Sino Clean Energy Inc
Form 10-Q
August 13, 2010

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

# FORM 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2010

or

q Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to .

Commission File Number 000-51753

SINO CLEAN ENERGY INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Nevada | 75-2882833 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

Room 1502, Building D, Wangzuo International City Building
No. 3 Tangyuan Road, Gaoxin District
Xi'an, Shaanxi Province, People's Republic of China
(Address of Principal Executive Offices including zip code)
+86 29 8844-7960
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þNo q

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every, Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). *Yes q No q* The registrant has not yet been phased into the interactive data requirements.

Indicate by check mark if the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company

| | | | |
|---|---|---|---|
| Large Accelerated Filer q | Accelerated Filer q | Non-Accelerated Filer q | Smaller reporting company þ |

(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 Securities Exchange Act). Yes No þ

As of August 11, 2010, 16,756,531 shares of the issuer's common stock, par value $0.001, were outstanding.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

Sino Clean Energy Inc. and Subsidiaries
Condensed Consolidated Balance Sheets

| | June 30, 2010 (Unaudited) | December 31, 2009 |
|---|---|---|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | $ 25,575,339 | $ 18,302,558 |
| Accounts receivable, net | 9,870,866 | 3,655,473 |
| Inventories | 744,717 | 892,609 |
| Prepaid inventories | 4,780,173 | 5,453,095 |
| Prepaid expenses | 8,716 | 259,627 |
| Tax recoverable | -- | 138,495 |
| Other receivables | 29,389 | 65,584 |
| Land use right - current portion | 38,952 | 38,739 |
| | | |
| Total current assets | 41,048,152 | 28,806,180 |
| | | |
| Property, plant and equipment, net | 15,416,876 | 12,557,691 |
| Land use right – non current portion | 1,768,811 | 1,778,562 |
| Goodwill | 762,018 | 762,018 |
| Prepayments and deposits | 1,478,701 | 729,328 |
| | | |
| Total assets | $ 60,474,558 | $ 44,633,779 |
| | | |
| LIABILITIES AND SHAREHOLDERS’ EQUITY (DEFICIENCY) | | |
| Current liabilities | | |
| Accounts payable and accrued expenses | $ 4,086,817 | $ 2,672,211 |
| Taxes payable | 2,688,277 | 1,577,249 |
| Amount due to directors | 73,466 | 73,466 |
| Derivative liabilities | 18,130,524 | 16,752,858 |
| | | |
| Total current liabilities | 24,979,084 | 21,075,784 |
| | | |
| Convertible notes, net of discount | - | 1,615,025 |
| Derivative liabilities | - | 28,404,181 |
| | | |
| Total liabilities | 24,979,084 | 51,094,990 |
| | | |
| Commitments and Contingencies | | |
| | | |
| Shareholders' Equity (Deficiency) | | |
| Preferred stock, $0.001 par value, | | |

| | | |
|---|---|---|
| 50,000,000 shares authorized, | | |
| none issued and outstanding | - | - |
| Common stock, $0.001 par value, | | |
| 30,000,000 shares authorized, 16,557,000 and 10,850,613 issued | | |
| and outstanding as of June 30, 2010 | | |
| and December 31, 2009 respectively | 16,557 | 10,850 |
| Additional paid-in capital | 37,700,930 | 25,432,804 |
| Accumulated deficit | (6,401,607) | (35,802,987) |
| Statutory reserves | 1,758,553 | 1,758,553 |
| Accumulated other comprehensive income | 2,421,041 | 2,139,569 |
| Total Shareholders' equity (deficiency) | 35,495,474 | (6,461,211) |
| Total liabilities and shareholders' equity (deficiency) | $ 60,474,558 | $ 44,633,779 |

See accompanying notes to condensed consolidated financial statements.

