CHINA HGS REAL ESTATE INC.
Form 10-Q
February 13, 2017

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, 2016

.. **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 9, 2017 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, 2016	September 30, 2016
ASSETS		
Current assets:		
Cash	$10,249,072	$6,401,237
Restricted cash	1,116,025	1,493,537
Cost and earnings in excess of billings	13,437,593	11,891,230
Real estate property development completed	101,761,829	113,185,929
Real estate property under development	84,609,389	-
Other current assets	2,643,599	2,722,036
Total current assets	213,817,507	135,693,969
Property, plant and equipment, net	745,600	792,650
Real estate property development completed, net of current portion	1,591,534	1,657,055
Security deposits	8,111,436	7,940,137
Real estate property under development, net of current portion	136,206,176	207,384,015
Due from local government for real estate property development completed	2,805,493	2,920,990
Total Assets	$363,277,746	$356,388,816
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Other loans	$11,767,078	$6,125,753
Accounts payable	28,098,980	30,574,497
Other payables	4,987,591	5,200,807
Construction deposits	1,417,092	1,911,158
Billings in excess of cost and earnings	2,007,849	2,110,808
Customer deposits	16,747,747	16,790,208
Shareholder loan	2,673,956	2,709,523

Accrued expenses	2,982,946	3,205,099
Taxes payable	15,365,447	15,843,815
Total current liabilities	86,048,686	84,471,668
Deferred tax liabilities	4,905,919	5,107,887
Customer deposits, net of current portion	10,387,894	10,687,272
Other long term loan payable, less current portion	111,158,026	99,843,228
Construction deposits, net of current portion	1,277,239	1,329,820
Total liabilities	213,777,764	201,439,875
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, 2016 and September 30, 2016	45,050	45,050
Additional paid-in capital	129,808,472	129,793,572
Statutory surplus	8,495,631	8,495,631
Retained earnings	21,423,316	20,661,184
Accumulated other comprehensive loss	(10,272,487)	(4,046,496)
Total stockholders' equity	149,499,982	154,948,941
Total Liabilities and Stockholders' Equity	$363,277,746	$356,388,816

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 LOSS

(Unaudited)

	Three months ended December 31,	
	2016	2015
Real estate sales	$ 8,897,854	$ 5,856,607
Less: Sales tax	(112,602)	(411,988)
Cost of real estate sales	(7,061,035)	(3,208,889)
Gross profit	1,724,217	2,235,730
Operating expenses		
Selling and distribution expenses	146,234	90,153
General and administrative expenses	472,730	478,511
Total operating expenses	618,964	568,664
Operating income	1,105,253	1,667,066
Interest expense	(121,123)	(104,046)
Income before income taxes	984,130	1,563,020
Provision for income taxes	221,998	135,796
Net income	762,132	1,427,224
Comprehensive loss		
Foreign currency translation adjustment	(6,225,991)	(3,339,117)
Comprehensive loss	$ (5,463,859)	$ (1,911,893)
Basic and diluted income per common share		
Basic and diluted	$ 0.02	$ 0.03
Weighted average common shares outstanding		
Basic and 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, 2016	2015
Cash flows from operating activities		
Net income	$ 762,132	$ 1,427,224
Adjustments to reconcile net income to net cash used in operating activities:		
Deferred tax provision	-	66,304
Depreciation	15,962	20,187
Stock based compensation	14,900	14,900
Changes in assets and liabilities:		
Advances to vendors	-	(84,577)
Cost and earnings in excess of billings	(2,049,151)	392,728
Real estate property development completed	7,061,036	2,258,837
Real estate property under development	(21,981,341)	(7,098,791)
Other current assets	(522,767)	(1,309,716)
Accounts payables	(1,287,068)	(8,509,618)
Other payables	(7,695)	3,635,725
Billings in excess of cost and earnings	(19,812)	122,823
Customer deposits	756,670	2,934,270
Construction deposits	(425,264)	(452,203)
Accrued expenses	(112,531)	(24,843)
Taxes payable	150,497	29,080
Net cash used in operating activities	(17,644,432)	(6,577,670)
Cash flow from financing activities		
Restricted cash	323,605	(61,120)
Net proceeds from shareholder loan	-	852,802
Proceeds from other loans	21,488,076	10,824,408
Repayment of other loans	-	(5,163,753)
Net cash provided by financing activities	21,811,681	6,452,337
Effect of changes of foreign exchange rate on cash	(319,414)	(25,769)
Net increase (decrease) in cash	3,847,835	(151,102)
Cash, beginning of period	6,401,237	1,333,919
Cash, end of period	$ 10,249,072	$ 1,182,817
Supplemental disclosures of cash flow information:		
Interest paid	$ 1,374,159	$ 486,077
Income taxes paid	$ 170,567	$ 69,492

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

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 and the requirement of Article 8 of Regulation S-X of the Securities and Exchange Commission ("SEC"). 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, 2016 and 2015 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 consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2016 filed with the SEC on December 21, 2016.

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 and its subsidiaries have been eliminated upon consolidation.

Use of estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes, and disclosure of contingent liabilities at the date of the consolidated financial statements. Estimates are used for, but not limited to, the assumptions and estimates used by management in recognizing development revenue under the percentage of completion method, the selection of the useful lives of property and equipment, provision necessary for contingent liabilities, revenue recognition, taxes, budgeted costs, share-based compensation and other similar charges. Management believes that the estimates utilized in preparing its 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.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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, advances to vendors, security deposits for land use rights, other current assets, accounts payable, short-term loans, other payables, customer deposits, 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, construction and security deposits approximate their carrying amounts because the deposits are received in cash. It was impractical to estimate the fair value of the amount due from the local government and the long term loan payable.

Revenue recognition

Percentage of Completion method

Real estate sales for the long term real estate projects are recognized under percentage completion method in accordance with the provisions of ASC 360-20-40D "Sale of Condominium Units". Revenue and profit from the sales of long term development properties is recognized by the percentage of completion method on the sale of individual units when all the following criteria are met:

a. Construction is beyond a preliminary stage.

b. The buyer is committed to the extent of being unable to require a refund except for non-delivery of the unit or interest.

c. Sufficient units have already been sold to assure that the entire property will not revert to rental property.

d. Sales prices are collectible.

e. Aggregate sales proceeds and costs can be reasonably estimated.

If any of the above criteria is not met, proceeds shall be accounted for as deposits until the criteria are met.

Under the percentage of completion method, revenues from condominium units sold and related costs are recognized over the course of the construction period, based on the completion progress of a project. In relation to any project, revenue is determined by calculating the ratio of incurred costs, including land use rights costs and construction costs, to total estimated costs and applying that ratio to the contracted sales amounts. Cost of sales is recognized by determining the ratio of contracted sales during the period to total estimated sales value, and applying that ratio to the incurred costs. Current period amounts are calculated based on the difference between the life-to-date project totals and the previously recognized amounts.

Any changes in significant judgments and/or estimates used in determining construction and development revenue could significantly change the timing or amount of construction and development revenue recognized. Changes in total estimated project costs or losses, if any, are recognized in the period in which they are determined.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Full accrual method

Revenue from the sales of short term development properties, where the construction period is expected to 18 months or less 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 Property 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 of the projects are completed.

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,
	2016	2015	2016
Period end RMB : USD exchange rate	6.9448	6.4917	6.6702
Period average RMB : USD exchange rate	6.8343	6.3907	6.5326

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.

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CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 PRC are not insured by the Federal Deposit Insurance Corporation or other programs.

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. 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.

Security deposits for land use rights

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

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.

