LANTRONIX INC
Form 4
May 27, 2008

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

OMB Number:	3235-0287
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(Print or Type Responses)

1. Name and Address of Reporting Person *
TL Investment GmbH

(Last) (First) (Middle)

WALDHOERNLESTR, 18

(Street)

72072 TUEBINGEN, GERMANY

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
LANTRONIX INC [LTRX]

3. Date of Earliest Transaction (Month/Day/Year)
05/23/2008

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director __X__ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	05/23/2008		P		28,100	A	$ 0.86	21,103,727	D	
Common Stock	05/27/2008		P		25,880	A	$ 0.86	21,129,607	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
TL Investment GmbH WALDHOERNLESTR, 18 72072 TUEBINGEN, GERMANY		X		

Signatures

/s/ Ronald Irick, Attorney-in-fact for TL Investment GmbH	05/27/2008
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. ">LIABILITIES AND STOCKHOLDERS' EQUITY
CURRENT LIABILITIES

Accounts payable
$1,507,115 $3,493,196
Unearned revenue
2,030,834 2,130,637
Taxes payable
- 2,140,627
Accrued liabilities and other payables
5,458,024 3,536,149
Notes payable - bank acceptances
1,723,165 1,806,564
Loans payable
4,394,767 4,393,544
Total current liabilities

15,113,905   17,649,840
DEFERRED TAX LIABILITY
944   8,526
COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY

Common stock, $0.001 par value; 75,000,000 shares authorized, 32,794,875 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively
32,795   32,795
Paid in capital
74,918,122   74,917,370
Statutory reserve
3,040,485   2,872,006
Accumulated other comprehensive income
1,009,133   969,988
Retained earnings
22,747,855   21,231,484
Total Company stockholders' equity
101,748,390   100,023,643
NONCONTROLLING INTEREST
706,365   694,201
TOTAL EQUITY
102,454,755   100,717,844
TOTAL LIABILITIES AND EQUITY
$117,569,604 $118,376,210

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
FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009

	THREE MONTHS ENDED MARCH 31, 2010	2009
Net sales	$ 9,368,836	$ 6,207,503
Cost of goods sold	6,129,801	3,900,947
Gross profit	3,239,035	2,306,556
Operating expenses		
Selling expenses	644,923	460,913
General and administrative expenses	776,996	569,522
Total operating expenses	1,421,919	1,030,435
Income from operations	1,817,116	1,276,121
Non-operating income (expenses)		
Interest income	155,037	16,681
Interest expense	(61,252)	(52,852)
Financial expense	(4,313)	(1,840)
Other income	66,735	760
Other expenses	(240)	-
Total non-operating income (expenses), net	155,967	(37,251)
Income before income tax	1,973,083	1,238,870
Income tax expense	269,520	217,601
Income from operations	1,703,563	1,021,269
Less: Income attributable to noncontrolling interest	(482)	-
Net income to SmartHeat Inc	1,703,081	1,021,269
Other comprehensive item		
Foreign currency translation	23,054	1,710
Comprehensive Income	$ 1,726,135	$ 1,022,979
Basic weighted average shares outstanding	32,794,875	24,179,900
Diluted weighted average shares outstanding	32,864,453	24,184,174
Basic earnings per share	$ 0.05	$ 0.04

Diluted earnings per share	$	0.05	$	0.04

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

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE THREE MONTHS ENDED MARCH 31, 2010 AND 2009

	THREE MONTHS ENDED MARCH 31, 2010	THREE MONTHS ENDED MARCH 31, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Income including noncontrolling interest	$ 1,703,563	$ 1,021,269
Adjustments to reconcile income including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	228,614	96,684
Unearned interest on accounts receivable	39,574	28,854
Stock option compensation expense	752	-
Changes in deferred tax liability	(7,584)	(122)
(Increase) decrease in current assets:		
Accounts receivable	8,273,722	1,073,545
Retentions receivable	(215,311)	(575,657)
Advances to suppliers	(887,598)	(838,551)
Other receivables, prepayments and deposits	(948,705)	(608,803)
Inventory	(11,996,634)	(2,044,149)
Increase (decrease) in current liabilities:		
Accounts payable	(2,070,772)	1,596,204
Unearned revenue	(100,387)	238,745
Taxes payable	(3,263,301)	(1,164,537)
Accrued liabilities and other payables	2,498,738	442,319
Net cash used in operating activities	(6,745,329)	(734,199)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(35,320)	47,361
Acquisition of property & equipment & intangible asset	(146,457)	(10,474)
Notes receivable	51,427	-
Net cash used in (provided by) investing activities	(130,350)	36,887
EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS	(12,791)	(248)
NET DECREASE IN CASH & CASH EQUIVALENTS	(6,888,470)	(697,560)
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD	48,967,992	1,435,212
CASH & CASH EQUIVALENTS, END OF PERIOD	$ 42,079,522	$ 737,652
Supplemental Cash flow data:		
Income tax paid	$ 648,603	$ 777,627
Interest paid	$ 61,252	$ 60,316

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

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

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 designs, manufactures, sells, and services plate heat exchangers (“PHE”), PHE Units, and heat meters through its wholly owned operating subsidiaries in China.

On April 14, 2008, the Company entered into a Share Exchange Agreement (the “Share Exchange Agreement”) with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu") and the Taiyu Shareholders. At the closing under the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu’s share capital in the amount of Yuan 25,000,000 were exchanged for 18,500,000 shares of SmartHeat common stock (the “Share Exchange”). 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, 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 recapitalization, and pro-forma information is not presented. Transaction costs incurred in the reverse acquisition were expensed.

Taiyu was incorporated in the Liaoning Province, China in July 2002. Taiyu manufactures and sells PHEs, PHE Units, and heat meters. 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") with Asialink (Far East) Limited ("Asialink") to acquire all 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 was 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 March 31, 2010, the Company paid approximately $3 million. The payment terms do not include any default provision. The Company paid approximately $1.8 million in April 2010.

