

CHINA RECYCLING ENERGY CORP

Form 10-Q

November 06, 2008

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from \_\_\_\_\_ to

Commission File No. 333-120431

**China Recycling Energy Corporation  
(Exact Name of Registrant as Specified in Its Charter)**

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

**90-0093373  
(I.R.S. Employer  
Identification No.)**

**Suite 909, Tower B  
Chang An International Building  
No. 88 Nan Guan Zheng Jie  
Xi An City, Shan Xi Province  
China 710068  
(Address of Principal Executive Offices, Zip Code)**

**Registrant's Telephone Number, Including Area Code: (011) 86-29-8769-1097**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

The number of shares outstanding of the registrant’s Common Stock, as of September 30, 2008 was 36,425,094.

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**INDEX**

Page No.

**PART I - FINANCIAL INFORMATION**

Item 1.	Financial Statements	1
	Consolidated Balance Sheet as of September 30, 2008 (Unaudited) and December 31, 2007	1
	Consolidated Statements of Operations (Unaudited) – Three and Nine Months Ended September 30, 2008 and September 30, 2007	2
	Consolidated Statements of Cash Flows (Unaudited) – Nine Months Ended September 30, 2008 and September 30, 2007	3
	Notes to Consolidated Financial Statements (Unaudited)	4
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	25
Item 4.	Controls and Procedures	25

**PART II - OTHER INFORMATION**

Item 1.	Legal Proceedings	27
Item 1A.	Risk Factors	27
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	27
Item 3.	Defaults Upon Senior Securities	27
Item 4.	Submission of Matters to a Vote of Security Holders	27
Item 5.	Other Information	27
Item 6.	Exhibits	27

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**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements****CHINA RECYCLING ENERGY CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET**AS OF SEPTEMBER 30, 2008 OF DECEMBER 31, 2007  
(UNAUDITED)

<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash & cash equivalents	\$	1,705,940	\$ 1,634,340
Restricted cash		843,356	-
Investment in sales type leases, net		1,201,747	1,081,981
Interest receivable on sales type lease		87,727	144,262
Prepaid equipment rent		6,725,654	-
Other receivables		86,255	32,902
Inventory		10,560,282	9,870,315
<b>Total current assets</b>		<b>21,210,962</b>	<b>12,763,800</b>
<b>NON-CURRENT ASSETS</b>			
Investment in sales type leases, net		7,691,772	7,933,780
Advance for equipment		2,640,701	2,467,579
Property and equipment, net		102,320	-
Construction in progress		10,046,935	-
Intangible assets, net		3,233	6,169
<b>Total non-current assets</b>		<b>20,484,961</b>	<b>10,407,528</b>
<b>TOTAL ASSETS</b>	<b>\$</b>	<b>41,695,923</b>	<b>\$ 23,171,328</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
<b>CURRENT LIABILITIES</b>			
Accounts payable	\$	1,212,226	\$ 2,298,201
Notes payable		440,012	-
Tax payable		1,294,997	534,522
Accrued liabilities and other payables		3,585,634	2,565,726
Advance from management		-	71,508
Convertible notes, net of discount due to beneficial conversion feature		5,000,000	315,068
<b>Total current liabilities</b>		<b>11,532,869</b>	<b>5,785,025</b>
<b>ACCRUED INTEREST ON CONVERTIBLE NOTES</b>		<b>105,480</b>	<b>63,014</b>
<b>CONTINGENCIES AND COMMITMENTS</b>			

MINORITY INTEREST	16,219	15,080
<b>STOCKHOLDERS' EQUITY</b>		
Common stock, \$0.001 par value; 100,000,000 shares authorized, 36,425,094 and 25,015,089 shares issued and outstanding as of September 30, 2008 and December 31, 2007, respectively	36,425	25,015
Additional paid in capital	30,347,469	19,070,908
Statutory reserve	1,057,854	832,467
Accumulated other comprehensive income	3,636,496	1,718,260
Accumulated deficit	(5,036,889)	(4,338,441)
Total stockholders' equity	30,041,355	17,308,209
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 41,695,923</b>	<b>\$ 23,171,328</b>

