

CLEAN DIESEL TECHNOLOGIES INC
Form 10-Q
November 13, 2012

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

FORM 10-Q

(Mark One)
b

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

For the quarterly period ended September 30, 2012

or

- o **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: 001-33710

CLEAN DIESEL TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Delaware

06-1393453

(State or other jurisdiction of
incorporation or organization)

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

**4567 Telephone Road, Suite 100
Ventura, CA 93003**

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (805) 639-9458

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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

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

As of November 7, 2012, the outstanding number of shares of the registrant's common stock, par value \$0.01 per share, was 7,231,315.

CLEAN DIESEL TECHNOLOGIES, INC.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

As used in this Quarterly Report on Form 10-Q, the terms “the Company,” “we,” “us,” and “our” refer to Clean Diesel Technologies, Inc. and its consolidated subsidiaries.

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, adopted pursuant to the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve risks and uncertainties, as well as assumptions, which could cause our results to differ materially from those expressed or implied by such forward-looking statements. Forward-looking statements generally are identified by the words “may,” “will,” “project,” “might,” “expects,” “anticipates,” “believes,” “intends,” “estimates,” “should,” “could,” “would,” “strategy,” “pursue,” or the negative of these words or other words or expressions of similar meaning. All statements, other than statements of historical fact, are statements that could be deemed forward-looking statements. These forward-looking statements are based on information available to us, are current only as of the date on which the statements are made, and are subject to numerous risks and uncertainties that could cause our actual results, performance, prospects or opportunities to differ materially from those expressed in, or implied by, the forward-looking statements. For a discussion of such risks and uncertainties, please see the discussion under the caption “Risk Factors” contained in our Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission (the “SEC”) on March 29, 2012, including without limitation the following:

- We have incurred losses and have not experienced positive cash flow from operations in the past and our ability to achieve profitability and positive cash flow from operations, or finance negative cash flow from operations, could depend on reductions in our operating costs, which may not be achievable, or from increased sales, which may not occur;
- The pursuit of opportunities relating to special government mandated retrofit programs requires cash investment in operating expenses and working capital such as inventory and receivables prior to the realization of profits and cash from sales and if we are not successful in accessing cash resources to make these investments we may miss out on these opportunities; further, if we are not successful in generating sufficient sales from these opportunities, we will not realize the benefits of the investments in inventory, which could have an adverse effect on our business, financial condition and results of operations;
- Future growth of our business depends, in part, on enforcement of existing emissions-related environmental regulations, further tightening of emission standards worldwide and the general availability of funding for emissions control programs and if such regulations and standards are not enacted or enforced, demand for our products could decrease, which would have an adverse effect on our financial condition and results of operations;
- Historically, we have been dependent on a few major customers for a significant portion of our company’s revenue and our revenue could decline if we are unable to maintain or develop relationships with current or potential customers, or if such customers reduce demand for our products;
- Failure of one or more key suppliers to timely deliver could prevent, delay or limit us from supplying products; and
-

Future growth of our business depends, in part, on market acceptance of our catalyst products, successful verification of our products and retention of our verifications and if we do not receive such acceptance or verification, it would have an adverse effect on demand for our catalyst products and our business.

You should not place undue reliance on any forward-looking statements. Except as otherwise required by federal securities laws, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, changed circumstances or any other reason. If we do update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to other forward-looking statements.

Table of Contents**PART I—FINANCIAL INFORMATION****Item 1. Financial Statements****CLEAN DIESEL TECHNOLOGIES, INC.****Condensed Consolidated Balance Sheets****(In thousands, except share and per share amounts)****(Unaudited)**

| | September 30, 2012 | December 31, 2011 |
|--|-------------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,649 | \$ 3,471 |
| Accounts receivable, net | 7,091 | 11,695 |
| Inventories | 8,162 | 10,288 |
| Prepaid expenses and other current assets | 1,631 | 1,664 |
| Total current assets | 24,533 | 27,118 |
| Property and equipment, net | 2,272 | 2,649 |
| Intangible assets, net | 4,584 | 4,999 |
| Goodwill | 6,122 | 5,955 |
| Other assets | 414 | 394 |
| Total assets | \$ 37,925 | \$ 41,115 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Line of credit | \$ 5,090 | \$ 4,527 |
| Shareholder notes payable | 4,608 | |
| Accounts payable | 5,287 | 5,952 |
| Warrant liability | 159 | 100 |
| Accrued expenses and other current liabilities | 4,628 | 4,915 |
| Income taxes payable | 29 | 274 |
| Total current liabilities | 19,801 | 15,768 |
| Shareholder notes payable | 2,934 | 4,520 |
| Capital lease obligation | 7 | 17 |
| Deferred tax liability | 978 | 942 |

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| | | |
|---|-----------|-----------|
| Total liabilities | 23,720 | 21,247 |
| Commitments and contingencies (Note 11) | | |
| Stockholders' equity: | | |
| Preferred stock, par value \$0.01 per share: authorized 100,000; no shares issued and outstanding | | |
| Common stock, par value \$0.01 per share: authorized 24,000,000; issued and outstanding 7,231,315 and 7,218,807 shares at | | |
| September 30, 2012 and December 31, 2011, respectively | 72 | 72 |
| Additional paid-in capital | 185,908 | 185,473 |
| Accumulated other comprehensive loss | 41 | (716) |
| Accumulated deficit | (171,816) | (164,961) |
| Total stockholders' equity | 14,205 | 19,868 |
| Total liabilities and stockholders' equity | \$ 37,925 | \$ 41,115 |

See accompanying notes to condensed consolidated financial statements.

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CLEAN DIESEL TECHNOLOGIES, INC.

Condensed Consolidated Statements of Operations and Comprehensive Loss

(In thousands, except per share amounts)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|------------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Revenues | \$ 14,400 | 14,974 | \$ 48,123 | \$ 40,290 |
| Cost of revenues | 10,526 | 10,704 | 36,135 | 28,582 |
| Gross profit | 3,874 | 4,270 | 11,988 | 11,708 |
| Operating expenses: | | | | |
| Selling, general and administrative (including stock-based compensation expense | | | | |
| of \$113, \$170, \$308 and \$1,153) | 3,380 | 3,896 | 11,582 | 13,004 |
| Research and development (including stock-based compensation expense of \$21, | | | | |
| \$12, \$56 and \$204) | 1,646 | 1,624 | 5,513 | 5,373 |
| Severance expense | 4 | | 353 | |
| Total operating expenses | 5,030 | 5,520 | 17,448 | 18,377 |
| Loss from operations | (1,156) | (1,250) | (5,460) | (6,669) |
| Other (expense) income: | | | | |
| Interest income | 4 | 4 | 9 | 12 |
| Interest expense | (442) | (333) | (1,109) | (868) |
| Other (expense) income, net | (500) | 244 | (692) | 964 |
| Total other (expense) income | (938) | (85) | (1,792) | 108 |
| Loss from continuing operations before income taxes | (2,094) | (1,335) | (7,252) | (6,561) |
| Income tax (benefit) expense from continuing operations | (123) | 541 | (328) | 1,012 |
| Net loss from continuing operations | (1,971) | (1,876) | (6,924) | (7,573) |
| Net income (loss) from operations of discontinued Energy Systems division | 201 | (141) | 69 | (187) |
| Net loss | \$ (1,770) | \$ (2,017) | \$ (6,855) | \$ (7,760) |

Basic and diluted net loss per share:

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| | | | | |
|--|------------|------------|------------|------------|
| Net loss from continuing operations per share | \$ (0.27) | \$ (0.27) | \$ (0.96) | \$ (1.51) |
| Net income (loss) from discontinued operations per share | 0.03 | (0.02) | 0.01 | (0.04) |
| Net loss per share | \$ (0.24) | \$ (0.29) | \$ (0.95) | \$ (1.55) |
| Weighted-average number of common shares outstanding - basic and diluted | 7,229 | 7,035 | 7,223 | 5,021 |
| Comprehensive Loss: | | | | |
| Net loss | \$ (1,770) | \$ (2,017) | \$ (6,855) | \$ (7,760) |
| Foreign currency translation adjustments | 834 | (1,140) | 757 | (679) |
| Comprehensive loss | \$ (936) | \$ (3,157) | \$ (6,098) | \$ (8,439) |

See accompanying notes to condensed consolidated financial statements.

Table of Contents**CLEAN DIESEL TECHNOLOGIES, INC.****Condensed Consolidated Statements of Cash Flows****(In thousands)****(Unaudited)**

| | Nine Months Ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2012 | 2011 |
| Cash flows from operating activities: | | |
| Net loss | \$ (6,855) | \$ (7,760) |
| (Income) loss from discontinued operations | (69) | 187 |
| Adjustments to reconcile net loss to cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,069 | 1,298 |
| (Recovery of) provision for doubtful accounts | (43) | 24 |
| Stock based compensation expense | 364 | 1,357 |
| Loss (gain) on change in fair value of liability-classified warrants | 59 | (1,072) |
| Amortization of debt discount and accretion of debt payment premium | 92 | 81 |
| Amortization of debt issuance costs | 75 | 75 |
| Income from unconsolidated affiliate | (18) | (35) |
| Loss on foreign currency transactions | 32 | 148 |
| Loss (gain) on disposal of property and equipment | 20 | (35) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 4,900 | (3,421) |
| Inventories | 2,357 | (7,032) |
| Prepaid expenses and other assets | 373 | (766) |
| Accounts payable | (762) | 3,030 |
| Income taxes | (504) | 416 |
| Accrued expenses and other current liabilities | (316) | 207 |
| Cash provided by (used in) operating activities of continuing operations | 774 | (13,298) |
| Cash provided by (used in) operating activities of discontinued operations | 51 | (167) |
| Net cash provided by (used in) operating activities | 825 | (13,465) |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (134) | (517) |
| Investment in unconsolidated affiliate | | 51 |
| Proceeds from sale of property and equipment | 13 | 37 |
| Net cash used in investing activities | (121) | (429) |
| Cash flows from financing activities: | | |

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| | | |
|---|----------|----------|
| Net borrowings under demand line of credit | 563 | 4,211 |
| Repayment of line of credit | | (2,540) |
| Proceeds from issuance of shareholder notes payable | 3,000 | 3,000 |
| Proceeds from issuance of common stock | | 10,212 |
| Proceeds from exercise of warrants | | 394 |
| Payment of settlement obligation | | (1,575) |
| Repayment of capital lease obligations | (9) | (23) |
| Payments for shelf registration costs | (94) | |
| Payments for debt issuance costs | (75) | (115) |
| Net cash provided by financing activities | 3,385 | 13,564 |
| Effect of exchange rates on cash | 89 | (119) |
| Net change in cash and cash equivalents | 4,178 | (449) |
| Cash and cash equivalents at beginning of period | 3,471 | 5,007 |
| Cash and cash equivalents at end of period | \$ 7,649 | \$ 4,558 |
| Supplemental disclosures: | | |
| Cash paid for interest | \$ 833 | \$ 715 |
| Cash paid for income taxes | \$ 364 | \$ 625 |

See accompanying notes to the condensed consolidated financial statements.

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CLEAN DIESEL TECHNOLOGIES, INC.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Organization

a. Description of Business

Clean Diesel Technologies, Inc. (the “Company”) is a global manufacturer and distributor of heavy duty diesel and light duty vehicle emissions control systems and products to major automakers and retrofitters. Its business is driven by increasingly stringent global emission standards for internal combustion engines, which are major sources of a variety of harmful pollutants. The Company has operations in the United States, Canada, the United Kingdom, France, Japan and Sweden as well as an Asian investment.

b. Liquidity

Historically, the revenue we have generated has not been sufficient to fund our operating requirements and debt servicing needs. Notably, the Company has suffered recurring losses and negative cash flows from operations since inception, resulting in an accumulated deficit of \$171.8 million at September 30, 2012. The Company has historically funded its operations through equity sales, debt and bank borrowings.

The Company has a \$7.5 million secured demand facility backed by its receivables and inventory with Faunus Group International, Inc. (“FGI”). At September 30, 2012, the Company had \$5.1 million in borrowings outstanding under this facility with \$2.4 million available, subject to the availability of eligible accounts receivable and inventory balances for collateral.

The Company also has a purchase agreement with Lincoln Park Capital (“LPC”), under which the Company has the right, in its sole discretion, over a 30-month period to sell up to \$10.0 million in common stock to LPC in amounts of up to \$0.5 million to up to \$1.5 million per sale, depending on certain conditions as set forth in the purchase agreement. Assuming a purchase price of \$2.81 per share (the closing sale price of the Company’s common stock on September 30, 2012) and the purchase by LPC of the full 1,702,836 currently registered purchase shares, proceeds to the Company would be \$4.8 million. There have been no sales to date under this arrangement.

On May 15, 2012, the Company filed a shelf registration statement on Form S-3 with the SEC (the “Shelf Registration”) which was declared effective by the SEC on May 21, 2012. The Shelf Registration permits the Company to sell, from time to time, up to an aggregate of \$50.0 million of various securities. See Note 8.