Sino Clean Energy Inc. and Subsidiaries
Condensed Consolidated Statements of Income and Other Comprehensive Income
(Unaudited)

| | Three months ended June 30, 2010 | Three months ended June 30, 2009 | Six months ended June 30, 2010 | Six months ended June 30, 2009 |
|---|---|---|---|---|
| Revenue | $ 24,149,761 | $ 8,314,500 | $ 48,658,765 | $ 16,092,777 |
| Cost of goods sold | (14,779,016) | (5,534,929) | (29,179,193) | (10,883,036) |
| Gross profit | 9,370,745 | 2,779,571 | 19,479,572 | 5,209,741 |
| Selling expenses | 1,136,019 | 2,261 | 2,047,098 | 5,820 |
| General and administrative expenses | 626,053 | 432,412 | 1,345,235 | 981,311 |
| Income from operations | 7,608,673 | 2,344,898 | 16,087,239 | 4,222,610 |
| Other income (expense) | | | | |
| Interest and finance costs | (13,591) | (596,098) | (10,458,154) | (1,081,845) |
| Expense related to escrow shares | - | (120,166) | - | (240,333) |
| Interest income | 19,353 | 7,285 | 32,224 | 11,271 |
| Gain on extinguishment of derivative liability | - | 989,260 | 28,404,181 | 989,260 |
| Change in fair value of derivative liabilities | 2,862,263 | (1,779,968) | (1,377,666) | (1,200,990) |
| Sundry income | 4,688 | - | 4,688 | - |
| Total other income (expense) | 2,872,713 | (1,499,687) | 16,605,273 | (1,522,637) |
| Income before provision for income taxes | 10,481,386 | 845,211 | 32,692,512 | 2,699,973 |
| Provision for income taxes | 1,540,627 | 303,382 | 3,291,132 | 592,668 |
| Net income | 8,940,759 | 541,829 | 29,401,380 | 2,107,305 |
| Other comprehensive income | | | | |
| Foreign currency translation adjustment | 269,266 | 12,010 | 281,472 | 8,694 |
| Comprehensive income | $ 9,210,025 | $ 553,839 | $ 29,682,852 | $ 2,115,999 |
| Weighted average number of shares | | | | |
| - Basic | 16,557,000 | 9,532,061 | 14,714,742 | 9,376,630 |
| - Diluted | 19,216,041 | 9,910,926 | 17,161,540 | 9,806,755 |
| Income per common share | | | | |
| - Basic | $ 0.54 | $ 0.06 | $ 2.00 | $ 0.22 |
| - Diluted | $ 0.47 | $ 0.05 | $ 1.71 | $ 0.21 |

See accompanying notes to condensed consolidated financial statements.

Sino-Clean Energy Inc. and Subsidiaries
Condensed Consolidated Statements of Changes in Shareholders' Equity (Deficiency)
For the six months ended June 30, 2010
(Unaudited)

| | Common stock | | Additional paid-in capital | Statutory reserves | Accumulated Deficit | Accumulated other comprehensive income | Total |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | | | | | |
| Balance, January 1, 2010 | 10,850,613 | $ 10,850 | $ 25,432,804 | $ 1,758,553 | $ (35,802,987) | $ 2,139,569 | $ (6,461,211) |
| Shares issued for exercise of warrants and options | 62,632 | 63 | 173,917 | -- | -- | -- | 173,980 |
| Fair value of options granted | -- | -- | 18,152 | -- | -- | -- | 18,152 |
| Shares issued upon conversion of notes payable | 5,643,755 | 5,644 | 12,076,057 | -- | -- | -- | 12,081,701 |
| Net income | -- | -- | -- | -- | 29,401,380 | -- | 29,401,380 |
| E Foreign currency translation gain | -- | -- | -- | -- | -- | 281,472 | 281,472 |
| Balance, June 30, 2010 | 16,557,000 | $ 16,557 | $ 37,700,930 | $ 1,758,553 | $ (6,401,607) | $ 2,421,041 | $ 35,495,474 |

See accompanying notes to condensed consolidated financial statements.

