

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

September 30, 2012

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTANT

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)
(IN US\$)

<u>Assets</u>	September 30, 2012	December 31, 2011
Current assets:		
Cash and equivalents	\$449,096	\$989,078
Accounts receivable, net of allowance for doubtful accounts of \$54,620 at September 30, 2012 and \$11,624 at December 31, 2011	191,553	299,050
Inventory	877,686	821,100
Prepaid expenses and other current assets	161,090	166,581
Total current assets	<u>1,679,425</u>	<u>2,275,809</u>
Equipment, net of accumulated depreciation	181,436	152,069
Investments	956,128	1,137,256
Guarantee deposits paid	34,106	-
Deferred income tax assets	89,000	89,000
Intangible assets	1,892	4,374
Total assets	<u>\$2,941,987</u>	<u>\$3,658,508</u>
<u>Liabilities and stockholders' equity</u>		
Current liabilities:		
Short term loan	\$409,277	\$396,223
Accounts payable	276,700	464,654
Accrued expenses	28,105	49,075
Loan from stockholder	-	100,000
Receipts in advance and other current liabilities	49,318	13,414
Total current liabilities	<u>763,400</u>	<u>1,023,366</u>
Stockholders' equity		
Common Stock –Par Value \$0.001 67,448,890 shares issued and outstanding at September 30, 2012 and December 31, 2011	67,449	67,449
Additional paid in capital	3,112,230	3,112,230
Accumulated other comprehensive income	242,463	226,527
Accumulated deficit	(1,243,555)	(771,064)
Total stockholders' equity	<u>2,178,587</u>	<u>2,635,142</u>
Total liabilities and stockholders' equity	<u>\$2,941,987</u>	<u>\$3,658,508</u>

The accompanying notes are an integral part of the financial statements.

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(IN US\$)

	Three months ended September 30,	
	2012	2011
Net sales	\$753,672	\$958,162
Cost of goods sold	477,779	693,937
Gross profit	275,893	264,225
Operating expenses		
Selling, general and administrative	281,915	313,715
Research and development	21,625	(5,708)
Total operating expenses	303,540	308,007
Loss from operations	(27,647)	(43,782)
Other income (expenses)		
Interest expense (net)	(2,708)	(3,127)
Share of investee's operating results (net)	(22,778)	(18,203)
Impairment of investment	(201,698)	-
Gain (loss) on foreign exchange, net	(9,377)	57,078
Other, net	969	1,236
Loss income before income tax	(263,239)	(6,798)
Income tax benefit (expense)	1,452	(18,675)
Net loss	(261,787)	(25,473)
Other comprehensive income (loss), net		
Translation adjustment	(24,302)	(159,970)
Comprehensive (loss)	\$(286,089)	\$(185,443)
Net (loss) attributable to common stockholders	\$(261,787)	\$(25,473)
Comprehensive (loss) attributable to common stockholders	\$(286,089)	\$(185,443)
Earnings per share attributable to common stockholders:		
Basic and diluted per share	\$0.00	\$0.00
Weighted average shares outstanding:		
Basic and diluted	67,448,890	67,448,890

The accompanying notes are an integral part of the financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(UNAUDITED)
(IN US\$)

	For nine months ended September 30,	
	2012	2011
Net sales	\$2,166,012	\$2,997,182
Cost of goods sold	1,400,199	2,180,320
Gross profit	765,813	816,862
Operating expenses		
Selling, general and administrative	916,660	821,461
Research and development	73,773	86,631
Total operating expenses	990,433	908,092
(Loss) from operations	(224,620)	(91,230)
Other income (expenses)		
Interest expense (net)	(8,596)	(8,882)
Share of investee's operating results (net)	(18,643)	-
Impairment of investment	(203,242)	-
Gain on disposal of investment	-	(62,744)
Gain (loss) on foreign exchange, net	(28,787)	47,557
Other, net	5,367	1,240
(Loss) before income tax	(478,521)	(114,059)
Income tax benefit (expense)	6,030	(18,656)
Net (loss)	(472,491)	(132,715)
Other comprehensive income (loss), net		
Translation adjustment	15,936	(137,987)
Comprehensive income (loss)	\$(456,555)	\$(270,702)
Net (loss) attributable to common stockholders	\$(472,491)	(132,715)
Comprehensive (loss) attributable to common stockholders	\$(456,555)	(270,702)
Earnings per share attributable to common stockholders:		
Basic and diluted per share	\$0.00	\$0.00
Weighted average shares outstanding:		
Basic and diluted	67,448,890	67,448,890