On July 27, 2012, the Company entered into a Loan Commitment Letter with Kanis S.A. pursuant to which the Company issued a promissory note in the principal amount of \$3.0 million. The promissory note bears interest at 8% per annum which is payable quarterly in arrears and matures on July 27, 2015. See Note 7 for a detailed description of the promissory note.

At September 30, 2012, the Company had \$7.6 million in cash and cash equivalents. Due to the proceeds from the note issued in July 2012 and availability under the secured demand facility with FGI and the purchase agreement with LPC, management believes that the Company will have access to sufficient working capital to sustain operations through at least the next twelve months. However, there is no assurance that, if necessary, the Company will be able to raise additional capital or reduce discretionary spending to provide the required liquidity.

2. Summary of Significant Accounting Policies

a. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation have been reflected. The results reported in these condensed consolidated financial statements should not necessarily be taken as indicative of results that may be expected for the entire year. Certain financial information that is normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles, but is not required for interim reporting purposes, has been condensed or omitted. The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in Clean Diesel Technologies, Inc.'s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Table of Contents**CLEAN DIESEL TECHNOLOGIES, INC.****Notes to Condensed Consolidated Financial Statements****(Unaudited)*****b. Principles of Consolidation***

The condensed consolidated financial statements include the financial statements of the Company and its wholly owned subsidiaries. Intercompany transactions and balances have been eliminated in consolidation.

c. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States ("U.S. GAAP") requires management of the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

d. Concentration of Risk

For the periods presented below, certain customers accounted for 10% or more of the Company's revenue as follows:

| Customer | Three Months Ended | | Nine Months Ended | |
|----------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2012 | September 30, 2011 | September 30, 2012 | September 30, 2011 |
| A | 33% | 26% | 29% | 21% |
| B | 10% | | 8% | |
| C | 7% | 15% | 6% | 9% |

Customer A is an automotive original equipment manufacturer ("OEM") and relates to sales within the Catalyst segment. Customers B and C are diesel system distributors within the HDD Systems segment.

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For the periods presented below, certain customers accounted for 10% or more of the Company's accounts receivable balance as follows:

| Customer | September 30, 2012 | December 31, 2011 |
|----------|-----------------------------------|------------------------------|
| | A | 33% |
| B | 20% | 4% |
| C | | 11% |
| D | 1% | 14% |

Customer A above is an automotive OEM, customers B and C are diesel system distributors and customer D is a diesel systems installer.

For the periods presented below, certain vendors accounted for 10% or more of the Company's raw material purchases as follows:

| Vendor | Three Months Ended | | Nine Months Ended | |
|--------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| A | 11% | 15% | 12% | 18% |
| B | 16% | 11% | 11% | 9% |
| C | 13% | 7% | 12% | 5% |

Vendor A above is a catalyst supplier, vendor B is a substrate supplier and vendor C is a rare earth material supplier.

Table of Contents***e. Net Loss per Share***

Basic net loss per share is computed using the weighted average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted average number of common shares and dilutive potential common shares. Dilutive potential common shares include employee stock options and restricted share units (“RSUs”) and other warrants and debt that are convertible into the Company’s common stock.

Diluted net loss per share excludes certain dilutive potential common shares outstanding as their effect is anti-dilutive. Because the Company incurred net losses in the three and nine months ended September 30, 2012 and 2011, the effect of potentially dilutive securities has been excluded in the computation of net loss per share and net loss from continuing operations per share as their impact would be anti-dilutive. Potential common stock equivalents excluded consist of the following (in thousands):

| | September 30, | |
|----------------------|----------------------|-------------|
| | 2012 | 2011 |
| Common stock options | 756 | 287 |
| RSUs | 168 | 25 |
| Warrants | 968 | 953 |
| Convertible notes | 250 | 370 |
| Total | 2,142 | 1,635 |

f. Fair Value Measurements

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset and liability. As a basis for considering such assumptions, a fair value hierarchy has been established that prioritizes the inputs used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1 measurement) and the lowest priority to unobservable inputs (level 3 measurements). The three levels of the fair value hierarchy are as follows:

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2: Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable including quoted prices for similar instruments in active markets and quoted prices for identical or similar instruments in markets that are not active; and
- Level 3: Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

The fair values of the Company’s cash and cash equivalents, trade accounts receivable, prepaid expenses and other current assets, accounts payable and accrued expenses and other current liabilities approximate carrying values due to the short maturity of these instruments. The fair value of borrowings under the line of credit approximates their carrying value due to their variable interest rates. The fair value of shareholder notes payable, current is approximately \$4.6 million and shareholder notes payable, noncurrent is \$2.7 million at September 30, 2012 based on estimated rates currently available to the Company. The carrying amount of the Company’s capital lease obligations approximates the fair value. See Note 9 regarding the fair value of the Company’s warrants.

Table of Contents***g. Accounting Changes***

In May 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-04, “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (“IFRS”).” This pronouncement was issued to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and IFRS. ASU 2011-04 changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. This pronouncement is effective for reporting periods beginning after December 15, 2011. The guidance concerns disclosure only and adoption did not have an impact on our financial position or results of operations.

In June 2011, the FASB issued ASU No. 2011-05, “Presentation of Comprehensive Income” which was issued to enhance comparability between entities that report under U.S. GAAP and IFRS, and to provide a more consistent method of presenting non-owner transactions that affect an entity’s equity. ASU 2011-05 eliminates the option to report other comprehensive income and its components in the statement of changes in stockholders’ equity and requires an entity to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement or in two separate but consecutive statements. This pronouncement is effective for reporting periods beginning after December 15, 2011 and full retrospective application is required. The guidance concerns disclosure only and adoption did not have an impact on our financial position or results of operations.

3. Inventories

Inventories consist of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|------------------|-------------------------------|------------------------------|
| Raw materials | \$ 3,250 | \$ 4,135 |
| Work in progress | 2,498 | 3,790 |
| Finished goods | 2,414 | 2,363 |
| | \$ 8,162 | \$ 10,288 |

4. Goodwill and Intangible Assets*Goodwill*

The Company’s Engine Control Systems reporting unit, which is within its Heavy Duty Diesel Systems reporting segment, contains all of the Company’s allocated goodwill. The changes in the carrying amount of goodwill for the nine months ended September 30, 2012 are as follows (in thousands):

| | |
|----------------------------------|----------|
| Balance at December 31, 2011 | \$ 5,955 |
| Effect of translation adjustment | 167 |
| Balance at September 30, 2012 | \$ 6,122 |

Intangible Assets

Intangible assets consist of the following (in thousands):

| | Useful Life | September 30, 2012 | December 31, 2011 |
|-------------------------------|--------------------|-----------------------------------|------------------------------|
| | in Years | | |
| Trade name | 15 – 20 | \$ 1,415 | \$ 1,387 |
| Patents and know-how | 5 – 12 | 5,123 | 4,987 |
| Customer relationships | 4 – 8 | 1,275 | 1,236 |
| | | 7,813 | 7,610 |
| Less accumulated amortization | | (3,229) | (2,611) |
| | | \$ 4,584 | \$ 4,999 |

The Company recorded amortization expense related to amortizable intangible assets of \$0.2 million during each of the three months ended September 30, 2012 and 2011. The Company recorded amortization expense related to amortizable intangible assets of \$0.5 million and \$0.7 million during the nine months ended September 30, 2012 and 2011, respectively.

Estimated amortization expense for existing intangible assets for each of the next five years is as follows (in thousands):

| | |
|---------------------------|--------|
| Years ending December 31: | |
| Remainder of 2012 | \$ 179 |
| 2013 | 717 |
| 2014 | 717 |
| 2015 | 712 |
| 2016 | 558 |

Table of Contents**CLEAN DIESEL TECHNOLOGIES, INC.****Notes to Condensed Consolidated Financial Statements****(Unaudited)****5. Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities consist of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|---|-------------------------------|------------------------------|
| Accrued salaries and benefits | \$ 1,852 | \$ 1,486 |
| Sales tax payable | 227 | 566 |
| Accrued warranty | 596 | 645 |
| Deferred revenue | | 650 |
| Liability for consigned precious metals | 987 | 652 |
| Other | 966 | 916 |
| | \$ 4,628 | \$ 4,915 |

On May 2, 2011, the Company entered into an agreement with Tanaka Kikinzoku Kogyo K.K. ("TKK"), its investment partner in the Asia Pacific region, to provide equipment, engineering and support services to assist in TKK's establishment of manufacturing operations in China under a joint venture between TKK and a Chinese entity for the purpose of manufacturing and selling diesel and automotive exhaust emission products in the China market. The Company received an up-front payment of \$0.6 million which was included in deferred revenue at December 31, 2011. In September 2012, the Company and TKK entered into an amendment to the agreement reducing the scope of services under the contract resulting in a change in the total value of the contract from \$1.5 million to \$1.0 million.

The Company accounted for this contract under ASC 605-35, "Revenue Recognition – Construction-type and Production-type Contracts" under the completed-contract method. As of September 30, 2012, the Company has completed its obligations under the agreement, as amended. As such, the Company has recognized \$1.0 million in revenue, including the \$0.6 million previously deferred, and \$0.3 million in cost of revenues in the three and nine months ended September 30, 2012.

6. Accrued Warranty

Changes in the Company's product warranty reserve are as follows (in thousands):

| | Nine Months Ended | |
|--------------------------------|--------------------------|-------------|
| | September 30, | |
| | 2012 | 2011 |
| Balance at beginning of period | \$ 645 | \$ 466 |
| Accrued warranty expense | 588 | 237 |
| Warranty claims paid | (658) | (209) |
| Translation adjustment | 21 | (16) |
| Balance at end of period | \$ 596 | \$ 478 |

7. Debt

Long-term debt consists of the following (in thousands):

| | September 30, 2012 | December 31, 2011 |
|--|-------------------------------|------------------------------|
| Line of credit with FGI | \$ 5,090 | \$ 4,527 |
| 6% shareholder note due 2013 | 1,608 | 1,520 |
| 8% subordinated convertible shareholder notes due 2016 | 3,000 | 3,000 |
| 8% shareholder note due 2015 | 2,934 | |
| Capital lease obligation | 7 | 17 |
| | 12,639 | 9,064 |
| Less current portion | (9,698) | (4,527) |
| | \$ 2,941 | \$ 4,537 |

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CLEAN DIESEL TECHNOLOGIES, INC.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

Line of Credit with FGI

On February 14, 2011, the Company and certain of its subsidiaries (the "Credit Subsidiaries") entered into Sale and Security Agreements with FGI to provide for a \$7.5 million secured demand facility backed by its receivables and inventory (the "FGI Facility"). The Company and the Credit Subsidiaries also entered into guarantees to guarantee the performance of their obligations under the Sale and Security Agreements. The Company also granted FGI a first lien collateral interest in substantially all of its assets. On August 15, 2012, the Company and FGI agreed to amend the FGI Facility. As amended, the initial term was extended from February 14, 2013 to August 15, 2015 and may be extended at the Company's option for additional one-year terms.

Under the FGI Facility, as amended, FGI can elect to purchase eligible accounts receivables from the Company and the Credit Subsidiaries at up to 80% of the value of such receivables (retaining a 20% reserve). Purchased receivables are subject to full recourse to the Company in the event of nonpayment by the customer. FGI becomes responsible for the servicing and administration of the accounts receivable purchased. The Company is not obligated to offer accounts in any month and FGI has the right to decline to purchase any accounts. At FGI's election, FGI may advance the Company up to 80% of the value of any purchased accounts receivable, subject to the \$7.5 million limit. Reserves retained by FGI on any purchased receivable are expected to be refunded to the Company net of interest and fees on advances once the receivables are collected from customers. The Company may also borrow against eligible inventory up to the inventory sublimit as determined by FGI subject to the aggregate \$7.5 million limit under the FGI Facility and certain other conditions. Pursuant to the amendment, the inventory sublimit amount was increased from \$1.0 million to the lesser of \$2.0 million or 50% of the aggregate purchase price paid for accounts receivable purchased under the FGI facility.

The interest rate on advances or borrowings under the FGI Facility was reduced from the greater of (i) 7.50% per annum and (ii) 2.50% per annum above the Wall Street Journal "prime rate" to the greater of (i) 6.50% per annum and (ii) 2.50% per annum above the prime rate, as defined. Any advances or borrowings under the FGI Facility are due on demand. The Company also agreed to pay FGI collateral management fees. As amended, the monthly collateral fees were reduced from 0.44% to 0.30% per month on the face amount of eligible receivables as to which advances have been made and from 0.55% to 0.38% per month on borrowings against inventory, if any. At any time outstanding advances or borrowings under the FGI Facility are less than \$2.4 million, the Company agreed to pay FGI standby fees of (i) the interest rate on the difference between \$2.4 million and the average outstanding amounts and (ii) 0.44% per month on 80% of the amount by which advances or borrowings are less than the agreed \$2.4 million minimum.

