

SMARTHEAT INC.  
Form 10-Q  
August 11, 2009

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2009

OR

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

Commission file number 000-53052

SMARTHEAT INC.  
(Exact name of registrant as specified in its charter)

NEVADA  
(State or other jurisdiction of  
incorporation or organization)

98-0514768  
(IRS Employer  
Identification No.)

A-1, 10, Street 7  
Shenyang Economic and Technological Development Zone  
Shenyang, China  
110027  
(Address of principal executive offices, including zip code.)

+86 (24) 2519-7699  
(telephone number, including area code)

(Former name or former address, if changed since last report)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the last 90 days. 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 definitions of "large accelerated filer," "accelerated filer," "non-accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer   
Non-accelerated filer

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 24,179,900 shares as of Aug 10, 2009.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

SMARTHEAT, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

	AS OF JUNE 30, 2009 (UNAUDITED)	AS OF DECEMBER 31, 2008
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash & cash equivalents	\$ 2,408,714	\$ 1,435,212
Restricted cash	933,312	462,048
Accounts receivable, net	8,997,822	11,390,169
Retentions receivable	357,683	290,852
Advances to suppliers	2,909,069	412,524
Other receivables, prepayments and deposits	1,366,965	698,834
Inventories	8,220,181	6,107,583
Note receivable - bank acceptance	14,637	14,631
<b>Total current assets</b>	<b>25,208,383</b>	<b>20,811,853</b>
<b>NON-CURRENT ASSETS</b>		
Restricted cash	23,345	219,472
Accounts receivable, net	740,116	310,810
Retentions receivable	1,420,830	166,912
Intangible assets, net	4,179,143	1,155,131
Property and equipment, net	7,363,041	2,436,553
<b>Total noncurrent assets</b>	<b>13,726,475</b>	<b>4,288,878</b>
<b>TOTAL ASSETS</b>	<b>\$ 38,934,858</b>	<b>\$ 25,100,731</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Accounts payable	\$ 1,620,935	\$ 1,210,906
Unearned revenue	1,691,800	850,408
Notes payable - bank acceptance	762,710	-
Taxes payable	559,085	1,327,775
Accrued liabilities and other payables	5,968,709	1,330,812
Due to minority shareholder	-	5,303
Loans payable	5,562,142	2,443,450

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Total current liabilities	16,165,381	7,168,654
OTHER PAYABLES - NONCURRENT	1,200,586	-
DEFERRED TAX LIABILITY	23,488	38,854
<b>COMMITMENTS AND CONTINGENCIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$0.001 par value; 75,000,000 shares authorized, 24,179,900 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively	24,180	24,180
Paid in capital	8,223,671	8,223,453
Statutory reserve	1,530,781	1,150,542
Accumulated other comprehensive income	997,772	984,629
Retained earnings	10,768,999	7,510,419
Total stockholders' equity	21,545,403	17,893,223
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 38,934,858	\$ 25,100,731

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

SMARTHEAT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME  
(UNAUDITED)

	FOR THE SIX MONTHS ENDED JUNE 30, 2009		FOR THE THREE MONTHS ENDED JUNE 30, 2008	
	2009	2008	2009	2008
Net sales	\$ 18,705,898	\$ 8,637,283	\$ 12,498,395	\$ 5,558,232
Cost of goods sold	11,874,903	6,228,156	7,973,956	4,115,200
Gross profit	6,830,995	2,409,127	4,524,439	1,443,032
Operating expenses				
Selling expenses	1,159,532	608,028	698,619	410,607
General and administrative expenses	1,340,132	446,470	770,610	162,325
Total operating expenses	2,499,664	1,054,498	1,469,229	572,932
Income from operations	4,331,331	1,354,629	3,055,210	870,100
Non-operating income (expenses)				
Interest income	80,421	260,683	63,740	113,545
Interest expense	(117,612)	(163,040)	(64,760)	(96,412)
Subsidy income	35,340	9,141	35,340	9,141
Other expense	(11,199)	-	(10,119)	(2,891)
Other income	969	8,290	969	-
Total non-operating income (expenses)	(12,081)	115,074	25,170	23,383
Income before income tax	4,319,250	1,469,703	3,080,380	893,483
Income tax expense	680,432	266,028	462,831	161,071
Net income	3,638,818	1,203,675	2,617,549	732,412
Other comprehensive item				
Foreign currency translation	13,143	410,896	11,433	168,802
Comprehensive Income	\$ 3,651,961	1,614,571	\$ 2,628,982	\$ 901,214
Basic weighted average shares outstanding	24,179,900	20,213,419	24,179,900	21,926,838
Diluted weighted average shares outstanding	24,191,063	20,213,419	24,206,099	21,926,838

