

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  
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### 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	\$ 6,107,583

### 4. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30, 2009 and December 31, 2008:

	June 30, 2009	December 31, 2008
Building	\$ 4,324,667	\$ 1,818,827
Production equipment	2,666,584	441,065
Office equipment	306,717	231,975
Vehicles	577,368	300,956
	7,875,336	2,792,823
Less: Accumulated depreciation	(512,296)	(356,270)
	\$ 7,363,041	\$ 2,436,553

Depreciation expense for the six months ended June 30, 2009 and 2008 was approximately \$111,000 and \$77,000, respectively. Depreciation expense for the three months ended June 30, 2009 and 2008 was approximately \$55,000 and \$39,000, respectively.

### 5. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at June 30, 2009 and December 31, 2008, respectively:

	June 30, 2009	December 31, 2008
Cash advance to third parties	\$ 407,866	\$ 89,628
Deposit for public bids of sales contracts	603,540	353,399
Prepayment for freight and related insurance expenses	102,082	95,888
Deposits	71,373	42,783
Advance to employees	182,104	117,136
Total	\$ 1,366,965	\$ 698,834

Cash advance to third parties was the short term cash advances to customers and vendors with repayment usually within three to six months. Deposits for public bidding represented the deposits for bidding expected contracts, which will be returned to the Company after the bidding process is completed unusually within three to four months from the

payment date. Prepayment for freight and /or related insurance expenses represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products. Deposits mainly consisted of deposits for rents and utilities. Cash advance to employees represented short term loan to employees and advance to employees for business trip and related expenses. Other receivables, prepayments and deposits are reimbursed or settled within 12 months.

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## 6. INTANGIBLE ASSETS

Intangible assets mainly consisted of land use rights, computer software, know-how technology, customer list and covenant not to compete. All land in the PRC is government owned and cannot be sold to any individual or company. However, the government grants the user a "land use right" to use the land. The Company acquired land use right during 2005 for approximately \$440,000 (RMB 3,549,682). The Company has the right to use the land for 50 years and is amortizing such rights on a straight-line basis for 50 years. The Company acquired another land use right of \$3,106,676 from Siping on June 16, 2009.

Intangible assets consisted of the following at June 30, 2009 and December 31, 2008, respectively:

	June 30, 2009	December 31, 2008
Land use rights	\$ 3,626,252	\$ 519,369
Know-how technology	266,913	266,808
Customer list	191,728	191,652
Covenant not to compete	104,299	104,258
Software	190,242	190,166
	4,379,433	1,272,253
Less: accumulated amortization	(200,290)	(117,122)
	\$ 4,179,143	\$ 1,155,131

Amortization expense of intangible assets for the six months ended June 30, 2009 and 2008 was approximately \$83,000 and \$26,000, respectively. Amortization expense for the three months ended June 30, 2009 and 2008 was approximately \$42,000 and \$15,000, respectively. Annual amortization expense for the next five years from June 30, 2009 is expected to be: \$242,000, \$242,000, \$242,000, \$242,000 and \$202,000.

## 7. MAJOR CUSTOMERS AND VENDORS

Three customers accounted for 21%, 14% and 10% of the Company's net revenue for the six months ended June 30, 2009 while one customer accounted for 19% of the Company's net revenue for the six months ended June 30, 2008. For the three months ended June 30, 2009, three customers accounted for about 32%, 21%, and 15% of the sales. For the three months ended June 30, 2008, one customer accounted for about 12% of the sales. At June 30, 2009 the total receivable balance due from these customers was approximately \$3,597,230.

There is no major vendor provided of the Company's purchases of raw materials for the six months and three months ended June 30, 2009 while two major vendors provided 44% and 27% of the Company's purchases of raw materials for the six months and three months ended June 30, 2008, respectively. The Company had approximately \$690,395 in accounts payable to these vendors at June 30, 2008.

## 8. TAXES PAYABLE

Taxes payable consisted of the following at June 30, 2009 and December 31, 2008:

June 30, 2009	December 31, 2008
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Income tax payable	\$	424,234	\$	723,958
Value added tax payable		131,204		597,676
Other taxes payable		3,647		6,141
	\$	559,085	\$	1,327,775

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#### 9. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at June 30, 2009 and December 31, 2008:

	June 30, 2009	December 31, 2008
Advance from third parties	\$ 88,000	\$ 453,625
Payable for purchase of SanDeKe	-	741,516
Payable for purchase of assets from SiPing – current portion	5,203,196	-
Other payables	322,020	99,418
Warranty reserve	188,151	-
Accrued liabilities	167,342	36,253
<b>Total</b>	<b>\$ 5,968,709</b>	<b>\$ 1,330,812</b>

Advance from third parties represented short term, non interest bearing advances from third parties. Other payables consisted of payables for the Company's miscellaneous expenses including postage, business insurance, employee benefits, bidding fee, etc. Accrued liabilities mainly consisted of accrued interest, payroll, utility, and liquidated damages for failure to declare the effectiveness of the Registration Statement within 180 days of the final closing of the offering.

