

SMARTHEAT INC.
Form 10-Q
August 09, 2011

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

FORM 10-Q

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

For the quarterly period ended June 30, 2011

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)

110141
(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 NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

YES NO

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

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Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 38,601,939 shares of common stock outstanding as of August 8, 2011.

SmartHeat Inc.

Table of Contents

	Page
PART I. FINANCIAL INFORMATION	
Item 1.	1
Item 2.	21
Item 3.	28
Item 4.	28
PART II. OTHER INFORMATION	
Item 1.	29
Item 1A.	29
Item 2.	29
Item 3.	29
Item 5.	29
Item 6.	29
	30
	31

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2011 (Unaudited)	December 31, 2010
ASSETS		
CURRENT ASSETS		
Cash & equivalents	\$ 21,185,220	\$ 56,806,471
Restricted cash	2,807,193	1,949,742
Accounts receivable, net	44,244,250	47,224,476
Retentions receivable	3,574,673	2,548,401
Advances to suppliers	19,040,093	8,351,579
Other receivables, prepayments and deposits	4,778,925	6,301,772
VAT receivable	1,214,614	-
Inventories	38,475,589	26,585,362
Deferred tax asset	1,310,393	380,232
Notes receivable - bank acceptances	954,649	1,457,457
Total current assets	137,585,599	151,605,492
NON-CURRENT ASSETS		
Restricted cash	125,823	502,672
Retentions receivable	590,481	1,062,167
Construction in progress	520,149	81,204
Property and equipment, net	11,296,956	8,381,019
Intangible assets, net	15,264,541	14,243,734
Goodwill	11,334,175	-
Deferred tax asset	37,788	22,266
Other non-current	19,559	-
Total non-current assets	39,189,472	24,293,062
TOTAL ASSETS	\$ 176,775,071	\$ 175,898,554
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 8,002,064	\$ 4,490,333
Advance from customers	1,882,200	1,131,193
Income tax payable	8,845	2,000,456
Accrued liabilities and other payables	2,499,011	3,039,701
Notes payable - bank acceptances	185,426	2,207,280
Loans payable	15,566,475	9,059,749

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Total current liabilities	28,144,021	21,928,712
DEFERRED TAX LIABILITY	269,873	-
LONG-TERM PAYABLE	11,919	-
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, \$0.001 par value; 75,000,000 shares authorized, 38,601,939 and 38,551,939 shares issued and outstanding at June 30, 2011, and December 31, 2010, respectively	38,602	38,552
Paid-in capital	102,665,245	102,251,027
Statutory reserve	3,535,997	5,301,918
Accumulated other comprehensive income	7,877,561	4,252,261
Retained earnings	32,893,758	41,500,015
Total Company stockholders' equity	147,011,163	153,343,773
NONCONTROLLING INTEREST	1,338,095	626,069
TOTAL STOCKHOLDERS' EQUITY	148,349,258	153,969,842
TOTAL LIABILITIES AND EQUITY	\$ 176,775,071	\$ 175,898,554

