

SMARTHEAT INC.  
Form 10-Q  
November 14, 2008

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 SEPTEMBER 30, 2008**

**OR**

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

**Commission file number 000-53052**

**SMARTHEAT INC.**

*(Exact name of registrant as specified in its charter)*

**NEVADA**

*(State or other jurisdiction of  
incorporation or organization)*

**98-0514768**

*(IRS Employer  
Identification No.)*

**A-1, 10, Street 7**

**Shenyang Economic and Technological Development Zone**

**Shenyang, China**

**110027**

*(Address of principal executive offices, including zip code.)*

**+86 (24) 2519-7699**

*(telephone number, including area code)*

*(Former name or former address, if changed since last report)*

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the last 90 days.

**YES x NO "**

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

**Large accelerated filer "**

**Accelerated filer "**

**Non-accelerated filer "**

**Smaller reporting company x**

(do not check if a smaller reporting company)

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 24,179,900 shares as of November 3, 2008.

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**SMARTHEAT INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements**

AS OF SEPTEMBER 30, 2008 OF DECEMBER 31, 2007  
(Unaudited)

<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash & cash equivalents	\$	1,702,938	\$ 393,147
Restricted cash		678,642	537,098
Accounts receivable, net		11,797,010	4,762,822
Retentions receivable		271,173	191,319
Prepaid expenses		8,316	-
Advances to suppliers		154,290	158,750
Other receivables		3,351,498	766,231
Inventories		8,454,000	7,928,408
Due from related party		251,547	118,560
Notes receivable		203,696	-
<b>Total current assets</b>		<b>26,873,110</b>	<b>14,856,335</b>
<b>NON-CURRENT ASSETS</b>			
Accounts receivable, net		-	949,998
Retentions receivable		-	169,309
Intangible assets, net		1,176,351	534,208
Property and equipment, net		2,349,147	2,040,809
Construction in progress		85,036	-
<b>Total noncurrent assets</b>		<b>3,610,534</b>	<b>3,694,324</b>
<b>TOTAL ASSETS</b>	<b>\$</b>	<b>30,483,644</b>	<b>\$ 18,550,659</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES</b>			
Accounts payable	\$	4,635,664	\$ 3,128,585
Unearned revenue		2,282,353	3,125,406
Taxes payable		1,423,528	503,010
Accrued liabilities and other payables		1,398,402	807,700
Due to related party		-	445,990
Due to minority shareholder		5,274	-
Loans payable		3,548,746	4,619,856
<b>Total current liabilities</b>		<b>13,293,967</b>	<b>12,630,547</b>

DEFERRED TAX LIABILITY	39,112	-
COMMITMENTS AND CONTINGENCIES		
MINORITY INTEREST	-	-
STOCKHOLDERS' EQUITY		
Common stock, \$0.001 par value; 75,000,000 shares authorized, 24,179,900 and 18,500,000 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	24,180	18,500
Paid in capital	8,219,898	3,102,132
Statutory reserve	1,064,768	506,532
Accumulated other comprehensive income	1,052,529	473,859
Retained earnings	6,789,190	1,819,089
Total stockholders' equity	17,150,565	5,920,112
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 30,483,644</b>	<b>\$ 18,550,659</b>

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

**SMARTHEAT INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME AND OTHER**  
**COMPREHENSIVE INCOME**  
(Unaudited)

**FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2008** **FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2007**

	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Net sales	\$ 29,345,571	\$ 5,473,573	\$ 20,708,288	\$ 3,015,606
Cost of goods sold	19,502,070	3,679,507	13,273,914	2,080,718
Gross profit	9,843,501	1,794,066	7,434,374	934,888
Operating expenses				
Selling expenses	1,664,882	805,099	1,056,854	320,206
General and administrative expenses	1,470,577	528,215	1,024,107	229,373
Total operating expenses	3,135,459	1,333,314	2,080,961	549,579
Income from operations	6,708,042	460,752	5,353,413	385,309
Non-operating income (expenses)				
Interest income	318,070	142,583	57,387	-
Interest expense	(257,116)	(170,985)	(94,076)	(104,857)
Investment expense	(1,628)	-	(1,628)	-
Non-operating income	9,744	22,110	9,744	22,110
Non-operating expense	(2,990)	(6,285)	(11,280)	(18,285)
Exchange loss	(9,058)	(11,855)	(9,058)	(11,855)
Subsidy income	16,141	52,193	7,000	363
Total non-operating income (expenses)	73,163	27,761	(41,911)	(112,524)
Income before income tax	6,781,205	488,513	5,311,502	272,785
Income tax expense	1,246,935	105,256	980,907	52,770
Income after income tax	5,534,270	383,257	4,330,595	220,015
Less: minority interest	5,934	(1,859)	5,934	(13)
Net income	5,528,336	385,116	4,324,661	220,028
Other comprehensive item				
Foreign currency translation	578,670	147,335	167,774	70,081
Comprehensive Income	\$ 6,107,006	\$ 532,451	\$ 4,492,435	\$ 290,109

Basic weighted average shares outstanding	21,503,588	18,500,000	24,055,878	18,500,000
Diluted weighted average shares outstanding	21,503,647	18,500,000	24,056,054	18,500,000
Basic earnings per share	\$ 0.26	\$ 0.02	\$ 0.18	\$ 0.01
Diluted earnings per share	\$ 0.26	\$ 0.02	\$ 0.18	\$ 0.01