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Basic earnings per share	\$	0.15	\$	0.06	\$	0.11	\$	0.03
Diluted earnings per share	\$	0.15	\$	0.06	\$	0.11	\$	0.03

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

SMARTHEAT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	FOR THE SIX MONTHS ENDED JUNE 30,	
	2009	2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 3,638,818	\$ 1,203,675
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	194,027	104,038
Unearned interest on accounts receivable	68,292	(22,366)
Stock option compensation expense	218	-
Decrease in deferred tax liability	(15,380)	-
(Increase) decrease in current assets:		
Accounts receivable	1,349,607	(1,803,120)
Retentions receivable	(1,320,413)	346,914
Advances to suppliers	(2,487,309)	(1,888,198)
Other receivables, prepayments and deposits	(1,468,178)	(277,990)
Inventories	(2,109,938)	2,874,481
Increase (decrease) in current liabilities:		
Accounts payable	1,721,658	1,358,223
Unearned revenue	840,957	(1,709,100)
Taxes payable	(769,124)	(167,960)
Accrued liabilities and other payables	226,202	423,418
Net cash (used in) provided by operating activities	(130,563)	442,015
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Restricted cash	(274,835)	(229,833)
Construction in progress	-	(39,549)
Acquisition of property & equipment	(239,005)	(119,299)
Net cash used in investing activities	(513,840)	(388,681)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Payment of assets acquisition liability	(1,500,139)	-
Repayment to shareholder	-	(44,862)
Proceeds from (Repayment to) short term loans	3,117,362	(213,152)
Net cash provided by (used in) financing activities	1,617,223	(258,014)
EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS	682	19,028
NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS	973,502	(185,652)
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD	1,435,212	393,147



CASH & CASH EQUIVALENTS, END OF PERIOD	\$	2,408,714	\$	207,495
Supplemental Cash flow data:				
Income tax paid	\$	995,787	\$	197,756
Interest paid	\$	121,259	\$	87,887

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

SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
JUNE 30, 2009 (UNAUDITED) AND DECEMBER 31, 2008

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

SmartHeat Inc., formerly known as Pacific Goldrim Resources, Inc. (the "Company" or "SmartHeat"), was incorporated on August 4, 2006 in the State of Nevada. The Company is engaged in the manufacturing and sale of plate heat exchangers and various packages, thermometer testing devices and heat usage calculators through its wholly owned operating subsidiaries in China.

On April 14, 2008, the Company entered into a Share Exchange Agreement with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu") and the Taiyu Shareholders. The Company issued 18,500,000 shares of its common stock to the shareholder of Taiyu in exchange for all of the equitable and legal rights, title and interests in and to Taiyu's share capital of RMB 25,000,000. Concurrent with the share exchange, one of SmartHeat's shareholders cancelled 2,500,000 shares out of 6,549,900 of total issued and outstanding shares of SmartHeat pursuant to the Split-Off Agreement dated April 14, 2008. As a result of the share exchange and the cancellation of the 2,500,000 shares of the Company's common stock, there were 22,549,900 shares of the Company's common stock issued and outstanding, 82.04% of which was held by the former Taiyu Shareholders. The shareholders of the Company immediately prior to the completion of these transactions held the remaining 17.96% of the issued and outstanding share capital of SmartHeat. Taiyu became a wholly-owned subsidiary of SmartHeat.

Prior to the acquisition of Taiyu, the Company was a non-operating public shell. Pursuant to Securities and Exchange Commission ("SEC") rules, the merger or acquisition of a private operating company into a non-operating public shell with nominal net assets is considered a capital transaction, rather than a business combination. Accordingly, for accounting purposes, the transaction was treated as a reverse acquisition and a recapitalization, and pro-forma information is not presented. Transaction costs incurred in the reverse acquisition were charged to expense.