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

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

	SIX MONTHS ENDED JUNE		THREE MONTHS ENDED JUNE	
	2011	30, 2010	2011	30, 2010
Net sales	\$ 14,970,050	\$ 32,136,429	\$ 7,077,901	\$ 22,767,593
Cost of goods sold	9,762,240	21,116,060	4,432,011	14,986,259
Gross profit	5,207,810	11,020,369	2,645,890	7,781,334
Operating expenses				
Selling	4,202,087	2,637,348	2,272,932	1,992,425
General and administrative				
R&D expense	512,867	290,573	383,885	-
Provision for doubtful debts	5,805,672	322,828	3,736,818	-
G&A expenses - other	6,306,145	1,947,614	3,356,681	1,784,019
Total operating expenses	16,826,771	5,198,363	9,750,316	3,776,444
Income (loss) from operations	(11,618,961)	5,822,006	(7,104,426)	4,004,890
Non-operating income (expenses)				
Interest income	132,494	204,609	57,160	49,572
Interest (expense) income	(293,235)	-	(163,063)	61,252
Financial expense	(77,284)	(19,003)	(56,857)	(14,690)
Foreign exchange transaction loss	(302,204)	(43,671)	(177,104)	(43,671)
Other income	305,270	83,805	148,911	17,070
Other expenses	18,959	(1,419)	142,613	(1,179)
Total non-operating income (expenses), net	(216,000)	224,321	(48,340)	68,354
Income (loss) before income tax	(11,834,961)	6,046,327	(7,152,766)	4,073,244
Income tax expense (benefits)	(1,328,059)	966,306	(647,160)	696,786
Income (loss) from operations	(10,506,902)	5,080,021	(6,505,606)	3,376,458
Less: Income (loss) attributable to noncontrolling interest	(134,724)	14,730	(87,230)	14,248
Net income (loss) to SmartHeat Inc.	(10,372,178)	5,065,291	(6,418,376)	3,362,210
Other comprehensive item				
Foreign currency translation gain	3,625,300	512,851	1,832,070	489,797
Comprehensive Income (Loss)	\$ (6,746,878)	\$ 5,578,142	\$ (4,586,306)	\$ 3,852,007
Basic weighted average shares outstanding	38,572,381	32,800,818	38,592,598	32,806,048

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Diluted weighted average shares outstanding	38,572,381	32,854,058	38,592,598	32,832,633
Basic earnings (loss) per share	\$ (0.27)	\$ 0.15	\$ (0.17)	\$ 0.10
Diluted earnings (loss) per share	\$ (0.27)	\$ 0.15	\$ (0.17)	\$ 0.10

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

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

	SIX MONTHS ENDED JUNE 30,	
	2011	2010
CASH FLOWS FROM OPERATING ACTIVITIES:		
Income (loss) including noncontrolling interest	\$ (10,506,902)	\$ 5,080,021
Adjustments to reconcile income (loss) including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	846,867	470,404
Unearned interest on accounts receivable	(51,955)	(25,023)
Stock based compensation expense	253,232	73,064
Changes in deferred tax	(1,344,853)	(15,032)
(Increase) decrease in current assets:		
Accounts receivable, net	5,243,426	7,487,830
Retentions receivable	(465,697)	(1,096,277)
Advances to suppliers	(10,382,745)	(6,104,038)
Other receivables, prepayments and deposits	1,412,427	1,406,764
Inventories	(9,186,101)	(11,009,976)
Increase (decrease) in current liabilities:		
Accounts payable	2,280,976	(71,654)
Advance from customers	717,616	1,327,817
Taxes payable	(2,823,643)	(843,313)
Accrued liabilities and other payables	(940,503)	(3,283,123)
Net cash used in operating activities	(24,947,855)	(6,602,536)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(418,844)	595,152
Deposit for equipment purchase	-	(5,370,066)
Acquisition of property & equipment	(2,135,598)	(324,587)
Acquisition of intangible asset	(97,420)	(102,666)
Notes receivable	531,133	-
Cash acquired from acquisition	448,849	-
Cash paid at acquisition	(13,536,914)	-
Construction in progress	(432,405)	(32,850)
Net cash used in investing activities	(15,641,199)	(5,235,017)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Warrants exercised	-	85,500
Proceeds from short-term loan	5,461,309	-
Repayment to short-term loan	-	(4,248,960)
Cash contribution from noncontrolling interest	749,303	-
Payment on notes payable	(2,051,360)	(1,653,077)
Net cash provided by (used in) financing activities	4,159,252	(5,816,537)

EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS	808,551	133,320
NET DECREASE IN CASH & EQUIVALENTS	(35,621,251)	(17,520,770)
CASH & EQUIVALENTS, BEGINNING OF PERIOD	56,806,471	48,967,992
CASH & EQUIVALENTS, END OF PERIOD	\$ 21,185,220	\$ 31,447,222
Supplemental cash flow data:		
Income tax paid	\$ 135,449	\$ 1,441,940
Interest paid	\$ 293,816	\$ 80,837

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

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

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, through its operating subsidiaries in China and Germany, designs, manufactures, sells and services plate heat exchangers (“PHEs”), PHE Units, which combine PHEs with various pumps, temperature sensors, valves and automated control systems, heat meters and heat pumps for use in commercial and residential buildings.