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

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

**FOR THE NINE MONTHS ENDED SEPTEMBER 30,**  
**2008** **2007**

<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$	5,528,336	\$ 385,116
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization		173,821	90,888
Unearned interest on accounts receivable		(71,804)	(91,645)
Stock option compensation expense		1,270	-
Minority interest		5,934	(1,859)
(Increase) decrease in current assets:			
Accounts receivable		(4,995,840)	2,234,468
Retentions receivable		107,279	376,944
Advances to suppliers		320,260	(1,186,901)
Other receivables		(2,346,526)	(94,544)
Inventory		118,223	(3,696,182)
Other assets		-	(1,433,510)
Increase (decrease) in current liabilities:			
Accounts payable		928,337	648,667
Unearned revenue		(1,581,803)	1,938,100
Taxes payable		864,934	(518,038)
Accrued liabilities and other payables		(266,072)	267,750
Net cash used in operating activities			
		(1,213,651)	(1,080,746)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Restricted cash		(101,542)	(71,483)
Acquisition of property & equipment		(287,398)	(184,535)
Construction in progress		(83,027)	(401,961)
Net cash used in investing activities			
		(471,967)	(657,979)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Due to minority shareholders		(660)	-
Due from / (to) shareholder		(587,644)	(201,173)
Notes receivable		(201,118)	(6,524)
Short term loans		(1,361,113)	2,314,795
Capital contribution, shares issued		5,100,000	-
Net cash provided by financing activities			
		2,949,465	2,107,098
<b>EFFECT OF EXCHANGE RATE CHANGE ON CASH &amp; CASH EQUIVALENTS</b>			
		(9,482)	16,811
<b>NET INCREASE IN CASH &amp; CASH EQUIVALENTS</b>			
		1,254,365	385,184



CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD	448,573	202,295
CASH & CASH EQUIVALENTS, END OF PERIOD	\$ 1,702,938	\$ 587,479
Supplemental Cash flow data:		
Income tax paid	\$ 426,809	\$ 95,082
Interest paid	\$ 201,269	\$ 180,265

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

**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

**1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

SmartHeat Inc., formerly known as Pacific Goldrim Resources, Inc. (the "Company" or "SmartHeat"), was incorporated on August 4, 2006 in the State of Nevada. The Company is engaged in the manufacturing and sale of plate heat exchangers and various packages, thermometer testing devices and heat usage calculators through its wholly owned operating subsidiary in China.

On April 14, 2008, the Company entered into a Share Exchange Agreement with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu") and the Taiyu Shareholders. The Company issued 18,500,000 shares of its common stock to the shareholder of Taiyu in exchange for all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of RMB 25,000,000. Concurrent with the share exchange, one of SmartHeat's shareholders cancelled 2,500,000 shares out of 6,549,900 of total issued and outstanding shares of SmartHeat pursuant to the Split-Off Agreement dated April 14, 2008. As a result of the share exchange and the cancellation of the 2,500,000 shares of the Company's common stock, there are 22,549,900 shares of the Company's common stock issued and outstanding, approximately 82.04% of which are held by the former Taiyu Shareholders. The shareholders of the Company immediately prior to the completion of these transactions hold the remaining 17.96% of the issued and outstanding share capital of SmartHeat. Taiyu became a wholly-owned subsidiary of SmartHeat.

Prior to the acquisition of Taiyu, the Company was a non-operating public shell corporation. Pursuant to Securities and Exchange Commission ("SEC") rules, the merger or acquisition of a private operating company into a non-operating public shell corporation with nominal net assets is considered a capital transaction in substance, rather than a business combination. Accordingly, for accounting purposes, the transaction has been treated as a reverse acquisition and a recapitalization, and pro-forma information is not presented. Transaction costs incurred in the reverse acquisition have been charged to expense.

Taiyu was incorporated in the Liaoning Province, People's Republic of China ("PRC" or "China") in July, 2002. Taiyu is engaged in the manufacturing and sale of plate heat exchangers and various packages, thermo meter testing devices and heat usage calculators. The Company is an authorized dealer of the SONDEX brand; SONDEX is the second largest plate heat exchanger manufacturer in the world.

On September 25, 2008, the Company entered into the Share Exchange Agreement (the "Agreement") between Asialink (Far East) Limited ("Asialink") and the Company providing for the acquisition by the Company from Asialink of all of the outstanding capital stock of San De Ke Co., Ltd., a Shanghai based manufacturer of heat plate exchangers ("SanDeKe"). The purchase price for the SanDeKe shares was \$741,516, of which \$222,455 was payable within 15 days after the signature date of the Agreement, \$370,758 is payable within 15 days after all necessary documents have been filed with government agencies, and \$148,303 of which is payable within 15 days after the purchase has been approved and registered by the government agencies. Under the terms of the Agreement, two of the shareholders of SanDeKe have agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase.

The unaudited financial statements have been prepared by the Company, pursuant to the rules and regulations of the SEC. The information furnished herein reflects all adjustments (consisting of normal recurring accruals and adjustments) which are, in the opinion of management, necessary to fairly present the operating results for the respective periods. Certain information and footnote disclosures normally present in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been

omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the 2007 audited financial statements and footnotes included in the Company's audited financial statements. The results for the nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year ending December 31, 2008.

## **2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of SmartHeat, SanDeKe, Taiyu, and Taiyu's 55% owned subsidiary, Qingdao Yushi Heat Power Equipment Co., Ltd ("Yushi"). Yushi is engaged in manufacturing and selling of heat power equipment. For purposes of this Quarterly Report, the "Company" refers collectively to SmartHeat, SanDeKe, Taiyu and Yushi. All significant inter-company accounts and transactions have been eliminated in consolidation.

**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

**Use of Estimates**

In preparing the financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting year. Significant estimates, required by management, include the recoverability of long-lived assets and the valuation of 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, 2008 and December 31, 2007, the Company maintained restricted cash of \$678,642 and \$537,098, respectively, in several bank accounts, which was pledged for the guarantee of certain contracts execution and completion.

**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 \$353,621 and \$330,518 at September 30, 2008 and December 31, 2007, respectively.

At September 30, 2008 and December 31, 2007, the Company had retentions receivable from customers for product quality assurance in the amount of \$271,173 and \$360,628, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 months to two years.

Accounts receivable is net of unearned interest of \$85,254 and \$148,421 at September 30, 2008 and December 31, 2007, 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 7.04% in 2008 and 2007.

**Inventories**

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

**Property and Equipment**

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicle	5 years
Office Equipment	5 years
Production Equipment	5-10 years

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**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

**Land Use Right**

Right to use land is stated at cost less accumulated amortization. Amortization is provided using the straight-line method over 50 years.

