SMARTHEAT INC.
Form 10-Q
November 16, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 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	98-0514768
(State or other jurisdiction of incorporation or organization)	(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 x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer, “accelerated filer,” “non-accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer ¨ Smaller reporting company x
(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 x

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 32,784,825 shares as of November 11, 2009.

PART I – FINANCIAL INFORMATION

SMARTHEAT, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	SEPTEMBER 30, 2009 (UNAUDITED)	DECEMBER 31, 2008
ASSETS		
CURRENT ASSETS		
Cash & cash equivalents	$ 60,294,695	$ 1,435,212
Restricted cash	1,043,524	462,048
Accounts receivable, net	20,276,792	11,390,169
Retentions receivable	553,105	290,852
Advances to suppliers	3,474,936	412,524
Other receivables, prepayments and deposits	3,282,014	698,834
Inventories	14,394,162	6,107,583
Note receivable - bank acceptance	70,655	14,631
Total current assets	103,389,881	20,811,853
NON-CURRENT ASSETS		
Restricted cash	19,185	219,472
Accounts receivable, net	582,375	310,810
Retentions receivable	2,309,852	166,912
Construction in progress	60,230	-
Intangible assets, net	4,122,844	1,155,131
Property and equipment, net	7,578,356	2,436,553
Total noncurrent assets	14,672,842	4,288,878
TOTAL ASSETS	$ 118,062,723	$ 25,100,731
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 6,030,827	$ 1,210,906
Unearned revenue	2,084,036	850,408
Notes payable - bank acceptance	1,000,543	-
Taxes payable	2,147,376	1,327,775
Accrued liabilities and other payables	7,071,473	1,330,812
Due to minority shareholder	-	5,303
Loans payable	5,564,504	2,443,450
Total current liabilities	23,898,759	7,168,654
DEFERRED TAX LIABILITY	15,519	38,854

COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' EQUITY				
Common stock, $0.001 par value; 75,000,000 shares authorized, 32,756,575 and 24,179,900 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively		32,757		24,180
Paid in capital		71,679,770		8,223,453
Statutory reserve		2,689,432		1,150,542
Accumulated other comprehensive income		1,255,603		984,629
Retained earnings		18,490,884		7,510,419
Total stockholders' equity		94,148,446		17,893,223
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$	118,062,723	$	25,100,731

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

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

	FOR THE NINE MONTHS ENDED SEPTEMBER 30,		FOR THE THREE MONTHS ENDED SEPTEMBER 30,	
	2009	2008	2009	2008
Net sales	$ 56,541,795	$ 29,345,571	$ 37,835,897	$ 20,708,288
Cost of goods sold	36,562,363	19,502,070	24,687,460	13,273,914
Gross profit	19,979,433	9,843,501	13,148,438	7,434,374
Operating expenses				
Selling expenses	2,325,471	1,664,882	1,165,939	1,056,854
General and administrative expenses	2,626,775	1,470,577	1,286,643	1,024,107
Total operating expenses	4,952,245	3,135,459	2,452,581	2,080,961
Income from operations	15,027,187	6,708,042	10,695,856	5,353,413
Non-operating income (expenses)				
Interest income	145,839	318,070	65,418	57,387
Interest expense	(209,462)	(257,116)	(91,850)	(94,076)
Subsidy income	21,443	16,141	(13,897)	7,000
Financial expense	(222,625)	-	(222,625)	-
Other expense		(13,676)	11,199	(13,676)
Other income	61,644	9,744	60,675	1,454
Total non-operating income (expenses)	(203,162)	73,163	(191,081)	(41,911)
Income before income tax	14,824,026	6,781,205	10,504,776	5,311,502
Income tax expense	2,304,672	1,246,935	1,624,240	980,907
Net income from operations	12,519,354	5,534,270	8,880,536	4,330,595
Less: net income attributable to noncontrolling interest	-	5,934	-	5,934
Net income	12,519,354	5,528,336	8,880,536	4,324,661
Other comprehensive item				
Foreign currency translation	270,399	578,670	257,256	167,774
Comprehensive Income	$ 12,789,753	6,107,006	$ 9,137,792	$ 4,492,435
	24,430,806	21,503,588	24,924,435	24,055,878