Taiyu was incorporated in the Liaoning Province, People's Republic of China ("PRC" or "China") in July, 2002. Taiyu is engaged in manufacturing and sale of plate heat exchangers and various packages, thermo meter testing devices and heat usage calculators. The Company is an authorized dealer of the SONDEX brand; SONDEX is the second largest plate heat exchanger manufacturer in the world.

On September 25, 2008, the Company entered into a Share Exchange Agreement (the "Agreement") between Asialink (Far East) Limited ("Asialink") and the Company providing for the acquisition by the Company from Asialink of all of the outstanding capital stock of SanDeKe Co., Ltd., a Shanghai based manufacturer of heat plate exchangers ("SanDeKe"). The purchase price for the SanDeKe shares was \$741,516. Under the terms of the Agreement, two of the shareholders of SanDeKe agreed not to compete with the business of SanDeKe for four years after the completion of the purchase.

On June 12, 2009, the Company incorporated a new subsidiary SmartHeat Siping Beifang Energy Technology Co., Ltd ("SmartHeat Siping") for the manufacturing of heat exchangers.

On June 16, 2009, Taiyu closed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd ("Siping"), a company organized under the laws of the PRC, to purchase certain assets consisting of the plant and equipment and certain land use rights for a purchase price of 54,000,000 RMB, or USD 7,906,296. Taiyu then transferred all the assets acquired to SmartHeat Siping, the newly incorporated subsidiary. The purchase consideration is non-interest bearing and payable according to the following schedule:



SMARTHEAT INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Payment in RMB	Payment in USD	Payment Date
RMB 3,000,000	\$ 439,239	May 27, 2009
RMB 10,250,000	\$ 1,500,732	June 30, 2009
RMB 13,000,000	\$ 1,903,367	September 30, 2009
RMB 12,300,000	\$ 1,800,878	March 1, 2010
RMB 8,200,000	\$ 1,200,586	September 30, 2010

At June 30, 2009, the Company paid RMB 10,250,000 or \$1,500,732. This payment includes the first payment of RMB 3,000,000 or \$439,239 and the balance of RMB 7,250,000 or \$1,061,500 is applied towards the second payment. The Company recorded RMB 8,200,000 or \$1,200,586 as part of other payable - non current. The payment terms does not include any default provision.

The unaudited financial statements have been prepared by the Company, pursuant to the rules and regulations of the SEC. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments) which are, in the opinion of management, necessary to fairly present the operating results for the respective periods. Certain information and footnote disclosures normally present in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP") have been omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the 2008 audited financial statements and footnotes included in the Company's audited financial statements. The results for the six months ended June 30, 2009 are not necessarily indicative of the results to be expected for the full year ending December 31, 2009.

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, Taiyu, SanDeKe and SmartHeat Siping, a newly incorporated subsidiary in June, 2009. For purposes of this Quarterly Report, the "Company" refers collectively to SmartHeat, Taiyu, SanDeKe and Siping. All significant inter-company accounts and transactions have been eliminated in consolidation.

### Use of Estimates

In preparing the financial statements in conformity with US GAAP, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting year. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts, and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

### Cash and Cash Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of June 30, 2009, the Company maintained total restricted cash of \$956,657 in several bank accounts, \$580,369 representing cash deposits from customers for securing payment from customers that occurs no later than the warranty period expires, and \$376,288 representing the deposits the Company paid to a commercial bank for the bank issuing the bank acceptance to its vendors (see Note 10); of the total restricted cash, \$933,312 was cash that will be released to the Company within one year. As of December 31, 2008, the Company maintained total restricted cash of \$681,520, of which, \$462,048 was the cash that will be released to the Company within one year. Restricted cash is held in the interest bearing bank accounts.

SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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#### Accounts and Retentions Receivable

The Company's policy is to maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Based on historical collection activity, the Company had allowances of \$629,936 and \$629,687 at June 30, 2009 and December 31, 2008, respectively.

At June 30, 2009 and December 31, 2008, the Company had retentions receivable from customers for product quality assurance of \$1,778,513 and \$457,764, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from three months to two years depending on the shipping date of the products and the number of heating seasons that the warranty period covers.

Accounts receivable is net of unearned interest of \$96,838 and \$28,526 at June 30, 2009 and December 31, 2008, respectively. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at the Company's borrowing rate, currently 7.16%, and it was 7.04% in 2008.