The Company paid FGI a one-time facility fee of \$75,000 upon entry into the FGI Facility and \$75,000 upon amending the FGI facility. Also, if the Company terminates the FGI facility prior to the last day of the initial term, as extended, or any additional term, it must pay a termination fee of 2% of the facility limit then in effect. No termination

fee will be due if the Company notifies FGI of its intent to terminate within 10 days of FGI increasing the reserve percentage for accounts to greater than 40% for more than 30 consecutive days. FGI may terminate the facility at any time. As such, the facility and amendment fees were expensed when incurred. The termination fee is not payable upon a termination by FGI or upon non-renewal.

The Company accounts for the sale of accounts receivable under the FGI Facility as a secured borrowing with a pledge of the subject receivables as collateral in accordance with ASC 860, "Transfers and Servicing." At September 30, 2012, the Company had \$4.5 million of gross accounts receivable pledged to FGI as collateral for short-term debt in the amount of \$3.5 million. At September 30, 2012, the Company also had \$1.6 million in borrowings outstanding against eligible inventory. The Company was in compliance with the terms of the FGI Facility at September 30, 2012.

6% Shareholder Note Due 2013

On December 30, 2010, the Company executed a Loan Commitment Letter with Kanis S.A., a shareholder of the Company, pursuant to which Kanis S.A. loaned the Company \$1.5 million. The loan bears interest on the unpaid principal at a rate of 6%, with interest only payable quarterly in arrears, commencing March 31, 2011. The loan matures on June 30, 2013. In addition to principal and accrued interest, the Company is obligated to pay Kanis S.A. at maturity a "Payment Premium" ranging from \$0.1 million to \$0.2 million based proportionally on the number of days that the loan remains outstanding. There is no prepayment penalty. The loan is unsecured. In connection with the loan, the Company issued Kanis S.A. warrants to acquire 25,000 shares of its common stock at \$10.40 per share. The relative estimated fair value of such warrants represents a discount from the face amount of the loan and has been recorded as a discount from the loan amount. The discount is being amortized using the effective interest method over the term of the loan.

8% Subordinated Convertible Shareholder Notes Due 2016

On April 11, 2011, the Company entered into a Subordinated Convertible Notes Commitment Letter with Kanis S.A. that provides for the sale and issuance by the Company of 8% subordinated convertible notes (the "Notes"). As provided in the Commitment Letter, on May 6, 2011 Kanis S.A. purchased from the Company at par \$3.0 million aggregate principal amount of the Notes, which bear interest at a rate of 8% per annum, payable quarterly in arrears.

The Notes have a stated maturity of five years from the date of issuance. The original agreement allowed for the acceleration of the maturity of the Notes if: (i) the Company was in breach of the notes or other agreements with Kanis S.A., or (ii) Kanis S.A. provided written notice, not less than 30 days prior to such date, that it elected to accelerate the maturity to a date not earlier than November 11, 2012. On February 16, 2012, the Company and Kanis S.A. agreed to amend the terms of the Notes to modify the early redemption date from November 11, 2012 to May 12, 2013. The Notes also provide that the Company has the option to redeem the Notes at any time at a price equal to 100% of the face amount plus accrued and unpaid interest through the date of redemption. There is no prepayment penalty. The Notes are unsecured obligations of the Company and subordinated to existing and future secured indebtedness of the Company.

On July 27, 2012, the Company and Kanis S.A. further amended the terms of the Notes to modify the conversion feature. As amended, the outstanding principal balance of, and accrued and unpaid interest on, the Notes are convertible, at the option of Kanis S.A. at any time upon written notice given not less than 75 calendar days prior to the date of conversion, into no more than 250,000 shares of the Company's common stock at a conversion price of \$4.00 per share.

In connection with the February 16, 2012 amendment, the Company issued to Kanis S.A. warrants to acquire 5,000 shares of its common stock at \$3.80 per share. The warrants are exercisable on or after August 16, 2014 and expire on the earlier of (x) August 16, 2017 and (y) that date that is 30 days after the Company gives notice to the warrant holder that the market value of one share of its common stock has exceeded 130% of the exercise price of the warrant

for 10 consecutive days, which 10 consecutive days commence on or after August 16, 2014. The Company did not receive any cash consideration for the issuance of the warrants. The Company relied on the private placement exemption provided by Regulation S.

8% Shareholder Note Due 2015

On July 27, 2012, the Company executed a Loan Commitment Letter with Kanis S.A., pursuant to which the Company issued a promissory note in the principal amount of \$3.0 million, which bears interest at 8% per annum, payable quarterly in arrears. The promissory note matures on July 27, 2015. There is no prepayment penalty or premium. The promissory note is unsecured. In connection with promissory note, the Company issued Kanis S.A. a warrant to acquire 45,000 shares of its common stock at \$2.09 per share, a third of which become exercisable on the issuance date and each of the first and second anniversaries of the issuance date. This warrant expires on July 27, 2018. The Company did not receive any cash consideration for the issuance of this warrant, which was issued in reliance upon the private placement exemption provided by Regulation S. The relative estimated fair value of such warrant represents a discount from the face amount of the loan and has been recorded as a discount from the loan amount. The discount is being amortized using the effective interest method over the term of the loan.

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8. Stockholders' Equity

On May 23, 2012, the Company amended its Restated Certificate of Incorporation to increase the number of authorized shares of common stock to 24 million shares. At September 30, 2012, the Company had 24.1 million shares authorized, 24 million of which are \$0.01 par value common stock and 100,000 of which are \$0.01 par value preferred stock.

On May 15, 2012, the Company filed a Shelf Registration which was declared effective by the SEC on May 21, 2012. The Shelf Registration permits the Company to sell, from time to time, up to an aggregate of \$50.0 million of various securities, including common stock, preferred stock, warrants to purchase common stock or preferred stock and units consisting of one or more shares of common stock, shares of preferred stock, warrants, or any combination of such securities. The Shelf Registration is intended to provide the Company with additional flexibility to access capital markets for general corporate purposes, subject to market conditions and the Company's capital needs.

On October 7, 2011, the Company signed a Purchase Agreement with LPC, together with a Registration Rights Agreement, whereby LPC agreed to purchase up to \$10.0 million of the Company's common stock over a 30-month period. Pursuant to the Registration Rights Agreement, the Company filed a registration statement on Form S-1 with the SEC on October 13, 2011 covering 1,823,577 shares that have been issued or may be issued to LPC under the Purchase Agreement. Of the shares registered, 40,247 shares were issued to LPC as a commitment fee upon entering into the Purchase Agreement; 80,494 shares may be issued to LPC pro rata as an additional commitment fee as up to \$10.0 million of our common stock is purchased by LPC; and 1,702,836 represent shares that the Company may sell to LPC under the Purchase Agreement. The registration statement related to the transaction was declared effective by the SEC on December 5, 2011. Accordingly, the Company has the right, in its sole discretion, over a 30-month period to sell shares of its common stock to LPC in amounts of up to \$0.5 million to up to \$1.5 million per sale, depending on certain conditions as set forth in the Purchase Agreement, up to the aggregate amount of \$10.0 million. There have been no sales to date under this arrangement.

There are no upper limits to the price LPC may pay to purchase the Company's common stock and the purchase price of the shares related to the \$10.0 million of future funding will be based on the prevailing market prices of the Company's shares preceding the time of sales as computed in accordance with the Purchase Agreement without any fixed discount, with the Company controlling the timing and amount of future sales, if any, of shares to LPC. The purchase price per share is equal to the lesser of the lowest sales price of our common stock on the purchase date or the average of the three lowest closing sales prices of our common stock during the twelve consecutive business days prior to the date of the purchase by LPC.

LPC has agreed not to cause or engage in any manner whatsoever, any direct or indirect short selling or hedging of the Company's shares of common stock. The fair value of the 40,247 shares issued as the initial commitment fee of \$0.1 million is recorded as a deferred charge in other assets in the accompanying balance sheet at September 30, 2012 and will be amortized into equity over the usage of the equity line. The Company may terminate the Purchase Agreement at any time at its discretion without any cost or penalty. Any proceeds received by the Company under the Purchase Agreement are expected to be used for working capital and general corporate purposes.

9. Warrants

Warrant activity for the nine months ended September 30, 2012 and warrant information as of September 30, 2012 is summarized as follows:

| | | Weighted | | |
|--|---------------|-----------------|--|------------------------|
| | | Average | | |
| | | Exercise | | Range of |
| | Shares | Price | | Exercise Prices |
| Outstanding at December 31, 2011 | 929,914 | \$ 15.13 | | \$2.80 - \$169.47 |
| Warrants issued | 50,000 | \$ 2.26 | | \$2.09 - \$3.80 |
| Warrants expired/forfeited | (11,709) | \$ 75.00 | | \$75.00 |
| Outstanding at September 30, 2012 | 968,205 | \$ 13.74 | | \$2.09 - \$169.47 |
| Warrants exercisable at September 30, 2012 | 908,205 | \$ 14.27 | | \$2.09 - \$169.47 |

Table of Contents*Warrant Liability*

The Company evaluates warrants on issuance and at each reporting date to determine proper classification as equity or as a liability. The Company has 379,678 outstanding warrants issued to former CSI Class A shareholders in connection with the business combination between Clean Diesel Technologies, Inc. (“CDTI”) and Catalytic Solutions, Inc. (“CSI”) on October 15, 2010 (the “Merger”) that it is required to physically settle by delivering registered shares. In addition, while the relevant warrant agreement does not require cash settlement if the Company fails to maintain registration of the warrant shares, it does not specifically preclude cash settlement. Accordingly, the Company’s agreement to deliver registered shares without express terms for settlement in the absence of continuous effective registration is presumed to create a liability to settle these warrants in cash, requiring liability classification. The contracts for the remaining warrants allow for settlement in unregistered shares and do not contain any other characteristics that would result in liability classification. Accordingly, these instruments have been classified in stockholders’ equity in the accompanying condensed consolidated balance sheets and are only valued on the issuance date and not subsequently revalued. The Company evaluated the balance sheet classification of all warrants at September 30, 2012 and noted no changes.

The liability-classified warrants are considered Level 3 in the fair value hierarchy because they are valued based on unobservable inputs. The Company determined the fair value of its liability-classified warrants using a Monte Carlo simulation model, which utilizes multiple input variables to estimate the probability that market conditions will be achieved. The assumptions used in the Monte Carlo simulation model were as follows:

| | September 30, 2012 | December 31, 2011 |
|---|-------------------------------|------------------------------|
| Expected volatility | 88.3% | 58.8% |
| Risk-free interest rate | 0.3% | 0.7% |
| Closing price of Clean Diesel Technologies, Inc. common stock | \$2.81 | \$2.80 |

Due to the significant change in the Company following the Merger, CDTI’s historical price volatility was not considered representative of expected volatility going forward. Therefore, the Company utilized an estimate based upon a weighted average of implied and historical volatility of a portfolio of peer companies and CDTI’s historical volatility.

The liability is remeasured at the end of each reporting period with changes in fair value recognized in other income (expense) in the consolidated statements of operations and comprehensive loss. The following is a reconciliation of the warrant liability measured at fair value using Level 3 inputs (in thousands):

| | Nine Months Ended | |
|--|-------------------------------|-------------|
| | September 30, 2012 | 2011 |
| Balance at beginning of period | \$ 100 | \$ 1,238 |
| Exercise of common stock warrants | | (39) |
| Remeasurement of common stock warrants | 59 | (1,072) |
| Balance at end of period | \$ 159 | \$ 127 |

10. Share Based Payment

The Clean Diesel Technologies, Inc. Stock Incentive Plan (formerly known as the Clean Diesel Technologies, Inc. 1994 Incentive Plan), as amended (the "Plan"), provided for the awarding of incentive stock options, non-qualified stock options, stock appreciation rights, restricted shares, performance awards, bonuses or other forms of share-based awards or cash, or combinations of these to the Company's directors, officers, employees, consultants and advisors (except consultants or advisors in capital-raising transactions) as the board of directors may determine. At the Company's Annual Meeting of Shareholders held on May 23, 2012, the Company's shareholders approved certain amendments to the Plan, the most significant of which changed the plan name, removed the evergreen provision and established a maximum number of 1.4 million shares to be reserved for issuance under the Plan, disallowed the repricing of outstanding stock options without shareholder approval, removed the ability to issue cash bonus awards under the Plan and modified the change in control provisions within the Plan. The Plan is more fully described in Note 13 to the Consolidated Financial Statements in the Company's 2011 Annual Report on Form 10-K.

Stock-based compensation expense for both employee and non-employee awards is as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Selling, general and administrative | \$ 113 | \$ 170 | \$ 308 | \$ 1,153 |
| Research and development | 21 | 12 | 56 | 204 |
| Total stock-based compensation expense | \$ 134 | \$ 182 | \$ 364 | \$ 1,357 |

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On March 8, 2012, the Compensation and Nominating Committee of the Company's Board of Directors (the "Compensation Committee") approved the grant of nonqualified stock options and RSUs to the Company's newly-appointed Chief Executive Officer and President in reliance on the employment inducement exception to the NASDAQ rules that require shareholder approval of equity-based incentive plans and awards. The Company granted 176,676 nonqualified stock options at an exercise price of \$2.83 per share. These options have a ten-year term, and vest 28% on the first anniversary of the date of grant and 9% quarterly thereafter. The Company also granted 58,892 RSUs at a fair value of \$2.83 per unit. These RSUs vest 28% on the first anniversary of the date of grant and 9% quarterly thereafter, beginning June 20, 2013.