#### 10. NOTES PAYABLE – BANK ACCEPTANCE

Notes payable represented accounts payable to vendors that were converted to notes payable accepted by the bank. The Company deposited a portion of the acceptance amount into the bank. The bank charged 2.5% of the face value of the note which is amortized over the term of the acceptance.

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## 11. LOANS PAYABLE

The Company was obligated for the following short term loans payable as of June 30, 2009 and December 31, 2008:

	June 30, 2009	December 31, 2008
Loans from a commercial bank in the PRC for 30,000,000 RMB. Of which, 17,000,000 RMB was entered into on April 22, 2009 and is due on April 22, 2010. 13,000,000 RMB was entered into on June 12, 2009 and is due on June 12, 2010. These loans currently bear interest at 5.576%. The Company pledged its building in the value of approximately RMB 12,430,950 or approximately \$1,818,000 for this loan.	\$ 4,391,165	\$ -
Loan from a commercial bank in the PRC for 6,000,000 RMB. This loan was entered into on Apr 28, 2007 and was due on Apr 12, 2008. This loan was renewed on Apr 12, 2008. The Company repaid loan in April, 2009.	-	877,886
The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10, 300,000 RMB. Some of the loans matured on various dates in 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% for 2009 and 2008. The Company repaid RMB 2,600,000 in 2008, RMB 2,700,000 in April, 2009, and had RMB 5,000,000 outstanding as of June 30, 2009, due on December 31, 2009 with interest of 8.591%.	731,861	1,126,621
The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB. This loan is renewed and due on December 31, 2009 with interest of 8.591%.	439,116	438,943
	\$ 5,562,142	\$ 2,443,450

## 12. DEFERRED TAX LIABILITY

Deferred tax liability represented differences between the tax bases and book bases of property and equipment and intangible assets arising from the acquisition of SanDeKe.

## 13. INCOME TAXES

The Company is subject to income taxes by entity on income arising in or derived from the tax jurisdiction in which each entity is domiciled.

SmartHeat was incorporated in the United States and has incurred net operating loss for income tax purposes. SmartHeat has net operating loss carry forwards for income taxes of approximately \$230,000 at June 30, 2009 which may be available to reduce future years' taxable income as NOL can be carried forward up to 20 years from the year the loss is incurred. Management believes that the realization of the benefits from these losses appears uncertain due to the Company's limited operating history and continuing losses. Accordingly, a 100% deferred tax asset valuation allowance has been provided.

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriated tax adjustments.

Taiyu, as a manufacturing business, is subject to 18% income tax rate for 2008 and 20% income tax rate for 2009. According to the new income tax law that became effective January 1, 2008, new high-tech enterprises that government gives special support are subject to income tax rate of 15%. Taiyu was recognized as a new high-tech enterprise and registered the status with tax bureau, therefore, enjoys the income tax rate of 15% from 2009 through 2010.

SanDeKe is subject to an 18% income tax rate after 7% reduction in federal income tax rate given by federal government. SanDeKe, is also exempt from income tax for two years starting from the 1st profitable year, and is entitled to a 50% discount on the 18% income tax rate for 2010 through 2012.

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The Company's net income for the six and three months ended June 30, 2009 would be lower by approximately \$191,000 or \$0.01 earnings per common share, and \$130,000 or \$0.0053 earnings per common share had Taiyu not enjoyed lower income tax rate and SanDeKe not been exempted from income tax for the six and three months ended June 30, 2009.

Foreign pretax earnings approximated \$4,436,000 and \$1,469,000 for the six months ended June 30, 2009 and 2008 respectively. Pretax earnings of a foreign subsidiary are subject to U.S. taxation when effectively repatriated. The Company provides income taxes on the undistributed earnings of non-U.S. subsidiaries except to the extent that such earnings are indefinitely invested outside the United States. At June 30, 2009, \$10,998,000 of accumulated undistributed earnings of non-U.S. subsidiaries was indefinitely invested. At the existing U.S. federal income tax rate, additional taxes of \$990,000 would have to be provided if such earnings were remitted currently.

The following table reconciles the U.S. statutory rates to the Company's effective tax rate for the six and three months ended June 30, 2009 and 2008:

	For the Six Months Ended		For the Three Months	
	June 30,		Ended June 30,	
	2009	2008	2009	2008
US statutory rates	34.0%	34.0%	34.0%	34.0%
Tax rate difference	(14.0)%	(16.0)%	(14.0)%	(16.0)%
Effect of tax holiday	(5.1)%	-	(5.0)%	-
Valuation allowance	0.9%	-	0.0%	-
Tax per financial statements	15.8%	18.0%	15.0%	18.0%

#### 14. STATUTORY RESERVES

Pursuant to the new corporate law of the PRC effective January 1, 2006, the Company is now only required to maintain one statutory reserve by appropriating from its after-tax profit before declaration or payment of dividends. The statutory reserve represents restricted retained earnings.

##### Surplus Reserve Fund

The Company is now only required to transfer 10% of its net income, as determined under PRC accounting rules and regulations, to a statutory surplus reserve fund until such reserve balance reaches 50% of the Company's registered capital.