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 development completed and real estate property under development are reclassified on the balance sheet into current and non-current portions based on the estimated date of construction completion and sales. The real estate property development completed classification is based on the estimated date that each property is expected to be sold within the Company's normal operating cycle of the business and the Company's sales plan. Real estate property development completed is classified as a current asset if the property is expected to be sold within the normal operating cycle of the business. Otherwise, it is classified as a non-current asset. Real estate property under development is classified as a current asset, if the property is reasonably expected to be completed within the Company's normal operating cycle of the business. Otherwise, it is classified as a non-current asset. The majority of real estate projects the Company has completed in the past were multi-layer or sub-high-rise real estate projects. The Company considers its normal operating cycle is 12 months.

In accordance with ASC 360, "Property, Plant and Equipment" ("ASC 360"), real estate property development completed and under development are subject to valuation adjustments when the carrying amount exceeds fair value. An impairment loss is 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. The Company reviewed all of its real estate projects for future losses and impairment by comparing the estimated future undiscounted cash flows for each project to the carrying value of such project. For the three months ended December 31, 2016 and 2015, the Company did not recognize any impairment for real estate property under development and completed.

Capitalization of Interest

Interest incurred during and directly related to real estate development projects is capitalized to the related real estate property under development during the active development period, which generally commences when borrowings are used to acquire real estate assets and ends when the properties are substantially complete or the property becomes inactive. Interest is capitalized based on the interest rate applicable to specific borrowings or the weighted average of the rates applicable to other borrowings during the period. Interest capitalized to real estate property under development is expensed as a component of cost of real estate sales when related units are sold. All other interest is expensed as incurred. For the three months ended December 31, 2016 and 2015, the total interest capitalized in the real estate property development was $1,281,875 and $433,410, respectively

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.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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, 2016 and 2015.

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 three months periods ended December 31, 2016 and 2015, the Company had not recognized any warranty costs in excess of the amount retained from subcontractors and therefore, no warranty reserve is considered necessary at the balance sheet dates.

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.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Share-based compensation

Share-based payment transactions are 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.

Forfeitures are 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

Deferred tax assets and liabilities are 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, 2016 and September 30, 2016.

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, 2016 and 2015, respectively. As of December 31, 2016, Chinese entities' income tax returns filed in China for the years ended December 31, 2016, 2015, 2014, 2013 and 2012 are subject to examination by the Chinese taxing authorities.

As of December 31, 2016, the tax years ended September 30, 2008 through September 30, 2016 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, 2012 through September 30, 2016 remains open for statutory examination by U.S. tax authorities.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 Mingzhou Garden, Nandajie, Central Plaza and Oriental Pearl Garden 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 and Yangzhou Palace are located, requires a tax rate of 0.5%.

Comprehensive income (loss)

In accordance with ASC 220-10-55, comprehensive income (loss) 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 loss during the three months ended December 31, 2016 and 2015 were net income and foreign currency translation adjustments.

Basic and diluted earnings per share

The Company computes earnings per share ("EPS") in accordance with the ASC 260, "Earnings per share", which requires companies to present basic and diluted EPS. Basic EPS is measured as net income divided by the weighted average common shares outstanding for the period. Diluted EPS is similar to basic EPS but presents the dilutive effect on a per share basis of potential common shares (e.g., convertible securities, options and warrants) as if they had been converted at the beginning of the periods presented, or issuance date, if later. Potential common shares that have an anti-dilutive effect (i.e., those that increase income per share or decrease loss per share) are excluded from the calculation of diluted EPS.

Advertising expenses

Advertising costs are expensed as incurred. For the three months ended December 31, 2016 and 2015, the Company recorded advertising expenses of $74,291 and $20,467, respectively.

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CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Concentration risk

The Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environment in the PRC, and by the general state of the PRC's economy. The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in North America. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things. Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and trade accounts receivable. All of the Company’s cash is maintained with state-owned banks within the People’s Republic of China of which no deposits are covered by insurance. The Company has not experienced any losses in such accounts and believes it is not exposed to any risks on its cash in bank accounts.

The Company is dependent on third-party sub-contractors, manufacturers, and distributors for all construction services and supply of construction materials. For the three months ended December 31, 2016, one supplier accounted for approximately 15% of the Company’s total project expenditures. For the three months ended December 31, 2015, one supplier accounted for over 70% of the Company’s total project expenditures.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” (“ASU 2014-09”). ASU 2014-09 requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. Generally Accepted Accounting Principles when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. The guidance also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts. In August 2015, the FASB issued ASU No. 2015-14, “Deferral of the Effective Date” (“ASU 2015-14”), which defers the effective date for ASU 2014-09 by one year. For public entities, the guidance in ASU 2014-09 will be effective for annual reporting periods beginning after December 15, 2017 (including interim reporting periods within those periods), which means it will be effective for the Company’s fiscal year beginning October 1, 2018. In March 2016, the FASB issued ASU No. 2016-08, “Principal versus Agent Considerations (Reporting Revenue versus Net)” (“ASU 2016-08”), which clarifies the implementation guidance on principal versus agent considerations in the new revenue recognition standard. In April 2016, the FASB issued ASU No. 2016-10, “Identifying Performance Obligations and Licensing” (“ASU 2016-10”), which reduces the complexity when applying the guidance for identifying performance obligations and improves the operability and understandability of the license implementation guidance. In May 2016, the FASB issued ASU No. 2016-12 “Narrow-Scope Improvements and Practical Expedients” (“ASU 2016-12”), which amends the guidance on transition, collectability, noncash consideration and the presentation of sales and other similar taxes. In December 2016, the FASB further issued ASU 2016-20, “Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers” (“ASU 2016-20”), which makes minor corrections or minor improvements to the Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. The amendments are intended to address implementation and provide additional practical expedients to reduce the cost and complexity of applying the new revenue standard. These amendments have the same effective date as the new revenue standard. Preliminarily, we plan to adopt Topic 606 in the first quarter of our fiscal 2019 using the retrospective transition method, and are continuing to evaluate the impact our pending adoption of Topic 606 will have on our unaudited condensed consolidated financial statements. The Company’s current revenue recognition policies are generally consistent with the new revenue recognition standards set forth in ASU 2014-09. Potential adjustments to input measures are not expected to be pervasive to the majority of the Company’s contracts. While no significant impact is expected upon adoption of the new guidance, the Company will not be able to make that determination until the time of adoption based upon outstanding contracts at that time.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 3. 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, 2016 and September 30, 2016:

	Balance as of	
	December 31, 2016	September 30, 2016
Development completed:		
Hanzhong City Mingzhu Garden Phase I	$914,421	$952,066
Hanzhong City Mingzhu Garden Phase II	49,983,513	54,933,680
Hanzhong City Nan Dajie (Mingzhu Xinju)	1,317,398	1,371,633
Hanzhong City Oriental Pearl Garden (a)	44,516,495	50,643,258
Yang County Yangzhou Pearl Garden Phase I	2,301,664	2,396,420
Yang County Yangzhou Pearl Garden Phase II	4,319,872	4,545,927
Real estate property development completed	103,353,363	114,842,984
Less: Real estate property completed – short-term	101,761,829	113,185,929
Real estate property completed – long-term	$1,591,534	$1,657,055
Under development:		
Yang County Yangzhou Palace	$81,681,583	$76,618,856
Hanzhong City Shijin Project	6,974,676	7,261,811
Hanzhong City Liangzhou Road and related projects (b)	114,764,694	117,226,429
Hanzhong City Hanfeng Beiyuan East (c)	631,700	657,706
Hanzhong City Beidajie (e)	14,466,805	3,228,580
Yang County East 2nd Ring Road (d)	2,296,107	2,390,633
Real estate property under development	220,815,565	207,384,015
Less: Short-term portion	84,609,389	-
Real estate property under development –long-term	$136,206,176	$207,384,015

(a) The Company recognized $Nil of development cost in cost of real estate sales under the percentage of completion method for the three months ended December 31, 2016 (2015 - $950,052)

(b) In September 2013, the Company entered into an agreement ("Liangzhou Agreement") with the Hanzhong local government on the Liangzhou Road reformation and expansion project (Liangzhou Road Project"). Pursuant to the agreement, the Company is contracted to reform and expand the Liangzhou Road, a commercial street in downtown Hanzhong City, with a total length of 2,080 meters and width of 30 meters and to resettle the existing residences in the Liangzhou road area. The government's original road construction budget was approximately $33 million in accordance with the Liangzhou Agreement. The Company, in return, is being compensated by the local government to have an exclusive right on acquiring at least 394.5 Mu land use rights in a specified location of Hanzhong City. The Liangzhou Road Project's road construction started at the end of 2013. In 2014, the original scope and budget on the Liangzhou road reformation and expansion project was extended, because the local government included more area and resettlement residences into the project, which resulted in additional investments from the Company. In return, the Company is authorized by the local government to develop and manage the commercial and residential properties surrounding the Liangzhou Road project. Due to the extension, the Company expected the road construction to be completed and approved by the local government in 2017.

