CHINA HGS REAL ESTATE INC.
Form 10-Q
February 06, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10–Q**

(Mark One)

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

For the quarterly period ended December 31, 2012

**¨ 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: 001-34864

**CHINA HGS REAL ESTATE, INC.**

(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| **Florida** | **33-0961490** |
| (State or Other Jurisdiction of Incorporation) | (I.R.S. Employer Identification Number) |

**6 Xinghan Road, 19th Floor, Hanzhong City**

**Shaanxi Province, PRC 723000**

(Address of Principal Executive Offices, Zip Code)

**+(86) 091 - 62622612**

(Registrant's Telephone Number, including Area Code)

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 ¨

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

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

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

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

The number of shares outstanding of each of the issuer's classes of common equity, as of February 6, 2013 is as follows:

| Class of Securities | Shares Outstanding |
|---|---|
| Common Stock, $0.001 par value | 45,050,000 |

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**PART I: FINANCIAL INFORMATION**

**ITEM 1. INTERIM FINANCIAL STATEMENTS**

**CHINA HGS REAL ESTATE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

**(Unaudited)**

| | December 31 2012 | September 30 2012 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash | $523,868 | $1,104,686 |
| Restricted cash | 1,161,158 | 1,080,985 |
| Accounts receivable | 4,654,636 | - |
| Advances to vendors | 4,376,112 | 2,566,422 |
| Loans to outside parties, net | 5,146 | 20,957 |
| Real estate property development completed | 15,912,612 | 19,534,088 |
| Real estate property under development | 9,582,760 | 8,590,275 |
| Other current assets | 181,873 | 171,863 |
| Total current assets | 36,398,165 | 33,069,276 |
| Property, plant and equipment, net | 1,017,668 | 1,037,080 |
| Real estate property development completed, net of current portion | 6,565,509 | 6,691,813 |
| Security deposits for land use right | 22,959,737 | 22,894,698 |
| Real estate property under development, net of current portion | 61,575,793 | 56,021,787 |
| **Total Assets** | $128,516,872 | $119,714,654 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $4,145,774 | $3,828,880 |
| Other payables | 1,395,244 | 1,213,394 |
| Construction deposits | 301,773 | 301,318 |
| Customer deposits | 13,875,722 | 11,597,422 |
| Shareholder loan | 1,810,000 | 1,810,000 |
| Accrued expenses | 2,402,089 | 2,305,086 |
| Taxes payable | 3,722,182 | 4,336,458 |
| Total current liabilities | 27,652,784 | 25,392,558 |
| Construction deposits, net of current portion | 866,385 | 864,259 |
| Customer deposits, net of current portion | 18,562,385 | 17,743,993 |

| | | |
|---|---|---|
| Total liabilities | 47,081,554 | 44,000,810 |
| Commitments and Contingencies | | |
| Stockholders' equity | | |
| Common stock, $0.001 par value, 100,000,000 shares authorized, 45,050,000 shares issued and outstanding December 31, 2012 and September 30, 2012 | $45,050 | $45,050 |
| Additional paid-in capital | 17,753,749 | 17,750,337 |
| Statutory surplus | 6,549,354 | 6,549,354 |
| Retained earnings | 50,403,306 | 44,894,229 |
| Accumulated other comprehensive income | 6,683,859 | 6,474,874 |
| Total stockholders' equity | 81,435,318 | 75,713,844 |
| Total Liabilities and Stockholders' Equity | $128,516,872 | $119,714,654 |

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

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**CHINA HGS REAL ESTATE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME**

**(Unaudited)**

| | Three months ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Real estate sales | $ 11,003,415 | $ 2,501,981 |
| Less: Sales tax | (710,717 ) | (175,905 ) |
| Cost of real estate sales | (3,830,244 ) | (881,900 ) |
| Gross profit | 6,462,454 | 1,444,176 |
| Operating expenses | | |
| Selling and distribution expenses | 161,094 | 42,441 |
| General and administrative expenses | 560,971 | 318,772 |
| Total operating expenses | 722,065 | 361,213 |
| Operating income | 5,740,389 | 1,082,963 |
| Interest expense | (18,100 ) | (4,163 ) |
| Other income | 7,952 | - |
| Income before income taxes | 5,730,241 | 1,078,800 |
| Provision for income taxes | 221,164 | 48,338 |
| Net income | 5,509,077 | 1,030,462 |
| Other comprehensive income | | |
| Foreign currency translation adjustment | 208,985 | $ 344,589 |
| Comprehensive income | $ 5,718,062 | $ 1,375,051 |
| Basic and diluted income per common share | | |
| Basic | $ 0.12 | $ 0.02 |
| Diluted | $ 0.12 | $ 0.02 |
| Weighted average common shares outstanding | | |
| Basic | 45,050,000 | 45,050,000 |
| Diluted | 45,050,000 | 45,050,000 |

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

**CHINA HGS REAL ESTATE, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(Unaudited)**

| | Three months ended December 31, 2012 | 2011 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income | $ 5,509,077 | $ 1,030,462 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation | 22,404 | 22,081 |
| Stock based compensation | 3,412 | 12,175 |
| Changes in assets and liabilities: | | |
| Restricted cash | (77,263) | (5,750) |
| Accounts receivable | (4,664,334) | - |
| Advances to vendors | (1,806,155) | 51,748 |
| Loans to outside parties | 15,903 | 579,495 |
| Security deposits for land use rights | - | (9,136,065) |
| Real estate property development completed | 3,830,244 | 881,900 |
| Real estate property under development | (6,376,199) | (1,898,986) |
| Other current assets | (9,542) | (15,367) |
| Accounts payables | 306,655 | (3,203,189) |
| Other payables | 178,775 | 310,247 |
| Customer deposits | 3,019,617 | 3,021,626 |
| Construction deposits | (731) | 6,272 |
| Accrued expenses | 90,860 | (122,461) |
| Taxes payable | (627,900) | (32,172) |
| Net cash used in operating activities | $ (585,177) | $ (8,497,984) |
| | | |
| Cash flow from financing activities | | |
| Proceeds from shareholder loan | - | 3,142,332 |
| Repayment of shareholder loan | - | (3,142,332) |
| Net cash provided by financing activities | $ - | $ - |
| | | |
| Effect of changes of foreign exchange rate on cash | 4,359 | 25,795 |
| Net decrease in cash | (580,818) | (8,472,189) |
| Cash, beginning of period | 1,104,686 | 8,837,795 |
| Cash, end of period | $ 523,868 | $ 365,606 |
| Supplemental disclosures of cash flow information: | | |
| Interest paid | $ - | $ - |
| Income taxes paid | $ 404,003 | $ 18,817 |

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

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**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

## NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

China HGS Real Estate, Inc. ("China HGS" or the "Company" or "we", "us", "our"), through its subsidiaries and variable interest entity ("VIE"), engages in real estate development, and the construction and sales of residential apartments, parking space and commercial properties in Tier 3 and Tier 4 cities and counties in China.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the U.S. generally accepted accounting principles ("GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended December 31, 2012 and 2011 are not necessarily indicative of the results that may be expected for the full year. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2012.

## NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of consolidation

The unaudited condensed consolidated financial statements include the financial statements of China HGS Real Estate Inc. (the "Company" or "China HGS"), China HGS Investment Inc. ("HGS Investment"), Shaanxi HGS Management and Consulting Co., Ltd. ("Shaanxi HGS") and its variable interest entity ("VIE"), Shaanxi Guangsha Investment and Development Group Co., Ltd. ("Guangsha"). All inter-company transactions and balances between the Company, its subsidiaries and VIE have been eliminated upon consolidation.

### Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, and disclosure of contingent liabilities at the date of the condensed consolidated financial statements. Estimates are used for, but not limited to, the selection of the useful lives of property and equipment, provision necessary for contingent liabilities, fair values, revenue recognition, taxes, budgeted costs and other similar charges. Management believes that the estimates utilized in preparing its condensed consolidated financial statements are reasonable and prudent. Actual results could differ from these estimates.

**Fair value of financial instruments**

The Company follows the provisions of Accounting Standards Codification (“ASC”) 820, Fair Value Measurements and Disclosures. It clarifies the definition of fair value, prescribes methods for measuring fair value, and establishes a fair value hierarchy to classify the inputs used in measuring fair value as follows:

Level 1-Inputs are unadjusted quoted prices in active markets for identical assets or liabilities available at the measurement date.

Level 2-Inputs are unadjusted quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, inputs other than quoted prices that are observable, and inputs derived from or corroborated by observable market data.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Fair value of financial instruments (continued)**

Level 3-Inputs are unobservable inputs which reflect the reporting entity’s own assumptions or what assumptions the market participants would use in pricing the asset or liability based on the best available information.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash, accounts receivable, restricted cash, advance to vendors, loans to outside parties, security deposits for land use rights, other current assets, accounts payable, customer deposits, other payables, accrued expenses, and taxes payable, approximate their fair value based on the short-term maturity of these instruments. The fair value of the long term customer and construction deposits approximate their carrying amounts because the deposits are received in cash.