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

**CHINA RECYCLING ENERGY CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	<b>FOR THE NINE MONTHS ENDED</b>		<b>FOR THE THREE MONTHS</b>	
	<b>SEPTEMBER 30,</b>		<b>ENDED SEPTEMBER 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Revenue				
Sales of products	\$ -	9,075,999	\$ -	4,294,836
Rental income	6,876,223	-	4,259,807	-
<b>Total revenue</b>	<b>6,876,223</b>	<b>9,075,999</b>	<b>4,259,807</b>	<b>4,294,836</b>
Cost of sales				
Cost of products	-	6,981,537	-	3,303,719
Rental expense	4,810,011	-	2,977,402	-
<b>Total cost of sales</b>	<b>4,810,011</b>	<b>6,981,537</b>	<b>2,977,402</b>	<b>3,303,719</b>
<b>Gross profit</b>	<b>2,066,212</b>	<b>2,094,462</b>	<b>1,282,405</b>	<b>991,117</b>
Interest income on sales-type leases	1,716,544	473,075	576,817	274,689
<b>Total operating income</b>	<b>3,782,756</b>	<b>2,567,537</b>	<b>1,859,222</b>	<b>1,265,806</b>
Operating expenses				
General and administrative expenses	2,142,728	358,726	638,949	15,183
<b>Total operating expenses</b>	<b>2,142,728</b>	<b>358,726</b>	<b>638,949</b>	<b>15,183</b>
<b>Income from operations</b>	<b>1,640,028</b>	<b>2,208,811</b>	<b>1,220,273</b>	<b>1,250,623</b>
Non-operating income (expenses)				
Investment income	1,621	-	17	-
Interest income (expense)	(1,233,964)	80	(57,029)	(24)
Financial expense	(1,991)	(101)	(990)	(6)
Other income	-	210,367	-	1,458
Other expense	(248)	-	(248)	-
Exchange loss	(81,969)	-	(1,524)	-
<b>Total non-operating income (expenses)</b>	<b>(1,316,551)</b>	<b>210,346</b>	<b>(59,774)</b>	<b>1,428</b>
<b>Income before income tax</b>	<b>323,477</b>	<b>2,419,157</b>	<b>1,160,499</b>	<b>1,252,051</b>
<b>Less: Income tax expense</b>	<b>796,458</b>	<b>399,049</b>	<b>427,960</b>	<b>187,456</b>
<b>Net income (loss) from continuing operations</b>	<b>(472,981)</b>	<b>2,020,108</b>	<b>732,539</b>	<b>1,064,595</b>

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Income from operations of discontinued component	-	28,457	-	5,352
Less: minority interest	83	-	27	-
Net income (loss)	(473,064)	2,048,565	732,512	1,069,947
Other comprehensive item				
Foreign currency translation gain (loss)	1,918,236	(220,092)	807,806	83,802
Comprehensive income	\$ 1,445,172	\$ 1,828,473	\$ 1,540,318	\$ 1,153,749
Basic weighted average shares outstanding				
	30,642,187	17,147,268	36,425,094	17,147,268
Diluted weighted average shares outstanding				
	34,100,635	17,147,268	36,997,300	17,147,268
Basic net earnings (loss) per share	\$ (0.01)	\$ 0.12	\$ 0.02	\$ 0.06
Diluted net earnings (loss) per share	\$ (0.01)	\$ 0.12	\$ 0.02	\$ 0.06

\* Basic and diluted loss per share are the same because common stock equivalent are anti-dilutive.

\* Accrued interest on convertible notes are added back to net income for the computation of basic EPS.

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

**CHINA RECYCLING ENERGY CORPORATION 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 (loss)	\$ (473,064)	\$ 2,048,565
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	10,848	-
Amortization of discount related to conversion feature of convertible note	1,212,329	-
Stock option compensation expense	728,316	-
Accrued interest on convertible notes	42,466	-
Minority interest	83	-
(Increase) decrease in current assets:		
Account receivable	-	5,842
Investment in sales type leases	734,692	(8,586,703)
Interest receivable on sales type lease	65,045	-
Prepaid equipment rent	(6,567,350)	-
Other receivables	(49,847)	-
Advances to suppliers	-	770,004
Increase (decrease) in current liabilities:		
Accounts payable	(1,217,170)	3,170,725
Unearned revenue	-	(7,831)
Advance from customers	-	(144,529)
Tax payable	694,556	466,268
Accrued liabilities and other payables	1,097,127	1,974,834
<b>Net cash used in operating activities</b>	<b>(3,721,969)</b>	<b>(302,825)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Restricted cash	(823,428)	-
Acquisition of property & equipment	(113,906)	-
Construction in progress	(9,986,879)	-
<b>Net cash used in investing activities</b>	<b>(10,924,213)</b>	<b>-</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Issuance of common stock	9,032,258	-
Convertible notes	5,000,000	-
Repayment to management	(74,699)	-
Notes payable	429,615	-
Advance from shareholder	-	48,015
<b>Net cash provided by financing activities</b>	<b>14,387,174</b>	<b>48,015</b>



EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS	330,608	9,066
NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS	71,600	(245,744)
CASH & CASH EQUIVALENTS, BEGINNING OF PERIOD	1,634,340	252,125
CASH & CASH EQUIVALENTS, END OF PERIOD	\$ 1,705,940	\$ 6,381
Supplemental Cash flow data:		
Income tax paid	\$ 152,049	\$ 35,281
Interest paid	\$ -	\$ -

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

**CHINA RECYCLING ENERGY CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2008 (UNAUDITED) AND DECEMBER 31, 2007**

**1. ORGANIZATION AND DESCRIPTION OF BUSINESS**

China Recycling Energy Corporation (the “Company” or “CREG”) (formerly China Digital Wireless, Inc.) was incorporated on May 8, 1980, under the laws of the State of Colorado. On September 6, 2001, the Company re-domiciled its state of incorporation from Colorado to Nevada. The Company, through its subsidiary, Shanghai TCH Data Technology Co., Ltd (“TCH”), sells and leases energy saving equipment. The businesses of mobile phone distribution and provision of pager and mobile phone value-added information services were discontinued in 2007. On March 8, 2007, the Company changed its name to “China Recycling Energy Corporation”.

Since January 2007, the Company has gradually phased out and substantially scaled down most of its business of mobile phone distribution and provision of pager and mobile phone value-added information services. In the first and second quarters of 2007, the Company did not engage in any substantial transactions or activity in connection to these businesses. On May 10, 2007, the Company ceased and discontinued the businesses related to mobile phones and pages. These businesses are reflected in continuing operations for all periods presented based on the criteria for discontinued operations prescribed by Statement of Financial Accounting Standards (“SFAS”) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets (“SFAS 144”).

On February 1, 2007, the Company’s subsidiary, TCH, entered into two TRT Project Joint-Operation Agreements (“Joint-Operation Agreement”) with Xi’an Yingfeng Science and Technology Co., Ltd. (“Yingfeng”). TRT is an electricity generating system that utilizes the exhaust pressure and heat produced in the blast furnace of a steel mill to generate electricity. Yingfeng is a joint stock company registered in Xi’an, Shaanxi Province, Peoples Republic of China (the “PRC”), and engages in the business of designing, installing, and operating TRT systems and sales of other renewable energy products. In October 2007, the Company terminated the joint operation agreement with Yingfeng and became fully entitled to the rights, titles, benefits and interests in the TRT Projects.

Under the Joint-Operation Agreement, TCH and Yingfeng jointly operated a top gas recovery turbine project (“TRT Project”) which designed, constructed, installed and operated a TRT system and leased it to Zhangzhi Iron and Steel Holdings Ltd. (“Zhangzhi”). The total investment costs contributed by TCH were approximately \$1,426,000 (equivalent to Renminbi (“RMB”) 10,690,000). TCH provided various forms of investments and properties into the TRT Project including cash, hardware, software, equipment, major components and devices. The construction of the TRT Project was completed and put into operation in August 2007. In October 2007, the Company terminated the Joint-Operation Agreement with Yingfeng. TCH became entitled to the rights, titles, benefits and interests in the TRT Project and receives monthly rental payments of approximately \$147,000 (equivalent to RMB 1,100,000) from Zhangzhi for a lease term of thirteen years. At the end of the lease term, TCH will transfer the rights and titles of the TRT Project to Zhangzhi without cost.