The surplus reserve fund is non-distributable other than during liquidation and can be used to fund previous years' losses, if any, and may be utilized for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholding or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issue is not less than 25% of the registered capital.

##### Common Welfare Fund

The common welfare fund is a voluntary fund that provides that the Company can elect to transfer 5% to 10% of its net income to this fund. This fund can only be utilized on capital items for the collective benefit of the Company's employees, such as construction of dormitories, cafeteria facilities, and other staff welfare facilities. This fund is

non-distributable other than upon liquidation.

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## 15. STOCKHOLDERS' EQUITY

### Common Stock with Warrants Issued for Cash

In August 2008, the Company closed a private placement offering of Units pursuant to which SmartHeat sold 1,630,000 Units at \$3.50 per Unit for aggregate gross proceeds of approximately \$5.7 million. Each "Unit" consists of one share of SmartHeat common stock and a three year warrant to purchase 15% of one share of common stock at an exercise price of \$6.00 per share. The Units sold represent an aggregate of 1,630,000 million shares of common stock and warrants to purchase 244,500 shares of Common Stock. In connection with the private placement offering, the Company paid commission of approximately \$340,000 and issued warrants to purchase 148,500 shares of common stock to its placement agents. The warrants are immediately exercisable and expire on the third anniversary of their issuance. The warrants require the Company to settle in its own shares. There is no provision for cash settlement, except in lieu of fractional shares. Net proceeds of approximately \$5.1 million were received by the Company. The value of warrants was determined by using the Black-Scholes pricing model with the following assumptions: discount rate – 2.76%; dividend yield – 0%; expected volatility – 15% and term of 3 years. The value of the Warrants was \$70,246. There were no warrants exercised from the grant date to June 30, 2009.

### Stock Options to Independent Directors

On July 17, 2008, the Company granted non-statutory stock options to each of its two independent US directors. The terms of each option are: 10,000 shares at an exercise price per share of \$4.60, with a life of five years and vesting over three years as follows: 3,333 shares vest on July 17, 2009; 3,333 shares vest on July 17, 2010; and 3,334 shares vest on July 17, 2011, subject in each case to the director continuing to be associated with the Company as a director.

Based on the fair value method under SFAS No. 123 (Revised) "Share Based Payment" ("SFAS 123(R)"), the fair value of each stock option granted is estimated on the date of the grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model has assumptions for risk free interest rates, dividends, stock volatility and expected life of an option grant. The risk free interest rate is based upon market yields for United States Treasury debt securities at a maturity near the term remaining on the option. Dividend rates are based on the Company's dividend history. The stock volatility factor is based on the historical volatility of the Company's stock price. The expected life of an option grant is based on management's estimate. The fair value of each option grant to independent directors is calculated by the Black-Scholes method and is recognized as compensation expense over the vesting period of each stock option award. For stock options issued, the fair value was estimated at the date of grant using the following range of assumptions:

The options vest over three years and have a life of 5 years, volatility of 15%, risk free interest rate of 2.76%, and dividend yield of 0%. No estimate of forfeitures was made as the Company has a short history of granting options. There were no options exercised during the six months ended June 30, 2009.

Following is a summary of the warrant activity:

	Number of Shares	Average Exercise Price per Share	Weighed Average Remaining Contractual Term in Years
Outstanding at December 31, 2007	-		

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Exercisable at December 31, 2007	-			
Granted	393,000	\$	6.00	3.00
Exercised				
Forfeited				
Outstanding at December 31, 2008	393,000		6.00	2.51
Exercisable at December 31, 2008	393,000		6.00	2.51
Granted				
Exercised				
Forfeited				
Outstanding at June 30, 2009	393,000	\$	6.00	2.02
Exercisable at June 30, 2009	393,000	\$	6.00	2.02

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Following is a summary of the option activity:

	Number of Shares	Average Exercise Price per Share	Weighed Average Remaining Contractual Term in Years
Outstanding at December 31, 2007	-		
Exercisable at December 31, 2007	-		
Granted	20,000	\$ 4.60	5.00
Exercised			
Forfeited			
Outstanding at December 31, 2008	20,000	4.60	4.54
Exercisable at December 31, 2008	20,000	4.60	4.54
Granted			
Exercised			
Forfeited			
Outstanding at June 30, 2009	20,000	\$ 4.60	4.04
Exercisable at June 30, 2009	20,000	\$ 4.60	4.04

## 16. COMMITMENTS

### Employment Agreements

On January 1, 2008, the Company entered into a three year employment agreement with Mr. Jun Wang, which agreement may be renewed at the end of the initial term upon mutual agreement between Mr. Jun Wang and the Company. Either party shall give written notice to the other party of its intention not to renew the agreement at least 30 days prior to the end of the initial term. Pursuant to the terms of the employment agreement, Mr. Jun Wang shall receive a salary in an amount that is not less than the lowest minimum wage per month paid in Shenyang and shall be based on the uniform wage and incentive system in Shenyang, currently \$18,000 per annum. In addition, Mr. Jun Wang shall be entitled to overtime pay in accordance with the applicable law.