**Revenue recognition**

Real estate sales are recognized in accordance with the ASC 360-20 “Real Estate Sales”.

Revenue from the sales of development properties is recognized by the full accrual method at the time of the closing of an individual unit sale. This occurs when title to or possession of the property is transferred to the buyer. A sale is not considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, (d) all conditions precedent to closing have been performed, (e) the seller does not have substantial continuing involvement with the property, and (f) the usual risks and rewards of ownership have been transferred to the buyer. Further, the buyer’s initial and continuing investment is adequate to demonstrate a commitment to pay for the property.

The Company provides “mortgage loan guarantees” only with respect to buyers who make down-payments of 30%-50% of the total purchase price of the property. The period of the mortgage loan guarantee begins on the date the bank approves the buyer’s mortgage and we receive the loan proceeds in our bank account and ends on the date the

"Certificate of Ownership" evidencing that title to the property has been transferred to the buyer. The procedures to obtain the Certificate of Ownership take six to twelve months (the "Mortgage Loan Guarantee Period"). If, after investigation of the buyer's income and other relevant factors, the bank decides not to grant the mortgage loan, our mortgage-loan based sales contract terminates and there will be no guarantee obligation. If, during the Mortgage Loan Guarantee Period, the buyer defaults on his or her monthly mortgage payment for three consecutive months, we are required to refund the loan proceeds back to the bank, although we have the right to keep the customer's deposit and resell the property to a third party. Once the Certificate of Ownership has been issued by the relevant government authority, our loan guarantee terminates. If the buyer then defaults on his or her mortgage loan, the bank has the right to take the property back and sell it and use the proceeds to pay off the loan. The Company is not liable for any shortfall that the bank may incur in this event. To date, no buyer has defaulted on his or her mortgage payments during the Mortgage Loan Guarantee Period and the Company has not had to refund any loan proceeds pursuant to its mortgage loan guarantees.

For municipal road construction projects, fees are generally recognized by the full accrual method at the time the projects are completed.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Revenue recognition (continued)**

On October 23, 2012, the Company entered into a sales agreement to sell the remaining commercial units in Nan Dajie (Mingzhu Xinju) project with a total GFA of 4,545.88 square meters located in Hanzhong City for a total contract amount of $5,393,038 (RMB 33,911,426). The purchaser is related to one of the Company's concrete suppliers for our Hanzhong City Oriental Pearl Garden project and Mingzhu Beiyuan project. The purchaser's payments are guaranteed by third parties. The Certificate of Ownership of the related property was issued to the purchaser on November 22, 2012. The Company expects to collect the balance of the receivable by July 31, 2013. As of December 31, 2012, accounts receivable balance of $4,654,636 was due from the purchaser.

**Foreign currency translation**

The Company's financial information is presented in U.S. dollars. The functional currency of the Company's operating subsidiaries is Renminbi ("RMB"), the currency of the PRC. The financial statements of the Company have been translated into U.S. dollars in accordance with ASC 830-30 "Translation of Financial Statements". The financial information is first prepared in RMB and then is translated into U.S. dollars at year-end exchange rates as to assets and liabilities and average exchange rates as to revenue and expenses. Capital accounts are translated at their historical exchange rates when the capital transactions occurred. The effects of foreign currency translation adjustments are included as a component of accumulated other comprehensive income in stockholders' equity.

| | For three months ended December 31, | | September 30, |
|---|---|---|---|
| | 2012 | 2011 | 2012 |
| Period end RMB : USD exchange rate | 6.3011 | 6.3647 | 6.3190 |
| Three months average RMB : USD exchange rate | 6.2880 | 6.3771 | |

The RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that the RMB amounts could have been, or could be, converted into U.S. dollars at the rates used in translation.

**Cash**

Cash includes cash on hand and demand deposits in accounts maintained with commercial banks within the PRC. The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents. The Company maintains bank accounts in the PRC. Cash balances in bank accounts in the PRC are not insured.

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**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Restricted Cash**

The restricted cash is required by the banks as collateral for mortgage loans given to the home buyers before obtaining the Certificates of Ownership of the properties as collateral. In order to provide the banks with the Certificates of Ownership, the Company is required to complete certain procedures with the Chinese government, which normally takes six to twelve months. Because the banks provide the loan proceeds to the Company without obtaining Certificates of Ownership as loan collateral during this six to twelve months' period, the mortgage banks require the Company to maintain, as restricted cash, 5% to 10% of the mortgage proceeds as security for the Company's obligations under such guarantees. The restricted cash is released by the banks once they receive the Certificates of Ownership. As of December 31, 2012 and September 30, 2012, the balances of restricted cash totaled $1,161,158 and $1,080,985, respectively. These deposits are not covered by insurance. The Company has not experienced any losses in such accounts and management believes its restricted cash account is not exposed to any risks.

**Advances to vendors**

Advances to vendors consist of balances paid to contractors and vendors for services and materials that have not been provided or received and generally relate to the development and construction of residential and commercial units in the PRC. Advances to vendors are reviewed periodically to determine whether their carrying value has become impaired. Historically, the Company has not experienced any losses as a result of these advances. As of December 31, 2012 and September 30, 2012, the Company had advances to vendors in the amounts of $4,376,112 and $2,566,422, respectively.

**Loans to outside parties, net**

Loans to outside parties consist of various cash advances to unrelated companies and individuals with which the Company has business relationships. Loans to outside parties are reviewed periodically as to whether their carrying value has become impaired. These loans bear no interest and they are due on demand. The Company considers the assets to be impaired if the collectability of the balances becomes doubtful. Substantially all these loans are considered collectible within the next twelve months based on the Company’s past experience.

**Security deposits for land use rights**

Security deposits for land use rights consist of the deposit held by the PRC government for the purchase of these rights in Hanzhong City and the deposit held by an unrelated party to transfer its land use rights in Hanzhong City to the Company. The deposits will be reclassified to real estate property under development upon the transfers of legal title.

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**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Real estate property development completed and under development**

Real estate property consists of finished residential unit sites, commercial offices and residential unit sites under development. The Company leases the land for the residential unit sites under land use right leases with various terms from the PRC government. The cost of land use rights is included in the development cost and allocated to each project. Real estate property development completed and real estate property under development are stated at the lower of cost or fair value.

Expenditures for land development, including cost of land use rights, deed tax, pre-development costs, and engineering costs, exclusive of depreciation, are capitalized and allocated to development projects by the specific identification method. Costs are allocated to specific units within a project based on the ratio of the sales area of units to the estimated total sales area of the project (or phase of the project) multiplied by the total cost of the project (or phase of the project).

Cost of amenities transferred to buyers is allocated to specific units as a component of total construction cost. The amenity cost includes landscaping, road paving, etc. Once the projects are completed, the amenities are under control of the property management companies. In accordance to GAAP, real estate property development completed and under development are subject to impairment when the carrying amount exceeds fair value. An impairment loss shall be recognized only if the carrying amount of the assets is not recoverable and exceeds fair value. The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected to be generated by the assets.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Impairment of long-lived assets**

In accordance with ASC 360, "Accounting for the Impairment or Disposal of Long-Lived Assets", the Company is required to review its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through the estimated undiscounted cash flows expected to result from the use and eventual disposition of the assets. Whenever any such impairment exists, an impairment loss will be recognized for the amount by which the carrying value exceeds the fair value.

Assets are grouped and evaluated at the lowest level for their identifiable cash flows that are largely independent of the cash flows of other groups of assets. The Company considers historical performance and future estimated results in its evaluation of potential impairment and then compares the carrying amount of the asset to the future estimated cash flows expected to result from the use of the asset. If the carrying amount of the asset exceeds estimated expected undiscounted future cash flows, the Company measures the amount of impairment by comparing the carrying amount of the asset to its fair value. The estimation of fair value is generally determined by using the asset's expected future discounted cash flows or market value. The Company estimates fair value of the assets based on certain assumptions such as budgets, internal projections, and other available information as considered necessary. There is no impairment of long-lived assets during the three months ended December 31, 2012 and 2011, respectively.

**Customer deposits**

Customer deposits consist of amounts received from customers relating to the sale of residential units in the PRC. In the PRC, customers will generally obtain permanent financing for the purchase of their residential unit prior to the completion of the project. The lending institution will provide the funding to the Company upon the completion of the financing rather than the completion of the project. The Company receives these funds and recognizes them as a liability until the revenue can be recognized.