Sino Clean Energy Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

| | Six months ended June 30, 2010 | 2009 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 29,401,380 | $ 2,107,305 |
| Adjustments to reconcile net income to cash provided by operating activities: | | - |
| Depreciation and amortization | 1,008,832 | 713,062 |
| Amortization of deferred debt issuance costs | - | 217,102 |
| Amortization of discount on convertible notes | 8,601,975 | 753,025 |
| Fair value of common stock issued for payment of interest expense | 1,864,701 | - |
| Gain on extinguishment of derivative liabilities | (28,404,181) | (989,260) |
| Expense related to escrow shares | - | 240,333 |
| Fair value of common stock issued for services | - | 454,935 |
| Change in fair value of derivative liabilities | 1,377,666 | 1,200,990 |
| Fair value of vested options | 18,152 | - |
| Change in operating assets and liabilities : | | |
| Accounts receivable | (6,215,393) | (1,213,446) |
| Other receivables | 36,195 | (6,444) |
| Inventories | 147,892 | (167,440) |
| Prepaid inventories | 672,922 | 819,974 |
| Prepaid expenses | 250,911 | 60,994 |
| Tax recoverable | 138,495 | - |
| Refundable advance | - | 731,861 |
| Government grant receivable | - | 146,314 |
| Accounts payable and accrued expenses | 236,559 | 429,654 |
| Taxes payable | 1,111,028 | 255,041 |
| Net cash provided by operating activities | 10,247,134 | 5,754,000 |
| Cash flows from investing activities : | | |
| Prepayments and deposits | (97,320) | 47,880 |
| Purchase of property, plant and equipment | (2,606,556) | - |
| Net cash (used in) provided by investing activities | (2,703,876) | 47,880 |
| | | - |
| Cash flows from financing activities: | | |
| Prepayments and deposits related to deferred offering costs | (652,053) | - |
| Payment of advances from director | - | (395,066) |
| Cash received from exercise of warrants and options | 173,980 | - |
| Net cash used in financing activities | (478,073) | (395,066) |
| Effect of foreign currency translation | 207,596 | 29,997 |
| Net increase in cash and cash equivalents | 7,272,781 | 5,436,811 |
| | | - |
| Cash and cash equivalents, beginning of period | 18,302,558 | 3,914,306 |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents, end of period | $ | 25,575,339 | $ | 9,351,117 |
| | | | | |
| Supplemental disclosure information | | | | |
| Cash paid for interest | $ | - | | - |
| Cash paid for taxes | $ | 2,641,771 | $ | 406,427 |
| | | | | |
| Supplemental non-cash investing and financing activities | | | | |
| Issuance of shares upon conversion of convertible notes | $ | 10,217,000 | $ | 448,520 |
| Cumulative effect of change in accounting principle, reclassification of warrants and conversion feature to derivative liability | $ | - | $ | 4,589,792 |

See accompanying notes to the condensed consolidated financial statements.

Sino Clean Energy Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
For the Six Months Ended June 30, 2010 (Unaudited)

1. ORGANIZATION AND BUSINESS ACTIVITIES

Overview

Sino Clean Energy Inc. (the “Company”, “we” or “our”) is a holding company that, through its subsidiaries, based upon total third party sales revenue in China, is a leading commercial producer and distributor of coal-water slurry fuel (“CWSF”) in China. CWSF is a clean fuel that consists of fine coal particles suspended in water. Our CWSF products are mainly used to fuel boilers and furnaces to generate steam and heat for residential and industrial applications. We sell our products in China and our customers include industrial, commercial, residential and government organizations. Our strong reputation in the CWSF industry in China, together with our established track record for consistently delivering products in large quantities, has enabled us to expand our customer base. We primarily use washed coal to produce CWSF. We acquire the raw materials for each of our production facilities primarily from three nearby coal mines. We have established strong relationships with our suppliers and our ability to purchase large quantities of raw materials has allowed us to achieve favorable pricing and delivery terms.

Corporate Organization and History

We were originally incorporated in Texas as “Discount Mortgage Services, Inc.” on July 11, 2000. In September 2001, we purchased Endo Networks, Inc., a Canadian software developer, and changed our name to “Endo Networks, Inc.” on November 5, 2001. We re-domiciled to the State of Nevada on December 13, 2001.

On October 20, 2006 we consummated a share exchange transaction with Hangson, a British Virgin Islands company, the stockholders of Hangson and a majority of our stockholders. We issued a total of 2,600,000 shares of our common stock to the Hangson Stockholders and a consultant in the transaction, in exchange for 100% of the common stock of Hangson. As a result of the transaction we became engaged in the CWSF business, through the operations of Suo’ang BST and Shaanxi Suo’ang New Energy. On January 4, 2007, we changed our name from “Endo Networks, Inc.” to “China West Coal Energy Inc.”, and then on August 15, 2007, we changed our name again to our present name, Sino Clean Energy Inc.

Hangson was a holding company that controlled Suo'ang BST and Suo'ang BST's 80%-owned subsidiary Suo'ang New Energy, through a series of contractual arrangements. The remaining 20% of Suo'ang New Energy was owned by Mr. Peng Zhou, a member of our board of directors and, at that time, the chief operating officer of Suo'ang BST. Suo'ang BST, through Suo'ang New Energy, commenced CWSF production in July 2007. Although Hangson was entitled to acquire the remaining 20% of Suo'ang New Energy from Mr. Zhou, the transfer was not completed and Mr. Zhou remained as the record shareholder of Suo'ang New Energy.