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 3. REAL ESTATE PROPERTY DEVELOPMENT COMPLETED AND UNDER DEVELOPMENT (continued)

The Company's development cost incurred on Liangzhou Road Project is treated as the Company's deposit on purchasing the related land use rights, as agreed by the local government. As of December 31, 2016, the actual costs incurred by the Company were $114,764,694 (September 30, 2016 - $117,226,429) and the incremental cost related to residence resettlement approved by the local government. The Company determined that the Company's Investment in Liangzhou Road Project in exchange for interests in future land use rights is a barter transaction with commercial substance. For the three months ended December 31, 2016 and 2015, the Company did not receive government's subsidies for its Shanty Area Reform Project surrounding Liang Zhou Road located in Hantai District, Hanzhong City, respectively and the Company recorded the subsidies to offset against the development cost of Liangzhou Road Project.

(c) In September 2012, the Company was approved by the Hanzhong local government to construct four municipal roads with a total length of approximately 1,192 meters. The project was deferred and then restarted during the year ended September 30, 2014. As of December 31, 2016, the local government was still in the process of assessing the budget for these projects.

(d) The Company was engaged by the Yang County local government to construct the East 2nd Ring Road with a total length of 2.15 km and a budgeted price of approximately $24.2 million (or RMB 168 million), which was approved by the local Yang County government in March 2014. The local government is required to repay the Company's project investment costs within 3 years with interest at the interest rate based on the commercial borrowing rate with the similar term published by China construction bank (December 31, 2016 - 4.75% and September 30, 2016 – 4.75%). The local government has approved a refund to the Company by reducing local surcharges or taxes otherwise required in the real estate development. The road construction is expected to be completed by 2017.

(e) For the three months ended December 31, 2016 and 2015, the Company received government's subsidies in the amount of $Nil and $3,234,900 for its Shanty Area Reform Project surrounding Beidajie Project located in Hantai District, Hanzhong City, respectively and the Company recorded the subsidies to offset against the development cost of Beidajie project.

As of December 31, 2016 and September 30, 2016, land use rights included in real estate property under development totaled $18,794,716 and $19,568,460, respectively.

NOTE 4. OTHER LOANS

	December 31, 2016	September 30, 2016
Loan A (i)	$99,265,621	$ 93,975,338
Loan B (ii)	11,519,411	11,993,643
Loan C (iii)	12,140,072	-
	122,925,104	105,968,981
Less: current maturities of other loans	11,767,078	6,125,753
Other loans – long-term portion	$111,158,026	$ 99,843,228

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 4. OTHER LOANS (continued)

(i) On June 26, 2015 and March 10, 2016, the Company signed phase I and Phase II agreements with Hanzhong Urban Construction Investment Development Co., Ltd, a state owned Company, to borrow up to $111,594,288 (RMB 775,000,000) for a long term loan at 4.245% interest per year to develop Liang Zhou Road Project. As of December 31, 2016 and September 30, 2016, the Company borrowed $99,265,621 and $93,975,338 under this credit line, respectively. The loan is guaranteed by Hanzhong City Hantai District Municipal Government and pledged by the Company's Yang County Palace project with carrying value of $81,681,583 as of December 31, 2016 (September 30, 2016 - $76,618,856). In addition, the Company was required to provide a security deposit for the loan received. As of December 31, 2016 and September 30, 2016, the deposit balances were $5,237,156 and $4,941,726, respectively, and included in the security deposits. For the three months ended December 31, 2016 and 2015, the interest was $1,137,874 and $293,480, respectively, which was capitalized in to the development cost of Liangzhou road project. The combined loan repayment schedule assuming total loan proceeds are borrowed are listed below:

	Repayment in USD	Repayment in RMB
29-May-2017	5,883,539	40,860,000
20-November-2017	5,883,539	40,860,000
20-April -2018	12,597,915	87,490,000
20-May-2018	5,985,774	41,570,000
20-November-2018	5,985,774	41,570,000
20-April-2019	12,597,915	87,490,000
20-May-2019	6,129,766	42,570,000
20-October-2019	12,597,915	87,490,000
29-November-2019	6,129,766	42,570,000
20-April-2020	12,602,235	87,520,000
20-October-2020	12,597,915	87,490,000
20-October-2021	12,602,235	87,520,000
Total	111,594,288	775,000,000

(ii) On January 8, 2016, the Company signed a loan agreement with Hanzhong Municipal Housing Provident Fund Management Center ("Housing Fund") to borrow up to approximately $11,519,411 (RMB 80,000,000) related to Oriental Garden related projects. The loan carries interest at 3.575% per year and is due in January 2019. The Company's major shareholder Mr. Xiaojun Zhu pledged his personal assets as collateral for the loan. As of December 31, 2016, the Company received all the proceeds from Housing Fund. The progress repayment is required based on certain sales milestones or a fixed repayment schedule starting in July 2018. The Housing Fund has rights to monitor the project's future cash flow. For the three months ended December 31, 2016 and 2015, total interest was $105,782 and $Nil, respectively. As of September 30, 2016, these projects were completed and the related interest was charged to expense. The full amount of loan has following repayment schedule:

	Repayment in USD	Repayment in RMB
Earlier of July 2018 or 60% sales completed	2,879,853	20,000,000
Earlier of October 2018 or 70% sales completed	4,319,779	30,000,000
Earlier of January 2019 or 75% sales completed	4,319,779	30,000,000
Total	11,519,411	80,000,000

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 4. OTHER LOANS (continued)

(iii) In December 2016, the Company received a loan proceed of $12,140,072 (RMB 84,310,375) in connection with a loan agreement with Hantai District Urban Construction Investment Development Co., Ltd, a state owned Company, to borrow up to $17,135,123 (RMB119,000,000) for the development of Hanzhong City Liangzhou Road project. The loan carries interest at a fixed interest of 1.2% and is due on June 30, 2021. The Company pledged the assets of Liangzhou Road and related projects with carrying value of $114,764,694 as collateral for the loan. For the three months ended December 31, 2016 and 2015, total financing costs were $130,503 and $Nil, respectively, which was capitalized in to the development cost of Hanzhong City Liangzhou Road project.

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, 2016	September 30, 2016
Customer deposits by real estate projects		
Mingzhu Garden (Mingzhu Nanyuan and Mingzhu Beiyuan)	$ 9,137,482	$ 9,150,119
Oriental Pearl Garden	5,288,000	5,582,158
Liangzhou road and related projects	2,707,062	2,593,625
Yang County Pearl Garden	2,322,265	2,057,931
Yang County Palace	7,680,832	8,093,647
Total	27,135,641	27,477,480
Less: Customer deposits - short-term	16,747,747	16,790,208
Customer deposits - long-term	$ 10,387,894	$ 10,687,272

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. Buyers with mortgage loans pay customer deposits. 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. As of December 31, 2016 and September 30, 2016, approximately $1.1 million and $1.5 million were guaranteed by the Company, respectively.