**Property warranty**

The Company provides its customers with warranties which cover major defects of building structure and certain fittings and facilities of properties sold. The warranty period varies from two years to five years, depending on different property components the warranty covers. The Company continually estimates potential costs for materials and labor with regard to warranty-type claims expected to be incurred subsequent to the delivery of a property. Reserves are determined based on historical data and trends with respect to similar property types and geographical areas. The Company continually monitors the warranty reserve and makes adjustments to its pre-existing warranties, if any, in order to reflect changes in trends and historical data as information becomes available. The Company may seek further recourse against its contractors or any related third parties if it can be proved that the faults are caused by them. In addition, the Company also withholds up to 2% of the contract cost from sub-contractors for periods of two to five years. These amounts are included in construction deposits, and are only paid to the extent that there has been no warranty claim against the Company relating to the work performed or materials supplied by the subcontractors. For the period ended December 31, 2012 and September 30, 2012, the Company had not recognized any warranty liability or incurred any warranty costs in excess of the amount retained from subcontractors.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Construction Deposits**

Construction deposits are the warranty deposits the real estate contractors provide to the Company upon signing the construction contracts. The Company can use such deposits to reimburse customers in the event of customer claims due to construction defects. The remaining balance of the deposits are returned to the contractors when the terms of the after-sale property warranty expires, which normally occurs within two to five years after the date of the deposit.

**Stock-based compensation**

The Company accounted for share-based compensation in accordance with ASC Topic 718, Compensation - Stock compensation, which requires that share-based payment transactions be measured based on the grant-date fair value of the equity instrument issued and recognized as compensation expense over the requisite service period, or vesting period.

ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in the subsequent period if actual forfeitures differ from initial estimates. Forfeiture rate is estimated based on historical and future expectation of employee turnover rate and are adjusted to reflect future change in circumstances and facts, if any. Share-based compensation expense is recorded net of estimated forfeitures such that expense was recorded only for those stock options and common stock awards that are expected to vest.

**Income taxes**

The Company utilizes ASC 740, “Income Taxes,” which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

ASC 740-10-25 prescribes a more-likely-than-not threshold for consolidated financial statement recognition and measurement of a tax position taken (or expected to be taken) in a tax return. It also provides guidance on the recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, years open for tax examination, accounting for income taxes in interim periods and income tax disclosures. There are no material uncertain tax positions as of December 31, 2012 and September 30, 2012.

The Company is a corporation organized under the laws of the State of Florida. However, all of the Company's operations are conducted solely by its subsidiaries in the PRC. No income is earned in the United States and the management does not repatriate any earnings outside the PRC. As a result, the Company did not generate any U.S. taxable income for the three months ended December 31, 2012, and 2011, respectively.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Income taxes (continued)**

As of December 31, 2012, the tax years ended September 30, 2006 through December 31, 2012 for the Company's PRC entities remain open for statutory examination by PRC tax authorities. The parent Company China HGS Real Estate Inc.'s tax years ended September 30, 2009 through December 31, 2012 remains open for statutory examination by U.S. tax authorities.

**Land appreciation tax ("LAT")**

In accordance with the relevant taxation laws in the PRC, the Company is subject to LAT based on progressive rates ranging from 30% to 60% on the appreciation of land value, which is calculated as the proceeds of sales of properties less deductible expenditures including borrowing costs and all property development expenditures. LAT is exempted if the appreciation values do not exceed certain thresholds specified in the relevant tax laws.

The whole project must be completed before the LAT obligation can be assessed. Accordingly, the Company should record the liability and the total related expense at the completion of a project unless the tax authorities impose an assessment at an earlier date. The methods to implement this tax law vary among different geographic areas. Hanzhong, where the project Mingzhu Garden, NanDajie and Central Plaza are located, implements this tax rule by requiring real estate companies prepay the LAT based upon customer deposits received. The tax rate in Hanzhong is 1%. Yang County, where the project Yangzhou Pearl Garden is located, requires a tax rate of 0.5%.

**Comprehensive income**

In accordance with ASC 220-10-55, comprehensive income is defined as all changes in equity except those resulting from investments by owners and distributions to owners. The Company's only components of comprehensive income during the three months ended December 31, 2012 and 2011 were net income and foreign currency translation adjustments.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 3. SECURITY DEPOSITS FOR LAND USE RIGHTS**

In May 2011, the Company entered into a development agreement with the local government. Pursuant to the agreement, the Company will prepay the development cost of $18,942,871 (RMB119, 700,000) and the Company has the right to acquire the land use rights through public bidding. The prepaid development cost will be deducted from the final purchase price of the land use rights. As of December 31, 2012, a deposit of $3,174,049 (RMB20,000,000) (September 30, 2012 - $3,165,058 or RMB 20,000,000) was paid by the Company. The Company currently expects to make payment of the remaining development cost within the next twelve months based on government's current work progress.

In August 2011, the Company entered into a land transfer agreement with Hanzhong Shijin Real Estate Development Limited ("Shijin"). Pursuant to the agreement, Shijin agreed to transfer certain land use rights to the Company for the total price of $7,200,506 (RMB45, 500,000). As of December 31, 2012, a deposit of $7,286,029 (consisting of the full contract amount of RMB45, 500,000 and a commission of RMB410,000) was paid by the Company. The Company is in the process of applying for the land use rights certificate. As of December 31, 2012, the deposit balance was $7,286,029 (RMB45, 910,000).

On November 18, 2011, the Company won two bids for the land use rights by auction to obtain two parcels of land in Yang County for total consideration and the bidding commission of $12,597,918 (RMB79,606,242). As of December 31, 2012, the Company has paid $12,499,659 (RMB78,761,600). The remaining balance of $134,047 is expected to be paid by March 31, 2013 when the Company receives the land use rights certificate. As of December 31, 2012, the deposit balance was $12,499,659 (RMB78, 761,600).

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 4. REAL ESTATE PROPERTY DEVELOPMENT COMPLETED AND UNDER DEVELOPMENT**

The following summarizes the components of real estate property development completed and under development as of December 31, 2012 and September 30, 2012:

| | December 31, 2012 | September 30, 2012 |
|---|---|---|
| Development completed | | |
| Hanzhong City Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) | $ 10,492,097 | $ 10,957,861 |
| Hanzhong City Nan Dajie (Mingzhu Xinju) | 1,883,125 | 3,651,828 |
| Yang County Yangzhou Pearl Garden | 9,504,846 | 11,019,854 |
| Hanzhong City Central Plaza | 598,053 | 596,358 |
| Real estate property development completed | $ 22,478,121 | $ 26,225,901 |
| Less: Real estate property completed –short-term | $ 15,912,612 | $ 19,534,088 |
| Real estate property completed –long-term | $ 6,565,509 | $ 6,691,813 |
| Under development: | | |
| Hanzhong City Oriental Pearl Garden | 33,053,789 | 30,964,847 |
| Hanzhong City Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) | 22,476,180 | 21,102,925 |
| Yang County Yangzhou Pearl Garden | 14,281,538 | 11,620,714 |
| Hanzhong City Mingzhu Road West (a) | 1,126,845 | 732,571 |
| Hanzhong City Liuhou Road (a) | 220,201 | 191,005 |
| Real estate property under development | $ 71,158,553 | $ 64,612,062 |
| Less: Short-term portion | $ 9,582,760 | $ 8,590,275 |
| Real estate property under development –long-term | $ 61,575,793 | $ 56,021,787 |

(a) In June 2012, the Company was approved by Hanzhong local government to construct two municipal roads with total length of 1,064.09 meters. The budgeted price for these two municipal roads is approximately $3.0 million (RMB18,716,489) which was approved by Hanzhong Ministry of Finance. The related construction has been substantially completed as of December 31, 2012 and is expected to be delivered to the local government in the next few months. For these construction projects, the Company recognizes the fee as other revenue using the full accrual method when the project is completed.

As of December 31, 2012 and September 30, 2012, land use rights included in real estate property under development totaled $42,021,146 and $41,902,111, respectively.

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**NOTE 5. CUSTOMER DEPOSITS**

Customer deposits consist of amounts received from customers for the pre-sale of residential units in the PRC. The detail of customer deposits is as follows:

| | December 31, 2012 | September 30, 2012 |
|---|---|---|
| Customer deposits by real estate projects | | |
| Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) | $ 19,419,644 | $ 16,900,566 |
| Hanzhong City Oriental Pearl Garden | 1,280,887 | - |
| Yangzhou Pearl Garden | 11,737,576 | 12,440,849 |
| Total | $ 32,438,107 | $ 29,341,415 |
| Including: Customer deposits -short-term | $ 13,875,722 | $ 11,597,422 |
| Customer deposits - long-term | $ 18,562,385 | $ 17,743,993 |

Customers are required to make initial customer deposits. The initial customer deposits are typically 10%-20% of the unit price for those customers who purchase properties in cash and 30%-50% of the unit price for those customers who purchase properties with mortgages. The banks provide the balance of the funding to the Company upon consummation of the sales. The banks hold the properties as collateral for customers' mortgage loans. If the customers default, the bank will repossess the collateral properties. Except during the Mortgage Loan Guarantee Period of approximately six to twelve months, the banks have no recourse to the Company for customers' defaults.