In 2009, we effected a reorganization of our corporate structure in order to make Suo'ang New Energy a wholly-owned subsidiary which included entering into a series of agreements transferring the contractual arrangements, through which Hangson controlled Suo'ang BST, to Suoke Clean Energy.

On September 15, 2009, Suo'ang BST and Hangson entered into a share transfer agreement with Suoke Clean Energy pursuant to which Suo'ang BST and Hangson agreed to transfer 100% of the equity interests in Suo'ang New Energy to Suoke Clean Energy. However, since Mr. Zhou still owned 20% of Suo'ang New Energy, on November 10, 2010, Suo'ang BST and Hangson entered into a subsequent share transfer agreement with Suoke Clean Energy to transfer 80% of Suo'ang New Energy's equity interests to Suoke Clean Energy and, Mr. Zhou, with Hangson's consent, entered into a share transfer agreement with Suoke Clean Energy to transfer the remaining 20% equity interest of Suo'ang

New Energy. On November 12, 2009, Suo'ang New Energy received a new business license from the Tongchuan Administration for Industry and Commerce, which reflected that the acquisition of 100% of the equity of Suo'ang New Energy by Suoke Clean Energy had been completed. As a result we were able, through Suoke Clean Energy to own 100% of the equity interests of Suo'ang New Energy. On October 12, 2009, Suo'ang New Energy established a wholly-owned subsidiary to conduct the CWSF business in Shenyang, Liaoning Province.

On December 31, 2009, we entered into a series of termination agreements to terminate the contractual arrangements by and among Suoke Clean Energy, Suo'ang BST and certain stockholders of Suo'ang BST. We no longer needed to keep such contractual arrangements in place due to the fact that Suo'ang BST was no longer engaged in any substantial business operations. In connection with the termination agreements, certain assets held by Suo'ang BST, such as office equipment, vehicles, bank deposits, and accounts receivable, were transferred to Suoke Clean Energy. Employees of Suo'ang BST signed new employment contracts with Suoke Clean Energy. All rights and obligations under certain business operation agreements and research and development contracts between Suo'ang BST and third parties were assigned to Suo'ang New Energy. Hangson has had no substantive operations of its own after the transfer and termination of the contractual arrangements.

On June 30, 2009, Hangson acquired all of the outstanding shares of Wiscon, a limited liability company incorporated in Hong Kong under the Companies Ordinance. On December 31, 2009, Hangson transferred all of the outstanding shares of Wiscon to Sino Clean Energy Inc. As a result, Wiscon became a direct wholly-owned subsidiary of Sino Clean Energy Inc.

Effective May 7, 2010, the Company announced a reverse stock split pursuant to which each ten shares of Company's common stock then issued and outstanding was automatically converted into one share of the Company’s common stock.  All share and per share amounts in the accompanying condensed consolidated financial statements have been adjusted to reflect the reverse stock split as if it had occurred at the beginning of the earliest period presented.

2. SUMMARY OF SIGNIFICANY ACCOUNTING POLICIES

Basis of presentation and consolidation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC"). Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The financial statements contained herein should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2009 Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the SEC. The results of operations for interim periods are not necessarily indicative of the results expected for a full year or for any future period.

The consolidated condensed financial statements include the financial statements of the Company, its wholly owned subsidiaries Wiscon, Tongchuan Suoke Clean Energy, Shaanxi Suo'ang New Energy and Shenyang Suo'ang New Energy.  Intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Because of the use of estimates inherent in the financial reporting process, actual results could differ from those estimates.

Revenue recognition

Revenues of the Company are from sales of CWSF. Sales are recognized when the following four revenue criteria are met: persuasive evidence of an arrangement exists, delivery has occurred, the selling price is fixed or determinable, and collectibility is reasonably assured.  Revenues are presented net of value added tax ("VAT"). In our revenue arrangements, physical delivery is the point in time when customer acceptance occurs since title and risk of loss are transferred to the customer.  No return allowance is made as products are normally not returnable upon acceptance by the customers.