**Impairment of Long-Lived Assets**

Long-lived assets, which include property, plant and equipment and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

Recoverability of long-lived assets to be held and used is measured by a comparison of the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the assets. Fair value is generally determined using the asset's expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of September 30, 2008 and December 31, 2007, there were no significant impairments of its long-lived assets.

**Income Taxes**

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company does not have any significant deferred tax asset or liability that relates to tax jurisdictions not covered by the tax holiday.

The Company adopted the provisions of the Financial Accounting Standards Board's ("FASB") Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. As a result of the implementation of FIN 48, the Company made a comprehensive review of its portfolio of tax positions in accordance with recognition standards established by FIN 48. As a result of the implementation of Interpretation 48, the Company recognized no material adjustments to liabilities or shareholders' equity. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest associated with unrecognized tax benefits is classified as interest expense and penalties are classified as selling, general and administrative expense in the statements of income. The adoption of FIN 48 did not have a material impact on the Company's financial statements.

**Revenue Recognition**

The Company's revenue recognition policies are in compliance with SEC Staff Accounting Bulletin 104. Sales revenue is recognized at the date of shipment to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

Sales revenue represents the invoiced value of goods, net of value-added tax ("VAT"). All of the Company's products that are sold in the PRC are subject to Chinese value-added tax of 17% of the gross sales price. This VAT may be offset by VAT paid by the Company on raw materials and other materials included in the cost of producing their finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

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

Sales returns and allowances were \$0 for both the nine and three months ended September 30, 2008 and 2007. The Company does not provide unconditional right of return, price protection or any other concessions to its customers. The Company provides free after-sale service for a period of one year. After-sale expense was \$61,106 and \$232,581 for the nine months ended September 30, 2008 and 2007; and \$28,783 and \$185,584 for the three months ended September 30, 2008 and 2007, respectively.

**Cost of Goods Sold**

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

**Concentration of Credit Risk**

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

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

**Statement of Cash Flows**

In accordance with SFAS No. 95, "Statement of Cash Flows," cash flows from the Company's operations is 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. Cash flows from operating, investing and financing activities exclude the effect of the acquisition of SanDeKe.

**Basic and Diluted Earnings per Share (EPS)**

Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is similarly computed, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted net earnings per share are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is



computed by applying the treasury stock method. Under this method, options and warrants are assumed to have been exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

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**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

The following table presents a reconciliation of basic and diluted earnings per share:

	For the Nine Months Ended September 30 (Unaudited)		For the Three Months Ended September 30 (Unaudited)	
	2008	2007	2008	2007
Net income	\$ 5,528,336	\$ 385,116	\$ 4,324,661	\$ 220,028
Weighted average shares outstanding - basic	21,503,588	18,500,000	24,055,878	18,500,000
Effect of dilutive securities:				
Unexercised warrants and options	59	—	176	—
Weighted average shares outstanding - diluted	21,503,647	18,500,000	24,056,054	18,500,000
Earnings per share - basic	\$ 0.26	\$ 0.02	0.18	0.01
Earnings per share - diluted	\$ 0.26	\$ 0.02	0.18	0.01

#### **Fair Value of Financial Instruments**

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires that the Company disclose estimated fair values of financial instruments. The carrying amounts reported in the statements of financial position for current assets and current liabilities qualifying as financial instruments are a reasonable estimate of fair value.

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

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

The Company uses SFAS No. 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

#### **Segment Reporting**

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company.

SFAS 131 has no effect on the Company's financial statements as substantially all of the Company's operations are conducted in one industry segment. All of the Company's assets are located in the PRC.

### **New Accounting Pronouncements**

#### **Accounting for Financial Guarantee Insurance Contracts**

In May 2008, FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60." The scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts, as described in this Statement, issued by enterprises included within the scope of Statement 60. Accordingly, this Statement does not apply to financial guarantee contracts issued by enterprises excluded from the scope of Statement 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). This Statement also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement will not have an impact on the Company's financial statements.

**SMARTHEAT INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

**The Hierarchy of Generally Accepted Accounting Principles**

In May 2008, FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 will not have an impact on the Company's financial statements.

**Disclosures about Derivative Instruments and Hedging Activities**

In March 2008, FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Based on current conditions, the Company does not expect the adoption of SFAS 161 to have a significant impact on its results of operations or financial position.

**Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51**

In December 2007, FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Based on current conditions, the Company does not expect the adoption of SFAS 160 to have a significant impact on its results of operations or financial position.

**Business Combinations**

In December 2007, FASB issued SFAS No. 141 (Revised 2007), "Business Combinations." SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Non-controlling interests (formerly known as "minority interests" - see SFAS 160 discussion above) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;

- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and

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Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since we are a calendar year-end company we will continue to record and disclose business combinations following existing GAAP until January 1, 2009. The Company expects SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

**Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R**

In September 2006, FASB issued SFAS, No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R," which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS 158 are effective for fiscal years ending after December 15, 2006. The Company adopted the provisions of SFAS 158 for the year end 2006, and the effect of recognizing the funded status in accumulated other comprehensive income was not significant. The new measurement date requirement applies for fiscal years ending after December 15, 2008.

**Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities**

In June 2007, FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. Management is currently evaluating the effect of this pronouncement on our financial statements.

**3. INVENTORIES**

Inventories at September 30, 2008 and December 31, 2007 were as follows:

	September 30, 2008	December 31, 2007
Raw materials	\$ 6,774,332	\$ 3,865,575
Work in process	543,019	48,627
Finished Goods	1,136,649	4,014,206
Total	\$ 8,454,000	\$ 7,928,408



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**4. PROPERTY AND EQUIPMENT, NET**

Property and equipment consisted of the following at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Building	\$ 1,738,219	\$ 1,624,651
Production equipment	420,789	298,242
Office equipment	223,078	156,368
Vehicles	274,940	134,724
	2,657,026	2,213,985
Less: Accumulated depreciation	(307,879)	(173,176)
	\$ 2,349,147	\$ 2,040,809

Depreciation expense for the nine months ended September 30, 2008 and 2007 was approximately \$119,000 and \$45,000; approximately \$42,000 and \$16,000 for the three months ended September 30, 2008 and 2007, respectively.