#### Inventories

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

#### Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicles	5 years
Office Equipment	5 years
Production Equipment	5-10 years

#### Land Use Rights

Right to use land is stated at cost less accumulated amortization. Amortization is provided using the straight-line method over 50 years.

#### Impairment of Long-Lived Assets

Long-lived assets, which include property, plant and equipment and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recoverability of long-lived assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the assets. Fair value is generally determined using the asset's expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of June 30, 2009 and December 31, 2008, there were no significant impairments of its long-lived assets.

SMARTHEAT INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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### Warranties

The Company offers warranties to all customers on its products for one or two heating seasons depending on the terms negotiated with the customers. The Company accrues for warranty costs based on estimates of the costs that may be incurred under its warranty obligations. The warranty expense and related accrual is included in the Company's selling expenses and other payable respectively, and is recorded at the time revenue is recognized. Factors that affect the Company's warranty liability include the number of sold units, its estimates of anticipated rates of warranty claims, costs per claim and estimated support labor costs and the associated overhead. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

The Company's warranty reserve at June 30, 2009 and December 31, 2008 is as follows:

	For the Six Months Ended June 30, 2009	For the Year Ended December 31, 2008
Beginning balance	\$ -	\$ -
Provisions made	219,893	95,000
Actual costs incurred	(31,743)	(95,000)
Ending balance in current liabilities	\$ 188,150	\$ -

### Income Taxes

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company adopted the provisions of the Financial Accounting Standards Board's ("FASB") Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. As a result of the implementation of FIN 48, the Company made a comprehensive review of its portfolio of tax positions in accordance with recognition standards established by FIN 48. As a result of the implementation of Interpretation 48, the Company recognized no material adjustments to liabilities or shareholders' equity. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.





SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Interest associated with unrecognized tax benefits is classified as interest expense and penalties are classified as selling, general and administrative expense in the statements of income. The adoption of FIN 48 did not have a material impact on the Company's financial statements.

#### Revenue Recognition

The Company's revenue recognition policies are in compliance with SEC Staff Accounting Bulletin ("SAB") 104. Sales revenue is recognized when products are delivered and for PHE and PHE units, when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of the Company exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

The Company's sales contracts with the customers generally provide that 30% of the purchase price is due upon the placement of an order, 30% is due on delivery, 30% is due upon installation and acceptance of the equipment after customer testing, the final 10% of the purchase price is due on a date that is no later than the termination date of the standard warranty period.

Sales revenue represents the invoiced value of goods, net of value-added tax ("VAT"). All of the Company's products that are sold in the PRC are subject to Chinese value-added tax of 17% of the gross sales price. This VAT may be offset by VAT paid by the Company on raw materials and other materials included in the cost of producing their finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

Sales and purchases are recorded net of VAT collected and paid as the Company acts as an agent for the government. VAT taxes are not affected by the income tax holiday.

Sales returns and allowances were \$0 for both the six months ended June 30, 2009 and 2008. The Company does not provide right of return, price protection or any other concessions to its customers.

The standard warranty of the Company is provided to all customers and is not considered an additional service; rather it is considered an integral part of the product's sale. The Company believes that the existence of its standard product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 separation and allocation model for a multiple deliverable arrangement. SFAS 5 specifically address the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. The Company believes that accounting for its standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

The Company provides after sales services at a charge after expiration of the warranty period, with after sales services mainly consisting of cleaning plate heat exchangers and repairing and exchanging parts. The Company recognizes such revenue when service is provided. For the six months ended June 30, 2009 and 2008, revenue from after sales services after expiration of the warranty period was approximately \$3,700 and \$21,000. For the three months ended June 30, 2009 and 2008, revenue from after sales services after expiration of the warranty period was approximately \$1,500 and \$16,000, respectively.

#### Cost of Goods Sold

Cost of goods sold consists primarily of material costs, direct labor, and manufacturing overhead which are directly attributable to the production of products. Write-down of inventories to lower of cost or market is also recorded in cost of goods sold.

SMARTHEAT INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 JUNE 30, 2009 (UNAUDITED) AND DECEMBER 31, 2008

### Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of accounts receivable and other receivables. The Company does not require collateral or other security to support these receivables. The Company conducts periodic reviews of its clients' financial condition and customer payment practices to minimize collection risk on accounts receivable.