During the nine months ended September 30, 2012, the Compensation Committee approved the grant of long-term incentive awards to other employees consisting of nonqualified stock options and RSUs. The Company granted a total of 330,219 nonqualified stock options at a weighted average exercise price of \$2.97 per share, a third of which vest on February 22, 2013 (the "Initial Vesting Date") and each of the first and second anniversaries of the Initial Vesting Date. The Company also issued 113,255 RSUs at a weighted average fair value of \$2.95 per unit, a third of which generally vest on March 20, 2013 (the "Vesting Commencement Date") and each of the first and second anniversaries of the Vesting Commencement Date.

Stock Options

Stock option activity for the nine months ended September 30, 2012 and stock option information as of September 30, 2012 is summarized as follows:

| | | | Weighted | |
|-----------------------------------|-----------------|--------------|--------------------|------------------|
| | | | Average | |
| | Weighted | | Remaining | Aggregate |
| | Average | | Contractual | |
| | Exercise | | Term | Intrinsic |
| | Options | Price | (in years) | Value |
| Outstanding at December 31, 2011 | 301,634 | \$ 18.57 | | |
| Granted | 506,895 | \$ 2.92 | | |
| Forfeited | (41,175) | \$ 3.06 | | |
| Expired | (11,368) | \$ 78.97 | | |
| Outstanding at September 30, 2012 | 755,986 | \$ 8.01 | 8.69 | \$18,823 |
| Exercisable at September 30, 2012 | 286,101 | \$ 16.40 | 7.46 | |

The aggregate intrinsic value represents the difference between the exercise price and the Company's closing stock price on the last trading day of the quarter.

The Company estimates the fair value of stock options using a Black-Scholes valuation model. The weighted-average fair value and assumptions used for the nine months ended September 30, 2012 and 2011 were as follows:

| | 2012 | 2011 |
|--|-------------|-------------|
| Expected volatility | 84.4% | 77.4% |
| Risk-free interest rate | 1.1% | 2.0% |
| Dividend yield | | |
| Expected life in years | 5.96 | 5.25 |
| Weighted average grant date fair value | \$2.07 | \$3.66 |

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The expected term of the options has historically been based upon the historical term until exercise or expiration of all granted options. Due to the significant change in the Company following the Merger and significant change in the terms of the options granted, CDTI's historical exercise data was not considered to provide a reasonable basis for estimating the expected term for current option grants. As such, the expected term of stock options granted in 2012 and 2011 was determined using the "simplified method" as allowed under ASC 718-10-S99. The "simplified method" calculates the expected term as the average of the vesting term and original contractual term of the options. Also, due to the significant change in the Company following the Merger, CDTI's historical price volatility was not considered representative of expected volatility going forward. Therefore, the Company utilized an estimate based upon the historical and implied volatility of a portfolio of peer companies. The risk-free interest rate is the constant maturity rate published by the U.S. Federal Reserve Board that corresponds to the expected term of the option. The dividend yield is assumed as 0% because the Company has not paid dividends and does not expect to pay dividends in the future.

Compensation costs for stock options that vest over time are recognized over the vesting period on a straight-line basis. As of September 30, 2012, the Company had \$0.8 million of unrecognized compensation cost related to stock option grants that remained to be recognized over vesting periods. These costs are expected to be recognized over a weighted average period of 2.4 years.

There was no cash received from option exercises under any share-based payment arrangements for the nine months ended September 30, 2012 or 2011.

Restricted Share Units

RSU activity for the nine months ended September 30, 2012 and RSU information as of September 30, 2012 is as follows:

| | | Weighted | |
|--|---------------|-------------------|------------------|
| | | Average | |
| | Shares | Grant Date | Aggregate |
| | | Fair Value | Intrinsic |
| | | | Value |
| Non-vested share units at December 31, 2011 | 25,238 | \$ 5.64 | |
| Granted | 172,147 | \$ 2.91 | |
| Vested | (12,508) | \$ 5.50 | |
| Forfeited | (17,312) | \$ 3.34 | |
| Non-vested share units at September 30, 2012 | 167,565 | \$ 3.08 | \$ 7,123 |

As of September 30, 2012, the Company had approximately \$0.4 million of unrecognized compensation expense, net of estimated forfeitures, related to RSUs, which will be recognized over a weighted average estimated remaining life of 2.3 years.

11. Contingencies

Legal Proceedings

On September 30, 2008, Applied Utility Systems, Inc. (“AUS”), a former subsidiary of the Company, filed a complaint against Benz Air Engineering, Inc. (“Benz Air”). The Company sold the majority of the assets of AUS to Johnson Matthey (“JM”) on October 1, 2009; however, this lawsuit was excluded from the sale. The complaint was amended on January 16, 2009, and asserted claims against Benz Air for breach of contract, common counts and slander. AUS was seeking \$0.2 million in damages, plus interest, costs and applicable penalties. In response to the complaint, Benz Air filed a cross-complaint on November 17, 2008, which named both AUS and the Company as defendants. The cross-complaint asserted claims against AUS and the Company for breach of oral contract, breach of express warranty, breach of implied warranty, negligent misrepresentation and intentional misrepresentation and was seeking not less than \$0.3 million in damages, plus interest, costs and punitive damages. The trial was concluded on July 29, 2011 with the jury awarding AUS \$0.2 million plus interest as well as an additional \$0.3 million for false statements. On October 18, 2011, the trial court granted Benz Air’s motion and overturned the jury’s verdict regarding the \$0.3 million for false statements, and denied Benz Air’s motion to overturn the jury’s verdict on the remaining counts. In addition, the trial court awarded the Company over \$0.5 million in attorney’s fees. In the fourth quarter of 2011, the Company recorded a gain of \$0.2 million related to a partial recovery of the award from the Benz Air litigation. On July 31, 2012, the Company and Benz Air completed a global settlement agreement that provides for a cash payment by Benz Air of \$175,000, plus three individual payments of \$25,000 each to be paid on October 1, 2012, January 2, 2013, and April 1, 2013. On September 25, 2012, the Company received all three remaining cash payments from Benz Air and recorded a gain which is presented in discontinued operations in the accompanying condensed consolidated statement of operations. As a result, the Company has dismissed its lawsuit in this matter.

On April 30, 2010, CDTI received a complaint from the Hartford, Connecticut office of the U.S. Department of Labor (“U.S. DOL”) under Section 806 of the Corporate and Criminal Fraud Accountability Act of 2001, Title VIII of the Sarbanes-Oxley Act of 2002, alleging that a former employee had been subject to discriminatory employment practices. CDTI’s Board of Directors terminated the employee’s employment on April 19, 2010. The complainant in this proceeding does not demand specific relief. However, the statute provides that a prevailing employee shall be entitled to all relief necessary to make the employee whole, including compensatory damages, which may be reinstatement, back pay with interest, front pay, and special damages such as attorney’s and expert witness fees. CDTI responded on June 14, 2010, denying the allegations of the complaint. On March 29, 2011, the U.S. DOL investigator assigned to this matter requested information and documentation regarding the former employee’s allegations and the Company provided responsive documents as requested. The Company also responded to additional requests from the U.S. DOL regarding electronic correspondence. On October 6, 2011, the U.S. DOL investigator requested that the Company provide additional information and requested interviews with certain individuals. The Company responded to those requests. On April 16, 2012, the U.S. DOL requested that the Company take part in non-binding mediation with the former employee. The Company has granted that request, but the former employee declined to participate in mediation. On July 17, 2012, the U.S. DOL conducted interviews of several former CDTI officers. On July 31, 2012, the Company submitted Supplemental Briefing to the U.S. DOL pertaining to the protections and applicability of Section 806 of the Sarbanes-Oxley Act of 2002. The U.S. DOL’s investigation is ongoing. Based upon current information, management, after consultation with legal counsel defending the Company’s interests, believes the ultimate disposition will have no material effect upon its business, results or financial position. As no specific quantification of damages has been provided by the Claimant, the Company cannot provide a reasonable range of possible outcomes.

BP Products North America (“BP”), a subsidiary of British Petroleum (BP p.l.c.) has made claims against JM as the parent company of and purchaser of AUS, pertaining to the Whiting Refinery SPS NOx Reduction Project. BP alleges JM is liable for default damages and various other set-offs to the contract price and has retained a significant portion of the contract amount, as well as made claims for additional damages. JM maintains that it fully performed its obligations under the contract, and BP has acted in bad faith and has inappropriately withheld the contract proceeds and is further liable for various other damages. On May 12, 2010, JM tendered to the Company a claim for indemnification under the Asset Purchase Agreement dated October 1, 2009, among JM, CSI and AUS. A recent

mediation did not result in a settlement. On May 14, 2012, JM filed a lawsuit in California state court alleging breach of contract. On June 25, 2012, BP removed the case to federal court. On June 29, 2012, BP filed their Answer and Counterclaimed against JM for Breach of Contract. The Parties are now preparing for their initial disclosures. As litigation has just begun and no discovery has been conducted, the Company cannot provide a reasonable range of possible outcomes. Any potential obligation is not expected to have a material impact on the Company, its results of operations or its financial position.

In addition to the foregoing, the Company is involved in legal proceedings from time to time in the ordinary course of its business. Management does not believe that any of these claims and proceedings against it is likely to have, individually or in the aggregate, a material adverse effect on the Company's consolidated financial condition or results of operations.

Sales and Use Tax Audit

The Company is undergoing a sales and use tax audit by the State of California on AUS for the period of 2007 through 2009. The audit has identified a project performed by the Company during that time period for which sales tax was not collected and remitted and for which the State of California asserts that proper documentation of resale may not have been obtained. The Company contends and believes that it received sufficient and proper documentation from its customer to support not collecting and remitting sales tax from that customer and is actively disputing the audit report with the State of California. Accordingly, no accrual has been recorded for this matter. The potential outcomes of this matter range from zero to \$1.3 million. Should the Company not prevail in this matter, it has certain indemnifications from its customer related to sales tax and would pursue reimbursement from the customer for all assessments from the State.

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The Company has two division segments based on the products it delivers:

Heavy Duty Diesel Systems division — The Heavy Duty Diesel Systems division designs and manufactures verified exhaust emissions control solutions. This division offers a full range of products for the verified retrofit and OEM markets through its distributor/dealer network and direct sales. The ECS and Clean Diesel Technologies-branded products are used to reduce exhaust emissions created by on-road, off-road and stationary diesel and alternative fuel engines including propane and natural gas. The retrofit market in the U.S. is driven in particular by state and municipal environmental regulations and incentive funding for voluntary early compliance. The Heavy Duty Diesel Systems division derives significant revenues from retrofit with a portfolio of solutions verified by the California Air Resources Board and the United States Environmental Protection Agency.

Catalyst division — The Catalyst division produces catalyst formulations to reduce emissions from gasoline, diesel and natural gas combustion engines that are offered for multiple markets and a wide range of applications. A family of unique high-performance catalysts has been developed — with base-metals or low platinum group metal and zero platinum group metal content — to provide increased catalytic function and value for technology-driven automotive industry customers. The Catalyst division's technical and manufacturing competence in the light duty vehicle market is aimed at meeting auto makers' most stringent requirements, and it has supplied over ten million parts to light duty vehicle customers since 1996. The Catalyst division also provides catalyst formulations for the Company's Heavy Duty Diesel Systems division. Intersegment revenues are based on market prices.

Corporate — Corporate includes cost for personnel, insurance and public company expenses such as legal, audit and taxes that are not allocated down to the operating divisions.

Summarized financial information for the Company's reportable segments is as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| Revenues | | | | \$ |
| Heavy Duty Diesel Systems | \$ 8,680 | \$ 11,076 | \$ 32,283 | 30,105 |
| Catalyst | 6,659 | 6,447 | 19,194 | 15,002 |
| Corporate | | | | |
| Eliminations (1) | (939) | (2,549) | (3,354) | (4,817) |
| | | | | \$ |
| Total | \$ 14,400 | \$ 14,974 | \$ 48,123 | 40,290 |
| Income (loss) from operations | | | | \$ |
| Heavy Duty Diesel Systems | \$ (272) | \$ 373 | \$ (545) | 84 |
| | | | | 35 |

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| | | | | |
|------------------|------------|------------|------------|---------|
| Catalyst | 261 | (170) | (750) | (1,064) |
| Corporate | (1,209) | (1,381) | (4,251) | (5,509) |
| Eliminations (1) | 64 | (72) | 86 | (180) |
| | | | | \$ |
| Total | \$ (1,156) | \$ (1,250) | \$ (5,460) | (6,669) |

(1) Elimination of Catalyst revenue and profit in ending inventory related to sales to Heavy Duty Diesel Systems.