Accounts receivable

Accounts receivables are recognized and carried at original invoiced amount less an allowance for any uncollectible accounts. The Company uses the aging method to estimate the valuation allowance for anticipated uncollectible receivable balances.  Under the aging method, bad debts determined by management are based on historical experience as well as the current economic climate and are applied to customers' balances categorized by the number of months the underlying invoices have remained outstanding.  The valuation allowance balance is adjusted to the amount computed as a result of the aging method.  When facts subsequently become available to indicate that an adjustment to the allowance should be made, this is recorded as a change in estimate in the current year. As of June 30, 2010 and December 31, 2009, accounts receivable were net of allowances of zero and zero, respectively.
.
Fair value of financial instruments

Fair value measurements are determined using authoritative guidance issued by the FASB, with the exception of the application of the guidance to non-recurring, non-financial assets and liabilities as permitted. Fair value is defined in the authoritative guidance as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date. A fair value hierarchy was established, which prioritizes the inputs used in measuring fair value into three broad levels as follows :

Level 1—Quoted prices in active markets for identical assets or liabilities.

Level 2—Inputs, other than the quoted prices in active markets, are observable either directly or indirectly.

Level 3—Unobservable inputs based on the Company's assumptions.

The Company is required to use observable market data if available without undue cost and effort.

The following table presents certain investments and liabilities of the Company's financial assets measured and recorded at fair value on the Company's consolidated balance sheets on a recurring basis and their level within the fair value hierarchy as of June 30, 2010 and December 31, 2009.

June 30, 2010 (Unaudited)

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fair value of warrants | $ -- | $ -- | $ 18,130,524 | $ 18,130,524 |

December 31, 2009

| | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fair value of convertible note conversion feature | -- | -- | $ 28,404,181 | $ 28,404,181 |
| Fair value of warrants | -- | -- | $ 16,752,858 | $ 16,752,858 |
| | -- | -- | $ 45,157,039 | $ 45,157,039 |

Derivative financial instruments

The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the consolidated statements of operations. For stock-based derivative financial instruments, the Company uses both the Black-Scholes-Merton and Binomial option pricing models to value the derivative instruments at inception and on subsequent valuation dates. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date.

Stock based compensation

The Company periodically issues stock options and warrants to employees and non-employees in capital raising transactions, for services and for financing costs. Stock-based compensation is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. Options vest and expire according to terms established at the grant date.

Income per common share

Basic earnings per share is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding during the period. The diluted earnings per share calculation give effect to all potentially dilutive common shares outstanding during the period using the treasury stock method for warrants and options and the if-converted method for convertible debentures.

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As of June 30, 2010, common stock equivalents were composed of warrants convertible into 4,063,982 shares of the Company's common stock, and options convertible into 60,000 shares of the Company's common stock. As of June 30, 2009, common stock equivalents were composed of warrants convertible into 926,143 shares of the Company's common stock, debentures convertible into 890,433 shares of the Company's common stock and options convertible into 10,000 shares of the Company's common stock.

The following is a reconciliation of the numerator and denominator used in the calculation of basic and diluted earnings per share.

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator | | | | |
| Net income | $ 8,940,759 | $ 541,829 | $ 29,401,380 | $ 2,107,305 |
| | | | | |
| Denominator | | | | |
| Weighted average shares outstanding-basic | 16,557,000 | 9,532,061 | 14,714,742 | 9,376,630 |
| Effect of dilutive instruments: | | | | |
| Warrants and options | 2,659,041 | 378,865 | 2,446,798 | 430,125 |
| Weighted average shares outstanding-diluted | 19,216,041 | 9,910,926 | 17,161,540 | 9,806,755 |

Foreign currency translation

The accompanying condensed consolidated financial statements are presented in United States dollars. The functional currency of the Company is the Renminbi (RMB). Capital accounts of the condensed consolidated financial statements are translated into United States dollars from RMB at their historical exchange rates when the capital transactions occurred. Assets and liabilities are translated at the exchange rate as of balance sheet date. Income and expenditures are translated at the average exchange rate of the period

| | June 30, 2010 | December 31, 2009 | June 30, 2009 |
|---|---|---|---|
| Period end RMB : US$ exchange rate | 6.7909 | 6.8172 | 6.8319 |
| | | | |
| Average period RMB : US$ exchange rate | 6.8251 | 6.8259 | 6.8343 |

The RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that the RMB amounts could have been, or could be, converted into US dollars at the rates used in translation.