**NOTE 6. SHAREHOLDER LOAN**

On June 28, 2011, the Company entered into a one-year loan agreement ("USD Loan Agreement") with Mr. Xiaojun Zhu, pursuant to which the Company borrowed $1,810,000 from Mr. Xiaojun Zhu to make a capital injection into Shaanxi HGS, the Company's subsidiary. The interest rate for the loan is 4% per annum. The Company recorded an interest expense of $18,100 for the three months ended December 31, 2012 and 2011, respectively. On July 19, 2012, the Company entered into an amendment to the USD Loan Agreement to extend the term until June 28, 2013.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

## NOTE 7. STOCK OPTIONS

Under the fair value recognition provisions of ASC Topic 718, stock-based compensation cost is measured at the grant date based on the value of the award and is recognized on a straight-line basis as expense over the vesting period. Additionally, the Company is required to use judgment in estimating the amount of stock-based awards that are expected to be forfeited. If actual forfeitures differ significantly from the original estimate, stock-based compensation expense and the results of operations could be impacted.

In January 2010, the Company's Board of Directors granted stock options to three newly appointed independent directors to purchase up to 34,000 shares of the Company's common stock ("2010 Stock Options). 20% of the shares underlying the options were exercisable on the grant date and the remaining 80% of the shares underlying the options become exercisable over the next eight quarters at the rate of 10% at the end of every quarter. The exercise price of the options is $2.60 per share and the options expire on January 6, 2015. As of December 31, 2012 and September 30, 2012, 100% of the option awards have vested, respectively. During the three months ended December 31, 2012, 24,000 2010 Stock Options were forfeited.

On March 16, 2011, the Company's Board of Directors granted stock options to three independent directors to purchase up to an aggregate of 34,000 shares of the Company's common stock ("2011 Stock Options). Twenty percent (20%) of the shares underlying the options were exercisable on the grant date and the remaining 80% of the shares underlying the options become vested over the next eight quarters at the rate of 10% at the end of every quarter. The exercise price of the options is $2.37 per share and the options expire on March 16, 2016. As of December 31, 2012 and September 30, 2012, 100% and 90% of the option awards have vested, respectively. During the three months ended December 31, 2012, 24,000 2011 Stock Options were forfeited.

On August 22, 2012, the Company's Board of Directors granted stock options to two newly appointed independent directors to purchase up to an aggregate of 120,000 shares of the Company's common stock ("2012 Stock Options). The shares underlying the options become vested during the following 12 months period at the end of each quarter. The exercise price of the options is $2.37 per share. As of December 31, 2012 and September 30, 2012, 33.3% and 8.3% of the option awards have vested, respectively.

| The assumptions used in calculating the fair value of options granted using the Black-Scholes | Options granted in | Options granted in |
|---|---|---|

| option pricing model are as follows: | August 2012 | March 2011 |
|---|---|---|
| Risk-free interest rate | 0.19% | 1.87% |
| Expected life of the options | 1 year | 5 years |
| Expected volatility | 148% | 65% |
| Expected dividend yield | 0% | 0% |
| Fair value | $ 8,400 | $ 44,590 |

The Company uses the Black-Scholes option-pricing model, which incorporates various assumptions including volatility, expected life and interest rates to determine fair value. The Company's expected volatility assumption is based on the historical volatility of Company's stock. The expected life assumption is primarily based on the simplified method due to the Company's limited option exercise behavior. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 7. STOCK OPTIONS (continued)**

The following table summarizes the stock option activities of the Company:

| | Number of options | Weighted Average Exercise Price | Weighted Average Remaining Life in Years | Grant Date Fair Value |
|---|---|---|---|---|
| Outstanding, September 30, 2012 | 188,000 | $ 2.41 | 1.60 | $ 130,147 |
| Granted | | | | |
| Forfeited | 48,000 | 2.49 | 2.61 | 85,940 |
| Exercised | | | | |
| Outstanding, December 31, 2012 | 140,000 | $ 2.39 | 0.92 | $ 44,207 |
| Exercisable, December 31, 2012 | 60,000 | $ 2.41 | 1.30 | $ 38,608 |

Total stock-based compensation expense recognized in the three months ended December 31, 2012 and 2011, was $3,412 and $12,175, respectively. As of December 31, 2012 and September 30, 2012, there was $5,600 and $9,012, respectively, of unrecognized compensation cost related to stock option awards that are expected to be recognized.

**NOTE 8. TAXES**

**(A) Business sales tax**

The Company is subject to a 5% business sales tax on revenue. It is the Company's continuing practice to recognize the 5% business sales tax based on revenue as a cost of sales as the revenue is recognized. As of December 31, 2012, the Company had business sales tax payable of $2,905,462 (September 30, 2012- $3,366,130), which is expected to be paid when the projects are completed and assessed by the local tax authority.

**B) Corporate income taxes ("CIT")**

The Company's PRC subsidiaries and VIE are governed by the Income Tax Law of the People's Republic of China concerning the privately run enterprises, which are generally subject to income tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriate tax adjustments.

However, as approved by the local tax authority of Hanzhong City, the Company's CIT was assessed annually at a pre-determined fixed rate as an incentive to stimulate the local economy and encourage entrepreneurship. The local income tax rate in Hanzhong is 2.5% and in Yang County is 1.25% on revenue. For the three months ended December 31, 2012 and 2011, the Company's assessed income taxes were $221,164 and $48,338, respectively.

Although the possibility exists for reinterpretation of the application of the tax regulations by higher tax authorities in the PRC, potentially overturning the decision made by the local tax authority, the Company has not experienced any reevaluation of the income taxes for prior years. The PRC tax rules are different from the local tax rules and the Company is required to comply with local tax rules. The difference between the two tax rules will not be a liability of the Company. There will be no further tax payments for the difference.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 8. TAXES (continued)**

**B) Corporate income taxes ("CIT")**

The following table reconciles the statutory rates to the Company's effective tax rate for the three months ended December 31, 2012 and 2011:

| | For the three months ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Chinese statutory tax rate | 25.0 % | 25.0 % |
| Exemption rendered by local tax authorities | (21.1 )% | (19.5 )% |
| Effective tax rate | 3.9 % | 4.5 % |

The parent Company China HGS Real Estate, Inc. is incorporated in the United States. Net operating loss carry forwards for United States income tax purposes amounted to $191,492 and $169,980 as of December 31, 2012 and September 30, 2012, respectively, which are available to reduce future years' taxable income. These carry forwards will expire in 2032. However, the change in control resulting from the reverse merger in 2009 limits the amount of loss to be utilized each year. Management doesn't expect to remit any of its net income back to the United States in the foreseeable future. Accordingly, the Company recorded a full valuation allowance as of December 31, 2012 and September 30, 2012. The components of deferred taxes as of December 31, 2012 and September 30, 2012 consist of the following:

| | As of December 31, 2012 | September 30, 2012 |
|---|---|---|
| Net operating loss carry-forwards for parent company | $65,107 | $ 57,793 |
| Valuation allowance | (65,107) | (57,793 ) |
| Net deferred tax asset | $- | $ - |

The valuation allowance increased $7,314 and $10,294 for the three months end December 31, 2012 and 2011, respectively.

**(C) LAT**

Since January 1, 1994, LAT has been applicable at progressive tax rates ranging from 30% to 60% on the appreciation of land values, with an exemption provided for the sales of ordinary residential properties if the appreciation values do not exceed certain thresholds specified in the relevant tax laws. However, the Company's local tax authority in Hanzhong City has not imposed the regulation on real estate companies in its area of administration. Instead, the local tax authority has levied the LAT at the rate of 0.8% or 1.0% against total cash receipts from sales of real estate properties, rather than according to the progressive rates.  As at December 31, 2012, the prepaid LAT balance is $221,461 with respect to properties sold up to December 31, 2012. As at September 30, 2012, the outstanding LAT payable balance is $22,650 with respect to properties sold up to September 30, 2012.

**CHINA HGS REAL ESTATE, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 8. TAXES (continued)**

**(D) Taxes payable consisted of the following:**

| | December 31, 2012 | September 30, 2012 |
|---|---|---|
| CIT | $ 582,933 | $ 765,206 |
| Business tax | 2,905,462 | 3,366,130 |
| Other tax and fees | 233,787 | 205,122 |
| Total taxes payable | $ 3,722,182 | $ 4,336,458 |

**NOTE 9. CONTINGENCY AND COMMITMENTS**

As an industry practice, the Company provides guarantees to PRC banks with respect to loans procured by the purchasers of the Company’s real estate properties for the total mortgage loan amount until the completion of obtaining the “Certificate of Ownership” of the properties from the government, which generally takes six to twelve months. Because the banks provide loan proceeds without getting the “Certificate of Ownership” as loan collateral during this six to twelve months’ period, the mortgage banks require the Company to maintain, as restricted cash, 5% to 10% of the mortgage proceeds as security for the Company’s obligations under such guarantees. If a purchaser defaults on its payment obligations, the mortgage bank may deduct the delinquent mortgage payment from the security deposit and require the Company to pay the excess amount if the delinquent mortgage payments exceed the security deposit. The Company has made necessary reserves in its restricted cash account to cover any potential mortgage defaults as required by the mortgage lenders. The Company has not experienced any losses related to this guarantee and believes that such reserves are sufficient.