Basic weighted average shares outstanding								
Diluted weighted average shares outstanding		24,513,092		21,503,647		25,010,735		24,056,054
Basic earnings per share	$	0.51	$	0.26	$	0.36	$	0.18
Diluted earnings per share	$	0.51	$	0.26	$	0.36	$	0.18

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

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

	FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income including noncontrolling interest	$ 12,519,354	$ 5,534,270
Adjustments to reconcile net income including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	409,371	173,821
Unearned interest on accounts receivable	195,901	(71,804)
Stock option compensation expense	1,755	1,270
Decrease in deferred tax liability	(23,357)	-
(Increase) decrease in current assets:		
Accounts receivable	(9,305,812)	(4,995,840)
Retentions receivable	(2,403,726)	107,279
Advances to suppliers	(3,051,902)	320,260
Other receivables, prepayments and deposits	485,060	(2,346,526)
Inventories	(8,277,813)	118,223
Note receivable	(55,986)	(201,118)
Increase (decrease) in current liabilities:		
Accounts payable	5,782,299	928,337
Unearned revenue	1,232,371	(1,581,803)
Taxes payable	818,141	864,934
Accrued liabilities and other payables	(4,450,011)	(266,072)
Net cash used in operating activities	(6,124,354)	(1,414,769)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Restricted cash	(380,457)	(101,542)
Purchase asset of Siping	(0)	-
Construction in progress	(60,203)	(83,027)
Acquisition of property & equipment	(3,610,566)	(287,398)
Net cash used in investing activities	(4,051,225)	(471,967)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Due to minority shareholders	-	(660)
Due from / (to) shareholder	-	(587,644)
Short term loans	12,117,636	-
Repayment of short term loans	(9,216,986)	(1,361,113)
Issuance of common stock	66,138,390	5,100,000
Net cash provided by financing activities	69,039,040	3,150,583
EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS	(3,978)	(9,482)

NET INCREASE IN CASH & CASH EQUIVALENTS		58,859,482		1,254,365
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD		1,435,213		448,573
CASH & CASH EQUIVALENTS, END OF PERIOD	$	60,294,695	$	1,702,938
Supplemental Cash flow data:				
Income tax paid	$	1,272,797	$	426,809
Interest paid	$	219,061	$	201,269

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

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 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 of 6,549,900 of 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 SanDeKe was $741,516. Under the terms of the Agreement, two shareholders of SanDeKe agreed not to compete with the business of SanDeKe for four years after the purchase.

On June 12, 2009, the Company incorporated a new subsidiary SmartHeat Siping Beifang Energy Technology Co., Ltd (“SmartHeat Siping”) to manufacture 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 54,000,000 RMB, or United States Dollars (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 was payable according to the following schedule:

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 September 30, 2009, the Company paid approximately $3 million. The payment terms do not include any default provision.

The unaudited financial statements were 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”) were 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 nine months ended September 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 of 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 September 30, 2009, the Company maintained restricted cash of $1,062,708 in several bank accounts, $562,436 representing cash deposits from customers for securing payment from customers that occurs no later than the warranty period expires, and $500,272 representing the deposits the Company paid to a commercial bank for the bank issuing the bank acceptance to its vendors; of the total restricted cash, $1,043,524 will be released to the Company within one year. As of December 31, 2008, the Company maintained restricted cash of $681,520, of which, $462,048 will be released to the Company within one year. Restricted cash is held in the interest bearing bank accounts.

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 $630,204 and $629,687 at September 30, 2009 and December 31, 2008, respectively.

At September 30, 2009 and December 31, 2008, the Company had retentions receivable from customers for product quality assurance of $2,862,956 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 $224,540 and $28,526 at September 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 September 30, 2009 and December 31, 2008, there were no significant impairments of its long-lived assets.