Deferred offering costs

Deferred offering costs, consisting of legal, accounting and filing fees relating to an offering are capitalized. The deferred offering costs will be offset against offering proceeds in the event the offering is successful. In the event the offering is unsuccessful or is abandoned, the deferred offering costs will be expensed. As of June 30, 2010 and December 31, 2009, deferred offering costs of $687,053 and $35,000, respectively, are included in Prepayments and Deposits in the accompanying condensed consolidated balance sheets.

Income taxes

The Company uses asset and liability approach for financial accounting and reporting for income taxes that allows recognition and measurement of deferred tax assets based upon the likelihood of realization of tax benefits in future years. Under the asset and liability approach, deferred taxes are provided for the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before the Company is able to realize their benefits, or that future deductibility is uncertain.

Research and Development

Research and development costs are expensed as incurred. For the six months ended June 30, 2010 and 2009, research and development expenses totaled $147,518 and $0, respectively and are included in the General and Administrative expenses in the accompanying condensed consolidated statements of income and other comprehensive income.

Concentrations

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and unsecured trade accounts receivable.

Cash denominated in Renminbi (“RMB”) with a US dollar equivalent of $24,702,112 and $18,275,847 at June 30, 2010 and December 31, 2009, respectively, was held in accounts at financial institutions located in the PRC. In addition, the Company maintains funds in bank accounts in the US which at times may exceed the federally insured balance of $250,000. The Company and its subsidiaries have not experienced any losses in such accounts and do not believe the cash is exposed to any significant risk. .

For the six months ended June 30, 2010, one customer, Shenyang Haizhong Heat Resource, Ltd., (“Shenyang Haizhong”) accounted for 47% of sales and at June 30, 2010, accounted for 68% of accounts receivable. Shenyang Haizhong is a subsidiary of Qingdao Haizhong Enterprise Co. (“Haizhong Boiler"), which the Company has an exclusive sales agency agreement to distribute CWSF boilers. The Company also has an exclusive agreement with Shenyang Haizhong to supply it with CWSF. Shenyang Haizhong is the sole supplier of heat to the commercial and residential customers in the new economic zone in Shenyang, Liaoning Province. For the six months ended June 30, 2010 and 2009, there were no other customers who accounted for 10% or more of sales or accounts receivable.

For the three months ended June 30, 2010, Shenyang Haizhong accounted for 31% of sales. For the three months ended June 30, 2010 and 2009, there were no other customers who accounted for 10% or more of sales.

For the six months ended June 30, 2010, three vendors accounted for 85% of total purchases (33%, 30% and 22% respectively). At June 30, 2010, two vendors accounted for 100% of accounts payable and one vendor accounted for 92% of prepaid coal. For the six months ended June 30, 2009, two vendors accounted for 100% of total purchases (85% and 15% respectively). At June 30, 2009, one vendor accounted for 100% of prepaid coal.

Reclassifications

In presenting the Company’s condensed consolidated statement of income and other comprehensive income for the three and six months ended June 30, 2009, the Company presented $152,597 and $191,291 respectively of commission income as part of Other Income (Expense). In presenting the Company’s condensed consolidated statement of income and other comprehensive income for the three and six months ended June 30, 2010, the Company has reclassified the commission income to revenue.

Recently issued Accounting Pronouncements

In April 2010, the Financial Accounting Standards Board (FASB) issued new accounting guidance in applying the milestone method of revenue recognition to research or development arrangements. Under this guidance management may recognize revenue contingent upon the achievement of a milestone in its entirety, in the period in which the milestone is achieved, only if the milestone meets all the criteria within the guidance to be considered substantive. This standard is effective on a prospective basis for research and development milestones achieved in fiscal years, beginning on or after June 15, 2010. Early adoption is permitted; however, adoption of this guidance as of a date other than January 1, 2011 will require the Company to apply this guidance retrospectively effective as of January 1, 2010 and will require disclosure of the effect of this guidance as applied to all previously reported interim periods in the fiscal year of adoption. As the Company plans to implement this standard prospectively, the effect of this guidance will be limited to future transactions. The Company does not expect adoption of this standard to have a material impact on its financial position or results of operations as it has no material research and development arrangements which will be accounted for under the milestone method.

In January 2010, the FASB issued new accounting guidance which requires new disclosures regarding transfers in and out of Level 1 and Level 2 fair value measurements, as well as requiring presentation on a gross basis of information about purchases, sales, issuances and settlements in Level 3 fair value measurements. The guidance also clarifies existing disclosures regarding level of disaggregation, inputs and valuation techniques. The new guidance is effective for interim and annual reporting periods beginning after December 15, 2009. Disclosures about purchases, sales, issuances and settlements in the roll forward of activity in Level 3 fair value measurements are effective for fiscal years beginning after December 15, 2010. As this guidance requires only additional disclosure, there should be no impact on the consolidated financial statements of the Company upon adoption.