The accompanying notes are an integral part of the financial statements.

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
(UnAUDITED)
(IN US\$)

	For three months ended September 30,	
	2012	2011
Cash flows from operating activities		
Net (loss)	\$(261,787)	\$(25,473)
Depreciation and amortization	11,279	8,644
Provision for doubtful accounts	35,931	7,096
Share of investment loss	22,778	18,203
Impairment of investment	201,698	-
Changes in operating assets and liabilities:		
Other assets	(567)	-
Accounts receivable	55,401	(139,761)
Inventories	50,702	60,770
Prepaid expenses and other current assets	(26,263)	(2,412)
Accounts payable	(143,529)	(58,153)
Accrued expenses	(2,418)	(17,802)
Receipts in advance and other current liabilities	589	(24,239)
Cash flows (used in) operating activities	(56,186)	(173,127)
 Cash flows from investing activities		
Addition to fixed assets	(942)	(64,593)
Cash flow (used in) investing activities	(942)	(64,593)
 Cash flows from financing activities		
Loan from/ (repayment to) stockholder	(100,000)	100,000
Cash flow (used in) provided from financing activities	(100,000)	100,000
 Effect of exchange rate changes on cash and cash equivalents	(8,190)	(58,280)
 Net (decrease) in cash and cash equivalents	(165,318)	(196,000)
Beginning cash and cash equivalents	614,414	1,374,520
 Ending cash and cash equivalents	\$449,096	\$1,178,520
 Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$2,974	\$3,127
Tax paid	23,484	18,676

The accompanying notes are an integral part of the financial statements.

COLORSTARS GROUP AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

(UNAUDITED)
(IN US\$)

	For nine months ended September 30,	
	2012	2011
Cash flows from operating activities		
Net (loss)	\$(472,491)	\$(132,715)
Depreciation and amortization	34,118	20,867
Provision for doubtful accounts	42,057	9,970
Share of investment loss	18,643	62,744
Impairment of investment	203,242	-
Changes in operating assets and liabilities:		
Other assets	(34,106)	-
Accounts receivable	65,442	(149,040)
Inventories	(56,586)	(55,819)
Prepaid expenses and other current assets	12,931	193,726
Accounts payable	(187,954)	(6,365)
Accrued expenses	(20,970)	(43,059)
Receipts in advance and other current liabilities	35,904	(7,721)
Cash flows (used in) operating activities	<u>(359,770)</u>	<u>(107,412)</u>
 Cash flows from investing activities		
Addition to fixed assets	(56,608)	(124,200)
Cash flow (used in) investing activities	<u>(56,608)</u>	<u>(124,200)</u>
 Cash flows from financing activities		
Loan from/ (repayment to) stockholder	(100,000)	100,000
Cash flow provided from (used in) financing activities	<u>(100,000)</u>	<u>100,000</u>
 Effect of exchange rate changes on cash and cash equivalents	<u>(23,604)</u>	<u>(86,102)</u>
 Net (decrease) in cash and cash equivalents	(539,982)	(217,714)
Beginning cash and cash equivalents	989,078	1,396,234
 Ending cash and cash equivalents	<u>\$449,096</u>	<u>\$1,178,520</u>
 Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$8,893	\$6,106
Tax paid	23,484	23,146

The accompanying notes are an integral part of the financial statements.