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. Pursuant to 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’s common stock (the “Share Exchange”). Concurrent with the Share Exchange, one of SmartHeat’s shareholders cancelled 2,500,000 shares of the 6,549,900 issued and outstanding shares of SmartHeat common stock pursuant to a 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 or by a non-operating public shell with nominal net assets was 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 was 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 Sondex brand PHEs; Sondex is the second largest PHE plate manufacturer in the world.

On September 25, 2008, the Company entered into a Share Exchange Agreement (the “SanDeKe Agreement”) with Asialink (Far East) Limited (“Asialink”) to acquire all of the outstanding capital stock of SanDeKe Co., Ltd., a Shanghai-based manufacturer of PHEs (“SanDeKe”). The purchase price for SanDeKe was \$741,516. Under the terms of the SanDeKe Agreement, two shareholders of SanDeKe agreed not to compete with SanDeKe’s business for four years after SanDeKe was purchased.

On June 12, 2009, the Company incorporated a new subsidiary, SmartHeat Siping Beifang Energy Technology Co., Ltd. (“SmartHeat Siping”), to manufacture PHEs.

On June 16, 2009, Taiyu closed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd. (“Siping Beifang”), a company organized under the laws of the People’s Republic of China (“PRC”), to purchase certain assets consisting of the plant, equipment and certain land use rights for RMB 54,000,000 (\$7,906,296). Taiyu then transferred all the acquired assets to SmartHeat Siping, the newly incorporated subsidiary. The Company paid RMB 7,250,000 (\$1,061,500) upon the completion of inventory inspection. At June 30, 2011, the Company has paid in full the remaining purchase consideration.

On August 14, 2009, the Company formed Beijing SmartHeat Jinhui Energy Technology Co., Ltd. (“Jinhui”), a joint venture in Beijing with registered capital of RMB 10 million (\$1.46 million), to provide consulting services and expand the Company’s sales of PHEs into new industries and regions of China. SmartHeat owns 52% of Jinhui and

invested approximately \$765,000.

On April 7, 2010, the Company formed SmartHeat (China) Investment Co., Ltd. (“SmartHeat Investment”), an investment holding company and wholly owned subsidiary in Shenyang with registered capital of \$70 million.

On April 12, 2010, SmartHeat Investment formed SmartHeat (Shenyang) Energy Equipment Co., Ltd. (“SmartHeat Energy”), a wholly owned subsidiary in Shenyang with registered capital of \$30 million, for the research, development, manufacturing and sales of energy products.

On May 6, 2010, SmartHeat formed SmartHeat (Shanghai) Trading Co., Ltd. (“SmartHeat Trading”) through a nominee to market and expand sales of the Company’s Taiyu-branded products. The Company made a capital contribution of \$1.5 million and is entitled to 100% of the profit or loss of SmartHeat Trading.

In January 2011, the Company invested \$771,658 for 51% of the equity interest in a newly formed joint venture, Hohhot Ruicheng Technology Co., Ltd. (“Ruicheng”), in Hohhot City, China for the design and manufacture of heat meters.