On August 14, 2009, the Company formed a joint venture in Beijing, named Beijing SmartHeat Jinhui Energy Technology Co., Ltd (“Jinhui”), with registered capital of RMB 10 million (US $1.46 million) for research, development, manufacturing , and sales of plate heat exchangers in more regions of China. Jinhui has not commenced operations as of March 31, 2010. SmartHeat owns 52% of Jinhui and invested approximately $765,000.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, Taiyu, SanDeKe, SmartHeat Siping, a newly incorporated subsidiary in June 2009, and Jinhui, a joint venture formed in August 2009. The "Company" refers collectively to SmartHeat, Taiyu, SanDeKe, SmartHeat Siping and Jinhui. All significant inter-company accounts and transactions were eliminated in consolidation.

Non-Controlling Interest

Effective January 1, 2009, the Company adopted Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 810, "Consolidation," which established new standards governing the accounting for and reporting of noncontrolling interests (NCIs) in partially owned consolidated subsidiaries and the loss of control of subsidiaries. Certain provisions of this standard indicate, among other things, that NCIs (previously referred to as minority interests) be treated as a separate component of equity, not as a liability (as was previously the case), that increases and decreases in the parent's ownership interest that leave control intact be treated as equity transactions rather than as step acquisitions or dilution gains or losses, and that losses of a partially owned consolidated subsidiary be allocated to the NCI even when such allocation might result in a deficit balance. This standard also required changes to certain presentation and disclosure requirements. Losses attributable to the NCI in a subsidiary may exceed the NCI's interests in the subsidiary's equity. The excess attributable to the NCI is attributed to those interests. The NCI shall continue to be attributed its share of losses even if that attribution results in a deficit NCI balance.

Use of Estimates

In preparing the financial statements in conformity with US generally accepted accounting principles ("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 March 31, 2010, the Company maintained restricted cash of $1,385,634 in several bank accounts, $1,193,831 representing cash deposits from customers for securing payment from customers that occurs no later than the warranty period expires, and $191,803 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, $1,326,313 will be released to the Company within one year. As of December 31, 2009, the Company maintained restricted cash of $1,349,934 in several bank accounts, $1,036,101 representing cash deposits from customers for securing payment from customers that occurs no later than the warranty period expires, and $313,833 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, $1,301,573 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 $1,128,734 and $1,128,420 at March 31, 2010 and December 31, 2009, respectively.

At March 31, 2010 and December 31, 2009, the Company had retentions receivable from customers for product quality assurance of $1,451,248 and $1,235,573, 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 $188,743 and $149,123 at March 31, 2010 and December 31, 2009, 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, 5.575% at March 31, 2010, and 7.16% in December 31, 2009.

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.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

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 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 March 31, 2010 and December 31, 2009, there were no significant impairments of its long-lived assets.

Warranties

The Company offers standard 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 March 31, 2010 and December 31, 2009 are as follows:

	2010	2009
Beginning balance	$ 675,562	$ -
Provisions made	89,774	675,562

Actual costs incurred		(89,585)		-
Ending balance in current liabilities	$	675,751	$	675,562

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.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

The Company adopted the provisions of the 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. At March 31, 2010 and December 31, 2009, the Company had not taken any significant uncertain tax position on its tax return for 2009 and prior years or in computing its tax provision for 2009.

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 PHE and heat meters are delivered, and for 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 met are recorded as unearned revenue.

The Company's sales 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 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 three months ended March 31, 2010 and 2009. The Company does not provide right of return, price protection or any other concessions to its customers.

The Company provides a standard warranty to all customers, which 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 the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses 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 three months ended March 31, 2010 and 2009, revenue from after sales services after expiration of the warranty period was approximately $17,390 and $1,700, respectively.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

Cost of Goods Sold

Cost of goods sold consists primarily of material costs, direct labor and manufacturing overhead which are directly attributable to the 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 acceptances of $83,895.

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 computed similarly, 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 three months ended March 31, 2010 and 2009:

	2010	2009
Net income	$ 1,703,081	$ 1,021,269
Weighted average shares outstanding - basic	32,794,875	24,179,900
Effect of dilutive securities:		
Unexercised warrants and options	69,578	4,274

Weighted average shares outstanding - diluted		32,864,453		24,184,174
Earnings per share - basic	$	0.05	$	0.04
Earnings per share - diluted	$	0.05	$	0.04

Fair Value of Financial Instruments

For certain of the Company’s financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities and short-term debt, the carrying amounts approximate their fair values due to their short maturities. ASC Topic 820, “Fair Value Measurements and Disclosures,” requires disclosure of the fair value of financial instruments held by the Company. ASC Topic 825, “Financial Instruments,” defines fair value, and establishes a three-level valuation hierarchy for disclosures of fair value measurement that enhances disclosure requirements for fair value measures. The carrying amounts reported in the consolidated balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of their fair values because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels of valuation hierarchy are defined as follows:

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

§ Level 1 inputs to the valuation methodology are quoted prices 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.

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480, “Distinguishing Liabilities from Equity,” and ASC 815.

As of March 31, 2010, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at 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 FASB 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 in 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 damages were recorded as the Company's G&A expense with charging corresponding account to accrued liabilities. The Registration Statement became effective June 23, 2009. The Company paid $63,004 for the liquidated damages and the remaining $46,996 has been waived by investors.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

Reclassifications

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period.

New Accounting Pronouncements

On February 25, 2010, the FASB issued Accounting Standards Update (“ASU”) 2010-09 Subsequent Events Topic 855, “Amendments to Certain Recognition and Disclosure Requirements,” effective immediately. The amendments in the ASU remove the requirement for an SEC filer to disclose a date through which subsequent events have been evaluated in both issued and revised financial statements. Revised financial statements include financial statements revised as a result of either correction of an error or retrospective application of US GAAP. The FASB believes these amendments remove potential conflicts with the SEC’s literature. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

On March 5, 2010, the FASB issued ASU No. 2010-11 Derivatives and Hedging Topic 815, “Scope Exception Related to Embedded Credit Derivatives.” This ASU clarifies the guidance within the derivative literature that exempts certain credit related features from analysis as potential embedded derivatives requiring separate accounting. The ASU specifies that an embedded credit derivative feature related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another is not subject to bifurcation from a host contract under ASC 815-15-25, Derivatives and Hedging — Embedded Derivatives — Recognition. All other embedded credit derivative features should be analyzed to determine whether their economic characteristics and risks are “clearly and closely related” to the economic characteristics and risks of the host contract and whether bifurcation is required. The ASU is effective for the Company on July 1, 2010. Early adoption is permitted. The adoption of this ASU will not have a material impact on the Company’s consolidated financial statements.