In May 2011, the Company entered into a development agreement with the local government. Pursuant to the agreement, the Company will prepay the development cost of $18,942,871 (RMB119,700,000) and the Company has the right to acquire the land use rights through public bidding unless another company wins the bidding. The prepaid development cost will be deducted from the final purchase price of the land use rights or refunded to the Company plus profit earned if the Company does not win the bidding. As of December 31, 2012, a deposit of $3,174,049 (RMB20,000,000) (September 30, 2012 -$3,165,058 (RMB20,000,000)) was paid by the Company. The Company currently expects to make payment of the remaining development cost within the next twelve months based on the government's current work in process.

On November 18, 2011, the Company won two bids for the land use rights by auction to obtain two parcels of land in Yang County for total consideration and the bidding commission of $12,597,918 (RMB 79,606,242). As of December 31, 2012, the Company has paid $12,499,659 (RMB78, 761,600) (September 30, 2012 - $12,464,250 (RMB78, 761,600)). The remaining balance of $134,047 is expected to be paid by March 31, 2013 when the Company receives the land use rights certificate.

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

*The following discussion and analysis of financial condition and results of operations relates to the operations and financial condition reported in the unaudited condensed consolidated financial statements of China HGS Real Estate, Inc. for the three months ended December 31, 2012 and 2011 and should be read in conjunction with such financial statements and related notes included in this report.*

As used in this report, the terms "Company," "we," "our," "us" and "HGS" refer to China HGS Real Estate, Inc. and its subsidiaries.

*Preliminary Note Regarding Forward-Looking Statements.*

*We make forward-looking statements in Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report based on the beliefs and assumptions of our management and on information currently available to us. Forward-looking statements include information about our possible or assumed future results of operations which follow under the headings "Business Overview," "Liquidity and Capital Resources," and other statements throughout this report preceded by, followed by or that include the words "believes," "expects," "anticipates," "intends," "plans," "estimates" or similar expressions.*

*Forward-looking statements are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed in these forward-looking statements, including the risks and uncertainties described below and other factors we describe from time to time in our periodic filings with the U.S. Securities and Exchange Commission (the "SEC"). We therefore caution you not to rely unduly on any forward-looking statements. The forward-looking statements in this report speak only as of the date of this report, and we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future developments or otherwise. These forward-looking statements include, among other things, statements relating to:*

- our ability to sustain our project development
- our ability to obtain additional land use rights at favorable prices;
- the market for real estate in Tier 3 and 4 cities and counties;

- our ability to obtain additional capital in future years to fund our planned expansion; or

- economic, political, regulatory, legal and foreign exchange risks associated with our operations.

**Business Overview**

We conduct substantially all of our business through Shaanxi Guangsha Investment and Development Group Co., Ltd, in Hanzhong, Shaanxi Province. Since the initiation of our business, we have been focused on expanding our business in certain Tier 3 and Tier 4 cities and counties in China.

The increasingly restrictive real estate policy and tightening liquidity policy left a profound negative impact on the residential housing transaction volume in 2011 and 2012. These policies also negatively affected buyers' confidence and consumption psychology. Some buyers are taking a wait-and-see attitude and may delay their purchasing decision.

The first three months of fiscal 2013 have been relatively quiet on the regulatory front, and no new real estate austerity control policy has been introduced. While the government's broad policy direction is likely to remain unchanged, expectations are that as the property market moves in the desired direction, it is likely to be relaxed to a certain extent. Although the restrictive real estate policies have created a 'wait-and-see' mentality among real estate buyers, the cumulative downward price adjustment has triggered the partial release of demand, creating a rise in transaction volumes in late 2012. Developers generally have been reducing inventory by adopting more aggressive sales tactics.

For the three months ended December 31, 2012, our sales volume significantly increased compared to the same period last year. Our sales, gross profit and net income for the three months ended December 31, 2012 were $11,003,415, $6,462,454 and $5,509,077, respectively, representing an approximately 339.8%, 347.5% and 434.6% increase from three months ended December 31, 2011, respectively.

We are using the full accrual method to recognize revenue and only recognize sales revenue upon delivery of sold properties to buyers instead of upon pre-sale of the properties. This accounting method adds uncertainties in our future sales trend and causes uneven sales revenue from period to period as our sales revenue depends upon the number of units delivered during the year. Currently, most of our real estate projects under construction are high-rise buildings with planned GFA over 709,038 square meters, which generally take about 2- 3 years for the construction, while our completed projects in the past were mostly multi-layer or sub-high-rise buildings and took 1-1.5 years for construction. None of our current construction projects were completed and delivered during the three months ended December 31, 2012 and 2011 and the revenue reported for these periods was resulted from sales of the remaining units of completed real estate projects. It might indicate that in certain future reporting periods, even if we have pre-sale contracts, we may not record any revenue because we have no new construction work completed and delivered to buyers in those periods. This is a typical characteristic of our business and the uneven sales revenues from period to period are due in part to the rate at which units are completed and delivered to buyers under the current full accrual method of revenue recognition policy.

The housing prices in Tier 3 and Tier 4 cities and counties are stable from last year. While short-term market correction is a process that the property sector is bound to undergo, we expect that the fundamental demand for residential housing will remain given the rising per capita income, accelerating urbanization and increasing demand for better living environment. For the three months ended December 31, 2012, our average selling price (“ASP”) for real estate projects (excluding sales of parking spaces) located in Yang County was approximately $615.2 per square meter, an increase of 38.6% from the ASP of $444 per square meter for the three months ended December 31, 2011. Due to our continuous promotion effects, we sold more commercial units in Yang County, which resulted in a higher ASP in Yang County comparing to the same period last year. The ASP of our Hanzhong real estate projects (excluding sales of parking spaces) was approximately $1,008.3 per square meter, consistent with the ASP of $1,034.9 per square meter for the three months ended December 31, 2011. For the first quarter of fiscal 2013 and 2012, revenue from commercial units’ sales represented about 69.0% and 38.7% of total revenue, respectively. The ASP for residential units in Hanzhong was $532.6 and $573.4 for the three months ended December 31, 2012 and 2011, respectively. Generally, the ASP of commercial units is more than doubled from the ASP of residential units.

With respect to capital funding requirements, while many property developers must now worry about their debt leverage and working capital needs for debt repayment, in contrast, the Company does not have any external bank loan outstanding at December 31, 2012. The Company’s cash flows from pre-sales and sales and, if necessary, shareholder loans should provide financial support for the current development and operations. In order to fully implement our business plan, however, we may need to raise capital in the future to sustain our expansion. Therefore, we may seek to access the capital markets in both the U.S. and China to obtain the funds we require. At the present time, however, we do not have commitments of funds from any source.

Market Outlook

We believe the fundamentals underpinning real estate demand remain strong. We intend to remain focused on our existing construction projects in Hanzhong City and Yang County, deepen our institutional sales network, enhance our cost and operational synergies and improve cash flows and strengthen our balance sheet. In this respect, in late 2012, we began the construction of two large residential projects in Hanzhong City and additional high-rise residential buildings in Yang County.

Oriental Pearl Garden

The project is located in the downtown of Hanzhong City. It consists of 12 high-rise residential buildings with commercial shops on the first and second floors with an estimated GFA of 260,000 square meters. The Company started construction in the third quarter of fiscal 2012 and expects to complete the whole construction in 2-3years. The pre-sale license is expected to be obtained by the third or fourth quarter of fiscal 2013. As of December 31, 2012, the customer deposit balance was $1,280,887 for the project.

Mingzhu Beiyuan

The project is located in the south west part of Hanzhong City. It includes 17 high-rise residential buildings with an estimated GFA of 350,000 square meters. The Company started construction in the third quarter of fiscal 2012 and expect to complete the whole construction in 2-3years. The pre-sale license is expected to be obtained by the second or third quarter of fiscal 2013. During fiscal 2011, we signed series of residential-apartment bulk-purchase agreements with Hanzhong Municipal Public Security Bureau, Hanzhong Municipal Bureau of Justice, Hanzhong Local Tax Bureau and the Hanzhong Social Insurance Center. The total residential units to be delivered in Mingzhu Beiyuan under these residential-apartment bulk-purchase agreements are 518 units with a total GFA of 68,752 square meters. As of December 31, 2012, the contracted sales under all residential-apartment bulk-purchase agreements and others individuals was approximately $34.8 million (RMB 219.1 million). As of December 31, 2012, the customer deposit balance related to these bulk-purchase agreements amounted to $15,448,040 (RMB 97,339,644). No revenue has been recognized during the three months ended December 31, 2012.