Under another Joint-Operation Agreement, TCH and Yingfeng jointly operated a TRT Project which designed, constructed, installed and operated a TRT system and lease to Xingtai Iron and Steel Company Ltd. (“Xingtai”). TCH provided various forms of investments and properties into the TRT Project including cash, hardware, software, equipment, major components and devices. The total estimated investment costs of this TRT Project were approximately \$3,900,000 (equivalent to RMB 30,000,000). The construction of the TRT Project was completed and put into operation in February 2007. In October 2007, the Company terminated the Joint-Operation Agreement with Yingfeng. TCH became fully entitled to all the rights, titles, benefits and interests of the TRT Project and receives monthly rental payments of approximately \$117,000 (equivalent to RMB 900,000) from Xingtai for a lease term of five years. At the end of the lease term, TCH will transfer all the rights and titles of the TRT Project to Xingtai without cost.

On September 21, 2007, the Company's subsidiary, TCH changed its name to "Shanghai TCH Energy Technology Co., Ltd."

Except as indicated, amounts reflected in the consolidated financial statements or the notes thereto relate to our continuing operations.

The unaudited financial statements have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission ("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 audited financial statements and footnotes included in the Company's 2007 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**

### **Basis of presentation**

These accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("US GAAP") and pursuant to the rules and regulations of the SEC for annual financial statements.

### **Basis of consolidation**

The consolidated financial statements include the accounts of CREG and, its subsidiaries, Sifang Holdings, TCH, and TCH's newly incorporated subsidiaries Xi'an TCH Energy Tech Co., Ltd. ("Xi'an TCH") and Xingtai Huaxin Energy Tech Co., Ltd. ("Huaxin"). Xi'an TCH and Huaxin engage in the same business with TCH. Substantially all of the Company's revenues are derived from the operations of TCH and its subsidiaries, which represent substantially all of the Company's consolidated assets and liabilities as of September 30, 2008 and December 31, 2007, respectively. All significant inter-company accounts and transactions have been eliminated in consolidation.

### **Use of estimates**

In preparing these consolidated financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities in the balance sheets and revenues and expenses during the period reported. Actual results may differ from these estimates.

### **Cash and cash equivalents**

Cash and cash equivalents are carried at cost and represent cash on hand, demand deposits placed with banks or other financial institutions and all highly liquid investments with an original maturity of three months or less as of the purchase date of such investments.

### **Accounts receivable and concentration of credit risk**

Accounts receivable are recorded at the invoiced amounts and do not bear interest. The Company extends unsecured credit to its customers in the ordinary course of business but mitigates the associated risks by performing credit checks and actively pursuing past due accounts. An allowance for doubtful accounts is established and determined based on managements' assessment of known requirements, aging of receivables, payment history, the customer's current credit worthiness and the economic environment. As of each of September 30, 2008 and December 31, 2007, the Company had accounts receivable of \$0.

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.

### **Inventory**

Inventory is valued at the lower of cost or market. Cost of work in progress and finished goods comprises direct material cost, direct production cost and an allocated portion of production overheads (See Note 6).

5

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## 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 over the estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicle	2 - 5 years
Office and Other Equipment	2 - 5 years
Software	2 - 3 years

## Impairment of long-life assets

In accordance with SFAS 144, the Company reviews its long-lived assets, including property, plant and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be fully recoverable. If the total of the expected undiscounted future net cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between the fair value and carrying amount of the asset. There has been no impairment as of September 30, 2008.

## Sales-type leasing and related revenue recognition

The Company leases TRT systems to Xingtai and Zhangzhi. The Company will transfer all benefits, risks and ownership of the TRT systems to Xingtai and Zhangzhi at the end of each lease term. The Company's investment in these projects is recorded as investment in sales-type leases in accordance with SFAS No. 13, "Accounting for Leases" and its various amendments and interpretations. The sales and cost of goods sold are recognized at the point of sale. The investment in sales-type leases consists of the sum of the total minimum lease payments receivable less unearned interest income. Unearned interest income is amortized to income over the lease term as to produce a constant periodic rate of return on the net investment in the lease.

## Cost of sales

Cost of sales consists primarily of the purchase price of the two TRT machines, expenses incurred directly for project construction, and rental expenses for two power generation equipment leases.

## Income taxes

The Company utilizes 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 related to tax jurisdictions not covered by the tax holiday provided by Tax Bureau of the PRC.

The Company adopted the provisions of Financial Accounting Standards Board (“FASB”) FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (“FIN 48”), 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 FIN 48, the Company recognized no material adjustments to liabilities or stockholders 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 are classified as interest expense and penalties are classified in selling, general and administrative expenses in the statements of income. The adoption of FIN 48 did not have a material impact on the Company's financial statements.