3. INVENTORIES

Inventories at March 31, 2010 and December 31, 2009, were as follows:

		2010		2009
Raw materials	$	16,364,889	$	8,627,624
Work in process		2,685,198		1,001,495
Finished Goods		4,210,009		1,630,154
Total	$	23,260,096	$	11,259,273

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received Commercial Notes (Bank Acceptance) from the customers in lieu of the payments for accounts receivable. The Company discounted the Notes with the bank or endorsed the Notes to vendors, which could be for payment of their own obligations or to get cash from the third parties. Most of the Commercial Notes have a maturity of less than six months. At March 31, 2010 and December 31, 2009, the Company had notes receivable of $345,927 and $397,248, respectively.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at March 31, 2010 and December 31, 2009:

	2010	2009
Building	$ 4,420,545	$ 4,419,315
Production equipment	2,999,879	2,979,017
Office equipment	572,878	545,789
Vehicles	646,013	594,168
	8,639,315	8,538,289
Less: Accumulated depreciation	(967,551)	(798,680)
	$ 7,671,764	$ 7,739,609

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

Depreciation expense for the three months ended March 31, 2010 and 2009 was approximately $168,900 and $55,000, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at March 31, 2010 and December 31, 2009, respectively:

	2010	2009
Cash advance to third parties	$ 2,850,246	$ 1,332,787
Deposit for public bids of sales contracts	505,986	1,148,526
Prepayment for freight and related insurance expenses	59,040	74,412
Deposits	7,662	8,523
Advance to employees	551,609	432,144
Due from officer	-	576,208
Total	$ 3,974,543	3,572,600

Cash advance to third parties was 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, usually 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 loans to employees and advances to employees for business trips and related expenses. Other receivables, prepayments and deposits are reimbursed or settled within 12 months.

Other receivables, prepayments and deposits also included remaining proceeds of $576,208 at December 31, 2009 from the exercise of warrants credited to a bank account in the name of the Chief Financial Officer, which was controlled by the Company pursuant to a Bank Account Control Agreement between the Company and the Chief Financial Officer. The Company has the exclusive right to direct the use of all funds in the account solely for its benefit or the benefit of its subsidiaries pursuant to the Bank Account Control Agreement. The Chief Financial Officer was prohibited from using the funds in the account for her personal use. The $576,208 deposit was transferred to the Company’s bank account on March 18, 2010.

7. INTANGIBLE ASSETS

Intangible assets consisted mainly 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 rights during 2005 for approximately $440,000 (RMB 3,549,682). In June 2009, the Company acquired land use rights for $3,108,000 from Siping. 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.

Intangible assets consisted of the following at March 31, 2010 and December 31, 2009, respectively:

	2010	2009

Land use rights	$ 3,629,226	$ 3,628,216
Know-how technology	267,132	267,058
Customer list	191,885	191,832
Covenant not to compete	104,385	104,356
Software	244,091	196,218
	4,436,719	4,387,680
Less: accumulated amortization	(376,730)	(316,659)
	$ 4,059,989	$ 4,071,021

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SMARTHEAT INC. AND SUBSIDIARIES
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MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

Amortization expense of intangible assets for the three months ended March 31, 2010 and 2009 was approximately $60,000 and $42,000, respectively. Annual amortization expense for the next five years from March 31, 2010, is expected to be: $243,000, $242,000, $213,000, $129,000 and $85,000.

8. TAXES PAYABLE (RECEIVABLE)

Taxes payable consisted of the following at March 31, 2010 and December 31, 2009:

	2010	2009
Income tax payable	$ 79,976	$ 1,202,058
Value added tax payable (receivable)	(1,398,227)	878,638
Other taxes payable	195,886	59,931
	$ (1,122,365)	$ 2,140,627

9. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at March 31, 2010 and December 31, 2009:

	2010	2009
Advance from third parties	$ 50,903	$ 258,759
Payable to Siping	4,631,898	2,080,013
Other payables	20,424	91,329
Warranty reserve	675,751	675,562
Accrued liabilities	77,741	326,318
Accrued salary	1,307	104,168
Total	$ 5,458,024	$ 3,536,149

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. LOAN PAYABLE – INSTITUTIONAL INVESTOR

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. Under the terms of the Agreement, the Company agreed to interest of 10% 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. This loan was repaid during 2009.

11. NOTES PAYABLE – BANK ACCEPTANCES

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 certain percentage of the face value of the note which is amortized over the term of the acceptance.

12. LOANS PAYABLE - BANK

The Company was obligated for the following short term loans payable as of March 31, 2010 and December 31, 2009:

	2010	2009
From a commercial bank in the PRC for 30,000,000 RMB. Of which, 17,000,000 RMB 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.	$ 4,394,767	$ 4,393,544
	$ 4,394,767	$ 4,393,544

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

13. 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.

14. 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 U.S. and has net operating losses (NOL) for income tax purposes. SmartHeat has net operating loss carry forwards for income taxes of approximately $1,945,000 and $1,775,000 at March 31, 2010 and December 31, 2009, respectively, which may be available to reduce future years' taxable income as NOL; NOL can be carried forward up to 20 years from the year the loss is incurred. Management believes the realization of benefits from these losses remains 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.

According to the new income tax law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu was recognized as a new high-tech enterprise and, having registered its status with the tax bureau, therefore enjoys the income tax rate of 15% from 2009 through 2010.