The Company conducted an intercompany transfer pricing study at the end of 2011 which resulted in it adjusting the prices its group companies charge each other for the sale of products and services. The Catalyst division adjusted certain prices it charges for products sold to the Heavy Duty Diesel Systems division to be consistent with market prices. The impact for the full year was recorded in the fourth quarter of 2011 which resulted in a \$1.3 million increase in revenues for the Catalyst division and the offsetting intercompany eliminations. The change also resulted in a \$1.3 million decrease in loss from continuing operations for the Catalyst division with an offsetting decrease in income from continuing operations for the Heavy Duty Diesel Systems division for the year ended December 31, 2011. Of this amount, \$1.0 million related to previous interim periods in 2011 with the impact on the individual quarters of \$0.1 million, \$0.4 million and \$0.5 million for the quarters ended March 31, June 30, and September 30, 2011, respectively. Catalyst division revenues and eliminations and the Heavy Duty Diesel Systems and Catalyst income (loss) from operations for the three and nine months ended September 30, 2011 have been recast to reflect the impact of this change in measurement. The change in intercompany pricing did not result in any change in consolidated revenues or in the consolidated loss from operations.

Net sales by geographic region are as follows (in thousands):

| | Three Months Ended | | Nine Months Ended | |
|----------------|--------------------|-----------|-------------------|-----------|
| | September 30, | | September 30, | |
| | 2012 | 2011 | 2012 | 2011 |
| United States | \$ 7,145 | \$ 5,596 | \$ 20,675 | \$ 15,331 |
| Canada | 5,461 | 6,049 | 16,966 | 17,363 |
| United Kingdom | 500 | 1,613 | 5,919 | 2,075 |
| Sweden | 1,294 | 1,716 | 4,563 | 5,521 |
| Total | \$ 14,400 | \$ 14,974 | \$ 48,123 | \$ 40,290 |

Geographic information is based on country of origin. The majority of Canadian sales are to U.S. customers.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q. This Quarterly Report on Form 10-Q should also be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties, see “Cautionary Note Concerning Forward-Looking Statements” at the beginning of this Quarterly Report on Form 10-Q. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, as a result of many important factors, including those set forth in Part I — Item 1A “Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

All percentage amounts and ratios included in this Management’s Discussion and Analysis of Financial Condition and Results of Operations were calculated using the underlying data in thousands.

Overview

We are a leading global manufacturer and distributor of heavy diesel and light duty vehicle emissions control systems and products to major automakers and retrofitters. Our emissions control systems and products are designed to deliver high value to our customers while benefiting the global environment through air quality improvement, sustainability and energy efficiency. Our business is driven by increasingly stringent global emission standards for internal combustion engines, which are major sources of a variety of harmful pollutants.

We organize our operations in two business divisions: the Heavy Duty Diesel Systems division and the Catalyst division.

Heavy Duty Diesel Systems: Through our Heavy Duty Diesel Systems division we design and manufacture verified exhaust emissions control solutions. Our Heavy Duty Diesel Systems division offers a full range of products for the verified retrofit and original equipment manufacturer, or OEM, markets through its distribution/dealer network and direct sales. These ECS and Clean Diesel Technologies-branded products, such as Purifilter[®], Purifier[™], ARPS and exhaust gas recirculation with selective catalytic reduction are used to reduce exhaust emissions created by on-road, off-road and stationary diesel and alternative fuel engines including propane and natural gas. Revenues from our Heavy Duty Diesel Systems division accounted for approximately 67% and 75% of the total consolidated revenues for the nine months ended September 30, 2012 and 2011, respectively.

Catalyst: Through our Catalyst division, we produce catalyst formulations to reduce emissions from gasoline, diesel and natural gas combustion engines that are offered for multiple markets and a wide range of applications. A family of unique high-performance catalysts has been developed — with base-metals or low platinum group metal and zero-platinum group metal content — to provide increased catalytic function and value for technology-driven automotive industry customers. Our technical and manufacturing competence in the light duty vehicle market is aimed at meeting

auto makers' most stringent requirements, and we have supplied over ten million parts to light duty vehicle customers since 1996. Our Catalyst division also provides catalyst formulations for our Heavy Duty Diesel Systems division. Revenues from our Catalyst division accounted for approximately 33% and 25% of the total consolidated revenues for the nine months ended September 30, 2012 and 2011, respectively.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures in the financial statements. Critical accounting policies are those accounting policies that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance. While we base our estimates and judgments on our experience and on various other factors that we believe to be reasonable under the circumstances, actual results may differ from these estimates under different assumptions or conditions.

We believe that the assumptions, judgments and estimates involved in the accounting for revenue recognition, allowance for doubtful accounts, inventory valuation, accounting for income taxes, business combinations, goodwill, impairment of long-lived assets other than goodwill, stock-based compensation and warrant derivative liability have the greatest potential impact on our condensed consolidated financial statements. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our year ended December 31, 2011 for a more complete discussion of our critical accounting policies and estimates.

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Recent Accounting Pronouncements

In December 2011, the FASB issued ASU 2011-11, "Disclosures about Offsetting Assets and Liabilities," which requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. ASU No. 2011-11 is effective for annual and interim periods beginning on or after January 1, 2013. Retrospective application is required. The guidance concerns disclosure only and will not have an impact on our financial position or results of operations.

For additional discussion regarding other recent accounting pronouncements, see Note 2 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

Factors Affecting Future Results

Factors Affecting our Heavy Duty Diesel Systems Division

The nature of our business and, in particular, our Heavy Duty Diesel Systems division, is heavily influenced by government funding of emissions control projects and increased diesel emission control regulations and mandates. Compliance with these regulatory initiatives drives demand for our products and the timing of implementation of emission reduction projects.

Emission reduction programs are often one-off, or have staggered compliance dates, which mean they do not generally result in a regular source of recurring revenues for our company. For example, London, U.K. had mandated that certain heavy duty diesel vehicles entering the London Low Emissions Zone (or LEZ) were required to meet certain emission standards by January 2012. We believe that approximately 20,000 such vehicles were required to have a retrofit emission control device installed on the vehicle by year end 2011. In December 2011, the regulator extended the deadline for compliance into the first quarter of 2012. We believe that the bulk of the vehicles were retrofitted in the fourth quarter of 2011, with sales of our products of approximately \$6 million in the fourth quarter and \$8 million in the full year 2011. However, due to the extension, we recorded additional sales of \$4.3 million and \$1.0 million in the first and second quarters of 2012, respectively. This program is now virtually complete and as such, we do not expect sales in London in the balance of 2012 and beyond. In addition, the California Air Resources Board ("CARB") has mandated that all Class 7 and Class 8 heavy diesel trucks meet certain emission targets by 2016, with interim targets established for 2011, 2012 and 2013, such that 90% of current operating diesel trucks will be required to meet these targets by 2014. We estimate that this rule will require well over 100,000 heavy duty diesel trucks to be replaced or retrofitted. According to industry estimates, approximately 66,000 vehicles have elected or will elect to retrofit between 2011 and 2015. We believe that the rate of adoption of electing to retrofit by truck owners as well as the overall level of retrofit activity and our ability to gain sales are dependent upon several factors, including the level of enforcement of the mandate by CARB, the level of new truck acquisitions by truck owners and also our success in attaining the required verifications and approvals for products currently under review by CARB. We have experienced a slower than anticipated ramp up in adoption by truck owners and a delay in verification for a product currently under review by CARB. This has resulted in weaker than expected sales in the third quarter and order activity in the fourth quarter to date. Though we continue to pursue this retrofit opportunity aggressively, the rate of adoption, industry projections pertaining to the overall market opportunity and the success and timing of product verifications are uncertain and are expected to have a negative effect on sales in the remainder of this year and could result in fluctuations in revenue and working capital requirements from quarter-to-quarter next year.

Factors Affecting our Catalyst Division

Because the customers of our Catalyst division are OEM auto makers, our business is also affected by macroeconomic factors that impact the automotive industry generally, which can result in increased or decreased purchases of vehicles, and consequently demand for our products. Sales to our largest OEM auto customer have been positively impacted during the first nine months of 2012 due to increased vehicle shipments, expansion of our catalysts onto new vehicle platforms, increased purchasing by the customer to build initial stock of parts for a new model and an increase in pass through sales of rare earth materials due to increased prices of these materials. At present, we expect sales in the fourth quarter to this customer to be consistent with the third quarter.

In addition, our sales and gross margins are also impacted by the pass through sales of rare earth materials and the extent to which the price increases are shared with our customer. Through June 2012, the customer was reimbursing us the full amount actually spent by us on these materials. In the third quarter and beyond, it is the intent of both our customer and us to establish a formula for this reimbursement which is based on formulae established by this customer with other vendors. Until such a formula is agreed to, our customer is reimbursing rare earth cost increases only partially. We expect that a formula will be agreed to before the end of the year. However, even if such a formula is in place, we may experience margin reduction if the formula does not accurately reflect actual costs.

Supply of Catalyst Division Products to Heavy Duty Diesel Systems Division

Our strategy is to progressively utilize the products of our Catalyst division in the products of our Heavy Duty Diesel Systems division. We anticipate that our intercompany sales of catalysts will increase compared to historical levels, as our planned new products are approved by the regulatory agencies and begin to generate sales. While this will not impact our reported sales, we believe that the manufacturing gross margin associated with these sales will improve our total gross margin.

Table of Contents**Results of Operations**

We conducted an intercompany transfer pricing study in the end of 2011 which resulted in us adjusting the prices our group companies charge each other for the sale of products and services. The Catalyst division adjusted certain prices it charges for products sold to the Heavy Duty Diesel Systems division to be consistent with market prices. The impact for the full year was recorded in the fourth quarter of 2011 which resulted in a \$1.3 million increase in revenues for the Catalyst division and the offsetting intercompany eliminations. The change also resulted in a \$1.3 million decrease in loss from continuing operations for the Catalyst division with an offsetting decrease in Heavy Duty Diesel Systems income from continuing operations for the year ended December 31, 2011. Of this amount, \$1.0 million related to previous interim periods in 2011 with the impact on the individual quarters of \$0.1 million, \$0.4 million and \$0.5 million for the quarters ended March 31, June 30, and September 30, 2011, respectively. The Catalyst revenues and related eliminations and the Heavy Duty Diesel Systems and Catalyst income (loss) from operations for the three and nine months ended September 30, 2011 have been recast to reflect the impact of this change in measurement. The change in intercompany pricing did not result in any change in consolidated revenues or in the consolidated loss from operations.

Comparison of Three Months Ended September 30, 2012 to Three Months Ended September 30, 2011***Revenues***

The table below and the tables in the discussion that follow are based upon the way we analyze our business. See Note 12 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q for additional information about our divisions.

| | Three Months Ended September 30, | | | | | |
|---------------------------|---|-----------------------------------|-------------|-----------------------------------|------------------|-----------------|
| | 2012 | % of Total Revenue | 2011 | % of Total Revenue | \$ Change | % Change |
| | (Dollars in millions) | | | | | |
| Heavy Duty Diesel Systems | \$ 8.7 | 60.3% | \$ 11.1 | 74.0% | \$ (2.4) | (21.6)% |
| Catalyst | 6.7 | 46.2% | 6.4 | 43.0% | 0.3 | 3.3% |
| Intercompany revenue | (1.0) | (6.5)% | (2.5) | (17.0)% | 1.5 | (63.2)% |
| Total revenue | \$ 14.4 | 100.0% | \$ 15.0 | 100.0% | \$ (0.6) | (3.8)% |

Total revenue for the three months ended September 30, 2012 decreased by \$0.6 million, or 3.8% to \$14.4 million from \$15.0 million for the three months ended September 30, 2011.

Our Heavy Duty Diesel Systems division includes on-road diesel retrofit business most often driven by increasingly stringent emission regulations as well as product applications sold on an OEM and aftermarket basis with applications for the reduction of exhaust emissions of off-road and stationary engines and licensing revenue. Revenues for our Heavy Duty Diesel Systems division for the three months ended September 30, 2012 decreased \$2.4 million, or 21.6%, to \$8.7 million from \$11.1 million for the three months ended September 30, 2011. The decrease was due to decreased retrofit sales of \$1.6 million and decreased non-retrofit sales of \$0.8 million. Retrofit sales declined \$1.1 million in the London LEZ and \$0.5 million in North America. Significant programs in North America included California and New Jersey. California sales of \$1.7 million continued to be weak compared to expectations and were down \$2.2 million year over year as we benefited from a CARB early compliance incentive program which was implemented in the second and third quarters of 2011. This decline was partially offset by growth driven by sales in the New Jersey Department of Environmental Protection Mandatory Diesel Retrofit Program and in other retrofit programs in North America. Non-retrofit sales decreased due to declines in sales of standard exhaust parts in North America, European material handling sales and North American sales to OEMs and integrators.