On March 3, 2011, the Company completed the acquisition of Gustrower Warmepumpen GmbH (“GWP”), a designer and manufacturer of high efficiency heat pumps in Germany, from Conergy AG. This acquisition will extend the Company’s clean technology heating solutions into the rapidly growing heat pump markets in Europe and China, enabling its customers to purchase technologically advanced heat pumps at competitive prices. The price was EUR 4,248,082 (\$5,898,887) and was paid at closing.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

On March 1, 2011, the Company entered into a purchase agreement with Shenyang Bingchuan Refrigerating Machine Limited Company (“Bingchuan”), a Shenyang-based state-owned heat pump manufacturer and designer. The Company paid RMB 50 million (\$7.6 million) to acquire 95% of the equity interest in Bingchuan; the local government will retain the remaining 5% equity interest.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat’s U.S. parent, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and Bingchuan. The “Company” refers collectively to SmartHeat’s U.S. parent, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, Ruicheng, GWP and Bingchuan. All significant intercompany accounts and transactions were eliminated in consolidation.

Noncontrolling 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 U.S. generally accepted accounting principles (“U.S. 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 Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of June 30, 2011, the Company maintained restricted cash of \$2.9 million in several bank accounts, of which \$1.25 million was cash deposits from customers for securing payment from such customers no later than the warranty period expiration and approximately \$1.68 million was 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 June 30, 2011, \$2.8 million will be released to the Company within one year. As of December 31, 2010, the Company maintained restricted cash of \$2.5 million in several bank accounts, of which \$1.05 million was cash deposits from customers for securing payment from such customers no later than the warranty period expiration and approximately \$1.40 million was 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, 2010, \$1.9 million will be released to the Company within one year.

Accounts and Retentions Receivable

The Company maintains 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 \$8.6 million and \$2.3 million at June 30, 2011, and December 31, 2010, respectively.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

At June 30, 2011, and December 31, 2010, the Company had retentions receivable from customers for product quality assurance of \$4.2 million and \$3.6 million, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 months to 2 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 \$24,356 and \$81,041 at June 30, 2011, and December 31, 2010, respectively. Unearned interest is imputed interest on accounts receivable with due dates over 1 year from the invoice date discounted at the Company's borrowing rate, which was 6.31% at June 30, 2011, and December 31, 2010.

Advance to Suppliers

The Company makes advances to certain vendors to purchase its material and equipment. The advances are interest-free and unsecured.

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 labor 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 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 June 30, 2011, and December 31, 2010, there were no significant impairments of its long-lived assets.

Warranties

The Company offers to all customers standard warranties on its products for one or two heating seasons depending on the terms negotiated. 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 payables respectively, and is recorded when revenue is recognized. Factors that affect the Company's warranty liability include the number of units sold, 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.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

Activity in the Company's warranty reserve during the periods ended June 30, 2011, and December 31, 2010, is as follows:

	2011	2010
Beginning balance	\$ 398,292	\$ 675,562
Provisions made or adjusted	(135,403)	(277,270)
Actual costs incurred	(168,187)	-
Ending balance in current liabilities	\$ 94,702	\$ 398,292

Research and Development Costs

Research and development costs are expensed as incurred and included in general and administrative expenses. These costs primarily consist of cost of materials used and salaries paid for the development department of the Company and fees paid to third parties. Research and development costs for the six months ended June 30, 2011 and 2010, were \$512,867 and \$290,573, respectively. Research and development costs for the three months ended June 30, 2011 and 2010, were \$383,885 and \$0, respectively.

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 June 30, 2011, and December 31, 2010, the Company had not taken any significant uncertain tax position on its tax return for 2010 and prior years or in computing its tax provision for 2010.

Revenue Recognition

The Company's revenue recognition policies are in compliance with SEC Staff Accounting Bulletin ("SAB") 104 (codified in FASB ASC Topic 605). Sales revenue is recognized when PHEs 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 collectability 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% no later than the termination of the standard warranty period, which ranges from 3 to 24 months from the acceptance date.

Sales revenue is the invoiced value of goods, net of value-added tax ("VAT"). All of the Company's products sold in the PRC are subject to a VAT of 17% of the gross sales price. This VAT may be offset by the VAT paid by the Company on raw materials and other materials included in the cost of producing the Company's 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.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

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.