SanDeKe is exempt from income tax for two years starting from its first profitable year, and is entitled to a 50% discount on the income tax rate for 2010 through 2012. The income tax rate for SanDeKe was 11% and 0% for 2010 and 2009, respectively.

SmartHeat Siping is subject to the regular 25% income tax rate.

Foreign pretax earnings were $2,144,260 and $1,352,956 for the three months ended March 31, 2010 and 209 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 those earnings are indefinitely invested outside the United States. At March 31, 2010, $24.7 million of accumulated undistributed earnings of non-U.S. subsidiaries was invested indefinitely. At the existing U.S. federal income tax rate, additional taxes of $4.8 million 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 three months ended March 31, 2010 and 2009:

	2010	2009
US statutory rates	34.0%	34.0%
Tax rate difference	(9.8)%	(15.7)%
Effect of tax holiday	(14.1)%	(4.5)%

Other	0.6%	-%
Valuation allowance for U.S. NOL	2.9%	4.2%
Tax per financial statements	13.6%	18.0%

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

15. MAJOR CUSTOMERS AND VENDORS

Four customers accounted for 61% and 50% of the Company’s net revenue for the three months ended March 31, 2010 and 2009, respectively. For the three months ended March 31, 2010, each customer accounted for approximately 17%, 17%, 14% and 13% of the sales. For the three months ended March 31, 2009, each customer accounted for approximately 18%, 16%, 12% and 5% of the sales. At March 31, 2010 and 2009, the total receivable balance due from these customers was approximately $3,500,000 and $3,319,000, respectively.

Two major vendors provided 37% of the Company’s purchases of raw materials for the three months ended March 31, 2010, and one major vendor provided 11% of the purchases for the three months ended March 31, 2009. For the three months ended March 31, 2010, the two vendors accounted for approximately 19% and 18% of the purchases. The Company had approximately $56,000 and $110,000 in accounts payable to its major vendors at March 31, 2010 and 2009, respectively.

16. STATUTORY RESERVES

Pursuant to the 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.

17. STOCKHOLDERS’ EQUITY

Common Stock with Warrants Issued for Cash

In August 2008, SmartHeat sold 1,630,000 Units at $3.50 per Unit for approximately $5.7 million. Each "Unit" consisted of one share of SmartHeat common stock and a three-year warrant to purchase 15% of one share of common stock at $6.00 per share. The Units sold represent 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 commissions 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. During 2009, 281,975 shares of warrants were exercised at $6 per share for $1,691,850.

Stock Options to Independent Directors and Employee

On July 17, 2008, the Company granted non-statutory stock options to each of its two independent U.S. 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. The options were valued at a 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.

On July 31, 2009, one of the Company’s independent U.S. directors voluntarily retired. As such, he forfeited his right to his unvested options to purchase 6,667 shares.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

On February 1, 2010, the Company issued stock options to one employee. The terms of the options are: 50,000 shares at an exercise price per share of $11.85, with a life of five years; 25,000 shares shall vest on June 30, 2011; 25,000 shares shall vest on June 29, 2012. The options were valued at a volatility of 74%, risk free interest rate of 2.76%, and dividend yield of 0%. The grant date fair value of options was $367,107.

Based on the fair value method under SFAS No. 123 (Revised) "Share Based Payment" ("SFAS 123(R)") (codified in FASB ASC Financial Instruments, Topic 718 & 505), 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.

Following is a summary of the warrant activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
Outstanding at December 31, 2008	393,000	6.00	2.51
Exercisable at December 31, 2008	393,000	6.00	2.51
Granted			
Exercised	(281,975)		
Forfeited			
Outstanding at December 31, 2009	111,025	$ 6.00	1.51
Exercisable at December 31, 2009	111,025	$ 6.00	1.51
Granted			
Exercised			
Forfeited			
Outstanding at March 31, 2010	111,025	6.00	1.26
Exercisable at March 31, 2010	111,025	6.00	1.26

Following is a summary of the option activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
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	6,667			
Outstanding at December 31, 2009	13,333	$	4.60	3.54
Exercisable at December 31, 2009	13,333	$	4.60	3.54
Granted	50,000	$	11.85	5.00
Exercised				
Forfeited				
Outstanding at March 31, 2010	63,333	$	10.32	4.51
Exercisable at March 31,2010	63,333	$	10.32	4.51

There were no options exercised during the three months ended March 31, 2010.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2010 (UNAUDITED) AND DECEMBER 31, 2009

Stocks issues for public offering

On September 22, 2009, the Company closed its public offering of 8,333,000 shares of its common stock, at $9 per share, which includes 1,086,913 shares sold as a result of the underwriters' exercise of their over-allotment option in full at closing. $74,997,000 was received from this offering. After underwriting discounts and commissions and offering expenses, the Company received net proceeds of $65,007,390. The Company paid $5,249,790 to the underwriters as commission for this public offering. In addition, the Company paid an additional $4,499,820 advisory fee in connection with this public offering.

18. 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. On February 1, 2010, the Company approved an increase in the annual compensation for Mr. Jun Wang to a base salary of US $150,000 per annum, effective as of February 1, 2010. 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. Ms. Zhijuan Guo’s current salary is $18,000 per annum.

Consulting Agreements

On January 1, 2010, the Company entered into a one-year consulting service agreement with a consultant for providing business development assistance and engineering advice regarding the sales and marketing of the products of the Company. The Company will compensate the consultant with an aggregate of up to 4,000 restricted shares of the Company’s common stock, with 1,000 shares to be granted on February 1, 2010, 1,000 shares to be granted on May 31, 2010, 1,000 shares to be granted on August 31, 2010, and 1,000 shares to be granted on November 30, 2010.

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. Total rental expense for the three months ended March 31, 2010 and 2009, was approximately $17,000 and $32,000, respectively.

19. CONTINGENCIES

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.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the shareholders of SmartHeat, Inc. and Subsidiaries
fka (Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd.)

