash equivalents is mainly attributable

to spending on the construction of the 3<sup>rd</sup> mill during the three months ended September 30, 2008.

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**Current Liabilities.** Current liabilities decreased by \$945,352, or 2%, period-on-period to \$44,284,050 as of September 30, 2008 from \$45,229,402 as of June 30, 2008. The decrease was due to decreases in advances from customers and was mitigated by increases in accounts payable and other taxes payable.

As of September 30, 2008, we had \$17,392,980 in short term bank debt. We expect to refinance such debt at its maturity, but we cannot assure you that we will be able to do so on terms favorable to the Company or at all.

**Capital Expenditures.** During the three months ended September 30, 2008, we invested \$7,709,434 in construction in progress and property, production plants and equipment. We believe these capital investments increase our capacity, expand our product line, and reduce risks related to occupancy costs, thereby creating new opportunities to grow sales and control expenses.

As of September 30, 2008, the Company had \$5,481,492 in commitments for capital expenditures for contractual commitments of the construction projects related to the 1450mm mill and expansion of our production facilities. We currently have sufficient capital resources to meet these contractual commitments and we plan to commence constructing of the 1450mm mill during the second quarter of fiscal 2009.

**Off-Balance Sheet Arrangements**

For the three months ended September 30, 2008, we did not have any off-balance sheet arrangements.

**Contractual Obligations**

(in thousands)	Total	At September 30, 2008 Payments Due By Period			
		Fiscal Year 2009	Fiscal Years 2010-2011	Fiscal Years 2012-2013	Fiscal Year 2014 and Beyond
<b>Contractual obligations:</b>					
Debt Obligations	\$ 18,798,333	\$ 18,798,333	\$ —	\$ —	\$ —
Construction Commitments	5,481,492	5,481,492	—	—	—
	\$ 24,279,825	\$ 24,279,825	\$ —	\$ —	\$ —

**Short-term bank loans**

Short-term bank loans decreased by \$72,819, period on period to \$17,392,980 as of March 31, 2008, compared to \$17,465,799 as of June 30, 2008.

**Land Use Rights**

In October 2004, Tuorong agreed to purchase a land use right from the Shanghai Labor and Economic Development Council with respect to a 20-acre parcel for a lease period of 50 years at a cost of \$472,441. Additionally in November 2005, Chengtong agreed to purchase a land use right from the Shanghai Xuhang Industrial Development Co., Ltd. with respect to a 27.04-acre parcel for a lease period of 50 years at a cost of \$497,795. In November 2006, Chengtong entered into an agreement with the Shanghai Labor and Economic Development Council which supersedes the aforementioned Tuorong agreement to purchase a total of 21.34-acre parcel for a lease period of 50 years at an aggregate amount of \$672,126. In December 2006, Tuorong entered into a Compensation Agreement with the Shanghai Jiading Housing, Land and Resource Management Bureau to pay an aggregate amount of \$637,294 in connection to the two aforementioned parcels.

**Inflation**

We believe that inflation has not had a material effect on our results of operations. We generally manufacture our products to match orders from our customers. Due to the specialized nature of our products, we are able to purchase raw materials based upon customer orders. This operating model allows us to effectively pass along fluctuations in the price of raw materials to our customers. For commonly used raw materials, we purchase larger quantities when we believe prices are likely to increase in the short term in order to minimize the impact of any such price increase.

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**Critical Accounting Policies and Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires our management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements, including the notes thereto, and related disclosures of commitments and contingencies, if any. We consider our critical accounting policies to be those that require the more significant judgments and estimates in the preparation of financial statements, including the following:

- *Functional Currency and Translating Financial Statements*— The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Our functional currency is Chinese Renminbi; however, the accompanying consolidated financial statements have been expressed in USD. The consolidated balance sheets have been translated into USD at the exchange rates prevailing at each balance sheet date. The consolidated statements of operations and cash flows have been translated using the weighted-average exchange rates prevailing during the periods of each statement.
- *Advances to Suppliers and from Customers* - As is common practice in China, Chengtong will often make advance payments to its suppliers for materials, or receive advance payments from its customers. In some cases, the same party may be both a supplier to, and customer of, Chengtong. In such cases, Chengtong may make an advance to a third party as supplier and receive an advance from the same party as a customer. Chengtong's practice is to offset such amounts against each other. We have established an allowance for doubtful accounts as a reserve against advances made to suppliers to the extent that the related goods are not received within ninety (90) days of the contract delivery date.
- *Other Policies* - Other accounting policies used by the Company are set forth in the notes accompanying our financial statements.

**Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement No.157, "Fair Value Measurements" ("SFAS No.157"). SFAS No.157 addresses how companies should measure fair value when they are required to use a fair value measure for recognition or disclosure purposes under generally accepted accounting principles. SFAS No.157 defines fair value, establishes a framework for measuring fair value and expands the required disclosures about fair value measurements. SFAS No.157 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The adoption of SFAS No. 157 did not impact our consolidated financial statements in any material respect.

In September 2006, the FASB issued Statement No.158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS No.158"), an amendment of FASB Statements No.87, 88, 106 and 132(R). "SFAS No. 158" requires (a) recognition of the funded status (measured as the difference between the fair value of the plan assets and the benefit obligation) of a benefit plan as an asset or liability in the employer's statement of financial position, (b) measurement of the funded status as of the employer's fiscal year-end with limited exceptions, and (c) recognition of changes in the funded status in the year in which the changes occur through comprehensive income. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006. The requirement to measure the plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years

ending after December 15, 2008. SFAS No. 158 has no current applicability to the Company's financial statements.

In February 2007, the FASB issued Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS No. 159"), an amendment of FASB Statement No. 115. SFAS No. 159 addresses how companies should measure many financial instruments and certain other items at fair value. The objective is to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The adoption of SFAS No. 159 did not impact our consolidated financial statements in any material respect.

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In December 2007, the FASB issued SFAS No.141 (revised 2007), “Business Combinations” (“SFAS 141(R)”). “SFAS 141(R)” will change the accounting for business combinations. Under SFAS No.141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS No.141(R) will change the accounting treatment and disclosure for certain specific items in a business combination. SFAS No.141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. SFAS 141(R) will impact the Company in the event of any future acquisition.

In December 2007, the FASB issued SFAS No.160, “Non-controlling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No.51” (“SFAS 160”). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS No.160 is effective for fiscal years beginning on or after December 15, 2008. The Company does not believe that SFAS 160 will have a material impact on its consolidated financial statements.

In March 2008, the FASB issued SFAS No.161, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No.133 (“SFAS 161”). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance, and cash flows. The guidance in “SFAS 161” is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This Statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company is currently assessing the impact of SFAS 161.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We have exposure to several types of market risk: changes in foreign currency exchange rates, interest rates and commodity prices. We neither hold nor issue financial instruments for trading purposes nor do we make use of derivative instruments to hedge the risks discussed below.

The following sections provide quantitative information on our exposure to market risks. Our use of sensitivity analyses are inherently limited in estimating actual losses in fair value that can occur from changes in market conditions.

#### **Foreign Currency Exchange Rates**

The Group collects revenues from operations principally in the Chinese Renminbi. Except for limited exports to Thailand and the Philippines, all of our local sales revenues are collected in and substantially all of its expenses are paid in the Chinese Renminbi. We face foreign currency rate translation risk when our results are translated to U.S. Dollars, as well as foreign currency rate transaction risk with respect to sales outside of China and with respect to financial instruments denominated in foreign currencies. Our results of operations denominated in foreign currency are translated at the average rate of exchange during the reporting period. Assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the market rate of exchange ruling at that date. The registered equity capital denominated in the functional currency is translated at the historical rate of exchange at the time of capital contribution.



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The Chinese Renminbi had remained stable against the U.S. Dollar at approximately 8.28 Yuan to 1.00 U.S. Dollar for several years and it was not until July 21, 2005 that the Chinese currency regime was altered, with a 2.1% revaluation versus the United States Dollar. This move initially valued the Renminbi at 8.11 per United States Dollar. In addition, the Renminbi is no longer linked to the U.S. currency but rather to a basket of currencies with a 0.3% margin of fluctuation. However, there remains international pressure on the Chinese government to adopt an even more flexible currency policy and as of September 30, 2008 the exchange rate was 6.8485 Yuan to 1.00 U.S. Dollar. The exchange rate of Renminbi is subject to changes in China's government policies which are, to a large extent, dependent on the economic and political development both internationally and locally and the demand and supply of Renminbi in the domestic market. There can be no assurance that such exchange rate will continue to remain stable in the future amongst the volatility of currencies, globalization and the unstable economies in recent years. Since (i) our income and profit are mainly denominated in Renminbi, and (ii) the payment of dividends will be in U.S. dollars, if any, any exchange fluctuation of the Renminbi against other foreign currencies would adversely affect the value of the shares and dividends payable to shareholders, in foreign currency terms.