### Statement of cash flows

In accordance with SFAS No. 95, "Statement of Cash Flows," cash flows from the Company's operations are calculated based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows may not necessarily agree with changes in the corresponding balances on the balance sheet.

### 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.

### Basic and diluted earnings per share (EPS)

Basic earnings per share ("EPS") is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed similar to basic net income per share 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 is 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 be exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period. The following table presents a reconciliation of basic and diluted earnings per share:

	Nine Months Ended, September 30, 2008	Nine Months Ended September 30, 2007	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007
Net (loss) income	\$ (473,064)	\$ 2,048,565	\$ 732,512	\$ 1,069,947
Weighted average shares outstanding - basic	30,642,187	17,147,268	36,425,094	17,147,268
Effect of dilutive securities:				
Convertible notes *	2,724,521	-	-	-
Options granted	733,927	-	571,906	-
Weighted average shares outstanding - diluted	34,100,635	17,147,268	36,997,000	17,147,268
(Loss) Earnings per share – basic *	\$ (0.01)	\$ 0.12	\$ 0.02	\$ 0.06
(Loss) Earnings per share - diluted	\$ (0.01)	\$ 0.12	\$ 0.02	\$ 0.06

\* These securities are anti-dilutive, therefore, basic and diluted loss per share are the same.

\* Interest expense on convertible note issued on April 29, 2008 has been added back to net income for the computation of diluted earnings per share.

### 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 stockholders' 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 stockholders’ equity, except those due to investments by stockholders, changes in paid-in capital and distributions to stockholders.

## **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, the 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, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” This Statement 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. This Statement will not have an impact on the Company’s financial statements.

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

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (“SFAS 133”). This Statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (iii) 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.

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

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51” (“SFAS 160”). SFAS 160 establishes new accounting and reporting standards for the

noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling 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 noncontrolling 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 noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling 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, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" ("SFAS 141R"). 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;
- Noncontrolling 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. We expect 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, the 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" ("SFAS 158"), 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. We 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.

### **3. RESTRICTED CASH**

Restricted cash consisted of cash in the bank of approximately \$440,000 (RMB 3,000,000) to secure a three-month bank acceptance that the Company issued to its vendor, and cash in another bank of approximately \$403,000 (RMB

2,750,000) to secure the execution of a project contract that the Company entered into with its customer during the quarter ended September 30, 2008.

9

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**4. NET INVESTMENT IN SALES-TYPE LEASES**

Under sales-type leases, TCH leased TRT systems to Xingtai and Zhangzhi with terms of five years and thirteen years, respectively. The components of the net investment in sales-type leases as of September 30, 2008 and December 31, 2007 are as follows:

	September 30, 2008	December 31, 2007
Total future minimum lease payments receivables	\$ 26,396,799	27,162,928
Less: unearned interest income	(17,503,279)	(18,147,167)
Net investment in sales - type leases	\$ 8,893,520	9,015,761
Current portion	\$ 1,201,748	1,081,981
Noncurrent portion	\$ 7,691,772	7,933,780

As of September 30, 2008, the future minimum rentals to be received on non-cancelable sales type leases are as follows:

Years ending September 30,		
2009	\$	3,429,954
2010		3,272,807
2011		3,272,807
2012		2,293,312
2013		1,803,564
Thereafter		12,324,355
	\$	26,396,799

**5. PREPAID EQUIPMENT RENT FOR OPERATING LEASES**

On April 10, 2008, the Company leased energy recycling power generation equipment for operating under a one-year, non-cancellable lease for the amount of approximately \$4,455,000 (RMB 31,000,000). At the end of this one-year lease term, the Company has the right to renew the lease for another four-year term at an aggregate price of approximately \$10,940,000 (RMB 75,000,000) with a separate agreement. The lease payment of approximately \$4,455,000 has been paid in full.

On the same day, the Company entered into a leasing agreement with a lessee to lease out the above power generation equipment under a one-year, non-cancellable lease for the lease payment of approximately \$583,000 (RMB 4,000,000) per month with the option to renew. The lessee will pay a lower monthly lease payment of approximately \$486,000 (RMB 3,333,000) under the circumstance that the Company renews the lease of the equipment from the ultimate lessor after one year.