We have audited the consolidated balance sheets of SmartHeat, Inc., fka (Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd.) and Subsidiaries (the "Company") as of December 31, 2009 and 2008, and the related consolidated statements of income and other comprehensive income, shareholders' equity and cash flows for each of the two years ended on December 31, 2009 and 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for the years ended December 31, 2009 and 2008, in conformity with U.S. generally accepted accounting principles.

Goldman Parks Kurland Mohidin, LLP
Encino, California
March 29, 2010

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2009 AND 2008

	2009	2008
ASSETS		
CURRENT ASSETS		
Cash & cash equivalents	$ 48,967,992	$ 1,435,212
Restricted cash	1,301,573	462,048
Accounts receivable, net	31,887,785	11,390,169
Retentions receivable	885,642	290,852
Advances to suppliers	7,657,791	412,524
Other receivables, prepayments and deposits	3,572,600	698,834
Inventories	11,259,273	6,107,583
Notes receivable - bank acceptances	397,248	14,631
Total current assets	105,929,904	20,811,853
NON-CURRENT ASSETS		
Restricted cash	48,361	219,472
Accounts receivable, net	237,384	310,810
Retentions receivable	349,931	166,912
Intangible assets, net	4,071,021	1,155,131
Property and equipment, net	7,739,609	2,436,553
Total noncurrent assets	12,446,306	4,288,878
TOTAL ASSETS	$ 118,376,210	$ 25,100,731
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 3,493,196	$ 1,210,906
Unearned revenue	2,130,637	850,408
Taxes payable	2,140,627	1,327,775
Accrued liabilities and other payables	3,685,272	1,330,812
Due to minority shareholder	-	5,303
Notes payable - bank acceptances	1,806,564	-
Loans payable	4,393,544	2,443,450
Total current liabilities	17,649,840	7,168,654
DEFERRED TAX LIABILITY	8,526	38,854
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
	32,795	24,180

Common stock, $0.001 par value; 75,000,000 shares authorized, 32,794,875 and 24,179,900 shares issued and outstanding at December 31, 2009 and 2008, respectively		
Paid in capital	74,917,370	8,223,453
Statutory reserve	2,872,006	1,150,542
Accumulated other comprehensive income	969,988	984,629
Retained earnings	21,231,484	7,510,419
Total Company stockholders' equity	100,023,643	17,893,223
NONCONTROLLING INTEREST	694,201	-
TOTAL EQUITY	100,717,844	17,893,223
TOTAL LIABILITIES AND EQUITY	$ 118,376,210	$ 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
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	YEARS ENDED DECEMBER 31, 2009	2008
Net sales	$ 82,563,869	$ 32,676,082
Cost of goods sold	53,467,805	21,717,735
Gross profit	29,096,064	10,958,347
Operating expenses		
Selling expenses	3,934,749	1,564,977
General and administrative expenses	6,986,116	1,851,693
Total operating expenses	10,920,865	3,416,670
Income from operations	18,175,199	7,541,677
Non-operating income (expenses)		
Interest income	409,221	405,266
Interest expense	(518,382)	(314,192)
Financial expense	(30,304)	-
Other income	116,795	11,738
Other expenses	(2,838)	(13,709)
Exchange loss	(26,255)	(12,044)
Subsidy income	165,598	16,230
Total non-operating income, net	113,835	93,289
Income before income tax	18,289,034	7,634,966
Income tax expense	2,858,186	1,293,660
Income from operations	15,430,848	6,341,306
Less: Income (loss) attributable to noncontrolling interest	(11,681)	5,966
Net income to SmartHeat Inc	15,442,529	6,335,340
Other comprehensive item		
Foreign currency translation	(14,641)	510,770
Comprehensive Income	$ 15,427,888	$ 6,846,110
Basic weighted average shares outstanding	26,535,502	22,176,322

Diluted weighted average shares outstanding		26,592,066		22,176,432
Basic earnings per share	$	0.58	$	0.29
Diluted earnings per share	$	0.58	$	0.29

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

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	Common stock				Other comprehensive		
	Shares	Amount	Paid in capital	Statutory reserves	income	Retained earnings	Total
Balance at January 1, 2008	18,500,000	$ 18,500	$ 3,102,132	$ 506,532	$ 473,859	$ 1,819,089	$ 5,920,112
Recapitalization on reverse acquisition	4,049,900	4,050	-4,050	-	-	-	-
Shares issued	1,630,000	1,630	5,119,758	-	-	-	5,121,388
Net income for the year	-	-	-	-	-	6,335,340	6,335,340
Stock compensation expense related to stock options	-	-	5,613	-	-	-	5,613
Transfer to statutory reserves	-	-	-	644,010	-	-644,010	-
Foreign currency translation gain	-	-	-	-	510,770	-	510,770
Balance at December 31, 2008	24,179,900	24,180	8,223,453	1,150,542	984,629	7,510,419	17,893,223
Shares issued	8,333,000	8,333	64,999,057	-	-	-	65,007,390
Warrants exercised	281,975	282	1,691,568	-	-	0	1,691,850
Net income for the year	-	-	-	-	-	15,442,529	15,442,529
Stock compensation expense related to stock options	-	-	3,292	-	-	-	3,292
Transfer to statutory reserves	-	-	-	1,721,464	-	-1,721,464	-
Foreign currency translation gain	-	-	-	-	-14,641	-	-14,641

Balance at December 31, 2009	32,794,875	$ 32,795	$ 74,917,370	$ 2,872,006	$ 969,988	$ 21,231,484	$ 100,023,643