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Total revenues for our Catalyst division for the three months ended September 30, 2012 increased \$0.3 million, or 3.3%, to \$6.7 million from \$6.4 million for the three months ended September 30, 2011. Excluding intercompany revenue, sales for this division increased 46.7% to \$5.7 million for the three months ended September 30, 2012 as compared to \$3.9 million for the three months ended September 30, 2011. The increase was in part due to the recognition of \$1.0 million in revenue upon completion of performance under a contract to provide equipment, engineering and support services to assist our investment partner in the Asia Pacific, TKK, in establishing operations in China to manufacture automotive and exhaust emission products for the China market. The remaining increase was due to an increase of \$1.0 million in sales to our Japanese OEM customer due to higher vehicle shipments, expansion of our catalysts onto new vehicle platforms, increased purchasing by the customer to build an initial stock of parts for a new model and rare earth material price increases that were passed on to the customer. This was partially offset by reductions of \$0.2 million in sales to other OEM customers for the three months ended September 30, 2012 as compared to the three months ended September 30, 2011. We eliminate intercompany sales by the Catalyst division to our Heavy Duty Diesel Systems division in consolidation.

Cost of revenues

Cost of revenues decreased by \$0.2 million, or 1.7% to \$10.5 million for the three months ended September 30, 2012, compared to \$10.7 million for the three months ended September 30, 2011. The primary reason for the decrease in costs was lower product sales volume.

Gross profit

The following table shows our gross profit and gross margin (gross profit as a percentage of revenues) by division for the periods indicated.

| | Three Months Ended September 30, | | | | | |
|---------------------------|---|------------------------|-------------|------------------------|------------------|-----------------|
| | % of | | % of | | \$ Change | % Change |
| | 2012 | Revenue (1) | 2011 | Revenue (1) | | |
| Heavy Duty Diesel Systems | \$ 2.2 | 25.7% | \$ 3.2 | 28.5% | \$ (1.0) | (29.3)% |
| Catalyst | 1.6 | 23.7% | 1.2 | 18.4% | 0.4 | 24.7% |
| Intercompany eliminations | 0.1 | | (0.1) | | 0.2 | NM |
| Total gross profit | \$ 3.9 | 26.9% | \$ 4.3 | 28.5% | \$ (0.4) | (9.3)% |

(1) Division calculation based on division revenue. Total based on total revenue.

Gross profit for the three months ended September 30, 2012 decreased by \$0.4 million, or 9.3%, to \$3.9 million from \$4.3 million for the three months ended September 30, 2011. Gross margin was 26.9% during the three months ended

September 30, 2012 compared to 28.5% during the three months ended September 30, 2011.

The decrease in gross margin for our Heavy Duty Diesel Systems division from 28.5% for the three months ended September 30, 2011 to 25.7% for the three months ended September 30, 2012 is a result of reduced leverage of fixed manufacturing costs resulting from lower sales volume, \$0.3 million of warranty expense and increased inventory obsolescence of \$0.2 million.

The increase in gross margin for our Catalyst division from 18.4% for the three months ended September 30, 2011 to 23.7% for the three months ended September 30, 2012 is due to the impact of favorable margins under the TKK contract which was completed during the three months ended September 30, 2012. The TKK contract was a non-standard contract for the Company and is not expected to occur on a regular basis. Excluding this impact, gross margins for our Catalyst division decreased to 14.9% for the three months ended September 30, 2012 from 18.4% for the three months ended September 30, 2011. This decrease in gross margin is a result of the escalation of prices of rare earth materials that we use in our catalysts. One of our OEM customers provides price adjustments to isolate us from the impact of rare earth cost increases. Through June 2012, that customer was reimbursing us the full amount actually spent by us on these materials. In the third quarter and beyond, it is the intent of both us and our customer to establish a formula for this reimbursement which is based on formulae established by this customer with other vendors. Until such a formula is agreed to, our customer is only partially reimbursing rare earth cost increases. We expect that a formula will be agreed to before the end of the year. With the significant increases in rare earth prices, this cost reimbursement is dilutive to margin on a percent of sales. With two of our other OEM customers, we were not reimbursed for the increased costs of the rare earth material but are pursuing both for retroactive reimbursement for the as well as for future business.

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The following table shows our operating expenses and operating expenses as a percentage of revenues for the periods indicated.

| | Three Months Ended September 30, | | | | | |
|-------------------------------------|---|-----------------------------------|-------------|-----------------------------------|------------------|-----------------|
| | 2012 | % of Total Revenue | 2011 | % of Total Revenue | \$ Change | % Change |
| | (Dollars in millions) | | | | | |
| Selling, general and administrative | \$ 3.4 | 23.4% | \$ 3.9 | 26.0% | \$ (0.5) | (13.2)% |
| Research and development | 1.6 | 11.4% | 1.6 | 10.8% | | 1.4% |
| Total operating expenses | \$ 5.0 | 34.8% | \$ 5.5 | 36.8% | \$ (0.5) | (8.9)% |

For the three months ended September 30, 2012, operating expenses decreased by \$0.5 million to \$5.0 million from \$5.5 million for the three months ended September 30, 2011.

Selling, general and administrative expenses

For the three months ended September 30, 2012, selling, general and administrative expenses decreased by \$0.5 million, or 13.2%, to \$3.4 million from \$3.9 million for the three months ended September 30, 2011. This decrease is a result of a reduction in costs related to the former Corporate office in Connecticut of \$0.2 million, our London operation of \$0.1 million and a reduction in stock compensation and bonus \$0.2 million. Selling, general and administrative expenses as a percentage of revenues decreased to 23.4% in the three months ended September 30, 2012 compared to 26.0% in the three months ended September 30, 2011.

Research and development expenses

Research and development expenses were \$1.6 million in each of the three months ended September 30, 2012 and 2011. As a percentage of revenues, research and development expenses were 11.4% in the three months ended September 30, 2012, compared to 10.8% in the three months ended September 30, 2011.

Other expense

The following table shows the components of other expense and other (expense) income as a percentage of revenues for the periods indicated.

| | Three Months Ended September 30, | | |
|---|---|------------------------------|--------------------------|
| | % of | | % of |
| | 2012 | Total Revenue | 2011 |
| | | (Dollars in millions) | Total Revenue |
| Interest expense | \$ (0.4) | (3.1)% | \$ (0.3) (2.2)% |
| Loss on change in fair value of common stock warrant liability | (0.1) | (0.4)% | |
| Foreign currency exchange (loss) gain | (0.4) | (3.1)% | 0.2 1.6 |
| Total other expense | \$ (0.9) | (6.6)% | \$ (0.1) (0.6)% |

We incurred interest expense of \$0.4 million in the three months ended September 30, 2012 compared to \$0.3 million in the three months ended September 30, 2011. The three months ended September 30, 2012 includes \$0.1 million in financing costs related to the amendment of our FGI credit facility (see —Description of Indebtedness below and Note 7 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q. For the three months ended September 30, 2012, there was a loss of \$0.1 million related to the change in fair value of liability classified common stock warrants. The three months ended September 30, 2012 included a \$0.4 million exchange loss related primarily to changes in value of the Canadian dollar in relation to the U.S. dollar as compared to a gain of \$0.2 million in the three months ended September 30, 2011.

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For the foregoing reasons, we had a net loss of \$1.8 million for the three months ended September 30, 2012 compared to a net loss of \$2.0 million for the three months ended September 30, 2011. Excluding net income of \$0.2 million in the three months ended September 30, 2012 from discontinued operations and net loss of \$0.1 million in the three months ended September 30, 2011, we had a net loss from continuing operations of \$2.0 million for the three months ended September 30, 2012 compared to a net loss from continuing operations of \$1.9 million for the three months ended September 30, 2011. We continue to have legal and other expenses as well as gains on litigation settlements related to the 2009 divestiture of the assets of Applied Utility Systems. We record these activities as discontinued operations. For additional information relating to Applied Utility Systems, see Note 17 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011.

Comparison of Nine Months Ended September 30, 2012 to Nine Months Ended September 30, 2011*Revenues*

| | Nine Months Ended September 30, | | Nine Months Ended September 30, | | | |
|---------------------------|--|--------------------------|--|--------------------------|------------------|-----------------|
| | % of | % of | % of | % of | | |
| | 2012 | Total Revenue | 2011 | Total Revenue | \$ Change | % Change |
| | | | (Dollars in millions) | | | |
| Heavy Duty Diesel Systems | \$ 32.3 | 67.1% | \$ 30.1 | 74.7% | \$ 2.2 | 7.2% |
| Catalyst | 19.2 | 39.9% | 15.0 | 37.3% | 4.2 | 27.9% |
| Intercompany revenue | (3.4) | (7.0)% | (4.8) | (12.0)% | 1.4 | 30.4% |
| Total revenue | \$ 48.1 | 100.0% | \$ 40.3 | 100.0% | \$ 7.8 | 19.4% |

Total revenue for the nine months ended September 30, 2012 increased by \$7.8 million, or 19.4%, to \$48.1 million from \$40.3 million for the nine months ended September 30, 2011.

Revenues for our Heavy Duty Diesel Systems division for the nine months ended September 30, 2012 increased \$2.2 million, or 7.2%, to \$32.3 million from \$30.1 million for the nine months ended September 30, 2011. The increase was due to increased retrofit sales of \$2.5 million partially offset by decreased non-retrofit sales of \$0.3 million. Retrofit sales increased \$4.0 million in the London LEZ and decreased \$1.5 million in North America. Significant programs in North America included California, New Jersey and Texas. California sales of \$6.2 million continued to be weak compared to expectations and were down \$1.5 million year over year as we benefited from a CARB early compliance incentive program which was implemented in the second and third quarters of 2011. Sales increased \$3.0 million under the New Jersey Department of Environmental Protection Mandatory Diesel Retrofit

Program, increased \$1.0 million for the retrofit of school buses in the State of Texas and decreased \$4.0 million related to the retrofit of school buses in New York and other northeastern states. Non-retrofit sales decreased due to declines in European material handling sales and North American sales to OEMs and integrators.

Revenues for our Catalyst division for the nine months ended September 30, 2012 increased \$4.2 million, or 27.9%, to \$19.2 million from \$15.0 million for the nine months ended September 30, 2011. Excluding intercompany revenue, sales for this division increased \$5.6 million, or 55.5%, to \$15.8 million for the nine months ended September 30, 2012 as compared to \$10.2 million for the nine months ended September 30, 2011. The nine months ended September 30, 2012 includes the recognition of \$1.0 million in revenue upon completion of performance under the contract with TKK, as discussed above. The remaining increase was due to an increase in sales to our Japanese OEM customer of \$6.0 million, of which \$1.2 million was as a result of increased prices of rare earth raw materials that were passed on to the customer. This was offset by a reduction of \$1.4 million in sales to other OEM customers for the nine months ended September 30, 2012 as compared to the nine months ended September 30, 2011. We eliminate intercompany sales by the Catalyst division to our Heavy Duty Diesel Systems division in consolidation.

Cost of revenues

Cost of revenues increased by \$7.5 million, or 26.4% to \$36.1 million for the nine months ended September 30, 2012, compared to \$28.6 million for the nine months ended September 30, 2011. The primary reason for the increase in costs was higher product sales volume. Additionally, we incurred \$1.0 million in expense related to inventory obsolescence and write-downs including amounts related to the London LEZ program which is virtually complete (see “—Factors Affecting Future Results” above).

Table of Contents*Gross profit*

The following table shows our gross profit and gross margin (gross profit as a percentage of revenues) by division for the periods indicated.

| | Nine Months Ended September 30, | | Nine Months Ended September 30, | | \$ Change | % Change |
|---------------------------|--|-------------------------|--|-------------------------|------------------|-----------------|
| | 2012 | % of Revenue (1) | 2011 | % of Revenue (1) | | |
| | | | (Dollars in millions) | | | |
| Heavy Duty Diesel Systems | \$ 8.4 | 26.0% | \$ 8.5 | 28.1% | \$ (0.1) | (0.8)% |
| Catalyst | 3.5 | 18.2% | 3.4 | 22.8% | 0.1 | 2.3% |
| Intercompany eliminations | 0.1 | | (0.2) | | 0.3 | NM |
| Total gross profit | \$ 12.0 | 24.9% | \$ 11.7 | 29.1% | \$ 0.3 | 2.4% |

(1) Division calculation based on division revenue. Total based on total revenue.

Gross profit for the nine months ended September 30, 2012 increased by \$0.3 million, or 2.4%, to \$12.0 million from \$11.7 million for the nine months ended September 30, 2011. Gross margin was 24.9% during the nine months ended September 30, 2012 compared to 29.1% during the nine months ended September 30, 2011.

The decrease in gross margin for our Heavy Duty Diesel Systems division from 28.1% for the nine months ended September 30, 2011 to 26.0% for the nine months ended September 30, 2012 is a result of the write-down of inventory related to the phase down of the London LEZ, the impact of product mix and discounting in the London LEZ and to an increase in warranty expense related to increased sales of more complex diesel particulate filters.

