SMARTHEAT INC.
Form 10-Q
November 10, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

OR

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

Commission file number: 001-34246

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

Nevada (State or other jurisdiction of incorporation or organization)	98-0514768 (IRS Employer Identification No.)
A-1, 10, Street 7 Shenyang Economic and Technological Development Zone Shenyang, China (Address of principal executive offices)	110027 (Zip Code)

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 32,811,125 shares of common stock outstanding as of November 8, 2010.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

		September 30, 2010 (Unaudited)		December 31, 2009
ASSETS				
CURRENT ASSETS				
Cash & cash equivalents	$	14,724,091	$	48,967,992
Restricted cash		1,296,318		1,301,573
Accounts receivable, net		50,052,608		31,887,785
Retentions receivable		2,096,943		885,642
Advances to suppliers		12,623,696		7,657,791
Other receivables, prepayments and deposits		5,352,081		3,572,600
Inventories		32,457,863		11,259,273
Notes receivable - bank acceptances		944,769		397,248
Total current assets		119,548,369		105,929,904
NON-CURRENT ASSETS				
Deferred tax asset		14,837		-
Restricted cash		92,013		48,361
Accounts receivable, net		219,725		237,384
Retentions receivable		734,238		349,931
Deposit for land use right		9,597,390		-
Intangible assets, net		4,127,767		4,071,021
Construction in progress		80,254		-
Property and equipment, net		8,044,911		7,739,609
Total noncurrent assets		22,911,135		12,446,306
TOTAL ASSETS	$	142,459,504	$	118,376,210
LIABILITIES AND STOCKHOLDERS' EQUITY				
CURRENT LIABILITIES				
Accounts payable	$	5,421,730	$	3,493,196
Unearned revenue		4,283,004		2,130,637
Taxes payable		2,799,694		2,140,627
Accrued liabilities and other payables		4,887,566		3,685,272
Notes payable - bank acceptances		1,516,865		1,806,564
Loans payable		4,476,877		4,393,544
Total current liabilities		23,385,736		17,649,840
DEFERRED TAX LIABILITY		-		8,526

COMMITMENTS AND CONTINGENCIES				
STOCKHOLDERS' EQUITY				
Common stock, $0.001 par value; 75,000,000 shares authorized, 32,811,125 and 32,794,875 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively		32,811		32,795
Paid in capital		75,163,813		74,917,370
Statutory reserve		4,613,151		2,872,006
Accumulated other comprehensive income		2,901,709		969,988
Retained earnings		35,673,363		21,231,484
Total Company stockholders' equity		118,384,847		100,023,643
NONCONTROLLING INTEREST		688,921		694,201
TOTAL EQUITY		119,073,768		100,717,844
TOTAL LIABILITIES AND EQUITY	$	142,459,504	$	118,376,210

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

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	NINE MONTHS ENDED SEPTEMBER 30,		THREE MONTHS ENDED SEPTEMBER 30,	
	2010	2009	2010	2009
Net sales	$ 83,613,250	$ 56,541,795	$ 51,476,821	$ 37,835,897
Cost of goods sold	54,177,914	36,562,363	33,061,854	24,687,460
Gross profit	29,435,336	19,979,432	18,414,968	13,148,438
Operating expenses				
Selling expenses	5,972,651	2,325,471	3,335,303	1,165,939
General and administrative expenses	4,622,468	2,626,775	2,061,453	1,286,643
Total operating expenses	10,595,119	4,952,245	5,396,756	2,452,582
Income from operations	18,840,217	15,027,187	13,018,212	10,695,856
Non-operating income (expenses)				
Interest income	322,462	145,839	122,898	65,418
Interest expense	(41,871)	(209,462)	(46,916)	(91,850)
Financial expense	(36,430)	(222,625)	(17,427)	(222,625)
Exchange loss	24,652	-	68,323	-
Other income	135,715	21,443	51,910	(14,866)
Other expenses	(1,269)	61,644	150	72,843
Total non-operating income (expenses), net	403,259	(203,161)	178,938	(191,080)
Income before income tax	19,243,476	14,824,026	13,197,149	10,504,776
Income tax expense	3,059,182	2,304,672	2,092,876	1,624,240
Income from operations	16,184,294	12,519,354	11,104,273	8,880,536
Less: Income attributable to noncontrolling interest	16,962	-	2,232	-
Income to SmartHeat Inc.	16,201,256	12,519,354	11,106,505	8,880,536
Other comprehensive item				
Foreign currency translation	1,931,721	270,399	1,418,870	257,256
Comprehensive Income	$ 18,132,977	$ 12,789,753	$ 12,525,375	$ 9,137,792
Basic weighted average shares outstanding	32,804,292	24,430,806	32,811,125	24,924,435
Diluted weighted average shares outstanding	32,846,171	24,513,092	32,817,520	25,010,735