Yangzhou Pearl Garden

During fiscal 2012, the Company also started the construction of 8 high-rise residential buildings and 1 sub-high-rise residential building with total GFA of 99,038 square meters in Yangzhou Pearl Garden located in Yang County. We have obtained a pre-sale license for 3 residential buildings. The rest of pre-sale licenses are expected to be obtained by September 30, 2013. During fiscal 2011, the Company entered into a preliminary contract with Yang County to develop affordable apartment buildings with a total GFA of 40,000 square meters. These units are mainly located in 4 of 8 high-rise residential buildings. The completion and delivery of 1 high-rise residential building is deferred to the second quarter of fiscal 2013 and we expected the 2 additional high-rise residential buildings to be completed at the same time. The construction for the balance of buildings is expected to be completed in 2 years. As of December 31, 2012, the total contracted sales for these residential buildings were approximately $11.9 million (RMB74.6 million). As of December 31, 2012, the customer deposit balance amounted to $9,114,862 (RMB 57,433,657). No revenue has been recognized during the three months ended December 31, 2012.

In addition to the above residential projects, the Company was approved by Hanzhong local government to construct two municipal roads with a total length of 1,064.09 meters. The budgeted price for these two municipal roads is RMB 18,716,489.34 (equivalent to $3.0 million), which was approved by Hanzhong Ministry of Finance. The related construction was substantially completed by December 31, 2012 but requires the government's quality approval before delivery for its intended use. For these construction projects, the Company recognizes the fee as other revenue using full accrual method when the project is completed. No revenue has been recognized during the three months ended December 31, 2012.

We expect these initiatives will help us cope with this difficult period and better position us to capitalize on opportunities from a future market upturn.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires us to make estimates and judgments that affect our reported assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis and use them on historical experience and various other assumptions that are believed to be reasonable under the circumstances as the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates because of different assumptions or conditions.

We believe the following critical accounting policies affect our significant estimates and judgments used in the preparation of our condensed consolidated financial statements. These policies should be read in conjunction with Note 2 of the notes to unaudited condensed consolidated financial statements.

**Use of estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes, and disclosure of contingent liabilities at the date of the condensed consolidated financial statements. Estimates are used for, but not limited to, the selection of the useful lives of property and equipment, provision necessary for contingent liabilities, fair values, revenue recognition, taxes, budgeted costs and other similar charges. Management believes that the estimates utilized in preparing its condensed consolidated financial statements are reasonable and prudent. Actual results could differ from these estimates.

**Fair value of financial instruments**

The Company follows the provisions of Accounting Standards Codification ("ASC") 820, Fair Value Measurements and Disclosures. It clarifies the definition of fair value, prescribes methods for measuring fair value, and establishes a fair value hierarchy to classify the inputs used in measuring fair value as follows:

Level 1-Inputs are unadjusted quoted prices in active markets for identical assets or liabilities available at the measurement date.

Level 2-Inputs are unadjusted quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, inputs other than quoted prices that are observable, and inputs derived from or corroborated by observable market data.

Level 3-Inputs are unobservable inputs which reflect the reporting entity's own assumptions or what assumptions the market participants would use in pricing the asset or liability based on the best available information.

The carrying amounts reported in the accompanying condensed consolidated balance sheets for cash, restricted cash, advance to vendors, loans to outside parties, security deposits for land use rights, other current assets, accounts payable, customer deposits, other payables, accrued expenses, and taxes payable, approximate their fair value based on the short-term maturity of these instruments. The fair value of the long term customer and construction deposits approximate their carrying amounts because the deposits are received in cash.

**Revenue recognition**

Real estate sales are recognized in accordance with the ASC 360-20 “Real Estate Sales”.

Revenue from the sales of development properties is recognized by the full accrual method at the time of the closing of an individual unit sale. This occurs when title to or possession of the property is transferred to the buyer. A sale is not considered consummated until (a) the parties are bound by the terms of a contract, (b) all consideration has been exchanged, (c) any permanent financing for which the seller is responsible has been arranged, (d) all conditions precedent to closing have been performed, (e) the seller does not have substantial continuing involvement with the property, and (f) the usual risks and rewards of ownership have been transferred to the buyer. Further, the buyer's initial and continuing investment is adequate to demonstrate a commitment to pay for the property.

The Company provides "mortgage loan guarantees" only with respect to buyers who make down-payments of 30%-50% of the total purchase price of the property. The period of the mortgage loan guarantee begins on the date the bank approves the buyer's mortgage and we receives the loan proceeds in our bank account and ends on the date the "Certificate of Ownership" evidencing that title to the property has been transferred to the buyer. The procedures to obtain the Certificate of Ownership take six to twelve months (the "Mortgage Loan Guarantee Period"). If, after investigation of the buyer's income and other relevant factors, the bank decides not to grant the mortgage loan, our mortgage-loan based sales contract terminates and there will be no guarantee obligation. If, during the Mortgage Loan Guarantee Period, the buyer defaults on his or her monthly mortgage payment for three consecutive months, we are required to refund the loan proceeds back to the bank, although we have the right to keep the customer's deposit and resell the property to a third party. Once the Certificate of Ownership has been issued by the relevant government authority, our loan guarantee terminates. If the buyer then defaults on his or her mortgage loan, the bank has the right to take the property back and sell it and use the proceeds to pay off the loan. The Company is not liable for any shortfall that the bank may incur in this event. To date, no buyer has defaulted on his or her mortgage payments during the Mortgage Loan Guarantee Period and the Company has not had to refund any loan proceeds pursuant to its mortgage loan guarantees.

For municipal road construction projects, fees are generally recognized by the full accrual method at the time the projects are completed.

**Customer Deposits**

Customer deposits consist of prepayments received from customers relating to the sale of residential units in the PRC. The Company receives these funds and recognizes them as a liability until the revenue can be recognized. The classification of customer deposits as current liabilities or long term liabilities is subject to our estimation on whether we expect to be able to recognize these deposits as revenue within one year of the balance sheet date. We convert the customer deposits to revenue when the homebuyers or banks pay off the balance, and the Certificates of the Ownership are delivered to the homebuyers or the banks.

**Advances to vendors**

Advances to vendors consist of balances paid to contractors and vendors for services and materials that have not been provided or received and generally relate to the development and construction of residential and commercial units in the PRC. Advances to vendors are reviewed periodically to determine whether their carrying value has become impaired. Historically, the Company has not experienced any losses as a result of these advances.

**Real estate property development completed and under development**

Real estate property consists of finished residential unit sites, commercial offices and residential unit sites under development. The Company leases the land for the residential unit sites under land use right leases with various terms from the PRC government. The cost of land use rights is included in the development cost and allocated to each project. Real estate property development completed and real estate property under development are stated at the lower of cost or fair value.

Expenditures for land development, including cost of land use rights, deed tax, pre-development costs, and engineering costs, exclusive of depreciation, are capitalized and allocated to development projects by the specific identification method. Costs are allocated to specific units within a project based on the ratio of the sales area of units to the estimated total sales area of the project (or phase of the project) multiplied by the total cost of the project (or phase of the project).

Cost of amenities transferred to buyers is allocated to specific units as a component of total construction cost. The amenity cost includes landscaping, road paving, etc. Once the projects are completed, the amenities are under control of the property management companies. In accordance to GAAP, real estate property development completed and under development are subject to impairment when the carrying amount exceeds fair value. An impairment loss shall be recognized only if the carrying amount of the assets is not recoverable and exceeds fair value. The carrying amount is not recoverable if it exceeds the sum of the undiscounted cash flows expected to be generated by the assets.

**Income taxes**

The Company utilizes ASC 740, “Income Taxes,” which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

ASC 740-10-25 prescribes a more-likely-than-not threshold for consolidated financial statement recognition and measurement of a tax position taken (or expected to be taken) in a tax return. It also provides guidance on the recognition of income tax assets and liabilities, classification of current and deferred income tax assets and liabilities, accounting for interest and penalties associated with tax positions, years open for tax examination, accounting for income taxes in interim periods and income tax disclosures.

The Company is a corporation organized under the laws of the State of Florida. However, all of the Company's operations are conducted solely by its subsidiaries in the PRC. No income is earned in the United States and the management does not repatriate any earnings outside the PRC. As a result, the Company did not generate any U.S. taxable income.