In April 2010, the FASB issued new accounting guidance to clarify that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010. The Company does not expect adoption of this standard will have a material impact on its consolidated financial statements.

In October 2009, a new accounting consensus was issued for multiple-deliverable revenue arrangements. This consensus amends existing revenue recognition accounting standards. This consensus provides accounting principles and application guidance on whether multiple deliverables exist, how the arrangement should be separated and the consideration allocated. This guidance eliminates the requirement to establish the fair value of undelivered products and services and instead provides for separate revenue recognition based upon management’s estimate of the selling price for an undelivered item when there is no other means to determine the fair value of that undelivered item. Previously the existing accounting consensus required that the fair value of the undelivered item be the price of the item either sold in a separate transaction between unrelated third parties or the price charged for each item when the item is sold separately by the vendor. Under the existing accounting consensus, if the fair value of all of the elements in the arrangement was not determinable, then revenue was deferred until all of the items were delivered or fair value was determined. This new approach is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is in the process of evaluating whether the adoption of this standard will have a material effect on its financial position, results of operations or cash flows.

In June 2009, the FASB issued authoritative guidance on consolidation of variable interest entities. The new guidance is intended to improve financial reporting by requiring additional disclosures about a company’s involvement in variable interest entities. This new guidance is effective for fiscal years and interim periods beginning after November 15, 2009. The Company adopted this guidance effective January 1, 2010, and it had no impact on the consolidated financial statements of the Company.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the Securities Exchange Commission (the "SEC") did not or are not believed by management to have a material impact on the Company's present or future consolidated financial statements.

3. INVENTORIES

Inventories consist of the following at:

| | June 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| Raw materials | $ 396,732 | $ 635,536 |

| | | |
|---|---|---|
| Finished goods | 347,985 | 257,073 |
| | | |
| | $ 744,717 | $ 892,609 |

The Company has contracts with coal mines to deliver coal for use in the production of CWSF. At times, the Company may make payments in advance of delivery and accounts for these prepayments as prepaid inventory. At June 30, 2010 and December 31, 2009, prepaid inventories totaled $4,780,173 and $5,453,095, respectively.

4 PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

| | June 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| Buildings | $ 2,812,390 | $ 2,564,638 |
| Plant and machinery | 15,264,317 | 11,762,449 |
| Office equipment | 77,243 | 76,639 |
| Motor vehicles | 262,328 | 148,020 |
| | | |
| | 18,416,278 | 14,551,746 |
| Less: Accumulated depreciation and amortization | (2,999,402) | (1,994,055) |
| | | |
| | $ 15,416,876 | $ 12,557,691 |

Depreciation expense for the six months ended June 30, 2010 and 2009 was $989,410 and $693,729, respectively.

5. CONVERTIBLE NOTES

Convertible notes consist of the following at:

| | June 30, 2010 (unaudited) | December 31, 2009 |
|---|---|---|
| 10% convertible notes | $ -- | $ 10,217,000 |
| Valuation discount | -- | (8,601,975) |
| Convertible notes, net | -- | 1,615,025 |
| Less current portion | -- | -- |
| Long term portion | $ -- | $ 1,615,025 |

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In July 2009, the Company issued $11,592,000 of 10% senior secured convertible notes (the "Notes") and issued warrants (the "Warrants") to purchase up to 6,101,054 shares of common stock of the Company in a private placement. The Notes bore interest at 10% per annum, were due in 2012, were unsecured, and were personally guaranteed by the Company's Chief Executive Officer and certain shareholders. The holders of the Notes had the right at any time to convert all or part of the outstanding principal amount of the Notes and any accrued and unpaid interest into common shares of the Company at the then effective conversion price, initially set at $1.90 per share. In 2009, $1,375,000 of the convertible notes was converted at the stated conversion price of $1.90 per share into 723,684 shares of the Company's common stock. During the first quarter of 2010, the balance of the notes of $10,217,000 was converted at the stated conversion price of $1.90 per share into 5,377,368 shares of the Company's common stock. On March 5, 2010, the Company issued 266,387 shares of common stock to all holders of notes outstanding as of March 5, 2010, as consideration for their forfeiture of certain rights and interest payments. The fair value of the additional 266,387 shares of common stock was $1,864,701 on the date the shares were issued, and is included in interest expense in the accompanying June 30, 2010 condensed consolidated financial statements.