Basic earnings per share	$	0.49	$	0.51	$	0.34	$	0.36
Diluted earnings per share	$	0.49	$	0.51	$	0.34	$	0.36

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

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	NINE MONTHS ENDED SEPTEMBER 30, 2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Income including noncontrolling interest	$ 16,184,294	$ 12,519,354
Adjustments to reconcile income including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	709,544	409,371
Allowance for accounts receivable	15,744	-
Unearned interest on accounts receivable	(74,520)	195,901
Stock option compensation expense	142,869	1,755
Stock issued for consulting service	18,090	-
Changes in deferred tax	(23,160)	(23,357)
(Increase) decrease in current assets:		
Accounts receivable	(17,807,291)	(9,305,812)
Retentions receivable	(1,547,759)	(2,403,726)
Advances to suppliers	(4,761,889)	(3,051,902)
Other receivables, prepayments and deposits	1,995,914	485,060
Inventory	(20,659,166)	(8,277,813)
Note receivables	(404,449)	(55,986)
Increase (decrease) in current liabilities:		
Accounts payable	3,635,847	5,782,299
Unearned revenue	2,079,159	1,232,371
Taxes payable	608,861	818,141
Accrued liabilities and other payables	128,354	(4,450,011)
Net cash used in operating activities	(19,759,558)	(6,124,354)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(12,593)	(380,457)
Acquisition of property & equipment	(3,277,320)	(3,610,566)
Acquisition of intangible asset	(170,689)	-
Deposit for land use right	(9,448,356)	-
Construction in progress	(79,008)	(60,203)
Net cash used in investing activities	(12,987,966)	(4,051,226)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short term loan	4,407,357	12,117,636
Repayment to short term loan	(4,407,357)	(9,216,986)
Payment on notes payable	(1,812,243)	-
Issuance of common stock	-	66,138,390
Warrants exercised	85,500	-
Net cash provided by (used in) financing activities	(1,726,743)	69,039,040
	230,366	(3,978)

EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS				
NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS		(34,243,901)		58,859,482
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD		48,967,992		1,435,213
CASH & CASH EQUIVALENTS, END OF PERIOD	$	14,724,091	$	60,294,695
Supplemental Cash flow data:				
Income tax paid	$	1,634,509	$	1,272,797
Interest paid	$	137,787	$	219,061

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

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 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 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 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 People’s Republic of China (“PRC”), to purchase certain assets consisting of the plant and equipment and certain land use rights for RMB 54,000,000, or United States Dollars (USD) $7,906,296. Taiyu then transferred all the assets acquired to SmartHeat Siping, the newly incorporated subsidiary. The Company paid RMB 7,250,000 ($1,061,500) upon the completion of inventory inspection. The remaining purchase consideration was non-interest bearing and was payable according to the following schedule:

Payment in RMB		Payment in USD		Scheduled Payment Date
RMB	3,000,000	$	439,239	May 27, 2009
RMB	10,250,000	$	1,500,732	June 30, 2009
RMB	13,000,000	$	1,903,367	September 30, 2009
RMB	12,300,000	$	1,800,878	March 1, 2010
RMB	8,200,000	$	1,200,586	September 30, 2010

At September 30, 2010, the Company had paid approximately $6.70 million and had a $1.2 million outstanding balance, which the Company expects to pay in December 2010 with the consent from the seller. The payment terms do not include any default provision.

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 ($1.46 million) for research, development, manufacturing and sales of plate heat exchangers in China. Jinhui has not commenced operations as of September 30, 2010. SmartHeat owns 52% of Jinhui and invested approximately $765,000.

On April 7, 2010, the Company formed a wholly-owned subsidiary in Shenyang, named Smartheat (China) Investment Co., Ltd (“HEAT Investment”), with registered capital of $70 million. HEAT Investment is an investment holding company.

On April 12, 2010, HEAT Investment formed a wholly-owned subsidiary in Shenyang, named SmartHeat (Shenyang) Energy Equipment Co., Ltd ("HEAT Energy"), with registered capital of $30 million for research, development, manufacturing and sales of energy products. HEAT Energy has not commenced operations as of September 30, 2010, except for a prepayment of $9.6 million for the purchase of a land use right; the Company expects to complete the acquisition of the land use right by the end of November 2010.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, HEAT Investment and HEAT Energy. The "Company" refers collectively to SmartHeat, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, HEAT Investment and HEAT Energy. 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 September 30, 2010, the Company maintained restricted cash of $1,388,331 in several bank accounts, of which $377,000 represented cash deposits from customers for securing payment from such customers that occurs no later than the warranty period expiration and approximately $1.01 million represented deposits the Company paid to a commercial bank for the bank issuing bank acceptances to the Company's vendors; of the total restricted cash at September 30, 2010, $1,296,318 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, of which approximately $1.03 million represented cash deposits from customers for securing payment from such customers that occurs no later than the warranty period expiration and $313,000 represented deposits the Company paid to a commercial bank for the bank issuing bank acceptances to the Company's vendors; of the total restricted cash at December 31, 2009, $1,301,573 will be released to the Company within one year. Restricted cash is held in 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 $1,165,814 and $1,128,420 at September 30, 2010 and December 31, 2009, respectively.