NOTE 6. RELATED PARTY LOANS

	As of December 31, 2016	September 30, 2016
Shareholder loan – USD loan (a)	$1,810,000	$1,810,000
Shareholder loan – RMB loan (b)	863,956	899,523
Total	$2,673,956	$2,709,523

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CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 6. RELATED PARTY LOANS (continued)

a. The Company has a one year loan agreement (“USD Loan Agreement”) with Mr. Xiaojun Zhu, our Chairman, CEO and major shareholder (“Mr. Zhu”), pursuant to which the Company borrowed $1,810,000 to make a capital injection into Shaanxi HGS, the Company’s subsidiary. The interest rate for the loan is 4% per annum and the loan matured on July 19, 2014. The Company entered into the amendments to the USD Loan Agreement to extend the term until July 31, 2017. The Company recorded interest expense of $18,100 and $18,100 for three months ended December 31, 2016 and 2015, respectively. The Company has not yet paid this interest and it is recorded in accrued expenses in the accompanying unaudited condensed consolidated balance sheets as of December 31, 2016 and September 30, 2016.

b. On December 31, 2013, Shaanxi Guangsha Investment and Development Group Co., Ltd. (the “Guangsha”) entered into a loan agreement with the Chairman (the “Shareholder RMB Loan Agreement”), pursuant to which Guangsha is able to borrow from Mr. Zhu in order to support the Company’s Liang Shan Road construction project development and the Company’s working capital needs. The Loan Agreement has a one-year term, and has been renewed with a new expiration date of June 30, 2017, with at an interest rate of 4.35% per year. The RMB loan balance as of December 31, 2016 and September 30, 2016 was $863,956 and $899,523, respectively. For the three months ended December 31, 2016 and 2015, the interest was $13,498 and $12,518, respectively, which is capitalized in the development cost of Liangzhou road project.

NOTE 7. STOCK OPTIONS

On August 22, 2015, the Company’s Board of Directors granted stock options to two new independent directors to repurchase up to an aggregate of 120,000 shares of the Company’s common stock (“2015 Stock Options”). The shares underlying the options become excisable during the following 36 months period at the end of each quarter. The exercise price of the options is $1.89 per share. As of December 31, 2016 and September 30, 2016, 44.4% and 36.1% of the option awards have vested, respectively. The assumptions used in calculating the fair value of options granted using the Black-Scholes option pricing model are as follows:

The assumptions used in calculating the fair value of options granted using the Black-Scholes option pricing model are as follows:	Options granted in August

	2015	
Risk-free interest rate	0.95	%
Expected life of the options	3 year	
Expected volatility	143	%
Expected dividend yield	0	%
Fair value	$178,800	

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

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 7. STOCK OPTIONS (continued)

	Number of options	Weighted Average Exercise Price	Weighted Average Remaining Life in Years	Grant Date Fair Value
Outstanding, September 30, 2016	120,000	$ 1.89	1.89	$178,800
Granted	-	-	-	-
Forfeited	-	-	-	-
Exercised	-	-	-	-
Outstanding, December 31, 2016	120,000	$ 1.89	1.64	$178,800
Exercisable, December 31, 2016	53,333	$ 1.89	1.64	$79,467

The Company recorded $14,900 and $14,900 stock-based compensation expense for the three months ended December 31, 2016 and 2015, respectively. Since the average share price for the three months ended December 31, 2016 was below the exercise price of the above options, these options were anti-dilutive for the three months ended December 31, 2016, and therefore would not be included in the diluted shares calculation.

NOTE 8. TAXES

(A) Business sales tax and VAT

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, 2016, the Company had business sales tax payable of $12,968,303 (September 30, 2016- $13,453,236), which is expected to be paid when the projects are completed and assessed by the local tax authority. In May of 2016, the Business Tax has been incorporated into Value Added Tax in China, which means there will be no more Business Tax and accordingly some business operations previously taxed in the name of Business Tax will be taxed in the manner of VAT thereafter. The Company is subject to 5% of VAT for its entire exiting real estate project based on the local tax authority's practice.

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, 2016 and 2015, the Company's income taxes were $221,998 and $135,796, 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)

Income tax expense for the three months ended December 31, 2016 and 2015 is summarized as follows:

	For the three months ended December 31,	
	2016	2015
Current tax provision	$221,998	$69,492
Deferred tax provision	-	66,304
Income tax provision	$221,998	$135,796

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 approximated to $566,160 and $533,160 as of December 31, 2016 and September 30, 2016, respectively, which are available to reduce future years' taxable income. These carry forwards will expire in 2035. 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, 2016 and September 30, 2016. The components of deferred taxes as of December 31, 2016 and September 30, 2016 consist of the following:

	December 31, 2016	September 30, 2016
Deferred tax assets:		
Deferred tax asset from net operating loss carry-forwards for parent company	$192,494	$181,274
Valuation allowance	(192,494)	(181,274)
Deferred tax asset - net	$-	$-
Deferred tax liability:		
Revenue recognized based on percentage of completion	$4,905,919	$5,107,087
Deferred tax liability – long term	$4,905,919	$5,107,087

Movement of valuation allowance:

	December 31, 2016	September 30, 2016
Beginning Balance	$ 181,274	$ 136,394
Current period additions	11,220	44,880
Ending Balance	$ 192,494	$ 181,274

CHINA HGS REAL ESTATE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 8. TAXES (continued)

The valuation allowance increased $11,220 and $11,220 for the three months end December 31, 2016 and 2015, respectively.

(C) Land Appreciation Tax ("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 0.5% in Yang County and 1.0% in Hanzhong against total cash receipts from sales of real estate properties, rather than according to the progressive rates. As at December 31, 2016, the outstanding LAT payable was $1,091,334 with respect to completed real estate properties sold up to December 31, 2016. As at September 30, 2016, the outstanding LAT payable balance was $1,049,401 with respect to completed real estate properties sold up to September 30, 2016.

(D) Taxes payable consisted of the following:

	December 31, 2016	September 30, 2016
CIT	$701,549	$677,734
Business tax	12,968,303	13,453,236
Other taxes and fees	1,695,595	1,712,845
Total taxes payable	$15,365,447	$15,843,815

NOTE 9. COMMITMENTS AND CONTINGENCIES

From time to time, the Company is a party to various legal actions arising in the ordinary course of business. The Company accrues costs associated with these matters when they become probable and the amount can be reasonably estimated. Legal costs incurred in connection with loss contingencies are expensed as incurred. The Company's management does not expect any liability from the disposition of such claims and litigation individually or in the aggregate would have a material adverse impact on the Company's consolidated financial position, results of operations and cash flows.

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. As of December 31, 2016 and September 30, 2016, the amount of security deposit provided for these guarantees was approximately $1.1 million and $1.5 million respectively.

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, 2016 and 2015 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.

For the three months ended December 31, 2016, our sales, gross profit and net income were $8,897,854, $1,724,217 and $762,132, respectively, representing an approximate 51.9% increase in sales but 22.9% and 46.6% decrease in gross profit and net income as compared to three months ended December 31, 2015, respectively. The increase in sales was mainly resulted from more gross floor area (“GFA”) sold during this quarter. The decrease in gross profit and net income was mainly resulted from lower margin residential units sold during this quarter.