**RESULTS OF OPERATIONS**

***Three Months Ended December 31, 2012 Compared to Three Months Ended December 31, 2011***

**Revenues**

The following table summarizes our revenue generated by different projects:

| | For Three Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | Variance | |
| | Revenue | % | Revenue | % | Amount | % |
| Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) | $1,272,786 | 11.6% | $1,021,241 | 40.8% | $251,545 | 24.6 % |
| Yangzhou Pearl Garden | 4,313,737 | 39.2% | 1,136,913 | 45.4% | 3,176,824 | 279.4 % |
| NanDajie (Mingzhu Xinju) | 5,416,892 | 49.2% | 343,827 | 13.8% | 5,073,065 | 1475.5% |
| Total Real Estate Sales before Sales Tax | $11,003,415 | 100 % | $2,501,981 | 100 % | $8,501,434 | 339.8 % |
| Sales Tax | (710,717 ) | | (175,905 ) | | 534,812 | 304.0 % |
| Revenue net of sales tax | $10,292,698 | | $2,326,076 | | $7,966,622 | 342.5 % |

Our revenues are derived from the sale of residential buildings, commercial front-stores and parking space in projects that we have developed. Revenues before sales tax increased by 339.8% to approximately $11.0 million for the three month ended December 31, 2012 from approximately $2.5 million for the same period in the last year. The total GFA sold during the three months ended December 31, 2012 was 13,028 square meters, representing over three times increase from 3,877.4 square meters completed and sold for the three months ended December 31, 2011. A significant portion of revenue during the first quarter of fiscal 2013 was from the sales of commercial units in NanDajie Project (Mingzhu Xinju) project. On October 23, 2012, the Company entered into a sales agreement to sell the remaining commercial units in Nan Dajie (Mingzhu Xinju) project with a total GFA of 4,545.88 square meters located in Hanzhong City for a total contract amount of $5,393,038 (RMB 33,911,426). The purchaser is related to one of the Company’s concrete suppliers for our Hanzhong City Oriental Pearl Garden project and Mingzhu Beiyuan project. The purchaser’s payments are guaranteed by third parties. The ownership certificate of the related property was issued to the purchaser on November 22, 2012. The Company expects to collect the balance of the receivable by July 31, 2013. As of December 31, 2012, accounts receivable of $4,654,636 was due from the purchaser.

Sales taxes for the three months ended December 31, 2012 and 2011 consisted of a business tax, 5% of the revenue, an urban construction tax, 7% of business tax, an education surcharge tax, 3% of business tax, and land appreciation tax. Land appreciation tax for the three months ended December 31, 2012 and 2011 was assessed at the rate of 0.5% of the customer deposits in Yang County and 1% of the customer deposits in Hanzhong. The sales taxes for the three months ended December 31, 2012 increased by 304.0% from the same period last year, primarily as a result of the increase in revenue.

We are developing more high-rise residential buildings, which requires longer construction periods. This indicates that in certain future reporting periods, we might not have any new construction work, completed and delivered to buyers, and the only available-for-sale properties would be from our inventories which are previously completed and unsold properties. Since we recognize revenue in accordance with the full accrual method at the time of the closing of an individual unit sale, the longer construction periods for high-rise residential building would have negative impact on our revenue recognition.

***Cost of Sales***

The following table sets forth a breakdown of our cost of sales:

| | For Three Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | 2011 | | Variance | |
| | Cost | % | Cost | % | Amount | % |
| Land use rights | $645,018 | 14 % | $112,316 | 13 % | $532,702 | 474.3% |
| Construction cost | 3,185,226 | 86 % | 769,584 | 87 % | 2,415,642 | 313.9% |
| Total cost | $3,830,244 | 100 % | $881,900 | 100 % | $2,948,344 | 334.3% |

Our cost of sales consists primarily of costs associated with land use rights and construction costs. Cost of sales are capitalized and allocated to development projects using the specific identification method. Costs are allocated to specific units within a project based on the ratio of the sales area of units to the estimated total sales area of the project (or phase of the project) times the total cost of the project (or phase of the project).

Cost of sales was approximately $3.8 million for the three months ended December 31, 2012 compared to $0.9 million for the three months ended December 31, 2011. The $2.9 million increase in cost of sales was mainly attributable to the increase in total GFA sold during this quarter.

*Land use rights cost*: The cost of land use rights includes the land premium we pay to acquire land use rights for our property development sites, plus taxes. Our land use rights cost varies for different projects according to the size and location of the site and the minimum land premium set for the site, all of which are influenced by government policies, as well as prevailing market conditions. Costs for land use rights for the three months ended December 31, 2012 were $645,018, as compared to $112,316 for the three months ended December 31, 2011, representing an increase of $532,702 from the same quarter last year. The increase was consistent with the fact that the total GFA sold during the three months ended December 31, 2012 was significantly higher than the same quarter of last year.

*Construction cost:* We outsource the construction of all of our projects to third party contractors, whom we select through a competitive tender process. Our construction contracts provide a fixed payment which covers substantially all labor, materials and equipment costs, subject to adjustments for some types of excess, such as design changes during construction or changes in government-suggested steel prices. Our construction costs consist primarily of the payments to our third-party contractors, which are paid over the construction period based on specified milestones. In addition, we purchase and supply a limited range of fittings and equipment, including elevators, window frames and door frames. Our construction costs for the three months ended December 31, 2012 were approximately $3.2 million as compared to approximately $0.8 million for the three months ended December 31, 2011, representing an increase of $2.4 million. The increase in construction cost was due to the additional units sold reflected in the increased revenue recognized.

The total cost of sales as a percentage of real estate sales before sales tax for the three months ended December 31, 2012 decreased to 34.8% from 35.3% for the three months ended December 31, 2011, which was mainly attributable to higher revenue resulted from sales of more commercial units.

***Gross Profit***

Gross profit was approximately $6.5 million for the three months ended December 31, 2012 as compared to approximately $1.4 million for the three months ended December 31, 2011, representing an increase of $5.1 million, which was mainly attributable to the increase in sales. The overall gross profit as a percentage of real estate sales before sales tax increased to 58.7% during the three months ended December 31, 2012 from 57.7% for the same quarter last year, mainly due to the fact that more commercial units in Hanzhong City and Yang County were sold during the three months ended December 31, 2012.

The following table sets forth the gross margin of each of our projects:

| | For Three Months Ended December 31, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | Gross Profit | Percentage of Revenue | Gross Profit | Percentage of Revenue |
| Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) | $774,858 | 60.9 % | $759,166 | 74.3 % |
| Yangzhou Pearl Garden | 2,764,202 | 64.1 % | 629,896 | 55.4 % |
| NanDajie (Mingzhu Xinju) | 3,634,111 | 67.1 % | 231,019 | 67.2 % |
| Sales Tax | (710,717 ) | | (175,905 ) | |
| Total Gross Profit | $6,462,454 | 58.7 % | $1,444,176 | 57.7 % |
| Total Real Estate Sales before Sales Tax | $11,003,415 | | $2,501,981 | |

***Operating Expenses***

Total operating expenses increased by 99.9% or $360,852 to $722,065 for the three months ended December 31, 2012 from $361,213 for the three months ended December 31, 2011 as a result of a 279.6% increase in selling expense of $118,653 and a 76.0% increase in general and administration expenses of $242,199.

The increase in selling expense for the three months ended December 31, 2012 was primarily attributed to more promotions, sales and marketing activities. The increased revenue also resulted in higher sales commission expense. The higher general administration expenses for the three months ended December 31, 2012 was attributed to higher executive compensation, taxes and office expense.

| | For Three Months Ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Selling expenses | $ 161,094 | $ 42,441 |
| General and administrative expenses | 560,971 | 318,772 |
| Total operating expenses | $ 722,065 | $ 361,213 |
| Percentage of Real Estate Sales before Sales Tax | 6.6 % | 14.4 % |

***Income Taxes***

***U.S. Taxes***

China HGS is a Florida corporation. However, all of our operations are conducted solely by our subsidiaries in the PRC. No income is earned in the United States and we do not repatriate any earnings outside the PRC. As a result, we did not generate any U.S. taxable income for the three months ended December 31, 2012.

***PRC Taxes***

Our Company is governed by the Income Tax Law of the People's Republic of China concerning private-run enterprises, which are generally subject to tax at a new statutory rate of 25% on income reported in the statutory financial statements after appropriate tax adjustments.

However, the local tax authority of Hanzhong City has the power to assess corporate taxes annually on local enterprises at a pre-determined fixed rate as an incentive to stimulate the local economy and encourage entrepreneurship. The tax authority assessed us for income taxes at the rate of 1.25% on revenue in Yang County and 2.5% on our revenue in Hanzhong, instead of statutory rate of 25% on the income before income tax. Income tax expenses for the three months ended December 31, 2012 were $221,164 compared to $48,338 for the three months ended December 31, 2011 as a result of the increase in our revenue.

***Net Income***

We reported net income of $5,509,077 for the three months ended December 31, 2012, as compared to net income of $1,030,462 for the three months ended December 31, 2011. The increase of $4.5 million in our net income was primarily due to the increase in revenue and gross profit as further discussed above under Revenues and Gross Profit.

***Other Comprehensive Income***

We operate primarily in the PRC and the functional currency of our operating subsidiary is the Chinese Renminbi ("RMB"). The RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that the RMB amounts could have been, or could be, converted into USD at the rates used in translation.