At December 31, 2009, the Company had recorded a derivative liability of $28,404,181 related to the conversion feature of the convertible notes. When the notes converted, the derivative liability was extinguished and a gain on extinguishment of the derivative was recorded. Also upon conversion, the unamortized balance of the note discount of $8,601,975 was fully amortized and included in interest expense in the accompanying condensed consolidated financial statements.

6. DERIVATIVE LIABILITIY

At June 30, 2010 and December 31, 2009, derivative liabilities were made up of the following valued based on the Black-Scholes-Merton and bi-nominal valuation techniques with the following assumptions:

| | | June 30, 2010 Unaudited | | December 31, 2009 |
|---|---|---|---|---|
| Conversion feature : | | | | |
| Risk-free interest rate | | -- | | 1.5% |
| Expected volatility | | .-- | | 148.47% |
| Expected life (in years) | | -- | | 2.75 years |
| Expected dividend yield | | -- | | -- |
| | | | | |
| Warrants : | | | | |
| Risk-free interest rate | | 0.59% | | 1.32% |
| Expected volatility | | 123.79% | | 148.47% |
| Expected weighted average life (in years) | | 1.94 years | | 2.81 years |
| Expected dividend yield | | 0 | | 0 |
| | | | | |
| Fair Value : | | | | |
| Conversion feature | $ | -- | $ | 28,404,181 |
| Warrants | | 18,130,524 | | 16,752,858 |
| | $ | 18,130,524 | $ | 45,157,039 |

The risk-free interest rate was based on rates established by the Federal Reserve Bank, the Company uses the historical volatility of its common stock, and the expected life of the instruments is determined by the expiration date of the instrument. The expected dividend yield was based on the fact that the Company has not paid dividends to common shareholders in the past and does not expect to pay dividends to common shareholders in the future.

At December 31, 2009, the Company had recorded a derivative liability of $28,404,181 related to the conversion feature of the convertible notes. When the notes converted, the derivative liability was extinguished and a gain on extinguishment of the derivative was recorded. For the three months ended June 30, 2010 and 2009, change in derivative liability was $2,862,263 and $(1,779,968), respectively. For the six months ended June 30, 2010 and 2009, change in derivative liability was $(1,377,666) and $(1,200,990), respectively.

7. COMMON STOCK

During the six months ended June 30, 2010, the Company issued 5,377,368 shares of common stock upon conversion of $10,217,000 of convertibles notes. On March 5, 2010, the Company issued 266,387 shares of common stock to all holders of notes outstanding as of March 5, 2010, as consideration for their forfeiture of certain rights and interest payments. The fair value of the additional 266,387 shares of common stock was $1,864,701 on the date the shares were issued, and is included in interest expense in the accompanying June 30, 2010 condensed consolidated financial statements.

.During the six months ended June 30, 2010, the Company issued 62,632 shares of common stock upon exercise of options and warrants for total proceeds of $173,980.

8. WARRANTS AND OPTIONS

The following table summarizes stock warrants and option activity for the six months ended June 30, 2010:

| | Number of Shares underlying Warrants and Options | Weighted Average Exercise Price |
|---|---|---|
| Warrants and options outstanding at January 1, 2010 | 4,413,744 | $ 2.51 |
| Warrants and options granted | 60,000 | $ 7.38 |
| Warrants and options exercised | (62,632) | $ 2.78 |
| Warrants and options expired | (287,130) | $ 1.50 |
| Warrants and options outstanding at June 30, 2010 | 4,123,982 | $ 2.66 |

The following table summarizes information about warrants and options outstanding at June 30, 2010:

| Outstanding Warrants and Options | | | Exercisable Warrants and Options | |
|---|---|---|---|---|
| Exercise price | Number of shares underlying warrants and options | Weighted average remaining contractual life (years) | Number of shares underlying warrants and options exercisable | Weighted average exercise price |
| $ 1.50 | 603,304 | 1.21 | 603,304 | $ 1.50 |
| $ 2.28 | 427,074 | 2.33 | 427,074 | $ 2.28 |
| $ 2.50 | 35,710 | 0.22 | 35,710 | $ 2.50 |