We anticipate collecting our VAT receivable within one year. We do not experience credit losses with respect to our VAT receivables because they are owed to us by the PRC government. We classify our VAT receivable as a current asset because it is an asset that is reasonably expected to be realized (or sold or consumed) within one year or within our normal operating cycle.

Sales returns and allowances were \$0 for the six months ended June 30, 2011 and 2010. Sales returns and allowances were \$0 for the three months ended June 30, 2011 and 2010. The Company does not provide a 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, 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 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

The Company charges for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. The Company recognizes such revenue when service is provided. For the six months ended June 30, 2011 and 2010, revenue from after-sales services after the expiration of the warranty period was \$140,200 and \$39,500, respectively. For the three months ended June 30, 2011 and 2010, revenue from after-sales services after the expiration of the warranty period was \$55,400 and \$22,100, respectively.

Cost of Goods Sold

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

Advance from Customers

The Company records payments received from customers in advance of their future orders to advance account. Those orders normally are delivered within a reasonable period of time based upon contract terms with the customers.

Concentration of Credit Risk

Cash includes cash on hand and demand deposits in accounts maintained within China. Balances at financial institutions within China are not covered by insurance. The Company has not experienced any losses in such accounts.

Certain other financial instruments, which subject the Company to concentration of credit risk, consist of accounts and other receivables. The Company does not require collateral or other security to support these receivables. The

Company conducts periodic reviews of its customers' 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.

Goodwill

Goodwill is the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets ("Statement No. 142"), codified in ASC Topic 350, goodwill is not amortized but is tested for impairment, annually or when circumstances indicate a possible impairment may exist. Impairment testing is performed at a reporting unit level. An impairment loss generally would be recognized when the carrying amount of the reporting unit exceeds its fair value, with the fair value of the reporting unit determined using discounted cash flow ("DCF") analysis. A number of significant assumptions and estimates are involved in the application of the DCF analysis to forecast operating cash flows, including the discount rate, the internal rate of return and projections of realizations and costs to produce. Management considers historical experience and all available information at the time the fair values of its reporting units are estimated.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

The excess of the purchase price over the fair value of the net assets acquired from GWP of \$5.3 million was recorded as goodwill. The excess of the purchase price over the fair value of the net assets acquired from Bingchuan of \$6.1 million was recorded as goodwill. As of June 30, 2011, the Company concluded there was no impairment of goodwill.

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 shown on the statement of cash flows may not necessarily agree with changes in the corresponding asset and liability on the balance sheet.

Basic and Diluted Earnings (Loss) 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 EPS 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 (loss) per share for the six months ended June 30, 2011 and 2010:

	2011	2010
Net income (loss)	\$ (10,372,178)	\$ 5,065,291
Weighted average shares outstanding - basic	38,572,381	32,800,818
Effect of dilutive securities:		
Unexercised warrants and options	-	53,240
Weighted average shares outstanding - diluted	38,572,381	32,854,058
Earnings (loss) per share - basic	\$ (0.27)	\$ 0.15
Earnings (loss) per share - diluted	\$ (0.27)	\$ 0.15

The following table presents a reconciliation of basic and diluted earnings (loss) per share for the three months ended June 30, 2011 and 2010:

	2011	2010
Net income (loss)	\$ (6,418,376)	\$ 3,362,210
Weighted average shares outstanding - basic	38,592,598	32,806,048
Effect of dilutive securities:		
Unexercised warrants and options	-	26,585
Weighted average shares outstanding - diluted	38,592,598	32,832,633

Earnings (loss) per share - basic	\$ (0.17)	\$ 0.10
Earnings (loss) per share - diluted	\$ (0.17)	\$ 0.10

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

Fair Value of Financial Instruments

For certain of the Company's financial instruments, including cash and 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 June 30, 2011, and December 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 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 functional currency of GWP, the Company's subsidiary in Germany, is the Euro (EUR). The accounts of the China subsidiaries and German subsidiary 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 No. 131 has no effect on the Company’s financial statements as substantially all of the Company’s operations are conducted in one industry segment.