On January 1, 2008, The Company entered into a three year employment agreement with Ms. Zhijuan Guo, at terms identical to the terms of the employment agreement with Mr. Jun Wang with current salary of \$10,684 per annum.

### Lease agreements

The Company leased several offices for its sales representative in different cities under various one-year, non-cancellable, and renewable operating lease agreements. At June 30, 2009, future minimum rental payments required under these operating leases are as follows:

Year Ending June 30,	Amount
2010	\$ 87,000
2011	87,000
Total	\$ 174,000





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## 17. CONTINGENCIES

The Company sold goods to its customers and received Commercial Notes from the customers in lieu of accounts receivable. The Company discounts the Notes with the bank or endorses the Notes to vendors, which could be for payment of their own obligations or get cash from the third parties. Most of the Commercial Notes have maturity of less than six months.

At June 30, 2009 and December 31, 2008, the Company is contingently liable to vendors for endorsed notes receivable of \$14,637 and \$14,631, respectively.

The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

The Company's sales, purchases and expense transactions are denominated in RMB and all of the Company's assets and liabilities are also denominated in RMB. The RMB is not freely convertible into foreign currencies under the current law. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB may require certain supporting documentation in order to affect the remittance.

## 18. ACQUISITION OF SANDEKE CO., LTD.

On September 25, 2008, the Company entered into an Agreement for the acquisition of all the outstanding capital stock of SanDeKe. The purchase price for the SanDeKe shares was \$741,516. Under the terms of the Agreement, two of the shareholders of SanDeKe have agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase. At June 30, 2009, the Company paid the purchase consideration for SanDeKe.

For convenience of reporting the acquisition for accounting purposes, September 1, 2008 was designated as the acquisition date.

The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition. The fair value of the net assets acquired exceeded the total consideration for the acquisition by approximately \$117,000 (RMB 800,000). The excess (negative goodwill) was allocated on a pro rata basis to long-lived assets.

Cash	\$ 59,245
Accounts receivable	489,527
Advance to suppliers	329,951
Other receivables	128,646
Inventory	92,370
Property and equipment	73,324
Intangible assets	563,567
Accounts payable	(332,276)
Advance from customers	(557,216)

Deferred tax liability	(39,076)
Other current liabilities	(66,546)
Purchase price	\$ 741,516

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The intangible asset consisted of know-how technology is amortized over 5 years, the customer list is amortized over 5 years and covenants not to compete, is amortized over 4 years.

The following unaudited pro forma consolidated results of operations of the Company for the six months ended June 30, 2008 presents the operations of the Company and SanDeKe as if the acquisition of SanDeKe occurred on January 1, 2008. The pro forma results are not necessarily indicative of the actual results that would have occurred had the acquisitions been completed as of the beginning of the periods presented, nor are they necessarily indicative of future consolidated results.

	Pro forma Consolidated
Net revenue	\$ 9,980,244
Cost of revenue	7,341,630
Gross profit	2,638,614
Selling expense	608,028
General & administrative expense	759,989
Total operating expenses	1,368,017
Income from operations	1,270,597
Non-operating income, net	113,572
Income before income tax	1,384,169
Income tax	266,028
Net income	\$ 1,118,141
Basic and diluted weighted average shares outstanding	20,213,419
Basic and diluted net earnings per share	\$ 0.06

## 19. SUBSEQUENT EVENTS

On July 3, 2009, the “Company entered into a Senior Loan Agreement with an institutional investor to obtain a loan of US \$9,000,000.00.

Under the terms of the Agreement, the Company agreed to a simple interest rate of 10% per annum payable quarterly beginning on September 30, 2009. The principal amount and any unpaid interest accrued thereon are due six (6) months from the date of the Agreement.

The Lender may demand payment of principal and interest three (3) months from the date of the Note, in the event of a change of control or upon material organic changes to the Company. The terms of any subsequent financing must meet with Lender’s consent.

Without the prior written consent of the Lender, from the date hereof until the date the Senior Note is repaid in full, the Company and its Subsidiary shall be prohibited from

(A) Effecting or entering into an agreement or to affect any subsequent financing which shall be senior to the Senior Notes, or any other financing;

(B) Selling, leasing, or otherwise disposing of their respective assets;

- (C) Dissolving, liquidating, or winding up their respective businesses;
- (D) Conducting their respective businesses other than in their ordinary and usual course;
- (E) Paying any dividend or make any other distributions of cash or property;

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(F) Merging or consolidating with another entity;

(G) Issuing any shares of Company capital stock or Company debt securities.

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fall. Additionally, any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines, or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue. In particular, our 2009 sales may be affected by weaker demand from steel processing, petrochemical and HVAC sectors. To date, we have not been adversely affected by these trends. Moreover, the PRC government has recently passed an economic stimulus package and we believe that our sales will benefit from an increase in government spending on infrastructure as provided in this package. However, due to the possibility of fluctuations in our revenue and net income or loss, we believe that quarterly comparisons of our operating results are not a good indication of future performance.