**5. CONSTRUCTION IN PROGRESS**

Construction in progress represented the amount the Company has paid for constructing a manufacturing workshop.

**6. OTHER RECEIVABLES**

Other receivables at September 30, 2008 consisted of cash advances to some customers in the amount of approximately \$1,870,000, guarantee deposits for public bidding of approximately \$510,000, prepayment and deposits for freight insurance expense of approximately \$155,000, receivables for consulting and installation service provided in the amount of approximately \$230,000, and cash advances to employees for normal business purposes such as travel expenses, etc.

**7. NOTES RECEIVABLE**

Notes receivable consisted of several notes that were due from third parties or the Company's customers. These notes receivable were interest-free and due within 3-6 months.

**8. RELATED PARTY TRANSACTIONS****Due from related party**

Due from related party consisted of purchase deposits and a short term advance to one of the Company's shareholders of \$251,547 and \$118,560 at September 30, 2008 and December 31, 2007, respectively.

**Due to Related Party**

Due to related party represented advance from the same shareholder with variable interest rate tied to the bank interest rate, currently at 8.591% per annum and 6.903% per annum as of December 31, 2007, principal and interest are payable on demand, this advance was paid of by September 30, 2008.



## **9. INTANGIBLE ASSETS**

Intangible assets mainly consisted of land use rights, computer software, know-how technology, customer list and covenant not to compete. All land in the PRC is government owned and cannot be sold to any individual or company. However, the government grants the user a “land use right” to use the land. The Company acquired land use rights during 2005 for \$439,850 (RMB 3,549,682). The Company has the right to use the land for 50 years and is amortizing such rights on a straight-line basis for 50 years.

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Intangible assets consisted of the following at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Land use right	\$ 520,634	\$ 486,618
Know-how technology	267,457	-
Customer list	192,119	-
Covenant not to compete	104,512	-
Software	184,086	140,476
	1,268,808	627,094
Less: accumulated amortization	(92,457)	(92,886)
	\$ 1,176,351	\$ 534,208

Amortization expense for the nine months ended September 30, 2008 and 2007 were approximately \$38,000 and \$34,000, approximately \$11,000 and \$23,000 for the three months ended September 30, 2008 and 2007, respectively. Annual amortization expense for the next five years is expected to be as follows: \$51,000, \$51,000, \$51,000, \$21,000 and \$21,000.

#### 10. TAXES PAYABLE

Taxes payable consisted of the following at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Income tax payable	\$ 934,558	\$ 74,981
Value added tax payable	502,026	421,009
Other taxes payable (receivable)	(13,056)	7,020
	\$ 1,423,528	\$ 503,010

#### 11. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities at September 30, 2008 mainly consisted of accrued interest, utility and employee benefits in the aggregate of approximately \$60,000. Other payables mainly consisted of short term, non interest bearing advances from third parties and payables for the Company's miscellaneous expenses in the aggregate of approximately \$590,000, and payable for the purchase consideration of SanDeKe for approximately \$741,000.

#### 12. LOANS PAYABLE - SHORT TERM

The Company is obligated for the following short term loans payable as of September 30, 2008 and December 31, 2007:

	Balance at September 30, 2008	Balance at December 31, 2007
Short term loan with a commercial bank in the PRC for 6,000,000 RMB, or \$822,526. This loan was entered into on Apr 28, 2007 and is due on Apr	\$ 880,023	\$ 822,526

12, 2008. This loan bears interest at 7.029% per annum. This loan was renewed on Apr 12, 2008 with new maturity date on June 13, 2009.

Short term loan with a foreign commercial bank with branch in the PRC for 10,200,000 RMB, or \$1,398,295. This loan was entered into on Jun 25, 2007 and is due on Jun 24, 2008. This loan born interest at 5.265% per annum. This loan was repaid in June, 2008.

— 1,302,333

The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB or \$1,412,003. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.

1,129,363 1,412,003

The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB, or \$390,700. These loans are due on various dates in year 2008. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.

358,661 390,701

The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB or \$625,759. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bears no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31, 2006.

740,686 692,293

The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB, or \$440,000. This loan is due on June 30, 2009 with interest rate of 8.591% per annum.

440,013 —

\$ 3,548,746 \$ 4,619,856

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**13. DEFERRED TAX LIABILITY**

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

**14. MINORITY INTEREST AND DUE TO MINORITY SHAREHOLDER**

Minority interest represented 45% interest in Yushi. At August 31, 2008, the Company liquidated Yushi and planned to distribute the remaining assets of \$5,274 to its minority shareholders. At September 30, 2008, minority interest was zero due to the liquidation of Yushi; at December 31, 2007, minority interest was zero as minority's share of cumulative losses exceeded its equity interest in Yushi. Minority's share of income for the nine months ended September 30, 2008 was \$5,934 as the forgiveness of the accounts payable by Taiyu, minority's share of loss for the nine months ended December 31, 2007 were limited to \$1,859.

**15. INCOME TAXES**

The Company is 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.

The Company, as a manufacturing business, is subject to a 15% income tax rate. Taiyu was exempted from income tax for two years starting from the 1st profitable year since incorporation, and was entitled to a 50% discount on the 15% income tax rate for 2005 through 2007. According to the new income tax law that became effective January 1, 2008, for those enterprises to which the 15% tax rate was applicable previously, the applicable rates shall be gradually increase over a five-year period as follows:

Year	Tax Rate
2007	15%
2008	18%
2009	20%
2010	22%
2011	24%
2012	25%

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SanDeKe is subject to an 18% income tax rate after 7% reduction in federal income tax rate given by federal government, is also exempted from income tax for two years starting from the 1st profitable year, and was entitled to a 50% discount on the 18% income tax rate for 2010 through 2012. SanDeKe's net income will be lowered by approximately \$17,000 for the period from acquisition date to September 30, 2008 if it is not exempted from income tax.

For the nine and three months ended September 30, 2008 and 2007, the Company's effective income tax rate differs from US statutory rate due to the effect of tax holiday.