The Company uses the percentage of completion method to account for real estate sales residential projects with construction periods from 18 to 24 months. For the quarter ended December 31, 2016, we did not recognize revenue under the percentage of completion method because we fully completed the construction work on Oriental Pearl Garden Phase I by September 30, 2016 and our current under development projects have not met the criteria for revenue recognition under the percentage of completion method. As a result, we put our focus on selling previously completed commercial and residential units in order to reduce the inventory stockpile during current quarter and accordingly 100% of our current quarter revenue was recognized under the full accrual method. For the same period of last year, we reported $2,652,178 or 45.3% of our total revenue recognized under the percentage of completion method, with related costs of these real estate sales of $950,052, or 29.6% of our total real estate costs, and gross profit from the percentage of completion method of $1,702,126, or 76.1% of the total gross profit.

For the three months ended December 31, 2016, the average selling price ("ASP") for our completed real estate projects (excluding sales of parking spaces) located in Yang County was approximately $200.1 per square meter, a decrease of 42.8% from the ASP of $350.1 per square meter for the three months ended December 31, 2015. The decrease in ASP was mainly due to the fact that we lowered the selling price for limited residential units to promote the sales for the quarter ended December 31, 2016. The ASP of our Hanzhong completed real estate projects (excluding sales of parking spaces) was approximately $498.0 per square meter, an 18.2% decrease from the ASP of $608.7 per square meter for the three months ended December 31, 2015. The decrease mainly due to more commercial units sold in the Oriental Garden project in the same period of last year. During the first quarter of last year, 62.9% of revenue recognized from Oriental Garden project were from sales of commercial properties, while all the revenue recognized from Oriental Garden project were from sales of residential properties in the first quarter of fiscal 2017.

Market Outlook

Based on recent market condition, we anticipate that the macro-economic backdrop will continue to be uncertain in 2017 with unrelenting downside pressure, while the overall inventory level of properties will remain high. The central government will continue to adopt policies aimed to ensure stability, economic growth and improved employment. The details of implementation by local government will vary among different PRC cities.

In 2017, the Company expects to launch the Liangzhou Road related projects. The new projects will comprise of residential for end-users and upgraders, shopping malls as well as serviced apartments and offices to satisfy different market demands. Our customers continue to experience growth of their disposable income. With a lower housing price to family disposable income ratio and an increasing urbanization level, there is a growing demand for high quality residential housing. From this perspective, the Company is positive about the outlook for the local real estate market in a long term. In the meantime, the Company is diversifying its revenue and developing more commercial and municipal projects.

We intend to remain focused on our existing construction projects in Hanzhong City and Yang County, deepening our institutional sales network, enhancing our cost and operational synergies and improving cash flows and strengthening our balance sheet. In this respect, we began the construction of the following large high rise residential projects in Hanzhong City and Yang County:

Liangzhou road and related projects

In September 2013, the Company entered into an agreement (“Liangzhou Agreement”) with the Hanzhong local government on the Liangzhou Road reformation and expansion project (Liangzhou Road Project”). Pursuant to the agreement, the Company is contracted to reform and expand the Liangzhou Road, a commercial street in downtown Hanzhong City, with a total length of 2,080 meters and width of 30 meters and to resettle the existing residences in the Liangzhou road area. The government’s original road construction budget was approximately $33 million in accordance with the Liangzhou Agreement. The Company, in return, is being compensated by the local government to have an exclusive right on acquiring at least 394.5 Mu land use rights in a specified location of Hanzhong City. The Liangzhou Road Project’s road construction started at the end of 2013. In 2014, the original scope and budget on the Liangzhou road reformation and expansion project was extended, because the local government included more area and resettlement residences into the project, which resulted in additional investments from the Company. In return, the Company is authorized by the local government to develop and manage the commercial and residential properties surrounding the Liangzhou Road project. Due to the extension, the Company expected the road construction to be completed and approved by the local government in early 2017. The Company’s development cost incurred on Liangzhou Road Project is treated as the Company’s deposit on purchasing the related land use rights, as agreed by the local government.

As of December 31, 2016, the actual costs incurred by the Company was $114,764,694 (September 30, 2016 - $117,226,429) and the incremental cost related to residence resettlement was approved by the local government. The Company determined that the Company's Investment in Liangzhou Road Project in exchange for interests in future land use rights is a barter transaction with commercial substance. For the three months ended December 31, 2016 and 2015, the Company did not receive government's subsidies for its Shanty Area Reform Project surrounding Liang Zhou Road located in Hantai District, Hanzhong City, respectively, and the Company recorded the subsidies to offset against the development cost of Liangzhou Road Project.

The Liangzhou road related projects mainly consists Oriental Garden Phase II, Liangzhou Mansion and Pearl Commercial Plaza surrounding the Liangzhou road area. The Company plans to start these three real estate projects in 2017 when the local government expects to complete the reallocation of the existing residence in the Liangzhou road area

Oriental Pearl Garden Phase II

Oriental Garden Phase II project is planned to consist of 8 high-rise residential buildings and 6 commercial buildings with total planned GFA of 370,298 square meters. The project will also include a farmer's market.

Liangzhou Mansion

Liangzhou Mansion project is planned to consist of 7 high-rise building and commercial shops on the first floor with total planned GFA of 160,000 square meters.

Pearl Commercial Plaza

Pearl Commercial Plaza is planned to consist one office building, one service apartment (or hotel), classical architecture style of Chinese traditional houses and shopping malls with total planned GFA of 124,191 square meters

Other projects

Yangzhou Palace

The Company is currently constructing 9 high-rise residential buildings and 16 sub-high-rise residential and multi-layer residential buildings with total GFA of 285,244 square meters in Yangzhou Palace located in Yang County. The construction started in the fourth quarter of fiscal 2013 and is expected to be completed by the end of 2017. The Company has obtained pre-sale license in September 2016.

Road Construction

Other road construction projects mainly included a Yang County East 2nd Ring Road construction project. The Company was engaged by Yang County local government to construct East 2nd Ring Road with total length of 2.15 km and budgeted price approximately of $24.2 million (or RMB 168 million) approved by local Yang County government in March 2014. The local government is required to repay the Company's project investment within 3-4 years with interest based on the commercial borrowing rate with the similar term published by China Construction Bank. The local government also was allowed to refund the Company by reducing local surcharges or taxes otherwise required in the real estate development. As of December 31, 2016 and September 30, 2016, the actual costs incurred by the Company were $2,296,107 and $2,390,633, respectively, which was included in real estate property under development on the unaudited condensed consolidated balance sheets. The local government is in the process of acceptance and assessment process. The Company is expected to deliver these two road construction projects to local government in 2017.

In September 2012, the Company was approved by the Hanzhong local government to construct four municipal roads with a total length of approximately 1,192 meters. The project was deferred and then restarted during the quarter ended March 31, 2014. As of December 31, 2016, the local government was still in the process of planning and assessing the scope and budget for these projects. We expect these initiatives will help us during this difficult period and better position us to capitalize on opportunities from a future market upturn.

Summary of real estate projects completion status

Development completed	**Actual (estimated) Completion time of construction**	**Estimated time to sell of the property**
Hanzhong City Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan)	Majority was completed during the third quarter of fiscal 2012	2017
Hanzhong City Nan Dajie (Mingzhu Xinju)	Phase one completed in 2010 and Phase two completed in 2011	2017
Hanzhong City Mingzhu Garden Phase II	Completed by Fiscal 2015	2017
Hanzhong City Oriental Pearl Garden	Completed by Fiscal 2016	2017
Yang County Yangzhou Pearl Garden Phase II	Completed by Fiscal 2015	2017
Yang County Yangzhou Pearl Garden	Majority completed in 2011 and 2012	2017

Under development:	**Estimated Completion time of construction**
Yang County Yangzhou Palace	To be completed in 2017
Hanzhong City Shijin Project	Under planning stage
Hanzhong City Hanfeng Beiyuan East Road	To deliver the road to government in 2017
Hanzhong City Liangzhou Road and related projects	The road construction to be completed in 2017, the related projects will be completed in 2018 and later years.
Hanzhong City Beidajie project	Under planning stage
Yang County East 2nd Ring Road	To be completed in 2017

We expect these initiatives will help us during 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.