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 – Nature of Business and Basis of Presentation

Nature of Business – Circletronics Inc., now ColorStars Group (“the Company”), was incorporated in Canada on January 21, 2005. Circletronics Inc., was redomiciled to Nevada and its name changed to ColorStars Group on November 3, 2005. ColorStars Group owns 100% of the shares of ColorStars Inc.

Color Stars Inc. (Color Stars TW) was incorporated as a limited liability company in Taiwan, Republic of China in April 2003 and commenced its operations in May 2003. The Subsidiary is mainly engaged in manufacturing, designing and selling light-emitting diode and lighting equipment.

Basis of Presentation – The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for a complete presentation of the financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for fair presentation have been included in the accompanying financial statements. For further information, refer to the consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Note 2 - Recently Issued Accounting Pronouncements

Balance Sheet the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-11 in December 2011, Balance sheet – Disclosures about Offsetting Assets and Liabilities. The new requirements state that entities must disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet, and instruments and transactions subject to an agreement similar to a master netting arrangement. The scope of the requirements includes derivatives, sales and repurchases agreements, reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The requirements are effective for annual periods beginning on or after January 1, 2013, and interim periods within those annual periods. The Company does not expect that the adoption will have a material effect on the consolidated financial statements.

Intangibles—Goodwill and Other in July 2012, the FASB issued ASU 2012-02 which intends to simplify how entities test indefinite-lived intangible assets other than goodwill for impairment. After an assessment of certain qualitative factors, if it is determined to be more likely than not that an indefinite-lived asset is impaired, entities must perform the quantitative impairment test. Otherwise, the quantitative test is optional. The amended guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The adoption of this guidance is not expected to have a material impact on the Company’s financial results.

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3 – Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist principally of accounts receivable, cash and cash equivalents. The Company's cash and cash equivalents are maintained with high quality institutions, the compositions and maturities of which are regularly monitored by management. Through September 30, 2012, the Company had not experienced any losses on such deposits.

Accounts receivable include amounts due from customers primarily in the manufactory industry. The Company performs ongoing credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary, but generally requires no collateral. The Company also maintains allowances for potential credit losses. In estimating the required allowances, the Company takes into consideration the overall quality and aging of the receivable portfolio, the existence of a limited amount of credit insurance and specifically identified customer risks. Through September 30, 2012, such losses have been within management's expectations.

For the nine months ended September 30, 2012, products sold to the Company's largest customer, accounted for approximately 8.11%. Products purchased from the Company's first two largest suppliers were accounted for approximately 31.15% of the total purchases.

As of September 30, 2012, the largest three customers exceeded 54.40% of the total consolidated accounts receivable balance.

Note 4 – Earnings per share

Basic net loss per share is computed by dividing net loss for the period by the weighted average number of shares of common stock outstanding during the period.

The following table sets forth the computation of basic and diluted net loss per share for the periods indicated:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Comprehensive (loss)	\$(286,089)	\$(185,443)	\$(456,555)	\$(270,702)
Weighted average common stock outstanding – Basic and diluted	67,448,890	67,448,890	67,448,890	67,448,890
Earning per share attributable to common stockholder Basic and diluted	\$.00	\$.00	\$.00	\$.00

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Long term investment

	September 30, 2012	December 31, 2011
Equity method investment – Anteya Technology Corp		
Carrying value of investment at the beginning	\$799,131	\$797,363
Interest in Anteya’s net (loss) income	(18,890)	40,835
Exchange difference	34,895	(39,067)
Carrying value at the end	<u>815,136</u>	<u>799,131</u>
Equity method investment – Fin-Core Corporation		
Carrying value of investment at the beginning	196,087	481,891
Interest in Fin-Core’s net loss	-	(135,200)
Impairment for the year	(114,884)	(132,799)
Exchange difference	6,108	(17,805)
Carrying value at the end	<u>87,311</u>	<u>196,087</u>
Cost-method investments – Phocos		
At cost	142,038	142,038
Impairment for the year	(88,357)	-
	<u>53,681</u>	<u>142,038</u>
	<u>\$956,128</u>	<u>\$1,137,256</u>

Anteya Technology Corp is a private company incorporated in Taiwan. The equity interest held by the Company is 20%. Accordingly, the Company adopted the equity method of accounting with respect to the investment in Anteya. There were 200,000 bonus shares issued in 2011 to the Company. The equity interest held by the Company remains unchanged.