While our significant accounting policies are more fully described in Note 2 to our consolidated financial statements, we believe that the following accounting policies are the most critical to aid you in fully understanding and evaluating this management discussion and analysis.

#### Basis of Presentation

Our financial statements are prepared in accordance with generally accepted accounting principles in the United States of America.

#### Principle of Consolidation

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



## Use of Estimates

In preparing the financial statements in conformity with accounting principles generally accepted in the United States of America, 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.

## Accounts Receivable

Our 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. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year.

## 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	5 years
Equipment	
Production	5 - 10 years
Equipment	

## Revenue Recognition

Our revenue recognition policies are in compliance with Securities and Exchange Commission (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.

Our 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.

Our standard warranty is provided to all customers and is not considered an additional service; rather it is considered an integral part of the products sale. We believe that the existence of the 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. We believe that accounting for our standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

We provide 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. We recognize such revenue when service is provided. The revenue earned from these services was not material.

#### Foreign Currency Translation and Comprehensive Income (Loss)

Our functional currency is the Chinese yuan - renminbi ("RMB"). For financial reporting purposes, RMB has been translated into United States dollars ("USD") as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of shareholders' equity as "Accumulated other comprehensive income." Gains and losses resulting from foreign currency transactions are included in income. There has been no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

We use Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

#### Recent 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 FASB's new Codification (full name: the FASB Accounting Standards Codification TM.) The new 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 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, which will require more information about the transfer of financial assets and identification of 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.

### 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.

#### 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.

## Results of Operations

### Six Months Ended June 30, 2009 Compared to the Six Months Ended June 30, 2008

The following table sets forth the results of our operations for the years indicated as a percentage of net sales:

	For the Six Months Ended June 30,			
	2009	2008		
	\$	% of Sales	\$	% of Sales
Sales	18,705,898		8,637,283	
Cost of sales	11,874,903	63.0%	6,228,156	72.0%
Gross Profit	6,830,995	37.0%	2,409,127	28.0%
Operating Expenses	2,499,664	13.0%	1,054,498	12.0%
Income from Operation	4,331,331	23.0%	1,354,629	16.0%
Other Income (Expenses), net	(12,081)	(0.1)%	115,074	1.0%
Net Income	3,638,818	19.0%	1,203,675	14.0%

Sales. Net sales during the six months ended June 30, 2009 were approximately \$18.71 million, while our net sales for the six months ended June 30, 2008 were approximately \$8.64 million, an increase in revenues of \$10.07 million, or 117%. The increase in sales was attributable to an increase in our sales volume with selling price determined based on our standard profit margin rate. We have a strict review process for approving each sales contract, especially with respect to the determination of selling price. Sales price under each contract is determined in proportion to our estimated cost in order to ensure our gross profit. Our selling price varies on each sale which mainly depends on each customer's specific needs and our negotiation of the contract amount and term. During the six months ended June 30, 2009, we've recognized \$5.02 million revenue or 26% of the total revenue from the contracts that we've previously signed; we have been continuously expanding the heat-supply market in more regions as a result of the PRC government's economy stimulus plan stressing on increasing domestic infrastructure construction and our sales from the traditional heat-supply industry was approximately \$9.78 million or 51% of the total sales. We have also developed new customers in other industries like chemical engineering, electric power, metal smelting, etc. which accounted for \$4.06 million or 21% of our total sales. In addition, our sales on heat meters have been increased to approximately \$430,000 during the first six months of 2009 from approximately \$70,000 during the first six months of 2008. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, increasing the sales channels, and improving the quality of our products.

**Cost of Sales.** Cost of sales for the six months ended June 30, 2009 was approximately \$11.87 million, while our cost of sales for the same period in 2008 was approximately \$6.23 million, an increase of \$5.65 million, or 91%. Cost of sales mainly consisted of the cost of materials and labor, as well as factory overhead costs, with material costs accounting for 70% or more of our total cost of sales. The increase in cost of sales can be attributed to the increase of production and sales volume in the first six months of 2009. Cost of sales as a percentage of sales was approximately 63% for the first six months of 2009 and 72% for the same period of 2008. The decrease in cost of sales as a percentage to the sales was mainly due to decreased raw material cost, economy of scale on fixed costs as a result of increased production, and our continuous improvement on control of the manufacturing costs. We believe our cost of sales will remain stable as a result of our current pricing strategy and the continued improvement in the efficiency of our manufacturing facility.

**Gross Profit.** Gross profit was \$6.83 million for the six months ended June 30, 2009, as compared to \$2.41 million for the same period in 2008, representing gross margins of approximately 37% and 28%, respectively. The increase in our gross profits and gross profit margin was mainly due to the decrease of cost of goods sold as a percentage of sales while the company's sales activities increased.