Revenue recognition

Percentage of Completion method

Real estate sales for the long term real estate projects are recognized under percentage completion method in accordance with the provisions of ASC 360-20-40D “Sale of Condominium Units”. Revenue and profit from the sales of long term development properties is recognized by the percentage of completion method on the sale of individual units when all the following criteria are met:

a. Construction is beyond a preliminary stage.
b. The buyer is committed to the extent of being unable to require a refund except for non-delivery of the unit or interest.
c. Sufficient units have already been sold to assure that the entire property will not revert to rental property.
d. Sales prices are collectible.
e. Aggregate sales proceeds and costs can be reasonably estimated.

If any of the above criteria is not met, proceeds shall be accounted for as deposits until the criteria are met.

Under the percentage of completion method, revenues from condominium units sold and related costs are recognized over the course of the construction period, based on the completion progress of a project. In relation to any project, revenue is determined by calculating the ratio of incurred costs, including land use rights costs and construction costs, to total estimated costs and applying that ratio to the contracted sales amounts. Cost of sales is recognized by determining the ratio of contracted sales during the period to total estimated sales value, and applying that ratio to the incurred costs. Current period amounts are calculated based on the difference between the life-to-date project totals and the previously recognized amounts.

Revenue recognized to date in excess of amounts received from customers is classified as current assets under cost and earnings in excess of billings. Amounts received from customers in excess of revenue recognized to date are classified as current liabilities under billings in excess of cost and earnings.

Any changes in significant judgments and/or estimates used in determining construction and development revenue could significantly change the timing or amount of construction and development revenue recognized. Changes in total estimated project costs or losses, if any, are recognized in the period in which they are determined.

Full accrual method

Revenue from the sales of short term development properties, where the construction period is expected to 18 months or less 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 return 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 Property 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 returned 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 of the projects are completed.

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Use of estimates

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

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.

Real estate property development completed and real estate property under development are reclassified on the balance sheet into current and non-current portions based on the estimated date of construction completion and sales. The real estate property development completed classification is based on the estimated date that each property is expected to be sold within the Company’s normal operating cycle of the business and the Company’s sales plan. Real estate property development completed is classified as a current asset if the property is expected to be sold within the normal operating cycle of the business. Otherwise, it is classified as a non-current asset. Real estate property under development is classified as a current asset, if the property is reasonably expected to be completed within the Company's normal operating cycle of the business. Otherwise, it is classified as a non-current asset. The majority of real estate projects the Company has completed in the past were multi-layer or sub-high-rise real estate projects. The Company considers its normal operating cycle is 12 months.

In accordance with ASC 360, "Property, Plant and Equipment" ("ASC 360"), real estate property development completed and under development are subject to valuation adjustments when the carrying amount exceeds fair value. An impairment loss is 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. The Company reviewed all of its real estate projects for future losses and impairment by comparing the estimated future undiscounted cash flows for each project to the carrying value of such project. For the three months ended December 31, 2016 and 2015, the Company did not recognize any impairment for real estate property under development and completed. If we had to recognize an impairment loss, it would have affected our net income and earnings per share.

RESULTS OF OPERATIONS

Three Months Ended December 31, 2016 compared to Three Months Ended December 31, 2015

Revenues

The following is a breakdown of revenue:

	For Three Months Ended December 31,	
	2016	2015
Revenue recognized under full accrual method	$8,897,854	$3,204,429
Revenue recognized under percentage of completion method	-	2,652,178
Total	$8,897,854	$5,856,607

Revenues recognized from completed projects

The following table summarizes our revenue generated by different projects:

	For Three Months Ended December 31,					
	2016		2015		Variance	
	Revenue	%	Revenue	%	Amount	%
Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) Phase I and II	$3,537,695	39.8%	$2,354,950	73.5%	$1,182,745	50.2 %
Oriental Pearl Garden	5,324,262	59.8%	-	0.0 %	5,324,262	100.0%
Yangzhou Pearl Garden Phase I and II	35,897	0.4 %	849,479	26.5%	(813,582)	(95.8 %)
Total Real Estate Sales before Sales Tax	8,897,854	100 %	3,204,429	100 %	5,693,425	177.7%
Sales Tax	(112,602)		(178,599)		65,997	37.0 %
Revenue net of sales tax	$8,785,252		$3,025,830		$5,759,422	

Our revenues are derived from the sale of residential buildings, commercial front-stores and parking space in projects that we have developed. Our Mingzhu Garden Phase I and Phase II, Yangzhou Pearl Garden Phase I and Phase II and Oriental Garden Phase I have all been completed in prior years, the related revenues have been included in revenue recognized from completed projects, which resulted in higher revenue reported for this quarter as compared to the same comparative period of 2015. For the completed real estate properties, only limited models are available for customer selection. In order to promote the sales of the remaining units, we lowered our selling price during the quarter ended December 31, 2016, which led to more GFA sold during the quarter than in the same period of 2015.

Revenues before sales tax increased by 177.7% to approximately $8.9 million for the three months ended December 31, 2016 from approximately $3.2 million for the same period last year. The total GFA sold during the three months ended December 31, 2016 was 17,976 square meters, representing a 185.6% increase from 6,295 square meters completed and sold for the same period of last year.

Sales tax for the three months ended December 31, 2016 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, 2016 and 2015 was assessed at the rate of 0.5% of the customer deposits in Yang County and 1% of the customer deposits in Hanzhong. In May of 2016, the Business Tax has been incorporated into Value Added Tax in China, which means there will be no more Business Tax and accordingly some business operations previously taxed in the name of Business Tax will be taxed in the manner of VAT thereafter. The Company is subject to 5% of VAT for its entire exiting real estate project based on the local tax authority’s practice. As our revenue is reported net of VAT, the Company does not expect the overall gross margin for the existing real estate properties will be reduced by the change from business tax to VAT. As a result of this tax policy change, the sales tax for the three months ended December 31, 2016 decreased by 37% from the same period last year.

Revenue recognized from projects under development

	For the three months ended December 31, 2016				
	Total GFA	**Average Percentage of Completion**(1)	**Qualified Contract Sales**(2)	Revenue Recognized under Percentage of Completion	Accumulated Revenue recognized under Percentage of completion
Real estate properties under development located in Hanzhong					
Oriental Garden Phase I	N/A	N/A	N/A	N/A	N/A

Oriental Garden Phase I has been completed by September 30, 2016, therefore the related revenue was not included in the above table. For the quarter ended December 31, 2016, we did not recognize any revenue under the percentage of completion method.

	For the three months ended December 31, 2015				
	Total GFA	**Average Percentage of Completion**(1)	**Qualified Contract Sales**(2)	Revenue Recognized under Percentage of Completion	Accumulated Revenue recognized under Percentage of completion
Real estate properties under development located in Hanzhong					
Oriental Garden Phase I	273,787	87%	$91,791,647	$ 2,652,178	$ 87,945,304

(1) Percentage of completion is calculated by dividing total costs incurred by total estimated costs for the relevant buildings in the each real estate building , estimated as of the time of preparation of our financial statements as of and for the year indicated.

(2) Qualified contract sales only include all contract sales with customer deposits balance as of December 31, 2016 and 2015 equal or greater than 30% of contract sales amount and related individual of buildings were sold over 20%.

(3)

Qualified contract sales only include all contract sales with customer deposits balance as of December 31, 2016 and 2015 equal or greater than 30% of contract sales amount and related individual of buildings were sold over 20%.