At September 30, 2010 and December 31, 2009, the Company had retentions receivable from customers for product quality assurance of $2,831,181 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 $91,127 and $149,123 at September 30, 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, which was 5.575% at September 30, 2010, and 7.16% at 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.

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 comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the assets. Fair value is generally determined using the asset’s expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of September 30, 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 September 30, 2010 and December 31, 2009, are as follows:

	2010	2009

Beginning balance	$	675,562	$	-
Provisions made		25,297		675,562
Actual costs incurred		-		-
Ending balance in current liabilities	$	700,859	$	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 included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company adopted the provisions of the FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (codified in FASB ASC Topic 740). 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 September 30, 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 VAT of 17% of gross sales price. This VAT may be offset by VAT paid by the Company on raw materials and other materials included in the cost of producing their finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

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

Sales returns and allowances were $0 for both the nine and three months ended September 30, 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 the expiration of the warranty period, with after-sales services mainly consisting of cleaning plate heat exchangers and repairing and exchanging parts. The Company recognizes such revenue when service is provided. For the nine months ended September 30, 2010 and 2009, revenue from after-sales services after the expiration of the warranty period was $74,000 and $299,000, respectively. For the three months ended September 30, 2010 and 2009, revenue from after-sales services after the expiration of the warranty period was $34,500 and $295,000, respectively.

Cost of Goods Sold

Cost of goods sold consists primarily of material costs, direct labor and manufacturing overhead that 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 for the nine months ended September 30, 2010, excluded the effect of issuance of notes payable (bank acceptance) of $1.5 million as payments for accounts payable, and $2.9 million notes receivable (bank acceptance) endorsed to vendors in lieu of payment.

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:

	Nine Months Ended September 30, (Unaudited)		Three Months Ended September 30, (Unaudited)	
	2010	2009	2010	2009
Net income	$ 16,201,256	$ 12,519,354	$ 11,106,505	$ 8,880,536
Weighted average shares outstanding - basic	32,804,292	24,430,806	32,811,125	24,924,435
Effect of dilutive securities:				
Unexercised warrants and options	41,879	82,286	6,395	86,300
Weighted average shares outstanding - diluted	32,846,171	24,513,092	32,817,520	25,010,735
Earnings per share - basic	$ 0.49	$ 0.51	$ 0.34	$ 0.36
Earnings per share - diluted	$ 0.49	$ 0.51	$ 0.34	$ 0.36

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:

§ 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 September 30, 2010 and 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 China 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 China 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 China 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 and 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 agreements 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).

Under the terms of the registration rights agreement entered into between the Company and the investors in the Company’s private placement offering conducted in 2008, the Company was required to file a registration statement (the “Registration Statement”) with the SEC within 60 days of the closing of the private placement and the Registration

Statement must be declared effective by the SEC within 180 days of the final closing of the private placement. 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 on September 24, 2008, and the 180-day period for effectiveness of the Registration Statement under the registration rights agreement ended on March 23, 2009. At March 31, 2009, the Company became liable to pay approximately $110,000 in liquidated damages to the investors because the Registration Statement had not been declared effective by the SEC 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 on June 23, 2009. The Company paid $63,004 for the liquidated damages and the remaining $46,996 was waived by investors.

Reclassifications

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

New Accounting Pronouncements

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

On February 25, 2010, the FASB issued 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. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In April 2010, the FASB codified the consensus reached in Emerging Issues Task Force Issue No. 08-09, "Milestone Method of Revenue Recognition." FASB ASU No. 2010-17 provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research and development transactions. FASB ASU No. 2010-17 is effective for fiscal years beginning on or after June 15, 2010, and is effective on a prospective basis for milestones achieved after the adoption date. The Company does not expect this ASU will have a material impact on its financial position or results of operations when it adopts this update on January 1, 2011.