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 September 30, 2009 and December 31, 2008 is as follows:

	For the Nine Months Ended September 30, 2009	For the Year Ended December 31, 2008
Beginning balance	$ -	$ -
Provisions made	564,466	95,000
Actual costs incurred	(42,207)	(95,000)
Ending balance in current liabilities	$ 522,259	$ -

Income Taxes

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," (codified in FASB ASC Topic 740), which requires recognition of deferred tax assets and liabilities for expected future tax consequences of events that were 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, (codified in FASB ASC Topic 740) 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.

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 (codified in FASB ASC Topic 480). Sales revenue is recognized when products are delivered and for PHE and PHE (codified in FASB ASC Topic 480) 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 for 30% of the purchase price on placement of an order, 30% on delivery, 30% upon installation and acceptance of the equipment after customer testing, and 10% of the purchase price on a date no later than the termination 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 sold in the PRC are subject to Chinese value-added tax of 17% of 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 nine months ended September 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 all customers and is not considered an additional service; rather it is an integral part of the product's sale. The Company believes 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 EITF 00-21 (codified in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) 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 (codified in FASB ASC Topic 450) 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 nine months ended September 30, 2009 and 2008, revenue from after sales services after expiration of the warranty period was approximately $299,000 and $28,000. For the three months ended September 30, 2009 and 2008, revenue from after sales services after expiration of the warranty period was approximately $295,000 and $7,200, 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.

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,” codified in FASB ASC Topic 230, 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 of $100,543 and assets purchased from Siping Manufacture of $7,906,296 during the nine months ended September 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 Nine Months Ended September 30, (Unaudited)		For the Three Months Ended September 30, (Unaudited)	
	2009	2008	2009	2008
Net income	$ 12,519,354	$ 5,528,336	$ 8,880,536	$ 4,324,661
Weighted average shares outstanding - basic	24,430,806	21,503,588	24,924,435	24,055,878
Effect of dilutive securities:				
Unexercised warrants and options	82,286	59	86,300	176
Weighted average shares outstanding - diluted	24,513,092	21,503,647	25,010,735	24,056,054
Earnings per share - basic	$ 0.51	$ 0.26	$ 0.36	$ 0.18
Earnings per share - diluted	$ 0.51	$ 0.26	$ 0.36	$ 0.18

Fair Value of Financial Instruments

SFAS No. 107, “Disclosures about Fair Value of Financial Instruments,” (codified in FASB ASC Financial Instruments, Topic 825) 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.

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," (codified in Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 830), 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” (codified in FASB ASC Topic 220).

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” (codified in FASB ASC Topics 718 & 505). 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" (codified in FASB ASC Topic 280) 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, (codified in FASB ASC Topic 815), which requires 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 (codified in FASB ASC Topic 450).

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 was 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.

New Accounting Pronouncements

On July 1, 2009, the Company adopted Accounting Standards Update (“ASU”) No. 2009-01, “Topic 105 - Generally Accepted Accounting Principles - amendments based on Statement of Financial Accounting Standards No. 168 , “The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles” (“ASU No. 2009-01”). ASU No. 2009-01 re-defines authoritative GAAP for nongovernmental entities to be only comprised of the FASB Accounting Standards Codification™ (“Codification”) and, for SEC registrants, guidance issued by the SEC. The Codification is a reorganization and compilation of all then-existing authoritative GAAP for nongovernmental entities, except for guidance issued by the SEC. The Codification is amended to effect non-SEC changes to authoritative GAAP. Adoption of ASU No. 2009-01 only changed the referencing convention of GAAP in Notes to the Consolidated Financial Statements.

In June 2009, the FASB issued SFAS No. 167, “Amendments to FASB Interpretation No. 46(R)” (“SFAS 167”), codified as FASB ASC Topic 810-10, which modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. SFAS 167 clarifies that the determination of whether a company is required to consolidate an entity is 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 requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. SFAS 167 also requires additional disclosures about a company’s involvement in variable interest entities and any significant changes in risk exposure due to that involvement. SFAS 167 is effective for fiscal years beginning after November 15, 2009. The Company does not believe the adoption of SFAS 167 will have an impact on its financial condition, results of operations or cash flows.