**Operating Expenses.** Operating expenses consisted of selling, general and administrative expenses totaled approximately \$2.50 million for the six months ended June 30, 2009, as compared to \$1.05 million for the six months ended June 30, 2008, an increase of approximately \$1.45 million or 137%. The increase in operating expenses was mainly due to a proportional increase in payroll, insurance, employee welfare and travel expenses with our increased sales and production; as well as the increase in audit, legal, consulting and filing expenses in connection with the Company of being public in US since April of 2008. In addition, a one-time charge of approximately \$110,000 occurred in the first quarter of 2009 as a result of failure to declare the effectiveness of the Registration Statement within 180 days of the final closing of the offering.

**Net Income.** Our net income for the six months ended June 30, 2009 was \$3.64 million as compared to approximately \$1.20 million for the same period in 2008, an increase of \$2.44 million or 202%. Net income as a percentage of sales increased from 14% in the first six months of 2008 to 19% in the same period of 2009. This increase was attributable to economy of scale combined with rapid growth in revenue and efficiency of operations, and lower income tax rate of 15% for Taiyu effective January 1, 2009, down from 18% for 2008. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

#### Quarter Ended June 30, 2009 Compared to the Quarter Ended June 30, 2008

The following table sets forth the results of our operations for the years indicated as a percentage of net sales:

	For the Quarter Ended June 30,		For the Quarter Ended June 30,	
	2009	2008	2009	2008
	\$	% of Sales	\$	% of Sales
Sales	12,498,395		5,558,232	
Cost of sales	7,973,956	64.0%	4,115,200	74.0%
Gross Profit	4,524,439	36.0%	1,443,032	26.0%
Operating Expenses	1,469,229	12.0%	572,932	10.0%
Income from Operation	3,055,210	24.0%	870,100	16.0%
Other Income (Expenses), net	25,170	0.2%	23,383	0.4%
Net Income	2,617,549	21.0%	732,412	13.0%

**Sales.** Net sales during the three months ended June 30, 2009 were approximately \$12.50 million, while our net sales for the three months ended June 30, 2008 were approximately \$5.56 million, an increase in revenues of \$6.94 million,



or 125%. The increase in sales was attributable to an increase in our sales volume with selling price determined based on our standard profit margin rate. We have a strict review process for approving each sales contract, especially with respect to the determination of selling price. Sales price under each contract is determined in proportion to our estimated cost in order to ensure our gross profit. Our selling price varies on each sale which mainly depends on each customer's specific needs and our negotiation of the contract amount and term. The increase in our sales volume was mainly attributed to (1) our continuous expansion in the heat-supply market in more regions as a result of the PRC government's economy stimulus plan stressing on increasing domestic infrastructure construction, (2) development of new customers from other industries like chemical engineering, electric power, metal smelting, etc. (3) increase sales in heat meters. As we continue to expand our customer base and increase our sales volume, we become less dependent on these customers for revenue. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, increasing the sales channels, and improving the quality of our products.

**Cost of Sales.** Cost of sales for the three months ended June 30, 2009 was approximately \$7.97 million while our cost of sales for the same period in 2008 was approximately \$4.12 million, an increase of \$3.86 million, or 94%. Cost of sales mainly consisted of the cost of materials and labor, as well as factory overhead costs, with material costs accounting for 70% or more of our total cost of sales. The increase in cost of sales can be attributed to the increase of production and sales volume in the second quarter of 2009. Cost of sales as a percentage of sales was approximately 64% for the second quarter of 2009 and 74% for the same period of 2008. The decrease in cost of sales as a percentage to the sales was mainly due to decreased raw material cost, economy of scale on fixed costs as a result of increased production, and our continuous improvement on control of the manufacturing costs. We believe our cost of sales will remain stable as a result of our current pricing strategy and the continued improvement in the efficiency of our manufacturing facility.

**Gross Profit.** Gross profit was \$4.52 million for the three months ended June 30, 2009, as compared to \$1.44 million for the same period in 2008, representing gross margins of approximately 36% and 26%, respectively. The increase in our gross profits and gross profit margin was mainly due to the decrease of cost of goods sold as a percentage of sales while the company's sales activities increased.

**Operating Expenses.** Operating expenses consisted of selling, general and administrative expenses totaled approximately \$1.47 million for the three months ended June 30, 2009, as compared to \$0.57 million for the three months ended June 30, 2008, an increase of approximately \$0.90 million or 156%. The increase in operating expenses was mainly due to a proportional increase in payroll, insurance, employee welfare and travel expenses with our increased sales and production; as well as the increase in audit, legal, consulting and filing expenses in connection with the Company of being public in US since April of 2008.

**Net Income.** Our net income for the three months ended June 30, 2009 was \$2.62 million as compared to approximately \$0.73 million for the same period in 2008, an increase of \$1.89 million or 257%. Net income as a percentage of sales increased from 13% in the second quarter of 2008 to 21% in the same period of 2009. This increase was attributable to economy of scale combined with rapid growth in revenue and efficiency of operations, and lower income tax rate of 15% for Taiyu effective January 1, 2009, down from 18% for 2008. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

## Liquidity and Capital Resources

### Six Months Ended June 30, 2009 Compared to the Six Months Ended June 30, 2008

As of June 30, 2009, we had cash and cash equivalents of approximately \$2.41 million. Working capital was approximately \$7.84 million at June 30, 2009. The ratio of current assets to current liabilities was 1.45:1 at June 30, 2009.