## **16. STATUTORY RESERVES**

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

### **Surplus Reserve Fund**

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

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

### **Common Welfare Fund**

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

## **17. STOCKHOLDERS' EQUITY**

### **Common Stock with Warrants Issued for Cash**

In August 2008, the Company closed a private placement offering of Units pursuant to which SmartHeat sold an aggregate of 1,630,000 Units at an offering price of \$3.50 per Unit for aggregate gross proceeds of approximately \$5.7 million. Each "Unit" consists of one share of SmartHeat's common stock and a three year warrant to purchase 15% of one share of common stock at an exercise price of \$6.00 per share. The Units sold represent an aggregate of 1,630,000 million shares of common stock and warrants to purchase 244,500 shares of Common Stock. In connection with the private placement offering, the Company paid commission of approximately \$340,000 and issued warrants to purchase 148,500 shares of common stock to its placement agents. The warrants are immediately exercisable and expire on the third anniversary of their issuance. Net proceeds of approximately \$5.1 million have been received by the Company. The value of warrants was determined by using the Black-Scholes pricing model with the following

assumptions: discount rate – 2.76%; dividend yield – 0%; expected volatility – 15% and term of 3 years. There were no warrants exercised from the grant date to September 30, 2008.

**Stock Options to Independent Directors**

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

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

The options vest over a period of three years and have a life of 5 years, volatility of 15%, risk free interest rate of 2.76%, and dividend yield of 0%. No estimate of forfeitures was made as the Company has a short history of granting options.

The Company recorded \$1,270 of compensation expense for stock options to its independent directors for the nine months ended September 30, 2008. There were no options exercised for the nine months ended September 30, 2008.

## 18. COMMITMENTS

The Company leased several offices for its sales representative in different cities under various one-year, non-cancellable, and renewable operating lease agreements.

Future minimum rental payments required under these operating leases are as follows:

Year Ending September 30,	Amount
2009	\$ 46,000
2010	21,000
Total	\$ 67,000

Total rental expense for the nine months ended September 30, 2008 and 2007 was approximately \$71,000 and \$39,000, and approximately \$39,000 and \$20,000 for the three months ended September 30, 2008 and 2007, respectively.

## 19. CONTINGENCIES

The Company sold goods to its customers and received Commercial Notes (Bank Acceptance) from the customers in lieu of the payments for accounts receivable. The Company discounted the Notes with the bank or endorsed the Notes to vendors, which could be for payment of their own obligations or get cash from the third parties. Most of the Commercial Notes have maturity of less than six months. At September 30, 2008, the Company is contingently liable to vendors and third parties for endorsed bank acceptance amounting to \$358,227.

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

measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

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



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**20. ACQUISITION OF SAN DE KE CO., LTD.**

On September 25, 2008, the Company entered into a Share Exchange Agreement ("Agreement") for the acquisition by the Company of all of the outstanding capital stock of SanDeKe. The purchase price for the SanDeKe shares was \$741,516, of which \$222,455 was payable within 15 days after the signature date of the Agreement, \$370,758 is payable within 15 days after all necessary documents have been filed with government agencies, and \$148,303 of which is payable within 15 days after the purchase has been approved and registered by the government agencies. Under the terms of the Agreement, two of the shareholders of SanDeKe have agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase.

The operating results of SanDeKe are included in the accompanying consolidated statements of income from the acquisition date. For convenience of reporting the acquisition for accounting purposes, September 1, 2008 has been designated as the acquisition date.

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

Cash	\$ 59,245
Accounts receivable	489,527
Advance to suppliers	329,951
Other receivables	128,646
Inventory	92,370
Property and equipment	73,324
Intangible assets	563,567
Accounts payable	(332,276)
Advance from customers	(557,216)
Deferred tax liability	(39,076)
Other current liabilities	(66,546)
Purchase price	\$ 741,516

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

The pro forma financial information of the consolidated operations of the Company as if the acquisition of SanDeKe had occurred as of the beginning of the year is presented below:

For the nine months ended September 30, 2008	SmartHeat	Taiyu	SanDeKe	Pro forma Adjustments	Pro forma Consolidated
Net revenue	\$ -	28,958,383	2,541,234	-	31,499,617
Cost of revenue	-	(19,252,126)	(2,012,066)	-	(21,264,191)
Gross profit	-	9,706,257	529,168	-	10,235,425
Selling expense	-	(1,664,882)	-	-	(1,664,882)
General & administrative expense	(107,195)	(1,297,666)	(384,526)	(87,898)	(1,877,286)

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Total operating expenses	(107,195)	(2,962,549)	(384,526)	(87,898)	(3,542,168)
Income (loss) from operations	(107,195)	6,743,708	144,642	(87,898)	6,693,257
Non-operating income (expenses), net	-	75,806	(870)	-	74,936
Income (loss) before income tax	(107,195)	6,819,514	143,773	(87,898)	6,768,193
Income tax	-	(1,246,935)	-	-	(1,246,935)
Minority interest	-	5,934	-	-	5,934
Net income (loss)	\$ (107,195)	5,566,645	143,773	(87,898)	5,515,324

a) Pro forma adjustment is to record additional amortization expense of \$86,440 and depreciation expense of \$1,458 for the increase in basis of the intangible assets and slight decrease in basis of the fixed assets as a result of the purchase.

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For the nine months ended September 30, 2007	SmartHeat	Taiyu	SanDeKe	Pro forma Adjustments	Pro forma Consolidated
Net revenue	\$ -	5,473,573	1,750,129	-	7,223,702
Cost of revenue	-	(3,679,507)	(1,504,957)	-	(5,184,465)
Gross profit	-	1,794,065	245,171	-	2,039,237
Selling expense	-	(805,099)	-	-	(805,099)
General & administrative expense	-	(528,215)	(168,431)	(80,770)	(777,416)
Total operating expenses	-	(1,333,314)	(168,431)	(80,770)	(1,582,515)
Income from operations	-	460,752	76,740	(80,770)	456,722
Non-operating income, net	-	27,760	451	-	28,211
Income before income tax	-	488,512	77,191	(80,770)	484,932
Income tax	-	(105,256)	-	-	(105,256)
Minority interest	-	(1,859)	-	-	(1,859)
Net income	\$ -	385,115	77,191	(80,770)	381,536

a) Pro forma adjustment is to record additional amortization expense of \$78,759 and depreciation expense of \$2,011 for the increase in basis of the intangible assets and slight decrease in basis of the fixed assets as a result of the purchase.

## CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

*This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to known and unknown risks, uncertainties and assumptions about us that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as "may," "will," "should," "could," "would," "expect," "plan," "anticipate," "believe," "estimate," or the negative of such terms or other similar expressions. Factors that might cause or contribute to such a discrepancy include, but are not limited to, those listed under the heading "Risk Factors" and those listed in our other SEC filings. The following discussion should be read in conjunction with our Financial Statements and related Notes thereto included elsewhere in this report. Throughout this Quarterly Report we will refer to SmartHeat Inc., together with its subsidiaries, as "SmartHeat," the "Company," "we," "us," and "our."*

### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Overview**

We are a leading provider of plate heat exchanger products to China's industrial, residential and commercial markets. We design, manufacture, sell, and service plate heat exchangers ("PHEs"), units which combine plate heat exchangers with various pumps, temperature sensors, valves, and automated control systems ("PHE Units"), and heat meters for a broad range of industries, including petroleum refining, petrochemicals, power generation, metallurgy, food & beverage and chemical processing. We sell PHEs under the Sondex brand and PHE Units designed by our engineers and assembled with Sondex plates under our Taiyu brand name. We are one of three authorized dealers of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is North China.

Our revenue is subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry and other unpredictable factors that may affect customer ordering patterns. Any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines, or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue. Due to the possibility of fluctuations in our revenue and net income or loss, we believe that quarterly comparisons of our operating results are not a good indication of future performance.

#### **Recent Developments**

##### *Share Exchange and Related Transactions*

On April 14, 2008, the Company entered into and consummated a series of agreements which resulted in the acquisition of all of share capital of Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd ("Taiyu"), a plate heat exchange products company organized under the laws of the People's Republic of China, the divestiture of the Company's prior exploration business, and the change of the Company's name to SmartHeat Inc. The acquisition of Taiyu's share capital was accomplished pursuant to the terms of a Share Exchange Agreement dated April 14, 2008 (the "Share Exchange Agreement") by and among the Company's wholly owned subsidiary SmartHeat Inc., a Nevada corporation, Taiyu and all of the shareholders of Taiyu (the "Taiyu Shareholders"). At the closing under the Share Exchange Agreement all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of RMB25,000,000 was exchanged for an aggregate of 18,500,000 shares of SmartHeat common stock (the "Share Exchange"). As a result of the Share Exchange, Taiyu became a wholly-owned subsidiary of SmartHeat.

SmartHeat was thereafter immediately merged into the Company.

In addition, the following actions occurred under the terms of the Share Exchange Agreement:

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- Immediately following the closing of the Share Exchange, the Company transferred all of its pre-closing assets and liabilities (other than the obligation to pay a \$10,000 fee to the Company's audit firm) to a wholly owned subsidiary, PGR Holdings, Inc., a Nevada corporation ("SplitCo"), under the terms of an Agreement of Conveyance, Transfer and Assignment of Assets and Assumption of Obligations dated April 14, 2008. The Company also sold all of the outstanding capital stock of SplitCo to Jason Schlombs (the former director and officer, and a major shareholder, of the Company) pursuant to a Stock Purchase Agreement dated April 14, 2008 in exchange for the surrender of 2,500,000 shares of the Company's common stock held by Mr. Schlombs.
- As a condition to the closing of the Share Exchange, Mr. Jun Wang, the Chairman and Chief Executive Officer of Taiyu was appointed to the board of directors of the Company. Mr. Wang is the sole member of the board of directors as of the date hereof; Mr. Schlombs, having resigned effective as of the close of business on April 15, 2008.
- Also as a condition to the closing of the Share Exchange, Mr. Schlombs resigned as the President, Chief Executive Officer, Secretary and Treasurer of the Company and Mr. Jun Wang was appointed as President and Chief Executive Officer, Ms. Zhijuan Guo was appointed as Chief Financial Officer and Ms. Huajun Ai was appointed as Corporate Secretary.

#### *Private Placement*

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

#### *Option Grants*

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

#### *San De Ke Transaction*

On September 25, 2008, the Company entered into the Share Exchange Agreement (the "Purchase Agreement") between Asialink (Far East) Limited ("Asialink") and the Company providing for the acquisition by the Company from Asialink of all of the outstanding capital stock of San De Ke Co., Ltd., a Shanghai - based manufacturer of heat plate exchangers ("SanDeKe"). The purchase price for the SanDeKe shares was \$741,516. SanDeKe has an annual production capacity of approximately 4,000 plate heat exchangers. SanDeKe was founded in October 2004 to capitalize and expand on the increasing need for energy saving and environmentally friendly products within China. Its client base spans a wide range of industries including manufacturing, consumer, chemical, and energy.

Under the terms of the Purchase Agreement, two of the shareholders of SanDeKe have agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase.



## **Critical Accounting Policies**

### Basis of Presentation

Our financial statements are prepared in accordance with GAAP and the requirements of Regulation S-X promulgated by the SEC.

### Principle of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its direct and indirect subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

### Use of Estimates

In preparing the financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting year. Significant estimates, required by management, include the recoverability of long-lived assets and the valuation of inventories. Actual results could differ from those estimates.

### 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.

Accounts receivable is net of unearned interest. 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 for the year.