In June 2009, the FASB issued SFAS No. 166, "Accounting for Transfers of Financial Assets — an amendment of FASB Statement No. 140" ("SFAS 166"), codified as FASB Topic ASC 860, which requires entities to provide more information regarding sales of securitized financial assets and similar transactions, particularly if the entity has continuing exposure to the risks related to transferred financial assets. SFAS 166 eliminates the concept of a "qualifying special-purpose entity," changes the requirements for derecognizing financial assets and requires additional disclosures. SFAS 166 is effective for fiscal years beginning after November 15, 2009. The Company does not believe the adoption of SFAS 166 will have an impact on its financial condition, results of operations or cash flows.

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events" ("SFAS 165") codified in FASB ASC Topic 855-10-05, which provides guidance 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. SFAS 165 also requires entities to disclose the date through which subsequent events were evaluated as well as the rationale for why that date was selected. SFAS 165 is effective for interim and annual periods ending after June 15, 2009, and accordingly, the Company adopted this pronouncement during the second quarter of 2009. SFAS 165 requires that public entities evaluate subsequent events through the date that the financial statements are issued. The Company has evaluated subsequent events through November 12, 2009.

In April 2009, the FASB issued FSP No. SFAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments," which is codified in FASB ASC Topic 825-10-50. This FSP essentially expands the disclosure about fair value of financial instruments that were previously required only annually to also be required for interim period reporting. In addition, the FSP requires certain additional disclosures regarding the methods and significant assumptions used to estimate the fair value of financial instruments. These additional disclosures are required beginning with the quarter ending June 30, 2009. This FSP had no material impact on the Company's financial position, results of operations or cash flows.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," which is codified in FASB ASC Topic 320-10. This FSP modifies the requirements for recognizing other-than-temporarily impaired debt securities and changes the existing impairment model for such securities. The FSP also requires additional disclosures for both annual and interim periods with respect to both debt and equity securities. Under the FSP, impairment of debt securities will be considered other-than-temporary if an entity (1) intends to sell the security, (2) more likely than not will be required to sell the security before recovering its cost, or (3) does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell). The FSP further indicates that, depending on which of the above factor(s) causes the impairment to be considered other-than-temporary, (1) the entire shortfall of the security's fair value versus its amortized cost basis or (2) only the credit loss portion would be recognized in earnings while the remaining shortfall (if any) would be recorded in other comprehensive income. FSP 115-2 requires entities to initially apply the provisions of the standard to previously other-than-temporarily impaired debt securities existing as of the date of initial adoption by making a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The cumulative-effect adjustment potentially reclassifies the noncredit portion of a previously other-than-temporarily impaired debt security held as of the date of initial adoption from retained earnings to accumulate other comprehensive income. The Company adopted FSP No. SFAS 115-2 and SFAS 124-2 beginning April 1, 2009. This FSP had no material impact on the Company's financial position, results of operations or cash flows.

In April 2009, the Financial Accounting Standards Board ("FASB") issued FSP No. SFAS 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" ("FSP No. SFAS 157-4"). FSP No. SFAS 157-4, which is codified in FASB ASC Topics 820-10-35-51 and 820-10-50-2, provides additional guidance for estimating fair value and emphasizes that even if there has been a significant decrease in the volume and level of activity for the asset or liability and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same. The Company adopted FSP No. SFAS 157-4 beginning April 1, 2009. This FSP had no material impact on the Company's financial position, results of operations or cash flows.

3. INVENTORIES

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

	2009	2008
Raw materials	$ 7,810,861	$ 4,411,298
Work in process	2,762,646	652,472
Finished Goods	3,820,655	1,043,813
Total	$ 14,394,162	$ 6,107,583

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4. PROPERTY AND EQUIPMENT, NET

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

	2009	2008
Building	$ 4,326,504	$ 1,818,827
Production equipment	2,970,416	441,065
Office equipment	362,166	231,975
Vehicles	544,158	300,956
	8,203,244	2,792,823
Less: Accumulated depreciation	(624,888)	(356,270)
	$ 7,578,356	$ 2,436,553

Depreciation expense for the nine months ended September 30, 2009 and 2008 was approximately $268,000 and $119,000, respectively. Depreciation expense for the three months ended September 30, 2009 and