The following is a summary of cash provided by or used in each of the indicated types of activities during the period ended June 30, 2009 and 2008:

	For the Six Months Ended June 30,	
	2009	2008
<b>Cash provided by (used in):</b>		
Operating Activities	\$ (130,563)	\$ 442,015
Investing Activities	(513,840)	(388,681)
Financing Activities	1,617,223	(258,014)

Net cash flow used in operating activities was \$130,563 in the first six months of 2009, as compared to net cash flow provided by operating activities of \$442,015 in the same period of 2008. The increase in net cash flow used in operating activities during the first six months of 2009 was mainly due to increased payment in advance to suppliers, other prepayments, deposits and purchase of inventory and more income tax paid as our net income increased. Our net income has increased rapidly compared to the same period of 2008 along with the timely collection of the accounts receivable, which brought about \$1.35 million cash to the Company, The significant amount in accounts receivable was due to the rapid increase in our sales with most of our accounts receivables aging within one year from the sales recognition date.

Net cash flow used in investing activities was \$513,840 in the first six months of 2009, as compared to net cash used in investing activities of \$388,681 in the same period of 2008. The increase of net cash flow used in investing activities in the first six months of 2009 was mainly due to purchase of fixed assets.

Net cash flow provided by financing activities was \$1,617,223 in the first six months of 2009 as compared to net cash used in financing activities of \$258,014 in the same period of 2008. The increase of cash inflow was mainly due to proceeds from the new bank loans of \$3.12 million less the partial payment \$1.51 million made for the assets purchased from Siping Beifang Heat Exchanger Manufacture Co., Ltd in June of 2009.

Our sales contracts with our customers generally provide that 30% of the purchase price is due upon the placement of an order, 30% is due on delivery and 30% is due upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment is due on the final 10% of the purchase price no later than the termination date of the standard warranty period which ranges from 3 to 24 months from the acceptance date of the products. Our receipts for payment on our products depend on the complexity of the equipment ordered which impacts manufacturing, delivery, installation and testing times and warranty periods. For example, PHEs are less complex than PHE units and therefore have a shorter manufacturing, acceptance, warranty and payment schedule. We may experience payment delays from time to time with a range from 1 month to 3 months from the due date; however, we do not believe the delays have significant negative impact on our liquidity as the payment delays are very common in heating manufacturing industry in China, and the collection of payment can be reasonably assured based on our historical collection experience. Our accounts receivable turnover and inventory turnover are relatively low, and days sales outstanding ratio relatively high. Consequently, collection on our sales is rather slow and capital is tied up in inventories which may result in pressure on cash flows. For the first six months of 2009, we had accounts receivable turnover of 3.16 on annualized basis, with days sales outstanding of 111 and inventory turnover of 3.31 on annualized basis. For the first six months of 2008, we had accounts receivable turnover of 2.46 on annualized basis, with days sales outstanding of 168 and inventory turnover of 1.86 on annualized basis. The low accounts receivable turnover and high days outstanding is due to relatively longer terms for payment collection in the heating manufacturing business in China.

We are in the manufacturing and processing business. We purchase substantial amounts of raw materials before the high season starts to meet production needs. There is no concern about inventory obsolescence since our product can be sold for a profit without time limitation as long as there is continued demand. Additionally, we have increased our sales force for developing new customers, which we believe will reduce on-hand inventory levels and increase inventory turnover going forward. Therefore, we believe the potential risks and uncertainties associated with lower inventory turnover are limited.

We recognize the final 10% of the purchase price as a Retention Receivable which is due no later than the termination of our warranty period. The deferral of the final payment is a common practice in the heating manufacturing business in China. Sometimes our customers are required to deposit 5%-10% of the sales price on high value products like assembled heat exchanger unit and main part of plate heat exchanger into designated bank accounts as restricted cash for securing the payment after such period expires. Based on our historical experience, there have been no defaults on such deferrals. Therefore, we believe the potential risks and uncertainty associated with defaults on such receivables are not material.

#### Recent Developments

Under the terms of the Registration Rights Agreement, the Company is required to file a Registration Statement registering the common stock and common stock underlying the warrants with the Securities and Exchange Commission (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 or the Company will be subject to penalties as described below. 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, it 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 closing the private placement occurred on September 24, 2008. The Company was obligated to cause the Registration Statement become effective on or before March 23, 2009. As a result of its failure to have a registration statement effective on this date, the Company is liable to pay approximately \$110,000 liquidated damages to investors in the private placement. The Company expects to pay liquidated damages from its working capital. The Registration Statement became effective on June 23, 2009.