Gross margin for our Catalyst division decreased from 22.8% for the nine months ended September 30, 2011 to 18.2% for the nine months ended September 30, 2012. Excluding the impact of the TTK contract, as discussed above, gross margins for our Catalyst division decreased to 15.2% for the nine months ended September 30, 2012 from 22.8% for the nine months ended September 30, 2011 a result of the impact of unfavorable product mix and the escalation of prices of rare earth materials that we use in our catalysts. This decrease in gross margin is a result of the escalation of prices of rare earth materials that we use in our catalysts. One of our OEM customers provides price adjustments to isolate us from the impact of rare earth cost increases, but that addition solely covers cost without any additional profit. Through June 2012, that customer was reimbursing us the full amount actually spent by us on these materials. In the third quarter and beyond, it is the intent of both us and our customer to establish a formula for this reimbursement which is based on formulae established by this customer with other vendors. Until such a formula is agreed to, our customer is only partially reimbursing rare earth cost increases. We expect that a formula will be agreed to before the end of the year. With the significant increases in rare earth prices, this cost reimbursement is dilutive to

margin on a percent of sales. With two of our other OEM customers, we were not reimbursed for the increased costs of the rare earth material but are pursuing both for retroactive reimbursement for the as well as for future business.

Operating expenses

The following table shows our operating expenses and operating expenses as a percentage of revenues for the periods indicated.

| | Nine Months Ended September 30, | | | | | |
|-------------------------------------|--|-----------------------------------|-------------|-----------------------------------|------------------|-----------------|
| | 2012 | % of Total Revenue | 2011 | % of Total Revenue | \$ Change | % Change |
| | (Dollars in millions) | | | | | |
| Selling, general and administrative | \$ 11.6 | 24.1% | \$ 13.0 | 32.3% | \$ (1.4) | (10.9)% |
| Research and development | 5.5 | 11.5% | 5.4 | 13.3% | 0.1 | 2.6% |
| Severance expense | 0.3 | 0.7% | | | 0.3 | NM |
| Total operating expenses | \$ 17.4 | 36.3% | \$ 18.4 | 45.6% | \$ (1.0) | (5.1)% |

For the nine months ended September 30, 2012, operating expenses decreased by \$1.0 million to \$17.4 million from \$18.4 million for the nine months ended September 30, 2011. Included in the nine months ended September 30, 2012 is \$0.3 million in severance expense related to the elimination of several positions at both the Heavy Duty Diesel Systems and Catalyst divisions.

Table of Contents*Selling, general and administrative expenses*

For the nine months ended September 30, 2012, selling, general and administrative expenses decreased by \$1.4 million, or 10.9%, to \$11.6 million from \$13.0 million for the nine months ended September 30, 2011. This decrease is primarily a result of a \$1.0 million reduction in stock based compensation, partially offset by an increase in executive recruiting and relocation expenses incurred in filling two key executive positions during the quarter as well as expense related to additional hiring in support of the California Truck and Bus rule. Selling, general and administrative expenses as a percentage of revenues decreased to 24.1% in the nine months ended September 30, 2012 compared to 32.3% in the nine months ended September 30, 2011.

Research and development expenses

For the nine months ended September 30, 2012, research and development expenses increased by \$0.1 million, or 2.6%, to \$5.5 million from \$5.4 million for the nine months ended September 30, 2011. The increase in research and development expenses was primarily attributable to material and outside test lab expenses for new product verifications to broaden our product offering in California and the rest of North America. As a percentage of revenues, research and development expenses were 11.5% in the nine months ended September 30, 2012, compared to 13.3% in the nine months ended September 30, 2011.

Other expense

The following table shows the components of other expense and other (expense) income as a percentage of revenues for the periods indicated.

| | Nine Months Ended September 30, | | | |
|---|--|------------------------------|-------------|--------------------------|
| | | % of | | % of |
| | 2012 | Total Revenue | 2011 | Total Revenue |
| | | (Dollars in millions) | | |
| Interest expense | \$ (1.1) | (2.3)% | \$ (0.9) | (2.2)% |
| Gain on change in fair value of common stock warrant liability | (0.1) | (0.1)% | 1.1 | 2.7% |
| Foreign currency exchange (loss) gain | (0.5) | (1.1)% | (0.2) | (0.3)% |
| All other, net | (0.1) | (0.2)% | 0.1 | 0.1% |
| Total other expense | \$ (1.8) | (3.7)% | \$ 0.1 | 0.3% |

For the nine months ended September 30, 2012, we incurred interest expense of \$1.1 million compared to \$0.9 million in the nine months ended September 30, 2011. For the nine months ended September 30, 2012, there was a loss of \$0.1 million related to the change in fair value of liability classified common stock warrants compared to a gain of \$1.1 million in the nine months ended September 30, 2011. The nine months ended September 30, 2012 included a \$0.5 million exchange loss related primarily to changes in value of the Canadian dollar in relation to the U.S. dollar as compared to a loss of \$0.2 million in the nine months ended September 30, 2011.

Net loss

For the foregoing reasons, we had a net loss of \$6.9 million for the nine months ended September 30, 2012 compared to a net loss of \$7.8 million for the nine months ended September 30, 2011. Excluding net income of \$0.1 million in the nine months ended September 30, 2012 from discontinued operations and net loss of \$0.2 million in the nine months ended September 30, 2011, we had a net loss from continuing operations of \$7.0 million for the nine months ended September 30, 2012 compared to a net loss from continuing operations of \$7.6 million for the nine months ended September 30, 2011. We continue to have legal and other expenses as well as gains on litigation settlements related to the 2009 divestiture of the assets of Applied Utility Systems. We record these activities as discontinued operations. For additional information relating to Applied Utility Systems, see Note 17 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011.

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Liquidity and Capital Resources

Historically, the revenue that we have generated has not been sufficient to fund our operating requirements and debt servicing needs. Notably, we have suffered recurring losses since inception. As of September 30, 2012, we had an accumulated deficit of approximately \$171.8 million compared to \$165.0 million at December 31, 2011. We have also had negative cash flows from operations from inception through the year ended December 31, 2011. For the nine months ended September 30, 2012, we generated cash flows from operations of \$0.8 million. We had \$7.6 million in cash and cash equivalents at September 30, 2012 compared to \$3.5 million in cash and cash equivalents at December 31, 2011, and total current liabilities of \$19.8 million at September 30, 2012 compared to \$15.8 million at December 31, 2011.

Our primary sources of liquidity in recent years have been asset sales, credit facilities and other borrowings and equity sales. We took several steps in 2011 to improve our liquidity position. In February 2011, we entered into a \$7.5 million secured demand financing facility with FGI backed by our receivables and inventory and repaid our previous demand facility with Fifth Third Bank. On August 15, 2012, the FGI Facility was amended and the initial term was extended from February 14, 2013 to August 15, 2015 and may be extended at the Company's option for additional one-year terms. For details on the amendment of the FGI facility, see —Description of Indebtedness below and Note 7 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q. At September 30, 2012, we had \$5.1 million in borrowings outstanding with \$2.4 million available under our FGI credit facility, subject to the availability of eligible accounts receivable and inventory balances for collateral. In May 2011, we issued \$3.0 million of our 8% subordinated convertible notes to a shareholder. Additionally, on July 5, 2011, we closed a public offering in which we sold 3,053,750 shares of common stock and received \$10.2 million in net proceeds from the offering after deducting underwriting discounts and commissions and offering expenses.

We continue to pursue revenue generating opportunities relating to special government mandated retrofit programs in California and potentially others in various jurisdictions domestically and internationally. Opportunities such as these require cash investment in operating expenses and working capital such as inventory and receivables prior to realizing profits and cash from sales. To address the potential need for capital, in October 2011, we signed a purchase agreement, together with a registration rights agreement, with LPC, whereby LPC has agreed to purchase up to \$10.0 million of our common stock over a 30-month period. We have registered 1,823,577 shares related to the transaction, 40,247 shares of which were issued to LPC as a commitment fee; 80,494 shares may be issued to LPC as an additional commitment fee on a pro rata basis as up to \$10.0 million of our common stock is purchased by LPC; and 1,702,836 represent shares that we may sell to LPC under the Purchase Agreement. We have the right, in our sole discretion, over a 30-month period to sell shares of our common stock to LPC in amounts of up to \$0.5 million to up to \$1.5 million per sale, depending on certain conditions as set forth in the Purchase Agreement, up to the aggregate amount of \$10.0 million. Assuming a purchase price of \$2.65 per share (the closing sale price of our common stock on November 7, 2012) and the purchase by LPC of the full 1,702,836 currently registered purchase shares, proceeds to us would be \$4.5 million. We expect to use the proceeds received under the Purchase Agreement for working capital and general corporate purposes. There have been no sales to date under this arrangement.

In addition, on May 15, 2012, we filed a shelf registration statement on Form S-3 with the SEC (the "Shelf Registration"). The Shelf Registration was declared effective by the SEC on May 21, 2012. The shelf registration statement permits us to sell, from time to time, up to an aggregate of \$50.0 million of various securities, including common stock, preferred stock, warrants to purchase common stock or preferred stock and units consisting of one or more shares of common stock, shares of preferred stock, warrants, or any combination of such securities. The registration statement is intended to provide us with additional flexibility to access capital markets for general

corporate purposes, subject to market conditions and our capital needs.

On July 27, 2012, we entered into a Loan Commitment Letter with Kanis S.A. pursuant to which we issued a promissory note in the principal amount of \$3.0 million. The promissory note bears interest at 8% per annum which is payable quarterly in arrears and matures on July 27, 2015. See —Description of Indebtedness below and Note 7 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

Due to actions taken to improve our liquidity, including the proceeds from the note issued in July 2012 and availability with FGI and LPC, as discussed above, management believes that we will have access to sufficient working capital to sustain operations through at least the next twelve months. However, no assurances can be provided that we will have sufficient cash and credit to sustain operations or that we will, if necessary, be able to raise additional capital or reduce discretionary spending to provide the required liquidity. In the meantime, we intend to continue to manage our cash in a manner designed to ensure that we have adequate cash and cash equivalents to fund our operations for the foreseeable future.

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The following table summarizes our cash flows for the periods indicated.

| | 2012 | Nine Months Ended September 30, | | |
|-----------------------------|-------------|--|------------------|-----------------|
| | | 2011 | \$ Change | % Change |
| | | (Dollars in millions) | | |
| Cash provided by (used in): | | | | |
| Operating activities | \$ 0.8 | \$ (13.5) | \$ 14.3 | 106.1% |
| Investing activities | \$ (0.1) | \$ (0.4) | \$ 0.3 | 71.8% |
| Financing activities | \$ 3.4 | \$ 13.6 | \$ (10.2) | (75.0)% |

Cash provided by (used in) operating activities

Our largest source of operating cash flows is cash collections from our customers following the sale of our products and services. Our primary uses of cash for operating activities are for purchasing inventory in support of the products that we sell, personnel related expenditures, facilities costs and payments for general operating matters.

Cash provided by operating activities in the nine months ended September 30, 2012 was \$0.8 million, an increase of \$14.3 million from the nine months ended June 30, 2011, when our operating activities used \$13.5 million of cash. The increase in cash provided by operations was due to a \$13.6 million increase in cash provided related to the change in net operating assets and liabilities, \$0.5 million decrease in net loss from continuing operations, after giving consideration to non-cash operating items, and \$0.2 million increase in cash provided by discontinued operations. Non-cash operating items in both periods include depreciation and amortization, stock-based compensation, the change in valuation of liability-classified warrants, non-cash interest expense and foreign exchange gain or loss and amortization of deferred financing costs. The decrease in net loss from continuing operations was primarily due to an increase in product sales and lower operating expense partially offset by lower margins related to product sales mix in the Heavy Duty Diesel division, the impact of rare earth price increases in the Catalyst division and the write-down of inventory related to the London LEZ program. Cash provided related to the change in net operating assets and liabilities was \$6.0 million in the nine months ended September 30, 2012 as compared to \$7.6 million in cash used related to changes in net operating assets and liabilities in the nine months ended September 30, 2011. The increase in cash provided is primarily due to a \$9.4 million increase in cash provided related to the change in inventories primarily due to the decline in the London LEZ project and to a \$8.3 million increase in cash provided related to the change in accounts receivable due primarily to collections on fourth quarter 2011 sales in the Heavy Duty Diesel Systems business partially offset by a \$3.8 million decrease in cash provided related to the change in accounts payable due to the wind down of the London LEZ project and timing of purchases of key raw materials.

Cash used in investing activities

Our cash flows from investing activities primarily relate to asset sales and acquisitions, our Asian investment as well as capital expenditures and other assets to support our growth plans.

Net cash used in investing activities was \$0.1 million in the nine months ended September 30, 2012 compared to cash used of \$0.4 million in the nine months ended September 30, 2011. Cash used in investing activities in the nine months ended September 30, 2012 and 2011 relates primarily to purchases of property and equipment.

Cash provided by financing activities

Since inception, we have financed our net operating cash usage through a combination of financing activities such as issuance of equity or debt and investing activities such as sale of intellectual property or other assets. Changes in our cash flows from financing activities primarily relate to borrowings and payments under debt obligations.