The operations of the Company are located in the PRC. Accordingly, the Company's business, financial condition, and results of operations may be influenced by the political, economic, and legal environments in the PRC, as well as by the general state of the PRC economy.

### Statement of Cash Flows

In accordance with SFAS No. 95, "Statement of Cash Flows," cash flows from the Company's operations are calculated based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows may not necessarily agree with changes in the corresponding balances on the balance sheet. The cash flows from operating, investing and financing activities exclude the effect of conversion from accounts payable to notes payable – bank acceptance in the amount of \$762,621 and assets purchased from Siping Manufacture in the amount of \$7,906,296 for the six months ended June 30, 2009.

### Basic and Diluted Earnings per Share (EPS)

Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is similarly computed, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted net earnings per share are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to have been exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

The following table presents a reconciliation of basic and diluted earnings per share:

	For the Six Months Ended June 30, (Unaudited)		For the Three Months Ended June 30, (Unaudited)	
	2009	2008	2009	2008
Net income	\$ 3,638,818	\$ 1,203,675	\$ 2,617,549	\$ 732,412
Weighted average shares outstanding - basic	24,179,900	20,213,419	24,179,900	21,926,838
Effect of dilutive securities:				
Unexercised warrants and options	11,163	—	26,199	—
Weighted average shares outstanding - diluted	24,191,063	20,213,419	24,206,099	21,926,838
Earnings per share - basic	\$ 0.15	\$ 0.06	\$ 0.11	\$ 0.03
Earnings per share - diluted	\$ 0.15	\$ 0.06	\$ 0.11	\$ 0.03

Fair Value of Financial Instruments

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires the Company disclose estimated fair values of financial instruments. The carrying amounts reported in the statements of financial position for current assets and current liabilities qualifying as financial instruments are a reasonable estimate of fair value.

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the Company's Chinese subsidiaries are maintained in the Chinese Yuan Renminbi (RMB) and the accounts of the U.S. parent company are maintained in the U.S. Dollar (USD). The accounts of the Chinese subsidiaries were translated into USD in accordance with SFAS No. 52, "Foreign Currency Translation," with the RMB as the functional currency for the Chinese subsidiaries. According to the Statement, all assets and liabilities were translated at the exchange rate on the balance sheet date, stockholders' equity are translated at the historical rates and statement of operations items are translated at the weighted average exchange rate for the year. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income".

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with SFAS No. 123R, "Share-Based Payment, an Amendment of FASB Statement No. 123." The Company recognizes in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees.

Segment Reporting

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company.

SFAS 131 has no effect on the Company's financial statements as substantially all of the Company's operations are conducted in one industry segment. All of the Company's assets are located in the PRC.

Registration Rights Agreement

The Company accounts for payment arrangements under registration rights agreement in accordance with FASB Staff Position EITF 00-19-2, which requires that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies.

The Company is required to file the Registration Statement with the SEC within 60 days of the closing of the private placement offering. The Registration Statement must be declared effective by the SEC within 180 days of the final closing of the offering. Subject to certain grace periods, the Registration Statement must remain effective and available for use until the Investors can sell all of the securities covered by the Registration Statement without restriction pursuant to Rule 144. If the Company fails to meet the filing or effectiveness requirements of the Registration Statement, the Company is required to pay liquidated damages of 2% of the aggregate purchase price paid by such Investor for any Registrable Securities then held by such Investor on the date of such failure and on each anniversary of the date of such failure until such failure is cured. The last closing under the private placement occurred on September 24, 2008 and the 180 day period for effectiveness of the registration statement under the Registration Rights Agreement ended on March 23, 2009. At March 31, 2009, the Company became liable to pay

approximately \$110,000 liquidated damages to our investors as a result of failure to declare the effectiveness of the Registration Statement within 180 days of the final closing of the offering. The liquidated damage was recorded as the Company's G&A expense with charging corresponding account to accrued liabilities. The Registration Statement became effective on June 23, 2009.

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New Accounting Pronouncements

The FASB Accounting Standards Codifications

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting. SFAS 168 represents the last numbered standard to be issued by FASB under the old (pre-Codification) numbering system, and amends the GAAP hierarchy. On July 1, FASB will launch new FASB's Codification (full name: the FASB Accounting Standards Codification TM.) The Codification will supersede existing GAAP for nongovernmental entities; governmental entities will continue to follow standards issued by FASB's sister organization, the Governmental Accounting Standards Board (GASB). This pronouncement has no effect on the Company's financial statements.