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

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2009 AND 2008

	YEARS ENDED DECEMBER 31, 2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Income including noncontrolling interest	$ 15,430,848	$ 6,341,306
Adjustments to reconcile income including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	635,368	252,598
Unearned interest on accounts receivable	120,522	(127,819)
Stock option compensation expense	3,292	5,613
Changes in deferred tax liability	(30,353)	(163)
(Increase) decrease in current assets:		
Accounts receivable	(20,724,401)	(4,943,868)
Retentions receivable	(777,062)	(74,797)
Advances to suppliers	(7,233,127)	62,759
Other receivables, prepayments and deposits	(2,230,595)	182,577
Inventory	(5,143,857)	2,405,678
Increase (decrease) in current liabilities:		
Accounts payable	4,051,684	(2,389,649)
Unearned revenue	1,278,907	(2,993,636)
Taxes payable	811,275	779,408
Accrued liabilities and other payables	(5,776,850)	(261,040)
Net cash used in operating activities	(19,584,349)	(761,033)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Increase in restricted cash	(667,502)	(108,040)
Cash purchased at acquisition	-	55,426
Acquisition of property & equipment	(942,442)	(439,861)
Notes receivable	-	(14,635)
Net cash used in investing activities	(1,609,944)	(507,110)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Cash contribution from noncontrolling interest	705,882	-
Change in due to minority shareholders	-	(663)
Repayment to shareholder	-	(343,913)
Proceeds from short term loans	4,552,774	5,136,069
Repayment on short term loans	(1,870,976)	(7,583,873)
Warrants exercised	380,850	-
Shares issued	65,007,390	5,100,000
Net cash provided by financing activities	68,775,920	2,307,620
	(48,847)	2,588

EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS				
NET INCREASE IN CASH & CASH EQUIVALENTS		47,532,780		1,042,065
CASH & CASH EQUIVALENTS, BEGINNING OF YEAR		1,435,212		393,147
CASH & CASH EQUIVALENTS, END OF YEAR	$	48,967,992	$	1,435,212
Supplemental Cash flow data:				
Income tax paid	$	1,500,415	$	660,127
Interest paid	$	338,513	$	274,969

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

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

SmartHeat Inc., formerly known as Pacific Goldrim Resources, Inc. (the "Company" or "SmartHeat"), was incorporated August 4, 2006 in the State of Nevada. The Company designs, manufactures, sells, and services plate heat exchangers ("PHE"), PHE Units, and heat meters through its wholly owned operating subsidiaries in China.

On April 14, 2008, the Company entered into a Share Exchange Agreement (the "Share Exchange Agreement") with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu") and the Taiyu Shareholders. At the closing under the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of Yuan 25,000,000 were exchanged for an aggregate of 18,5000,000 shares of SmartHeat common stock (the "Share Exchange"). 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, 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 recapitalization, and pro-forma information is not presented. Transaction costs incurred in the reverse acquisition were expensed.

Taiyu was incorporated in the Liaoning Province, China in July, 2002. Taiyu manufactures and sells PHEs, PHE Units, and heat meters. . 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") with Asialink (Far East) Limited ("Asialink") to acquire all 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 was 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 December 31, 2009, the Company paid approximately $3 million. The payment terms do not include any default provision.

On August 14, 2009, the Company formed a Joint Venture (JV) with registered capital of RMB 10 million (US $1.46 million), Beijing SmartHeat Jinhui Energy Technology Co., Ltd ("Jinhui") for research, development, manufacturing , and sales of plate heat exchangers. The JV did not commence operations as of December 31, 2009. SmartHeat owns 52% of the JV and invested approximately $765,000.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, Taiyu, SanDeKe, SmartHeat Siping, a newly incorporated subsidiary in June of 2009 and Jinhui, a joint venture formed in August of 2009. The "Company" refers collectively to SmartHeat, Taiyu, SanDeKe, SmartHeat Siping and Jinhui. All significant inter-company accounts and transactions were eliminated in consolidation.

Non-Controlling Interest

Effective January 1, 2009, the Company adopted Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 810, "Consolidation," which established new standards governing the accounting for and reporting of noncontrolling interests (NCIs) in partially owned consolidated subsidiaries and the loss of control of subsidiaries. Certain provisions of this standard indicate, among other things, that NCIs (previously referred to as minority interests) be treated as a separate component of equity, not as a liability (as was previously the case), that increases and decreases in the parent's ownership interest that leave control intact be treated as equity transactions rather than as step acquisitions or dilution gains or losses, and that losses of a partially owned consolidated subsidiary be allocated to the NCI even when such allocation might result in a deficit balance. This standard also required changes to certain presentation and disclosure requirements. Losses attributable to the NCI in a subsidiary may exceed the NCI's interests in the subsidiary's equity. The excess attributable to the NCI is attributed to those interests. The NCI shall continue to be attributed its share of losses even if that attribution results in a deficit NCI balance.

Use of Estimates

In preparing the financial statements in conformity with US generally accepted accounting principle ("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 December 31, 2009, the Company maintained restricted cash of $1,349,934 in several bank accounts, $1,036,101 representing cash deposits from customers for securing payment from customers that occurs no later than the warranty period expires, and $313,833 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, $1,301,573 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 was 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 $1,128,420 and $629,687 at December 31, 2009 and December 31, 2008, respectively.

At December 31, 2009 and 2008, the Company had retentions receivable from customers for product quality assurance of $1,235,573 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 $149,123 and $28,526 at December 31, 2009 and 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, 7.16% at December 31, 2009 and 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.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

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 December 31, 2009 and 2008, there were no significant impairments of its long-lived assets.

Warranties

The Company offers standard 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 activity for 2009 and 2008 was as follows:

	2009	2008
Beginning balance	$ -	$ -

Provisions made		675,562		95,000
Actual costs incurred		-		(95,000)
Ending balance in current liabilities	$	675,562	$	-

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.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

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. At December 31, 2009 and 2008, the Company had not taken any significant uncertain tax position on its tax return for 2008 and prior years or in computing its tax provision for 2009.

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 PHE and heat meters are delivered and for 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 met are recorded as unearned revenue.

The Company's sales 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 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 2009 and 2008. The Company does not provide right of return, price protection or any other concessions to its customers.