#### Off-Balance Sheet Arrangements

We have not entered into any other financial guarantees or other commitments to guarantee the payment obligations of any third parties. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder's equity or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. We do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

#### Contractual Obligations

The Company was obligated for the following short term loans payable as of June 30, 2009 and December 31, 2008:

	June 30, 2009	December 31, 2008
Loans from a commercial bank in the PRC for 30,000,000 RMB. Of which, 17,000,000 RMB was entered into on April 22, 2009 and is due on April 22, 2010. 13,000,000 RMB was entered into on June 12, 2009 and is due on June 12, 2010. These loans currently bear interest at 5.576%. The Company pledged its building in the value of approximately RMB 12,430,950 or approximately \$1,818,000 for this loan.	\$ 4,391,165	\$ -
Loan from a commercial bank in the PRC for 6,000,000 RMB. This loan was entered into on Apr 28, 2007 and was due on Apr 12, 2008. This loan was renewed on Apr 12, 2008 with new maturity date on June 13, 2009. This loan currently bears interest at 7.159%. The Company pledged its building in the value of approximately RMB 12,430,950 or approximately \$1,818,000 for this loan. The Company repaid loan in April, 2009.	-	877,886
The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10, 300,000 RMB. Some of the loans matured on various dates in 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% for 2009 and 2008. The Company repaid RMB 2,600,000 in 2008, RMB 2,700,000 in April, 2009, and had RMB 5,000,000 outstanding as of June 30, 2009, due on December 31, 2009 with interest of 8.591%.	731,861	1,126,621
The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB. This loan is renewed and due on December 31, 2009 with interest of 8.591%.	439,116	438,943
	\$ 5,562,142	\$ 2,443,450



Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required

Item 4T. Controls and Procedures

Disclosure Controls and Procedures

An evaluation was conducted under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO"), its principal executive officer, and Chief Financial Officer ("CFO"), its principal financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act) as of June 30, 2009. Based on that evaluation, the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of such date to ensure that information required to be disclosed in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may become involved in various lawsuits and legal proceedings, which arise in the ordinary course of business. However, litigation is subject to inherent uncertainties, and an adverse result in these or other matters may arise from time to time that may have an adverse affect on our business, financial conditions, or operating results. We are currently not aware of any such legal proceedings or claims that will have, individually or in the aggregate, a material adverse affect on our business, financial condition or operating results.



## Item 1A. Risk Factors

Our common stock price is subject to significant volatility, which could result in substantial losses for investors.

During the nine month period ended January 28, 2009, the high and low bid prices of our common stock on the Over-The-Counter Bulletin Board ("OTCBB") were \$6.50 per share and \$2.00 per share, respectively. We began trading on the Nasdaq Stock Market on January 29, 2009 and were subsequently listed on the Nasdaq Global Market on March 10, 2009. The high and low sales prices of our common stock were \$8.00 and \$4.11, from January 29, 2009 to August 7, 2009. Prices for our shares are determined in the marketplace and may accordingly be influenced by many factors, including, but not limited to:

- the depth and liquidity of the market for the shares;
- quarter-to-quarter variations in our operating results;
- announcements about our performance as well as the announcements of our competitors about the performance of their businesses;
- investors' evaluations of our future prospects and the food industry generally,
- changes in earnings estimates by, or failure to meet the expectations of, securities analysts;
- our dividend policy; and
- general economic and market conditions.

In addition, the stock market often experiences significant price fluctuations that are unrelated to the operating performance of the specific companies whose stock is traded. These market fluctuations could adversely affect the trading price of our shares.

The price at which investors purchase shares of our common stock may not be indicative of the price that will prevail in the trading market. Investors may be unable to sell their shares of common stock at or above their purchase price, which may result in substantial losses.

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

On July 7, 2008, the Company completed a closing of a private placement offering (the "Offering") of Units pursuant to which SmartHeat sold an aggregate of 1,620,000 Units at an offering price of \$3.50 per Unit for aggregate gross proceeds of approximately \$5.67 million. An additional 10,000 Units was sold in a second closing of the Offering on August 12, 2008 for aggregate gross proceeds of approximately \$35,000. Each "Unit" consists of one share of SmartHeat's common stock and a three year warrant to purchase 15% of one share of common stock at an exercise price of \$6.00 per share. The Units sold represent an aggregate of 1,630,000 million shares of common stock and warrants to purchase 244,500 shares of Common Stock. The warrants are immediately exercisable and expire on the third anniversary of their issuance. In connection with the Offering, the Company paid commissions and fees approximately \$340,000 and issued warrants to purchase 148,500 shares of common stock. The proceeds from the sale of the Units in the Offering were used for general corporate purposes.

## Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibit No. Document Description

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-15(e) and 15d-15(e), promulgated under the Securities and Exchange Act of 1934, as amended.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-15(e) and 15d-15(e), promulgated under the Securities and Exchange Act of 1934, as amended.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer).
- 32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer).

SIGNATURES

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

SMARTHEAT INC.  
(Registrant)

August 10, 2009

By: /s/ Jun Wang  
Jun Wang  
President and Chief Executive Officer  
(Principal Executive Officer)

August 10, 2009

By: /s/ Zhijuan Guo  
Zhijuan Guo  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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