At September 30, 2008, the Group's outstanding financial instruments with foreign currency exchange rate risk exposure had an aggregate fair value of \$16 million (including the Group's non-U.S. dollar denominated debt). The potential increase in the fair values of these instruments resulting from a 10% adverse change in quoted foreign currency exchange rates would be approximately \$1.6 million at September 30, 2008.

## **Interest Rates**

The Group is subject to interest rate risk on its non-derivative financial instruments. The Group does not hedge its interest rate risk. At September 30, 2008, the Group's total bank debt outstanding was \$17,392,980, all of which was interest-bearing. Substantially all of the bank debt was floating-rate debt with interest rates which vary with changes in the standard rate set by the People's Bank of China. A change in the interest rate or yield of fixed rate debt will only impact the fair value of such debt, while a change in the interest rate of floating rate, or variable rate, debt will impact interest expense as well as the amount of cash required to service such debt. To the extent interest rates increase, we will be liable for higher interest payments to our lenders. For the current financial year, annual interest on loans is anticipated to be approximately \$1.4 million. The impact of a 1% increase in interest rates will increase interest expense by approximately \$175,000. As our short-term borrowings mature, we will be required to either repay or refinance these borrowings. An increase in short-term interest rates at the time that we seek to refinance short-term borrowings may increase the cost of borrowings, which may adversely affect our earnings and cash available for distribution to its shareholders.

At March 31, 2008, the aggregate fair value of the Group's financial instruments with exposure to interest rate risk was approximately \$17 million. The potential change in fair value for these financial instruments from an adverse 10% change in quoted interest rates across all maturities, often referred to as a parallel shift in the yield curve, would be approximately \$0.2 million at September 30, 2008.

## **Commodity Prices**

The steel coils and other raw materials used by Chengtong, require large amounts of raw materials - iron ore or other iron containing material, steel scrap, coke and coal - as well as large amounts of energy to produce. Additionally, we also use large amounts of energy in our operations. Over the last several years, prices for raw materials and energy, in particular natural gas and oil, have increased significantly. In many cases these price increases have been at a greater percentage than price increases for the sale of steel products.

The Group has no open derivative commodity instruments as of September 30, 2008 and does not currently hedge its exposure to price fluctuations in the raw materials and energy required for the manufacture of its products.

**ITEM 4. CONTROLS AND PROCEDURES.**

**Evaluation of Disclosure Controls and Procedures.**

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) that are designed to ensure that information that would be required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including to our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

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As required by Rule 13a-15 under the Exchange Act, our management, including Wo Hing Li, our President and Chief Executive Officer and Leada Tak Tai Li, our Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2008. Based on that evaluation, these executive officers concluded that as of September 30, 2008, and as of the date that the evaluation of the effectiveness of our disclosure controls and procedures was completed, our disclosure controls and procedures were effective to satisfy the objectives for which they are intended.

**Changes in Internal Control Over Financial Reporting.**

During the fiscal quarter ended September 30, 2008, there were no changes in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II**  
**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

From time to time, we may become involved in various lawsuits and legal proceedings, which arise, in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these, or other matters, may arise from time to time that may harm our business. We are currently not aware of any such legal proceedings or claims that we believe will have a material adverse affect on our business, financial condition or operating results.

**ITEM 1A. RISK FACTORS.**

None.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

None.

**ITEM 5. OTHER INFORMATION.**

None.

**ITEM 6. EXHIBITS.**

The following exhibits are filed as part of this report or incorporated by reference:

**Description**

**Exhibit**

<b>No.</b>	
<u>31.1</u>	Certification of Principal Executive Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31.2</u>	Certification of Principal Financial Officer filed pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32.1</u>	Certifications of Principal Executive Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
<u>32.2</u>	Certifications of Principal Financial Officer furnished pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

Dated: November 10, 2008

**CHINA PRECISION STEEL, INC.**

By: /s/ Wo Hing Li  
Wo Hing Li  
Chief Executive Officer

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**EXHIBIT INDEX**

**Exhibit**

<b>No.</b>	<b>Description</b>
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