On July 5, 2010, the Company’s board of directors approved the sale of 30.4% equity (or 456,000 shares) in Fin-Core Corporation (FCC) to a third party at the consideration of NTD13,680,000 (equivalent to USD429,000). After the disposal, the equity interest of the Company in FCC decreased from 50.4% to 20%.

On July 5, 2010, the Company’s board of directors approved the participation in subscribing FCC's newly issued shares and maintain the overall equity interest of 20%. The Company subscribed 500,000 shares at consideration of NTD\$10,000,000 (equivalent of USD320,000). The Company adopted the equity method of accounting to the investment in FCC.

In October 2011, the associated company, Fin-Core Corporation, decided to increase its capital by issuing 3,000,000 new shares at par value of NTD10 per share. The Company was entitled to subscribe for up to 600,000 shares for NTD6,000,000. However the Company chose not to participate in the subscription of any newly issued shares of Fin-Core. As a result, on November 4, 2011 the Company’s equity interest in Fin-Core decreased to 11.43% from 20% after issuance of 3,000,000 new shares. The Company recorded the investment in Fin-Core Corporation at cost on the date when the Company ceased to have significant influence over the investee.

Phocos AG is a private company incorporated in Germany. The equity interest held by the Company is 2.38%.

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 5 – Long term investment (continued)

The unaudited financial information of Anteya Technology Corp. as of September 30, 2012 and December 31, 2011 and for nine months ended September 30, 2012 and 2011 (in US dollars) are as follows:

<u>Balance sheet</u>	September 30, 2012	December 31, 2011
Current assets	\$4,267,667	\$4,671,187
Non-current assets	1,071,424	1,101,058
Total assets	<u>5,339,091</u>	<u>5,772,245</u>
Current liabilities	2,269,569	2,437,814
Non-current liabilities	853,258	1,097,420
Stockholders' equity	<u>2,216,264</u>	<u>2,237,011</u>
Total stockholders' equity and liabilities	<u>\$5,339,091</u>	<u>\$5,772,245</u>
	<u>Nine months ended September 30,</u>	
<u>Statement of operation</u>	2012	2011
Net sale	\$3,756,783	\$4,570,963
Cost of goods sold	<u>(2,912,419)</u>	<u>(3,479,777)</u>
Gross profit	844,364	1,091,186
Operating and non-operating expenses	<u>(934,520)</u>	<u>(862,060)</u>
Net profit (loss)	<u>\$(90,156)</u>	<u>\$229,126</u>

Note 6 – Inventory

Inventories stated at the lower of cost or market value are as follows:

	September 30, 2012	December 31, 2011
Finished goods	<u>\$877,686</u>	<u>\$821,100</u>

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 – Income taxes

The Company is subject to U.S. federal income tax as well as income tax in states and foreign jurisdictions. For the major taxing jurisdictions, the tax years 2006 through 2011 remain open for state and federal examination. The Company believes assessments, if any, would be immaterial to its consolidated financial statements. With respect to the foreign jurisdiction, the local tax authority has assessed the Company's business income tax return for the year 2011 (inclusive).