Both Mingzhu Garden Phase II and Yangzhou Pear Garden Phase II projects were completed by September 30, 2015, therefore the related revenue was not included in the above table. For Oriental Garden real estate property under development, total contract sales as of December 31, 2015 were $95,384,869. Total GFA sold under contract sales as of December 31, 2015 was 122,545 square meters. The average unit price was $778 per square meters. For the purpose of percentage of completion calculation, the qualified contract sales amount was approximately $91,791,647 for the three months ended December 31, 2015.

Cost of Sales

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

	For Three Months Ended December 31,					
	2016		2015		Variance	
	Cost	%	Cost	%	Amount	%
Land use rights	$353,051	5.0 %	$223,006	6.9 %	$130,045	58.3 %
Construction cost	6,707,984	95.0%	2,985,883	93.1%	3,722,101	124.7%
Total cost	$7,061,035	100 %	$3,208,889	100 %	$3,852,146	120.0%

Our cost of sales consists 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 $7.1 million for the three months ended December 31, 2016 compared to $3.2 million for the three months ended December 31, 2015. The $3.85 million increase in cost of sales was mainly attributable to the increase in total GFA sold during the quarter ended December 31, 2016 which led to increased revenue and cost of sales 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, 2016 were $0.4 million, as compared to $0.2 million for the three months ended December 31, 2015, representing an increase of $0.2 million from the same quarter last year. The increase was consistent with the fact that total GFA sold in this quarter was higher than the same period 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 ending December 31, 2016 were approximately $6.7 million as compared to approximately $3.0 million for the three months ended December 31, 2015, representing an increase of $3.7 million. The increase in construction cost was due to increase in units sold during the quarter ended December 31, 2016.

The total cost of sales as a percentage of real estate sales before sales tax for the three months ended December 31, 2016 increased to 79.4% from 54.8% for the three months ended December 31, 2015, which was mainly attributable to more residential units with lower margin sold in current quarter.

Gross Profit

Gross profit was approximately $1.7 million for the three months ended December 31, 2016 as compared to approximately $2.2 million for the three months ended December 31, 2015, representing a decrease of $0.5 million. The overall gross profit as a percentage of real estate sales before sales tax decreased to 19.4% during the three months ended December 31, 2016 from 38.2% for the same quarter last year, mainly due to more lower margin residential properties, instead of higher margin commercial properties, sold in Mingzhu Garden and Oriental Pearl Garden projects during the first quarter fiscal 2017. During the first quarter of fiscal 2017, 100% of revenue recognized from Mingzhu Garden and Oriental Pearl Garden projects were from sales of residential properties, while 62.9% of revenue recognized from Oriental Pearl Garden project were from sales of commercial properties in the same period of last year. Due to this change in sales mix, our gross profit margin for the three months ended December 31, 2016 decreased. In addition, the Company reduced the selling price for a limited portion of residential units in Yang County and Hanzhong City to promote the sales in 2017.

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

	For Three Months Ended December 31,			
	2016		2015	
	Gross Profit	Percentage of Revenue	Gross Profit	Percentage of Revenue
Mingzhu Garden (Mingzhu Nanyuan & Mingzhu Beiyuan) Phase I and II	$714,709	20.2 %	$717,654	30.5 %
Oriental Garden	1,133,268	21.3 %	1,702,127	64.2 %
Yangzhou Pearl Garden Phase I and II	(11,158)	(31.1 %)	227,937	26.8 %
Sales Tax	(112,602)		(411,988)	
Total Gross Profit	1,724,217	19.4 %	2,235,730	38.2 %
Total Real Estate Sales before Sales Tax	$8,897,854		$5,856,607	

Operating Expenses

Total operating expenses increased by 8.8% or $50,300 to $618,964 for the three months ended December 31, 2016 from $568,664 for the three months ended December 31, 2015 as a result of an increase in selling expense of 56,081 primarily attributed to more sales commission paid to the sales representatives to promote the sales of our completed residential and commercial units. Our general and administrative expense was $472,730 for the three months ended December 31, 2016, which was consistent with $478,511 for the three months ended December 31, 2015. Our total operating expenses accounted for 7.0% and 9.7% of our real estate sales before sales taxes for the three months ended December 31, 2016 and 2015, respectively.

	For Three Months Ended December 31,	
	2016	2015
Selling expenses	$ 146,234	$ 90,153
General and administrative expenses	472,730	478,511
Total operating expenses	$ 618,964	$ 568,664
Percentage of Real Estate Sales before Sales Tax	7.0 %	9.7 %

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, 2016 and 2015.

PRC Taxes

The 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 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 City, instead of statutory rate of 25% on the income before income tax. Income tax provision for the three months ended December 31, 2016 were $221,998 compared to $135,796 for the three months ended December 31, 2015 as a result of the increase in our revenue. .

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. Management believes that the possibility of any reevaluation of income taxes is remote based on the fact that the Company has obtained the written tax clearance from the local tax authority. Thus, no additional taxes payable have been recorded for the difference between the taxes due based on taxable income calculated according to statutory taxable income method and the taxes due based on the fixed rate method. It is the Company's policy that if such reevaluation of income taxes becomes probable and the amount of additional taxes due can be reasonably estimated, additional taxes shall be recorded in the period in which the amount can be reasonably estimated and shall not be charged retroactively to an earlier period.

Net Income

We reported net income of $762,132 for the three months ended December 31, 2016, as compared to net income of $1,427,224 for the three months ended December 31, 2015. The decrease of approximately $0.67 million in our net income was primarily due to higher costs of sales and lower gross profit as discussed above under Revenues and Gross Profit.

Other Comprehensive Income (loss)

We operate primarily in the PRC and the functional currency of our operating subsidiary is the Chinese Renminbi ("RMB"). RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that 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 negative $6.2 million and negative $3.3 million for the three months ended December 31, 2016 and 2015, respectively, due to the significant depreciation of RMB. The balance sheet amounts with the exception of equity at December 31, 2016 were translated at 6.9448 RMB to 1.00 USD as compared to 6. 6702 RMB to 1.00 USD at September 30, 2016, RMB has depreciated 4.1% against the U.S. dollar from September 30, 2016 to December 31, 2016. 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, 2016 and 2015 were 6.8343 RMB and 6.3907 RMB, respectively. RMB has depreciated 6.9% against the U.S. dollar from December 31, 2015 to December 31, 2016. As a result, our financial statements reported more translation loss.

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. Historically we mainly financed our operations primarily through cash flows from operations and borrowings from our principal shareholder.

As of December 31, 2016, the Company had approximately $127.8 million in working capital, an increase of $76.6 million as compared to $51.2 million as of September 30, 2016. Our total cash and restricted cash balance were approximately $11.4 million and $7.9 million as of December 31, 2016 and September 30, 2016, respectively. Since most of our current real estate development is completed, we are expecting to collect the full purchase price from our existing customers in the coming months. We expect our cash collection will improve during fiscal 2017. In addition, on June 26, 2015 and March 10, 2016, the Company signed phase I and Phase II agreements with Hanzhong Urban Construction Investment Development Co., Ltd, a state owned Company, to borrow up to $111,594,288 (RMB 775,000,000) long term loan at 4.245% interest to develop Liangzhou Road Project. As of December 31, 2016, the Company borrowed $99,265,621 (September 30, 2016 - $93,975,338) from this credit line. The loan is guaranteed by Hanzhong City Hantai District Municipal Government and pledged by the Company's Yang County Palace project with carrying value of $81,681,583 as of December 31, 2016 (September 30, 20016 - $76,618,856). On January 8, 2016, the Company signed a loan agreement with Hanzhong Municipal Housing Provident Fund Management Center to borrow up to $11,519,411 (RMB 80,000,000) related to Oriental Garden project. The loan carries interest at is 3.575% and is due in January 2019. The repayment is required based on certain sales milestones or a fixed repayment schedule starting in July 2018. Our major shareholder pledged their assets for the loan. The Housing Fund has rights to monitor the project's future cash flow. In addition, in December 2016, the Company received a loan proceed of $12,140,072 (RMB 84,310,375) in connection with a loan agreement with Hantai District Urban Construction Investment Development Co., Ltd, a state owned Company, to borrow up to $17,135,123 (RMB119,000,000) for the development of Hanzhong City Liangzhou Road project. The loan carries interest at a fixed interest of 1.2% and is due on June 30, 2021. The Company pledged the assets of Liangzhou Road and related projects with carrying value of $114,764,694 as collateral for the loan. For the three months ended December 31, 2016 and 2015, total financing costs were $130,503 and $Nil, respectively, which was capitalized in to the development cost of Hanzhong City Liangzhou Road project.