The Company provides standard warranty to all customers, which 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 years ended December 31, 2009 and 2008, revenue from after sales services after expiration of the warranty period was approximately $471,900 and $49,800, 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 products. Write-down of inventories to lower of cost or market is also recorded in cost of goods sold.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

Concentration of Credit Risk

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

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

Statement of Cash Flows

In accordance with SFAS No. 95, “Statement of Cash Flows,” 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 acceptances of $1,805,823, conversion from accounts receivable to notes receivable – bank acceptances of $382,446, and assets purchased from Siping of $7,906,296 during 2009. Cash from financing activity and operating activity excludes (1) $1.3 million proceeds from the exercise of warrants, the proceeds of which were deposited in a bank account in the name of the Chief Financial Officer but was controlled by the Company pursuant to a Bank Account Control Agreement and (2) $734,792 paid from that account to an independent third party as repayment of a loan due from the Company.

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:

	2009	2008
Net income	$ 15,442,529	$ 6,335,340
Weighted average shares outstanding - basic	26,535,502	22,176,322
Effect of dilutive securities:		
Unexercised warrants and options	56,564	110
Weighted average shares outstanding - diluted	26,592,066	22,176,432

Earnings per share - basic	$	0.58	$	0.29
Earnings per share - diluted	$	0.58	$	0.29

Fair Value of Financial Instruments

For certain of the Company’s financial instruments, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities and short-term debt, the carrying amounts approximate their fair values due to their short maturities. ASC Topic 820, “Fair Value Measurements and Disclosures,” requires disclosure of the fair value of financial instruments held by the Company. ASC Topic 825, “Financial Instruments,” defines fair value, and establishes a three-level valuation hierarchy for disclosures of fair value measurement that enhances disclosure requirements for fair value measures. The carrying amounts reported in the consolidated balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of their fair values because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels of valuation hierarchy are defined as follows:

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Level 1 inputs to the valuation methodology are quoted prices 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.

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480, “Distinguishing Liabilities from Equity,” and ASC 815.

As of December 31, 2009, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at 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 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 June 23, 2009. The Company paid $63,004 for the liquidated damage in 2009.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2009 AND 2008

New Accounting Pronouncements

In October 2009, the FASB issued an Accounting Standards Update ("ASU") regarding accounting for own-share lending arrangements in contemplation of convertible debt issuance or other financing. This ASU requires that at the date of issuance of the shares in a share-lending arrangement entered into in contemplation of a convertible debt offering or other financing, the shares issued shall be measured at fair value and be recognized as an issuance cost, with an offset to additional paid-in capital. Further, loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs, at which time the loaned shares would be included in the basic and diluted earnings-per-share calculation. This ASU is effective for fiscal years beginning on or after December 15, 2009, and interim periods within those fiscal years for arrangements outstanding as of the beginning of those fiscal years. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

In August 2009, the FASB issued an ASU regarding measuring liabilities at fair value. This ASU provides additional guidance clarifying the measurement of liabilities at fair value in circumstances in which a quoted price in an active market for the identical liability is not available; under those circumstances, a reporting entity is required to measure fair value using one or more of valuation techniques, as defined. This ASU is effective for the first reporting period, including interim periods, beginning after the issuance of this ASU. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

On July 1, 2009, the Company adopted ASUNo. 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. ASC Topic 810-10requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. ASC Topic 810also 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. ASC Topic 855-requires that public entities evaluate subsequent events through the date that the financial statements are issued.

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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 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 December 31, 2009 and 2008 were as follows:

	2009	2008
Raw materials	$ 8,627,624	$ 4,411,298
Work in process	1,001,495	652,472
Finished Goods	1,630,154	1,043,813

Total	$ 11,259,273	$ 6,107,583

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received Commercial Notes (Bank Acceptance) from the customers in lieu of the payments for accounts receivable. The Company discounted the Notes with the bank or endorsed 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 December 31, 2009 and 2008, the Company had notes receivable of $397,248 and $14,631, respectively.

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5. PROPERTY AND EQUIPMENT, NET

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

	2009	2008
Building	$ 4,419,315	$ 1,818,827
Production equipment	2,979,017	441,065
Office equipment	545,789	231,975
Vehicles	594,168	300,956
	8,538,289	2,792,823
Less: Accumulated depreciation	(798,680)	(356,270)
	$ 7,739,609	$ 2,436,553

Depreciation expense for 2009 and 2008 was approximately $442,400 and $168,000, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

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

	2009	2008
Cash advance to third parties	$ 1,332,787	$ 89,628
Deposit for public bids of sales contracts	1,148,526	353,399
Prepayment for freight and related insurance expenses	74,412	95,888
Deposits	8,523	42,783
Advance to employees	432,144	117,136
Due from officer	576,208	-
Total	$ 3,572,600	698,834

Cash advance to third parties was 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.

Other receivables, prepayments and deposits include remaining proceeds of $576,210 at December 31, 2009 from the exercise of warrants credited to a bank account in the name of the Chief Financial Officer which was controlled by the Company pursuant to a Bank Account Control Agreement between the Company and the Chief Financial Officer. The Company has exclusive right to direct the use of all funds in the account solely for its benefit or the benefit of its subsidiaries pursuant to the Bank Account Control Agreement. The Chief Financial Officer was prohibited from using the funds in the account for her personal use. The $576,210 deposit was transferred to the Company’s bank account on March 18, 2010.

7. 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). In June of 2009, the Company acquired land use rights for $3,108,000 from Siping. 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.

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

	2009	2008
Land use rights	$ 3,628,216	$ 519,369
Know-how technology	267,058	266,808
Customer list	191,832	191,652
Covenant not to compete	104,356	104,258
Software	196,218	190,166
	4,387,680	1,272,253
Less: accumulated amortization	(316,659)	(117,122)
	$ 4,071,021	$ 1,155,131

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Amortization expense of intangible assets for 2009 and 2008 was approximately $199,500 and $63,000, respectively. Annual amortization expense for the next five years from December 31, 2009 is expected to be: $233,000, $233,000, $215,000, $146,000 and $77,000.