The income tax provision information is provided as follows:

	Three months ended		Nine months ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Component of income (loss)				
before income taxes:				
United States	\$(143,185)	\$(95,896)	\$(255,984)	\$(201,746)
Foreign	(117,150)	89,098	(222,537)	210,477
	<u>(120,054)</u>		<u>77</u>	87,687
(Loss) before income taxes	<u>\$(260,335)</u>	<u>\$26</u>	<u>\$(466,461)</u>	<u>\$478</u>
	<u>3,239</u>		<u>521</u>	
Provision for income taxes				
Current				
U.S. federal	-	-	-	-
State and local	-	-	-	-
Foreign	\$1,452	\$(18,675)	\$6,030	\$(18,656)
Income tax benefit (provision)	<u>\$1,452</u>	<u>\$(18,675)</u>	<u>\$6,030</u>	<u>\$(18,656)</u>

Note 8 – Accrued expenses

	September 30, 2012	December 31, 2011
Salaries and allowance	\$19,081	\$19,987
Insurance	7,610	8,150
Tax payable	-	11,040
Others	1,414	9,898
	<u>\$28,105</u>	<u>\$49,075</u>

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 9 - Bank short term debt

	September 30, 2012	December 31, 2011
Bank loan payable to Taiwan banks	<u>\$409,277</u>	<u>\$396,223</u>

The Company signed revolving credit agreements with a lending institution. The interest rate on short-term borrowings outstanding as of September 2012 ranges from 3.15% to 3.16% per annum, as of December 31, 2011, interest rate ranges from 2.946% to 3.175% per annum. The short term debt is secured by:

1. personal guarantee from directors
2. the realty property of spouse of a director

Note 10- Geographic Information

Product revenues for the three and nine months ended September 30, 2012 and 2011 are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
Customers based in:				
Europe	\$416,516	\$406,109	\$1,172,745	\$1,615,628
Asia	158,180	4,248	307,586	87,258
United States	100,797	206,563	467,671	678,047
Others	78,179	341,242	218,010	616,249
	<u>\$753,672</u>	<u>\$958,162</u>	<u>\$2,166,012</u>	<u>\$2,997,182</u>

Note 11 – Related Party Transactions

The Company has recorded expenses for the following related party transactions for nine months ended September 30, 2012 and 2011:

	Nine months ended September 30,	
	2012	2011
Purchase from Anteya Technology Corp	\$916,532	\$1,274,608
Purchase from Fin-Core Corporation	-	139,875
Rent paid to Mr. Wei-Rur Chen	36,354	37,095
Sale to Anteya Technology Corp	-	1,072
Sale to Fin-Core Corporation	-	12,647

COLORSTARS GROUP AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 11 – Related Party Transactions (continued)

As of the balance sheet date indicated, the Company had the following liabilities recorded with respect to related party transactions:

	September 30, 2012	December 31, 2011
Liabilities:		
Anteya Technology Corp	\$188,425	\$298,887

The Company leases office space from Mr. Wei-Rur Chen which the term for the agreement is from November 2010 to November 2015.

The Company conducted business with related party companies, Anteya Technology Corp and Fin-Core Corporation. The Company owns 20% and 11.43% of the outstanding common stock of Anteya Technology Corp and Fin-Core Corporation as of September 30, 2012. All transactions were at market-based prices.

The stockholder, Mr. Wei-Rur Chen, provided a personal loan of USD\$100,000 to the company. The personal loan is unsecured, repayable on demand and interest bearing at applicable federal short-term rate in effect for each day on outstanding loan principal and unpaid accrued interest. The effective interest rate is 0.19% and the interest paid to Mr. Chen is \$35 for three months ended September 30, 2012. On August 2012, the personal loan was paid in full.

Note 12 – Commitments

	Nine months ended September 30, 2012	2011
Rent expenses	\$92,709	\$95,510

The company leases offices in Taiwan and in California, US under operating leases. Minimum future rental payments due under non-cancelable operating leases with remaining terms at June 30, 2012 are as follows:

2012 remaining 3 months	26,995
2013	82,638
2014	49,113
2015	41,746
	<u>\$200,492</u>

Note 13– Subsequent Events

The Company evaluated all events subsequent to September 30, 2012 through the date of the issuance of the financial statements, there are no other significant or material transactions to be reported.