With respect to capital funding requirements, the Company budgeted capital spending based on an ongoing assessment of needs to maintain adequate cash. Due to the long term relationship with our construction suppliers, we were able to effectively manage cash spending on construction. Also, our major shareholder, Mr. Xiaojun Zhu has agreed to provide his personal funds, if necessary, to support on an as needed basis. In addition, the Company's cash flows from pre-sales and current sales should provide financial support for our current developments and operations.

In order to fully implement our business plan and sustain continued growth, we may also need to raise capital from outside investors. Our expectation, therefore, is that we will seek to access the capital markets in both the U.S. and China to obtain the funds as needed. At the present time, however, we do not have commitments of funds from any third party.

Cash Flow

Comparison of cash flows results is summarized as follows:

	Three months ended December 31,	
	2016	2015
Net cash used in operating activities	$(17,644,432)	$(6,577,670)
Net cash provided by financing activities	21,811,681	6,452,337
Effect of change of foreign exchange rate on cash	(319,414)	(25,769)
Net cash increase (decrease) in cash	3,847,835	(151,102)
Cash, beginning of period	6,401,237	1,333,919
Cash, end of period	$10,249,072	$1,182,817

Operating Activities

Net cash used in operating activities during the three months ended December 31, 2016 was $17.6 million, consisting of net income of $762,132, noncash adjustments of $30,862 and net changes in our operating assets and liabilities, which mainly included a decrease in real estate property completed by approximately $7.1 million because we sold these completed residential and commercial units during current quarter, an increase in the real estate under development of approximately $22 million due to constructions on the Liangzhou road and related projects and Hanzhong City Beidajie project, payments of accounts payable of approximately $1.3 million and the increase in customer deposits of approximately $0.8 million. The cash outflows used in operating activities is mainly attributable to our increased spending on our real estate properties under development.

Net cash used in operating activities during the three months ended December 31, 2015 was $6.6 million, consisting of net income of $1.4 million, noncash adjustments of $0.1 million and net changes in our operating assets and liabilities, which mainly included an increase in the real estate under development of $7.1 million due to constructions on the Liangzhou road and related projects, payments of accounts payable of $8.5 million and increase in the other current assets of $1.3 million due to prepayment and deposits made to the suppliers, offset by the increase of other payables of $3.6 million, the increase in customer deposits of $2.9 million and the reduction of real estate property completed of $2.3 million. The cash outflows used in operating activities is mainly attributable to our increased spending on our real estate properties under development.

Financing Activities

Net cash flows provided by financing activities amounted to approximately $21.8 million for the three months ended December 31, 2016, primarily because we received loan proceeds of approximately $21.5 million from local bank and other financial institution and invested these amounts on our real estate projects under development, including approximately $9.2 million (RMB 62,545,587) borrowed from Hanzhong Urban Construction Investment Development Co., Ltd for our Liangzhou Road related projects, and $12.3 million (RMB 84,310,375) borrowed from Hantai District Urban Construction Investment Development Co., Ltd for our Hanzhong Liangzhou Road project.

Net cash flows provided by financing activities amounted to approximately $6.5 million for the three months ended December 31, 2015, which included a loan from a financial institution approximately $10.8 million and $0.9 million of shareholder loans from our principle shareholder, offset by the repayment of other loans of $5.2 million.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

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

Foreign Exchange Risk

All of our net sales, and a majority of our costs and expenses are denominated in RMB. Although the conversion of RMB is highly regulated in China, the value of RMB against the value of the U.S. dollar or any other currency nonetheless may fluctuate and be affected by, among other things, changes in China's political and economic conditions. Under current policy, the value of RMB is permitted to fluctuate within a narrow band against a basket of certain foreign currencies. China is currently under significant international pressures to liberalize this government currency policy, and if such liberalization were to occur, the value of RMB could appreciate or depreciate against the U.S. dollar.

Because substantially all of our earnings and majority of our cash assets are denominated in RMB, other than certain cash deposits we keep in a bank in Hong Kong and the U.S., appreciation or depreciation in the value of RMB relative to the U.S. dollar would affect our financial results reported in U.S. dollar terms without giving effect to any underlying change in our business or results of operations. Fluctuations in the exchange rate will also affect the relative value of any dividends we may issue in future that will be exchanged into U.S. dollars and earnings from, and the value of, any U.S. dollar-denominated investments we make in the future.

Very limited hedging transactions are available in China to reduce our exposure to exchange rate fluctuations. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedging transactions may be limited and we may not be able to successfully hedge our exposure at all. In addition, our currency exchange losses may be magnified by the PRC exchange control regulations that restrict our ability to convert RMB into foreign currency.

Interest Rate Risk

We have not been, nor do we anticipate being exposed to material risks due to changes in interest rates. Our risk exposure to changes in interest rates relates primarily to the interest income generated by cash deposited in interest-bearing savings accounts and interest expense on variable rate bank loan. We have not used, and do not expect to use in the future any derivative financial instruments to hedge our interest risk exposure. However, fluctuations in interest rates can lead to significant changes in our interest income and interest expense.

Credit Risk

We are exposed to credit risk from our cash in banks, accounts receivable and due from local government for real estate property development completed. The credit risk on cash in bank and fixed deposits is limited because the counterparties are recognized financial institutions. Accounts receivable are subjected to credit evaluations. An allowance would be made, if necessary, for estimated unrecoverable amounts by reference to past default experience, if any, and by reference to the current economic environment.

Inflation

Inflationary factors, such as increases in the cost of our products and overhead costs, could impair our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross margin and selling, general and administrative expenses as a percentage of sales revenue if the selling prices of our products do not increase with these increased costs.

Our Company's Operations are Substantially in Foreign Countries

Substantially all of our operations are conducted in China and are subject to various political, economic, and other risks and uncertainties inherent in conducting business in China. Among other risks, our Company and our subsidiaries' operations are subject to the risks of restrictions on transfer of funds; export duties, quotas, and embargoes; domestic and international customs and tariffs; changing taxation policies; foreign exchange restrictions; and political conditions and governmental regulations.

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 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 not effective as of December 31, 2016. 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 material weakness and significant deficiencies and to prevent similar deficiencies in the future, we are currently evaluating additional controls and procedures, which may include:

- Engaging a third party IT consulting firm to help formalize the Company's policies and procedures on information technology, analyzing the capability and reliability of existing systems, and establish an integrated information technology development plan.
- Providing more U.S. GAAP knowledge and SEC reporting requirement training for the internal audit department and establishing formal policies and procedures in internal audit function
- Implementing an ongoing initiative and training in the Company to ensure the importance of internal controls and compliance to ensure that established policies and procedures are fully understood throughout the organization and plan to provide continuous U.S. GAAP knowledge training to relevant employees involved to ensure the performance of and compliance with those procedures and policies

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, 2016 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

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 13, 2017 By: /s/ Xiaojun Zhu
Xiaojun Zhu
Chief Executive Officer