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 SFAS No. 5, Accounting for Contingencies (codified in FASB ASC Topic 450).

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

Under the terms of the registration rights agreement entered into between the Company and the investors in the Company's private placement offering 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 have been 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 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 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 general and administrative expense with charging corresponding account to accrued liabilities. The Registration Statement became effective on June 23, 2009, a post-effective amendment became effective on May 21, 2010, and another post-effective amendment became effective on April 20, 2011. 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

In June 2011, FASB issued ASU 2011-05, Comprehensive Income (ASC Topic 220): Presentation of Comprehensive Income. Under the amendments in this update, an entity has the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. Under both options, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income and a total amount for comprehensive income. In a single continuous statement, the entity is required to present the components of net income and total net income, the components of other comprehensive income and a total for other comprehensive income, along with the total of comprehensive income in that statement. In the two-statement approach, an entity is required to present components of net income and total net income in the statement of net income. The statement of other comprehensive income should immediately follow the statement of net income and include the components of other comprehensive income and a total for other comprehensive income, along with a total for comprehensive income. In addition, the entity is required to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The amendments in this update should be applied retrospectively and are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The Company is currently assessing the effect that the adoption of this pronouncement will have on its financial statements.

3. INVENTORIES

Inventories at June 30, 2011, and December 31, 2010 were as follows:

	2011	2010
Raw materials	\$ 24,339,636	\$ 15,803,040
Work in process	5,207,767	3,157,799
Finished goods	8,928,186	7,624,523
Total	\$ 38,475,589	\$ 26,585,362

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 commercial notes with the bank or endorsed the commercial notes to vendors for payment of their own obligations or to get cash from third parties. Most of the commercial notes have a maturity of less than six months. At June 30, 2011, and December 31, 2010, the Company had notes receivable of \$954,649 and \$1,457,457, respectively.

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011 (UNAUDITED) AND 2010

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30, 2011, and December 31, 2010:

	2011	2010
Building	\$4,662,830	\$4,556,445
Production equipment	7,029,751	3,923,521
Office equipment	870,818	794,816
Vehicles	902,852	711,798
Total	13,466,251	9,986,580
Less: Accumulated depreciation	(2,169,295)	(1,605,561)
Net	\$11,296,956	\$8,381,019

Depreciation for the six months ended June 30, 2011 and 2010, was \$521,600 and \$399,100, respectively.

Depreciation for the three months ended June 30, 2011 and 2010, was \$284,800 and \$230,200, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at June 30, 2011, and December 31, 2010, respectively:

	2011	2010
Cash advanced to third parties	\$1,123,989	\$2,076,862
Deposit for public bids of sales contracts	1,253,242	846,739
Deposit for acquisition of Bingchuan	-	1,834,600
Prepayment for freight and related insurance expenses	185,782	115,542
Other deposits	203,967	53,289
Advance to employees	487,697	600,427
Others	1,524,248	774,313
Total	\$4,778,925	6,301,772

Cash advanced to third parties was short-term cash advances to unrelated third parties 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 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.

7. INTANGIBLE ASSETS

Intangible assets consisted mainly of land use rights, trademark, 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 \$3.2 million from Siping Beifang. In November 2010, the Company's subsidiary, SmartHeat Energy, acquired land use rights for \$10.1 million. 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 June 30, 2011, and December 31, 2010, respectively:

12

SMARTHEAT INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 JUNE 30, 2011 (UNAUDITED) AND 2010

	2011	2010
Land use rights	\$14,245,689	\$13,884,020
Know-how technology	858,653	275,345
Customer list	202,402	197,784
Covenant not to compete	110,106	107,593
Software	487,961	403,680
Trademark	281,263	-
Total	16,186,074	14,868,422
Less: Accumulated amortization	(921,533)	(624,688)
Net		