### Inventories

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

## **Property and Equipment**

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts, and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicle	5 years
Office Equipment	5 years
Production Equipment	5 - 10 years



Revenue Recognition

Our revenue recognition policies are in compliance with SEC Staff Accounting Bulletin No. 104. Sales revenue is recognized at the date of shipment to customers when a formal arrangement exists, the price is fixed or determinable, the delivery is completed, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

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## Foreign Currency Translation and Comprehensive Income (Loss)

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

The Company uses SFAS 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

## Results of Operations

### *Quarter Ended September 30, 2008 Compared to the Quarter Ended September 30, 2007*

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

	For the Quarter Ended September 30,		2007	
	2008			2007
	\$	% of sales	\$	% of sales
Sales	20,708,288		3,015,606	
Cost of Sales	(13,273,914)	64.0	(2,080,718)	69.0
Gross Profit	7,434,374	36.0	934,888	31.0
Operating Expenses	(2,080,961)	10.0	(549,579)	18.0
Income from Operations	5,353,413	26.0	385,309	13.0
Other Income (Expenses), net	(41,911)	(0.2)	(112,524)	(3.7)
Net Income	4,324,661	21.0	220,028	7.3

*Sales.* Our net sales for the three months ended September 30, 2008 were approximately \$20.71 million while our net sales in same period for 2007 were approximately \$3.02 million, an increase in revenues of \$17.69 million, or about 587%. The increase was primarily due to the expansion of our sales force, growth of our existing sales channels to develop new customers and the extension of our customer base into other industries and new regions in China. We believe that our sales will continue to grow as we strengthen our sales efforts by hiring more sales personnel, expanding sales channels, and improving the quality of our products.

*Cost of Sales.* Our cost of sales for the three months ended September 30, 2008 were approximately \$13.27 million while our cost of sales for the same period in 2007, were approximately \$2.08 million, an increase of \$11.19 million, or 538%. The increase in cost of sales is attributed to increases in our production and sales during the period. Cost of sales as a percentage of sales was approximately 64% for the third fiscal quarter of 2008 and 69% for the same period in 2007. The decrease in cost of sales as a percentage of sales for the third quarter of 2008 was mainly due to efficient cost control on our purchasing, manufacturing and quality control departments.

*Gross Profit.* Gross profit was \$7.43 million for the quarter ended September 30, 2008 as compared to \$0.93 million for the same period in 2007, representing gross margins of approximately 36% and 31% for the third quarter of 2008 and 2007, respectively. The increase in our gross profits was mainly due to the significant increase in our sales and decrease in cost of sales. We believe our gross profit margin will continue to increase due to the economies of scale as we continue to increase our production, improve efficiency on cost control and increase the sales on assembled heat

exchanger unit.

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*Operating Expenses.* Operating expenses, consisting of selling, general and administrative expenses, totaled approximately \$2.08 million for the three months ended September 30, 2008 as compared to \$0.55 million for the same period in 2007, an increase of approximately \$1.53 million or 279%. The increase in operating expenses was mainly due to proportional increases in after-sale service, payroll, insurance and travel expenses, coupled with our increased sales and production; as well as the audit, legal, consulting and filing expenses in connection with the Company of being public in US since April of 2008.

*Net Income.* Our net income for the three month period ended September 30, 2008 was approximately \$4.32 million as compared to \$0.22 million for the same period in 2007, an increase of \$4.1 million or 1866%. This increase is attributable to economy of scale combined with rapid growth in revenue and efficiency of operations. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

***Nine Months Ended September 30, 2008 Compared to the Nine Months Ended September 30, 2007***

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

	2008		For the Nine Months Ended September 30, 2007	
	\$	% of Sales	\$	% of Sales
Sales	29,345,571		5,473,573	
Cost of sales	(19,502,070)	66.5	(3,679,507)	67.0
Gross Profit	9,843,501	33.5	1,794,066	33.0
Operating Expenses	(3,135,459)	10.7	(1,333,314)	24.4
Income from Operation	6,708,042	23.0	460,752	8.4
Other Income (Expenses), net	73,163	0.25	27,761	0.51
Net Income	5,528,336	19.0	385,116	7.0

*Sales.* Our net sales for the nine months ended September 30, 2008 were approximately \$29.35 million while our net sales for the same period in 2007, were approximately \$5.47 million, an increase in revenues of \$23.87 million, or 436%. The increase was due to 1) growing demand for our product resulting from rapid increase in newly-built residential communities in Shenyang City and the surrounding area, 2) increased number of our sales representatives to develop new customers in more cities in China, 3) expanding the field of applications for our products to industries other than heating providers, such as steel, electrical power plants and chemical engineering, etc. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, offering incentive rewarding and compensating system to our sales representatives, increasing the sales channels, and improving the quality of our products.

*Cost of Sales.* Our cost of sales for the nine months ended September 30, 2008 were approximately \$19.5 million while our cost of sales for the same period in 2007 were approximately \$3.68 million, an increase of \$15.82 million, or 430%. The increase in cost of sales is attributed to the increase of production and sales activities in 2008. Cost of sales as a percentage of sales was approximately 66.5% for the nine months ended September 30, 2008 and 67% for the same period in 2007. A slight decrease in cost of sales as a percentage of sales for nine months ended September 30, 2008 was a result of improvement on cost control which benefited from our strictly established cost control procedures.

*Gross Profit.* Gross profit was \$9.84 million for the nine months ended September 30, 2008 as compared to \$1.79 million for the same period in 2007, representing gross margins of approximately 33.5% and 33% for nine months ended September 30, 2008 and 2007, respectively. The increase in our gross profits due to the increase of sales

activities and decrease in cost of sales which benefited from our strict cost control procedures. We believe our gross profit margin will increase due to the economy of scale as we will increase our production and improving our efficiency on cost control.

*Operating Expenses.* Operating expenses consisted of selling, general and administrative expenses and totaled approximately \$3.14 million for the nine months ended September 30, 2008 as compared to \$1.33 million for the same period in 2007, an increase of approximately \$1.8 million or 136%. The increased in operating expenses was mainly due to increase in rental expense as we leased new offices for our representatives in the major cities of China, after-sale service, payroll, insurance and travel expenses coupled with our increased sales and production; as well as the audit, legal, consulting and filing expenses in connection with the Company of being public in the US since April of 2008.

*Net Income.* Our net income for the nine months ended September 30, 2008 was \$5.53 million as compared to approximately \$0.39 million for the same period in 2007, an increase of \$5.14 million or 1336%. This increase is attributable to economy of scale combined with rapid growth in revenue and efficiency of operations. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

### Liquidity and Capital Resources

As of September 30, 2008, we had cash and cash equivalents of approximately \$1,702,938. Working capital was approximately \$13.58 million at September 30, 2008. The ratio of current assets to current liabilities was 2.02:1 at September 30, 2008.