Net cash provided by financing activities was \$3.4 million in the nine months ended September 30, 2012, compared to cash provided of \$13.6 million in the nine months ended September 30, 2011. Cash provided by financing activities in the nine months ended September 30, 2012 includes proceeds of \$3.0 million on the issuance of 8% notes and to the net increase in borrowings under our line of credit with FGI. Cash provided by financing activities in the nine months ended September 30, 2011 includes net proceeds of \$10.2 million from the issuance of common stock in a public offering, proceeds of \$3.0 million on the issuance of secured convertible notes, \$1.7 million in increased borrowings under credit facilities and \$0.4 million in proceeds from the exercise of common stock warrants, all of which were partially offset by \$1.6 million in payment of a settlement obligation pursuant to the October 20, 2010 settlement agreement with respect to litigation and other disputes in connection with our purchase of AUS assets in August 2006, and the payment of \$0.1 million in debt issuance costs.

Table of Contents**Description of Indebtedness**

Our outstanding borrowings at September 30, 2012 and December 31, 2011 are as follows:

| | September 30, | December 31, |
|--|------------------------------|---------------------|
| | 2012 | 2011 |
| | (Dollars in millions) | |
| Line of credit with FGI | \$ 5.1 | \$ 4.5 |
| 6% shareholder note due 2013 | 1.6 | 1.5 |
| 8% subordinated convertible shareholder notes due 2016 | 3.0 | 3.0 |
| 8% shareholder note due 2015 | 2.9 | |
| Capital lease obligation | | 0.1 |
| | \$ 12.6 | \$ 9.1 |

Line of Credit with FGI

On February 14, 2011, we and certain of our subsidiaries (the “Credit Subsidiaries”) entered into separate Sale and Security Agreements with FGI to provide for a \$7.5 million secured demand facility backed by our receivables and inventory (the “FGI Facility”). We and the Credit Subsidiaries also entered into guarantees to guarantee the performance of their obligations under the Sale and Security Agreements. We also granted FGI a first lien collateral interest in substantially all of our assets. On August 15, 2012, we and FGI agreed to amend the FGI Facility. As amended, the initial term was extended from February 14, 2013 to August 15, 2015 and may be extended at our option for additional one-year terms.

Under the FGI facility, as amended, FGI can elect to purchase eligible accounts receivables from us and the Credit Subsidiaries at up to 80% of the value of such receivables (retaining a 20% reserve). At FGI’s election, FGI may advance us up to 80% of the value of any purchased accounts receivable, subject to the \$7.5 million limit. Reserves retained by FGI on any purchased receivable are expected to be refunded to us net of interest and fees on advances once the receivables are collected from customers. We may also borrow against eligible inventory up to the inventory sublimit as determined by FGI subject to the aggregate \$7.5 million limit under the FGI Facility and certain other conditions. Pursuant to the amendment, the inventory sublimit amount was increased from \$1.0 million to the lesser of \$2.0 million or 50% of the aggregate purchase price paid for accounts receivable purchased under the FGI facility.

Under the amendment, the interest rate on advances or borrowings under the FGI Facility was reduced from the greater of (i) 7.50% per annum and (ii) 2.50% per annum above the Wall Street Journal “prime rate” to the greater of (i) 6.50% per annum and (ii) 2.50% per annum above the prime rate, as defined. Any advances or borrowings under the FGI Facility are due on demand. We also agreed to pay FGI collateral management fees. As amended, the monthly

collateral fees were reduced from 0.44% to 0.30% per month on the face amount of eligible receivables as to which advances have been made and from 0.55% to 0.38% per month on borrowings against inventory, if any. At any time outstanding advances or borrowings under the FGI facility are less than \$2.4 million, we agreed to pay FGI standby fees of (i) the interest rate on the difference between \$2.4 million and the average outstanding amounts and (ii) 0.44% per month on 80% of the amount by which our advances or borrowings are less than the agreed \$2.4 million minimum.

We account for the sale of accounts receivable under the FGI facility as a secured borrowing with a pledge of the subject receivables as collateral. At September 30, 2012, we had \$4.5 million of gross accounts receivable pledged to FGI as collateral for short-term debt in the amount of \$3.5 million. At September 30, 2012, we also had \$1.6 million in borrowings outstanding against eligible inventory. We were in compliance with the terms of the FGI Facility at September 30, 2012.

We paid FGI a one-time facility fee of \$75,000 upon entry into the FGI Facility and \$75,000 upon amending the FGI facility. Also, if we terminate the FGI facility prior to the last day of the initial term, as extended, or any additional term, we must pay a termination fee of 2% of the facility limit then in effect. No termination fee will be due if we notify FGI of our intent to terminate within 10 days of FGI increasing the reserve percentage for accounts to greater than 40% for more than 30 consecutive days. FGI may terminate the facility at any time. As such, the facility and amendment fees were expensed when incurred. The termination fee is not payable upon a termination by FGI or upon non-renewal.

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6% Shareholder Note Due 2013

On December 30, 2010, we executed a Loan Commitment Letter with Kanis S.A., a shareholder of our company, pursuant to which Kanis S.A. loaned us \$1.5 million. The unsecured loan bears interest on the unpaid principal at a rate of 6% per annum, with interest only payable quarterly on each March 31, June 30, September 30 and December 31, commencing March 31, 2011 and matures on June 30, 2013. In addition to principal and accrued interest, we are obligated to pay Kanis S.A. at maturity a "Payment Premium" ranging from \$0.1 million to \$0.2 million based proportionally on the number of days that the loan remains outstanding. There is no prepayment penalty.

In connection with the loan, we issued Kanis S.A. warrants to acquire 25,000 shares of our common stock at \$10.40 per share. These warrants are exercisable on or after June 30, 2013 and expire on the earlier of (x) June 30, 2016 and (y) the date that is 30 days after we give notice to the warrant holder that the market value of one share of our common stock has exceeded 130% of the exercise price of the warrant for 10 consecutive days, which 10 consecutive days commence on or after June 30, 2013. We have recorded the relative estimated fair value of these warrants as a discount from the loan amount and are amortizing the discount using the effective interest method over the term of the loan.

8% Subordinated Convertible Notes Due 2016

On May 6, 2011, we issued to Kanis S.A. \$3.0 million aggregate principal amount of our subordinated convertible notes. The notes bear interest at a rate of 8% per annum, which is payable quarterly in arrears. The notes have a stated maturity of five years from the date of issuance. The original agreement allowed for the acceleration of the maturity of the notes if: (i) we were in breach of the notes or other agreements with Kanis S.A., or (ii) Kanis S.A. provided written notice, not less than 30 days prior to such date, that it elected to accelerate the maturity to a date not earlier than November 11, 2012. On February 16, 2012, the agreement was amended to modify the early redemption date from November 11, 2012 to May 12, 2013.

We may be required to redeem all or a portion of the notes at any time on or after May 12, 2013 on not less than 30 days prior written notice at a purchase price in cash equal to 100% of the principal amount of the notes to be purchased plus any accrued but unpaid interest through the date of redemption. We also have the option to redeem the notes at any time at a price equal to 100% of the face amount plus accrued and unpaid interest through the date of redemption. There is no prepayment penalty. We used the net proceeds from the sale of the notes for general working capital purposes. The subordinated convertible notes are unsecured obligations and are subordinated to our existing and future secured indebtedness.

On July 27, 2012, the Company and Kanis S.A. further amended the terms of the Notes to modify the conversion feature. As amended, the outstanding principal balance of, and accrued and unpaid interest on, the Notes are convertible, at the option of Kanis S.A. at any time upon written notice given not less than 75 calendar days prior to the date of conversion, into no more than 250,000 shares of Company common stock at a conversion price of \$4.00 per share. See Note 13 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q.

In connection with the February 16, 2012 amendment, we issued to Kanis S.A., warrants to acquire 5,000 shares of our common stock at \$3.80 per share. The warrants are exercisable on or after August 16, 2014 and expire on the

earlier of (x) August 16, 2017 and (y) that date that is 30 days after we give notice to the warrant holder that the market value of one share of our common stock has exceeded 130% of the exercise price of the warrant for 10 consecutive days, which 10 consecutive days commence on or after August 16, 2014. We did not receive any cash consideration for the issuance of the warrants. We relied on the private placement exemption provided by Regulation S.

8% Shareholder Note Due 2015

On July 27, 2012, we executed a Loan Commitment Letter with Kanis S.A., pursuant to which we issued a promissory note in the principal amount of \$3.0 million. The unsecured promissory note bears interest at 8% per annum, payable quarterly in arrears. The promissory note has a stated maturity of three years from the date of issuance. There is no prepayment penalty or premium.

In connection with the issuance of the promissory note, on July 27, 2012, we issued Kanis S.A. a warrant to acquire 45,000 shares of our common stock at \$2.09 per share, a third of which became exercisable on the issuance date and the remainder will vest as to one third on each of the first and second anniversaries of the issuance date. This warrant expires on July 27, 2018. We did not receive any cash consideration for the issuance of this warrant, which was issued in reliance upon the private placement exemption provided by Regulation S.

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Capital Expenditures

As of September 30, 2012, we had no commitments for capital expenditures and no material commitments are anticipated in the near future.

Off-Balance Sheet Arrangements

As of September 30, 2012 and December 31, 2011, we had no off-balance sheet arrangements.

Commitments and Contingencies

As of September 30, 2012 and December 31, 2011, other than office leases, employment agreements with key executive officers and the obligation to fund our portion (5%) of the losses of our investment in TCC (see Note 16 to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2011), we had no material commitments other than the liabilities reflected in our consolidated financial statement included elsewhere in this Quarterly Report on Form 10-Q).

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

In evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective, at the reasonable assurance level, as of the end of the period covered by this report to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 (1) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (2) is accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting during the period covered by this Quarterly Report on Form 10-Q.

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PART II—OTHER INFORMATION

Item 1. Legal Proceedings

There have been no material developments in our legal proceedings since the legal proceedings reported in Item 3 of our Annual Report on Form 10-K for the year ended December 31, 2011.

Item 1A. Risk Factors

Not applicable.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

| No. | Description |
|------------|--|
| 3.1 | Restated Certificate of Incorporation of Clean Diesel (incorporated by reference to Exhibit 3(i)(a) to Clean Diesel's Annual report on Form 10-K for the year ended December 31, 2006 and filed on March 30, 2007). |
| 3.2 | Certificate of Amendment of Restated Certificate of Incorporation (incorporated by reference to Exhibit 3(i)(b) to Clean Diesel's Registration Statement on Form S-1 (No. 333-144201) dated on June 29, 2007). |
| 3.3 | Certificate of Amendment of Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.3 to Clean Diesel's Post-Effective Amendment No. 1 to Form S-4 on Form S-3 (No. 333-166865) filed on November 10, 2010). |

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- 3.4 Certificate of Amendment of Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to Clean Diesel's Current Report on Form 8-K filed on May 24, 2012).
- 3.5 By-Laws of Clean Diesel as amended through November 6, 2008 (incorporated by reference to Exhibit 3.1 to Clean Diesel's Quarterly Report on Form 10-Q filed on November 10, 2008).
- 10.1 Loan Commitment Letter dated July 27, 2012 between Kanis S.A. and Clean Diesel (incorporated by reference to Exhibit 10.1 to Clean Diesel's Current Report on Form 8-K filed on August 2, 2012).
- 10.2 Form of \$3,000,000 Promissory Note dated July 27, 2012 between Kanis S.A. and Clean Diesel (included as Exhibit 10.2 to Clean Diesel's Current Report on Form 8-K filed on August 2, 2012).
- 10.3 Second Amendment of 8% Subordinated Convertible Promissory Note dated July 27, 2012 between Kanis S.A. and Clean Diesel (incorporated by reference to Exhibit 10.3 to Clean Diesel's Current Report on Form 8-K filed on August 2, 2012).
- 10.4 Form of Warrant issued to Kanis S.A. dated July 27, 2012 (incorporated by reference to Exhibit 10.4 to Clean Diesel's Current Report on Form 8-K filed on August 2, 2012).
- 10.5 Omnibus Amendment to Sale of Accounts and Security Agreements and Guaranty Agreement dated August 15, 2012 among Clean Diesel, certain of its subsidiaries and Faunus Group International, Inc. (incorporated by reference to Exhibit 10.1 to Clean Diesel's Current Report on Form 8-K filed on August 21, 2012).
- 31.1* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32** Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS**+ XBRL Instance Document.
- 101.SCH**+ XBRL Taxonomy Extension Schema Document.
- 101.CAL**+ XBRL Taxonomy Extension Calculation Linkbase Document.
- 101.DEF**+ XBRL Taxonomy Extension Definition Linkbase Document.
- 101.LAB**+ XBRL Taxonomy Extension Label Linkbase Document.
- 101.PRE**+ XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith

** Furnished herewith

** + Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933,

as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

CLEAN DIESEL TECHNOLOGIES, INC.

(Registrant)

Date: November 13, 2012

By: /s/ R. Craig Breese
R. Craig Breese
Director and Chief Executive Officer

Date: November 13, 2012

By: /s/ Nikhil A. Mehta
Nikhil A. Mehta
Chief Financial Officer and Treasurer