8. TAXES PAYABLE

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

	2009	2008
Income tax payable	$ 1,202,058	$ 723,958
Value added tax payable	878,638	597,676
Other taxes payable	59,931	6,141
	$ 2,140,627	$ 1,327,775

9. ACCRUED LIABILITIES AND OTHER PAYABLES

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

	2009	2008
Advance from third parties	$ 258,759	$ 453,625
Payable for purchase of SanDeKe	-	741,516
Payable to SiPing – current portion	2,080,013	-
Other payables	91,329	99,418
Warranty reserve	675,562	-
Accrued liabilities	475,441	36,253
Accrued salary	104,168	-
Total	$ 3,685,272	$ 1,330,812

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. LOAN PAYABLE – INSTITUTIONAL INVESTOR

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. Under the terms of the Agreement, the Company agreed to interest of 10% 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. This loan was repaid during the quarter from the proceeds of a public offering.

11. NOTES PAYABLE – BANK ACCEPTANCES

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 certain percentage of the face value of the note which is amortized over the term of the acceptance.

12. LOANS PAYABLE - BANK

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

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	2009	2008
From a commercial bank in the PRC for 30,000,000 RMB. Of which, 17,000,000 RMB 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.	$ 4,393,544	$ -
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 of 2009.	-	877,886
Loans during 2006 and 2007 with a third party in the PRC for total of 10, 300,000 RMB. These loans bore variable interest at 8.591% for 2009 and 2008. The Company repaid RMB 2,600,000 in 2008, RMB 2,700,000 in April of 2009, and RMB 5,000,000 in December of 2009.	-	1,126,621
One year loan on July 1, 2008 with another third party company in the PRC for 3,000,000 RMB. This loan has renewed and due on December 31, 2009 with interest of 8.591%. The Company repaid loan in December of 2009.	-	438,943
	$ 4,393,544	$ 2,443,450

13. 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.

14. 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 US and has net operating losses (NOL) for income tax purposes. SmartHeat has net operating loss carry forwards for income taxes of approximately $1,775,000 at December 31, 2009 which may be available to reduce future years' taxable income as NOL; NOL can be carried forward up to 20 years from the year the loss is incurred. Management believes the realization of benefits from these losses 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.

The Company's net income for the year ended December 31, 2009 would be lower by approximately $2,319,000 or $0.09 earnings per common share, had Taiyu not enjoyed lower income tax rate and SanDeKe not been exempted from income tax for the year ended December 31, 2009.

Foreign pretax earnings approximated $19,957,433 and $7,746,800 for the years ended December 31, 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 those earnings are indefinitely invested outside the United States. At December 31, 2009, $23,011,781 of accumulated undistributed earnings of non-U.S. subsidiaries was indefinitely invested. At the existing U.S. federal income tax rate, additional taxes of $4,758,600 would have to be provided if such earnings were remitted currently.

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The following table reconciles the U.S. statutory rates to the Company's effective tax rate for the years ended December 31, 2009 and 2008:

	2009	2008
US statutory rates	34.0%	34.0%
Tax rate difference	(15.3)%	(16.4)%
Effect of tax holiday	(7.2)%	(1.2)%
Other	1.0%	-%
Valuation allowance for US NOL	3.1%	0.5%
Tax per financial statements	15.6%	16.9%

15. STATUTORY RESERVES

Pursuant to the 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.

16. STOCKHOLDERS' EQUITY

Common Stock with Warrants Issued for Cash

In August 2008, SmartHeat sold 1,630,000 Units at $3.50 per Unit for gross proceeds of approximately $5.7 million. Each "Unit" consisted of one share of SmartHeat common stock and a three year warrant to purchase 15% of one share of common stock at $6.00 per share. The Units sold represent 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. During 2009, 281,975 shares of warrants were exercised at $6 per share for the aggregate amount of $1,691,850.

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.

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On July 31, 2009, one of the Company's independent US directors voltuntarily retired. As such, he forefeited his right to his unvested options to purchase 6,667 shares.

Based on the fair value method under SFAS No. 123 (Revised) "Share Based Payment" ("SFAS 123(R)"), (codified in FASB ASC Financial Instruments, Topic 718 & 505) 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 year ended December 31, 2009.

Following is a summary of the warrant activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
Outstanding at December 31, 2007	-		
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	(281,975)		
Forfeited			
Outstanding at December 31, 2009	111,025	$ 6.00	1.51
Exercisable at December 31, 2009	111,025	$ 6.00	1.51

Following is a summary of the option activity:

	Number of Shares	Average Exercise Price per Share	Weighted 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	6,667			
Outstanding at December 31, 2009	13,333	$	4.60	3.54
Exercisable at December 31, 2009	13,333	$	4.60	3.54

SMARTHEAT INC. AND SUBSIDIARIES
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Stocks issues for public offering

On September 22, 2009, the Company closed its public offering of 8,333,000 shares of its common stock, at $9 per share, which includes 1,086,913 shares sold as a result of the underwriters' exercise of their over-allotment option in full at closing. A total gross proceeds of $74,997,000 was received from this offering. After underwriting discounts and commissions and offering expenses, the Company received net proceeds of US $65,007,390. The Company paid $5,249,790 to the underwriters as commission for this public offering. In addition, the Company paid an additional $4,499,820 advisory fee in connection with this public offering.

17. 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 $18,000 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. Total rental expense for the years ended December 31, 2009 and 2008 was approximately $128,000 and $87,000, respectively.

18. CONTINGENCIES

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.

19. 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.

SMARTHEAT INC. AND SUBSIDIARIES
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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

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

The following unaudited pro forma consolidated results of operations of the Company for the year ended December 31, 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.

For the year ended December 31, 2008	Pro forma Consolidated
Net revenue	$ 34,811,919
Cost of revenue	23,470,686
Gross profit	11,341,233
Selling expense	1,564,370
General & administrative expense	2,215,839
Total operating expenses	3,780,209
Income from operations	7,561,024
Non-operating income net	92,887
Income before income tax	7,653,337
Income tax	1,293,823
Minority interest	5,966
Net income	$ 6,353,548

SMARTHEAT INC.

2,023,000 SHARES OF COMMON STOCK

PROSPECTUS

MAY 24, 2010