3. INVENTORIES

Inventories at September 30, 2010 and December 31, 2009, were as follows:

	2010	2009
Raw materials	$ 16,023,547	$ 8,627,624
Work in process	3,801,792	1,001,495

Finished goods		12,632,524		1,630,154
Total	$	32,457,863	$	11,259,273

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received Commercial Notes (Bank Acceptance) from them in lieu of 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 September 30, 2010 and December 31, 2009, the Company had notes receivable of $944,769 and $397,248, respectively.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at September 30, 2010 and December 31, 2009:

	2010	2009
Building	$ 4,503,137	$ 4,419,315
Production equipment	3,501,841	2,979,017
Office equipment	625,212	545,789
Vehicles	801,269	594,168
Total	9,431,459	8,538,289
Less: Accumulated depreciation	(1,386,548)	(798,680)
Net	$ 8,044,911	$ 7,739,609

Depreciation expense for the nine months ended September 30, 2010 and 2009, was $518,703 and $268,000, respectively. Depreciation expense for the three months ended September 30, 2010 and 2009, was $119,603 and $157,000, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at September 30, 2010 and December 31, 2009, respectively:

	2010	2009
Cash advance to third parties	$ 1,737,327	$ 1,332,787
Deposit for public bids of sales contracts	1,275,501	1,148,526
Prepayment for freight and related insurance expenses	57,923	74,412
Deposits	374,296	8,523
Advance to employees	896,809	432,144
Others	1,010,225	-
Due from officer	-	576,208
Total	$ 5,352,081	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 on 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, payroll expense 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 September 30, 2010 and December 31, 2009, respectively:

	2010	2009
Land use rights	$ 3,697,033	$ 3,628,216
Know-how technology	272,123	267,058
Customer list	195,470	191,832
Covenant not to compete	106,335	104,356
Software	373,320	196,218
Total	4,644,281	4,387,680
Less: Accumulated amortization	(516,514)	(316,659)
Net	$ 4,127,767	$ 4,071,021

Amortization of intangible assets for the nine months ended September 30, 2010 and 2009 was $191,000 and $141,000, respectively. Amortization of intangible assets for the three months ended September 30, 2010 and 2009 was $67,000 and $58,000, respectively. Annual amortization expense for the next five years from September 30, 2010, is expected to be: $255,000, $250,000, $209,000, $104,000 and $92,000.

8. TAXES PAYABLE

Taxes payable consisted of the following at September 30, 2010 and December 31, 2009:

	2010	2009
Income tax	$ 2,354,163	$ 1,202,058
Value added tax	425,357	878,638
Other taxes	20,174	59,931
	$ 2,799,694	$ 2,140,627

9. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at September 30, 2010 and December 31, 2009:

	2010	2009
Advance from third parties	$ -	$ 258,759
Payable to Siping (see Note 1)	1,223,680	2,080,013
Other payables	1,022,993	91,329
Warranty reserve	700,859	675,562
Accrued liabilities	1,940,034	579,609
Total	$ 4,887,566	$ 3,685,272

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 purchase, interest, utility, and liquidated damages for failure of the Registration Statement to be declared effective by the SEC within 180 days of the final closing of the private placement, which Registration Statement was subsequently declared effective in June 2009 (See Note 2).

10. NOTES PAYABLE – BANK ACCEPTANCES

Notes payable represented the conversion of accounts payable into notes payable, which were issued from the bank. The Company deposited a portion of the acceptance amount into the bank. The bank charged a certain percentage of the face value of the note, which is amortized over the term of the acceptance.

11. LOANS PAYABLE - BANK

The Company was obligated for the following short term loans payable as of September 30, 2010 and December 31, 2009:

	2010	2009
From a commercial bank in the PRC for RMB 30,000,000, of which RMB 17,000,000 was entered into on April 22, 2009, and was due on April 22, 2010, and RMB 13,000,000 was entered into on June 12, 2009, and was due on June 12, 2010. These loans had an interest rate of 5.576%. The Company pledged its building in the value of approximately	$ -	$ 4,393,544

RMB 12,430,950 or approximately $1,818,000 for these loans. The Company paid the loans in full when they matured.		
From a commercial bank in the PRC for RMB 17,000,000 entered into on July 1, 2010. The loan currently bears interest at 5.31% with maturity on June 30, 2011. The Company pledged its building and land use rights for this loan.	2,536,897	-
From a commercial bank in the PRC for RMB 13,000,000 entered into on August 9, 2010. The loan currently bears interest at 5.31% with maturity on June 30, 2011. The Company pledged its building and land use rights for this loan,.	1,939,980	-
	$ 4,476,877	$ 4,393,544

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12. DEFERRED TAX ASSET (LIABILITY)

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

13. INCOME TAXES

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

SmartHeat was incorporated in the U.S. and has net operating losses (NOL) for income tax purposes. SmartHeat has net operating loss carry forwards for income taxes of approximately $2,381,000 and $1,775,000 at September 30, 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, Jinhui, HEAT Investment and HEAT Energy are subject to the regular 25% income tax rate.

The following table reconciles the U.S. statutory rates to the Company's effective tax rate for the nine and three months ended September 30, 2010 and 2009:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2010	2009	2010	2009
US statutory rates	34.0%	34.0%	34.0%	34.0%
Tax rate difference	(9.4)%	(14.0)%	(9.2)%	(14.0)%
Effect of tax holiday	(10.7)%			