Translation adjustments resulting from this process amounted to $208,985 and $344,589 for the three months ended December 31, 2012 and 2011, respectively. The balance sheet amounts with the exception of equity at December 31, 2012 were translated at 6.3011 RMB to 1.00 USD as compared to 6.3190 RMB to 1.00 USD at September 30, 2012. The equity accounts were stated at their historical rate. The average translation rates applied to the income statements accounts for the periods ended December 31, 2012 and 2011 were 6.2880 RMB and 6.3771 RMB, respectively.

***Liquidity and Capital Resources***

***Current Assets and Liabilities***

Our principal need for liquidity and capital resources is to maintain working capital sufficient to support our operations and to make capital expenditures to finance the growth of our business. To date, we have financed our operations primarily through cash flows from operations and borrowings from our principal shareholder.

We spent more on the new development projects under construction and provided a longer payment term for certain major customer who made a bulk purchase of commercial units in Nan Dajie (Mingzhu Xinju) project. As a result, our total cash and restricted cash balance decreased to approximately $1.7 million as of December 31, 2012. Since most of our customers are first-time home buyers and our affordable housing units are in the pre-sales stage, we expect our cash flow will improve during the balance of fiscal 2013.

As of December 31, 2012, the Company had approximately $8.7 million in working capital, an increase of $1.0 million as compared to $7.7 million as of September 30, 2012. The increase in working capital was mainly related to the increase of accounts receivable for approximately $4.7 million, an increase of $1.8 million in advance to vendors, an increase of the current portion of real estate property under development of $1.0 million, a decrease in taxes payable of $0.6 million, offset by the decrease from the current portion of real estate property development completed of $3.6 million and an increase of customer deposits approximately $2.3 million.

Current assets increased by $3.3 million to approximately $36.4 million as of December 31, 2012 from $33.1 million as of September 30, 2012. The primary changes in our current assets during this period were increases in accounts receivable, advance to vendors and the current portion of real estate property under development, offsetting by decreases in the current portion of real estate property development completed.

The decrease of cash from $1.1 million as of September 30, 2012 to $0.5 million as of December 31, 2012 was mainly due to the spending on the new projects under construction by $6.4 million. The decrease in cash was partially offset by an increase in customer deposits of $2.3 million. The increase of advance to venders from $2.6 million as of September 30, 2012 to $4.4 million as of December 31, 2012 was due to more prepayment made to the development and construction of residential and commercial units. The decrease of real estate property development completed from $19.5 million as of September 30, 2012 to $15.9 million as of December 31, 2012 was attributed to higher sales from our continuous sales efforts. The balance of real estate property under development current portion increased by $1.0 million from $8.6 million as of September 30, 2012 to $9.6 million as of December 31, 2012, due to more spending on the new development projects.

Total current liabilities as of December 31, 2012 was approximately $27.7 million, representing a 8.9% increase compared to $25.4 million as of September 30, 2012. The increase in current liabilities was mainly due to the increase of $2.3 million in customer deposits, offset by a decrease in taxes payable of $0.6 million.

In order to fully implement our business plan, however, we may need to raise capital in the future. Our expectation, therefore, is that we will seek to access the capital markets in both the U.S. and China to obtain the funds we require. At the present time, however, we do not have commitments of funds from any source.

***Cash Flow***

Comparison of cash flows results is summarized as follows:

| | Three months ended December 31, | |
|---|---|---|
| | 2012 | 2011 |
| Net cash used in operating activities | $(585,177) | $(8,497,984) |
| Net cash used in investing activities | | - |
| Net cash provided by financing activities | | - |
| Effect of change of foreign exchange rate on cash | 4,359 | 25,795 |
| Net cash decrease in cash | (580,818) | (8,472,189) |

| | | |
|---|---|---|
| Cash, beginning of period | 1,104,686 | 8,837,795 |
| Cash, end of period | $523,868 | $365,606 |

***Operating Activities***

Net cash used in operating activities during the three months ended December 31, 2012 was $0.6 million, consisting of net income of $5.5 million, noncash adjustments of $0.03 million and net changes in our operating assets and liabilities, which mainly included an increase in advances to venders of $1.8 million due to the more construction prepayments made on the projects under construction, an increase in account receivable of $4.7 million as we extended payment term for one major customer who made a bulk purchase of commercial units in our Nan Dajie (Mingzhu Xinju) project located in Hanzhong City, an increase in real estate property under development of $6.4 million resulting from more progress on our real estate projects under development, a decrease in real estate property completed of $3.8 million due to sales and an increase in customer deposits of $3.0 million resulted from our pre-sale efforts. The negative cash provided by operating activities is mainly attributable to our significant spending on our new real estate property under development.

Net cash used in operating activities during the three months ended December 31, 2011 was $8,497,984, consisting of net income of $1,030,462, noncash adjustments of $34,256 and net changes in our operating assets and liabilities, which mainly included a decrease in loan to outside parties of $579,495 due to the repayment from these venders, a decrease in real estate property development completed of $881,900 resulted from our sales and a decrease in account payable of $3,203,189 as we settled balances with our suppliers; an increase in security deposits for land use rights of $9,136,065, an increase in real estate property completed of $1,898,986 attributable to our construction progress and an increase in customer deposits of $3,021,626 resulted from our pre-sale efforts. The negative cash provided by operating activities is mainly attributable to our significant payment on security deposits on the land use rights, settlements of account payable with our suppliers and spending in the real estate property under development.

***Financing Activities***

Net cash flows provided by financing activities amounted to $0 for the three months ended December 31, 2011, which represents $3,142,332 proceeds of a short-term loans from a controlling shareholder to finance the land use rights payment and the Company`s full repayment of such loan during the quarter.

***Inflation***

Inflation has not had a material impact on our business and we do not expect inflation to have a material impact on our business in the near future.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Not applicable.

**ITEM 4. CONTROLS AND PROCEDURES**

***Evaluation of Disclosure Controls and Procedures***

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this Quarterly Report on Form 10-Q (the “Evaluation Date”). The evaluation of our disclosure controls and procedures included a review of our processes and the effect on the information generated for use in this Quarterly Report on Form 10-Q. In the course of this evaluation, we sought to identify any material weaknesses in our disclosure controls and procedures and to confirm that any necessary corrective action, including process improvements, was taken. The purpose of this evaluation is to determine if, as of the Evaluation Date, our disclosure controls and procedures were operating effectively such that the information, required to be disclosed in our Securities and Exchange Commission (“SEC”) reports (i) was recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) was accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management conducted its evaluation of disclosure controls and procedures under the supervision of our chief executive officer and our chief financial officer. Based upon this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2012.

Management is committed to improving the internal controls over financial reporting and will undertake the consistent improvements or enhancements on an ongoing basis. To remediate the weakness in lack of internal audit function, the Company has employed an internal auditor to reinforce the function of the internal audit department. Currently, the internal audit department has two employees.

The Company continued to engage the existing independent professional consulting firm to assist the Company’s Internal Control Evaluation Committee in evaluating the internal control effectiveness in fiscal 2013.

The remedial measures being undertaken may not be fully effectuated or may be insufficient to address the significant deficiencies we identified, and there can be no assurance that significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified or occur in the future. If additional significant deficiencies (or if material weaknesses) in our internal controls are discovered or occur in the future, among other similar or related effects: (i) the Company may fail to meet future reporting obligations on a timely basis, (ii) the Company’s consolidated financial statements may contain material misstatements, and (iii) the Company’s business and operating results may be harmed.

***Changes in Internal Control over Financial Reporting***

Except for the matters described above to improve our internal controls over financial reporting, there were no changes in our internal control over financial reporting for the three months ended December 31, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting, however the Company is in the process of designing and planning to change as described above.

## PART II: OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We may be subject to, from time to time, various legal proceedings relating to claims arising out of our operations in the ordinary course of our business. We are not currently a party to any legal proceedings, the adverse outcome of which, individually or in the aggregate, would have a material adverse effect on the business, financial condition, or results of operations of the Company.

### ITEM 1A. RISK FACTORS

As a “smaller reporting company” as defined by Item 10 of Regulation S-K, the Company is not required to provide information required by this item.

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

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) Exhibits

| Exhibit Number | Description of Exhibit |
|---|---|
| 31.1* | Rule 13a-14(a) Certification of Chief Executive Officer |
| 31.2* | Rule 13a-14(a) Certification of Chief Financial Officer |
| 32.1* | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer |
| 101.INS* | XBRL Instance |
| 101.SCH* | XBRL Taxonomy Extension Schema |
| 101.CAL* | XBRL Taxonomy Extension Calculation |
| 101.DEF* | XBRL Taxonomy Extension Definition |
| 101.LAB* | XBRL Taxonomy Extension Labels |
| 101.PRE* | XBRL Taxonomy Extension Presentation |

* Furnished electronically herewith

**SIGNATURES**

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

China HGS Real Estate, Inc.

February 6, 2013 By: /s/ Xiaojun Zhu
Xiaojun Zhu
Chief Executive Officer

By: /s/ Wei Shen
Wei Shen
Chief Financial Officer

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