Consolidation of Variable Interest Entities

In June 2009, the FASB issued SFAS No. 167, a revision to FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities, and will change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. Under SFAS No. 167, determining whether a company is required to consolidate an entity will be based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. SFAS 167 is effective at the start of a company's first fiscal year beginning after November 15, 2009, or January 1, 2010 for companies reporting earnings on a calendar-year basis.

Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

In June 2009, the FASB issued SFAS No. 166, a revision to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and will require more information about transferred of financial assets and where companies have continuing exposure to the risks related to transferred financial assets. SFAS 166 is effective at the start of a company's first fiscal year beginning after November 15, 2009, or January 1, 2010 for companies reporting earnings on a calendar-year basis.

Subsequent Events

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events" ("SFAS 165"). SFAS 165 is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009.

The Hierarchy of Generally Accepted Accounting Principles

In May 2008, FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 adoption did not have an impact on the Company's financial statements.





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#### Determination of the Useful Life of Intangible Assets

In April 2008, the FASB issued FASB Staff Position FAS 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP FAS 142-3"). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), and requires additional disclosures. The objective of FSP FAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (R), "Business Combinations" ("SFAS 141(R)"), and other accounting principles generally accepted in the USA. FSP FAS 142-3 applies to all intangible assets, whether acquired in a business combination or otherwise and shall be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The guidance for determining the useful life of intangible assets shall be applied prospectively to intangible assets acquired after the effective date. The disclosure requirements apply prospectively to all intangible assets recognized as of, and subsequent to, the effective date. Early adoption is prohibited. The adoption of FSP FAS 142-3 did not have a material impact on the Company's financial statements.

#### Disclosures about Derivative Instruments and Hedging Activities

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." This Statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS 161 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after November 15, 2008. The adoption of SFAS 161 did not have a material impact on the Company's financial statements.

#### Fair value of measurements

On January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements," SFAS 157 defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measurements. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

As of June 30, 2009, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at fair value.

#### Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51

In December 2007, FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company expects SFAS 160 will have an impact on accounting for business combinations, but the effect is dependent upon acquisitions at that time. The Company adopted the provisions of SFAS 160 on January 1, 2009.

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Business Combinations

SFAS 141 (Revised 2007), Business Combinations (SFAS 141(R)), is effective for the Company for business combinations for which the acquisition date is on or after January 1, 2009. SFAS 141(R) changes how the acquisition method is applied in accordance with SFAS 141. The primary revisions to this Statement require an acquirer in a business combination to measure assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at the acquisition date, at their fair values as of that date, with limited exceptions specified in the Statement. This Statement also requires the acquirer in a business combination achieved in stages to recognize the identifiable assets and liabilities, as well as the noncontrolling interest in the acquiree, at the full amounts of their fair values (or other amounts determined in accordance with the Statement). Assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date are to be measured at their acquisition-date fair values, and assets or liabilities arising from all other contingencies as of the acquisition date are to be measured at their acquisition-date fair value, only if it is more likely than not that they meet the definition of an asset or a liability in FASB Concepts Statement No. 6, Elements of Financial Statements. This Statement significantly amends other Statements and authoritative guidance, including FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method, and now requires the capitalization of research and development assets acquired in a business combination at their acquisition-date fair values, separately from goodwill. FASB Statement No. 109, Accounting for Income Taxes, was also amended by this Statement to require the acquirer to recognize changes in the amount of its deferred tax benefits that are recognizable because of a business combination either in income from continuing operations in the period of the combination or directly in contributed capital, depending on the circumstances. The Company expects SFAS 141R will have a significant impact on accounting for business combinations, but the effect is dependent upon acquisitions at that time. The Company adopted the provisions of SFAS 160 on January 1, 2009.

Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities

In June 2007, FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. EITF 07-03 is effective for fiscal years beginning after December 15, 2008. The adoption of EITF 07-03 did not have a significant impact on the Company's financial statements.

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3. INVENTORIES

Inventories at June 30, 2009 and December 31, 2008 were as follows:

	June 30, 2009	December 31, 2008
Raw materials	\$ 4,760,139	\$ 4,411,298
Work in process	1,601,767	652,472
Finished Goods	1,858,275	1,043,813
Total	\$ 8,220,181	