The following is a summary of cash provided by or used in each of the indicated types of activities during the nine months ended September 30, 2008 and 2007:

	For the Nine Months Ended September 30,	
	2008	2007
Cash provided by (used in):		
Operating Activities	\$ (1,213,651)	\$ (1,080,746)
Investing Activities	(471,967)	(657,979)
Financing Activities	2,949,465	2,107,098

Net cash flow used in operating activities was \$1,213,651 for the nine months ended September 30, 2008, as compared to net cash flow used in operating activities of \$1,080,746 for the nine months ended September 30, 2007. The increase in net cash flow used in operating activities for the nine months ended September 30, 2008 was mainly due to an increase in other receivables and decrease in customer deposits. In addition, our net income for nine months ended September 30, 2008 has increased rapidly compared to the same period of 2007, bringing more cash in to the Company, while at the same time our accounts receivables have increased significantly, reducing our cash inflows.

Net cash flow used in investing activities was \$471,967 for the nine months ended September 30, 2008, as compared to net cash used in investing activities of \$657,979 in the same period of 2007. The slight decrease of net cash flow used in investing activities in the nine months ended September 30, 2008 was mainly due to the completion of construction in progress that was commenced and paid in 2007.

Net cash flow provided by financing activities was \$2,949,465 for the nine months ended September 30, 2008 as compared to net cash provided by financing activities of \$2,107,098 for the same period of 2007. The increase of net cash inflow provided by financing activities for the nine months ended September 30, 2008 was mainly due to net proceeds of \$5,100,000 from the shares issued despite repayments of \$2,149,875 for the loans during the nine months ended September 30, 2008.

We believe we have sufficient cash to continue our current business through September 30, 2009 due to expected increased sales revenue and net income from operations.

We do not believe that inflation had a significant negative impact on our results of operations during the year ended September 30, 2009.

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**Off-Balance Sheet Arrangements**

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

**Contractual Obligations**

The Company is obligated for the following short term loans payable as of September 30, 2008:

	Balance at September 30, 2008
Short term loan with a commercial bank in the PRC for 6,000,000 RMB, or \$822,526. This loan was entered into on Apr 28, 2007 and is due on Apr 12, 2008. This loan bears interest at 7.029% per annum. This loan was renewed on Apr 12, 2008 with new maturity date on June 13, 2009.	\$ 880,023
The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB or \$1,412,003. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.	1,129,363
The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB, or \$390,700. These loans are due on various dates in year 2008. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007.	358,661
The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB or \$625,759. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bears no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31, 2006.	740,686
The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB, or \$440,000. This loan is due on June 30, 2009 with interest rate of 8.591% per annum.	440,013
	\$ 3,548,746

**Recent Accounting Pronouncements****Accounting for Financial Guarantee Insurance Contracts**

In May 2008, FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60." The scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts, as described in this Statement, issued by enterprises included within the scope of Statement 60. Accordingly, this Statement does not apply to financial guarantee contracts issued by enterprises excluded from the



scope of Statement 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). This Statement also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement will not have an impact on the Company's financial statements.

### **The Hierarchy of Generally Accepted Accounting Principles**

In May 2008, FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States. SFAS 162 will not have an impact on the Company's financial statements.

### **Disclosures about Derivative Instruments and Hedging Activities**

In March 2008, FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Based on current conditions, the Company does not expect the adoption of SFAS 161 to have a significant impact on its results of operations or financial position.

### **Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51**

In December 2007, FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Based on current conditions, the Company does not expect the adoption of SFAS 160 to have a significant impact on its results of operations or financial position.

### **Business Combinations**

In December 2007, FASB issued SFAS No. 141 (Revised 2007), "Business Combinations." SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Non-controlling interests (formerly known as "minority interests" – see SFAS 160 discussion above) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;
- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and

Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since we are a calendar year-end company we will continue to record and disclose business combinations following existing GAAP until January 1, 2009. The Company expects SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

**Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R**

In September 2006, FASB issued SFAS, No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132R," which requires employers to recognize the underfunded or overfunded status of a defined benefit postretirement plan as an asset or liability in its statement of financial position and to recognize changes in the funded status in the year in which the changes occur through accumulated other comprehensive income. Additionally, SFAS 158 requires employers to measure the funded status of a plan as of the date of its year-end statement of financial position. The new reporting requirements and related new footnote disclosure rules of SFAS 158 are effective for fiscal years ending after December 15, 2006. The Company adopted the provisions of SFAS 158 for the year end 2006, and the effect of recognizing the funded status in accumulated other comprehensive income was not significant. The new measurement date requirement applies for fiscal years ending after December 15, 2008.

**Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities**

In June 2007, FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. Management is currently evaluating the effect of this pronouncement on our financial statements.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Not required

**Item 4T. Controls and Procedures**

**Disclosure Controls and Procedures**

As of September 30, 2008, we carried out an evaluation of the effectiveness of the design and operation of our "disclosure controls and procedures" (as defined in the Exchange Act Rules 13a-15(e) and 15d-15(e)) under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, we concluded that our disclosure controls and procedures are effective.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management to allow timely decisions regarding required disclosure.

**Changes in Internal Controls Over Financial Reporting**

During the quarter ended September 30, 2008, there were no changes in our internal control over financial reporting that materially affected our internal control over financial reporting.

## **Part II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

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

### **Item 1A. Risk Factors**

Not required.

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

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

### **Item 3. Defaults Upon Senior Securities**

None.

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

None.

### **Item 5. Other Information**

None.

### **Item 6. Exhibits**

#### **Exhibit No. Document Description**

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



**SIGNATURES**

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

**SMARTHEAT INC.  
(Registrant)**

November 14, 2008                      By:                      /s/ Jun Wang  
   Jun Wang  
   President and Chief Executive Officer

November 14, 2008                      By:                      /s/ Zhijuan Guo  
   Zhijuan Guo  
   Chief Financial Officer

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**EXHIBIT INDEX**

**Exhibit No. Document Description**

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

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