On May 21, 2008, the Company leased energy recycling power generation equipment from the same lessor for operating under a one-year, non-cancellable lease for the amount of approximately \$6,560,000 (RMB 45,000,000). At the end of the one-year lease term, the Company has the right to renew the lease for another four-year term at an aggregate price of approximately \$17,500,000 (RMB 120,000,000) with a separate agreement. The lease payment of approximately \$6,560,000 has been paid in full.

On the same day, the Company entered into a leasing agreement with the same lessee to lease out the above power generation equipment under a one-year, non-cancellable lease for the lease payment of approximately \$887,000 (RMB 5,850,000) per month with the option to renew. The lessee will pay a lower monthly lease payment of approximately

\$729,000 (RMB 5,000,000) if the Company renews the lease of the equipment from the ultimate lessor after one year.

## **6. INVENTORY**

Inventory consisted of two equipment systems that will be used for TRT projects in the amount of \$10,560,282 and \$9,870,315 at September 30, 2008 and December 31, 2007, respectively.

10

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**7. ADVANCE FOR EQUIPMENT**

Advance for equipment represented advance payment of approximately \$2,640,701 (RMB 18,000,000) to an independent contractor for constructing a power generation system and purchase of the equipment that will be used for the construction. At September 30, 2008, this project has not commenced construction yet. Upon completion of the construction, the Company will sell the power that is generated from this system to certain customers or lease out the whole system for rental income (See Note 20).

**8. CONSTRUCTION IN PROGRESS**

Construction in progress represented the amount paid to an independent contractor for constructing another power generation system for the total amount of approximately \$10,046,935 (RMB 68,500,000). The construction project commenced in March 2008, and will take about 11 months to complete. Upon completion, the Company will sell the power that is generated from this system to predetermined customers (See Note 20).

**9. TAX PAYABLE**

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

	September 30, 2008	December 31, 2007
Income tax payable	\$ 1,198,015	\$ 491,835
Business tax payable	86,902	41,126
Other taxes payable	10,080	1,561
	\$ 1,294,997	\$ 534,522

**10. ACCRUED LIABILITIES AND OTHER PAYABLES**

Accrued liabilities and other payables consisted of the following at September 30, 2008 and December 31, 2007:

	September 30, 2008	December 31, 2007
Other payables	\$ 3,230,777	\$ 2,274,805
Employee welfare payable	240,124	228,923
Accrued expenses	114,733	61,998
Total	\$ 3,585,634	\$ 2,565,726

At, September 30, 2008, other payable mainly consisted of employee training and social insurance payable of approximately \$152,000, consulting and legal expenses paid by a third party on behalf of the Company, which will be repaid by the Company in the amount of approximately \$370,000, a payable to Yingfeng for the cost of obtaining the ownership of two TRT projects that were previously owned by Yingfeng of approximately \$1,681,000 (RMB 11,460,257), and leasing deposits received from the lessee for leasing the power generation equipments of approximately \$1,027,000 (RMB 7,000,000).

**11. ADVANCE FROM MANAGEMENT**

Advance from management represented the balances due to a director for unsecured advances in 2007, which are interest free and repayable in the next twelve months. This advance was repaid as of September 30, 2008.

**12. MINORITY INTEREST**



Minority interest represented a 20% equity interest in Huaxin. Huaxin was incorporated in November 2, 2007, and engages in a similar business to TCH. At September 30, 2008 and December 31, 2007, minority interest was \$16,219 and \$15,080, respectively.

### **13. DISCONTINUED OPERATIONS**

Since January 2007, the Company has gradually phased out and substantially scaled down most of its business of mobile phone distribution and provision of pager and mobile phone value-added information services. In the first and second quarters of 2007, the Company did not engage in any substantial transactions or activity in connection with these businesses. On May 10, 2007, the Company ceased and discontinued these businesses. Accordingly, the results of the discontinued operations have been segregated from continuing operations. The discontinued operations had an income of \$28,457 for the nine months ended September 30, 2007. The income represented the write down of deferred revenue generated from the provision of pager value-added information services.

### **14. INCOME TAX**

Effective January 1, 2008, the PRC government implemented a new corporate income tax law with a new maximum corporate income tax rate of 25%. 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% (33% prior to 2008) on income reported in the statutory financial statements after appropriate tax adjustments.

The Company's subsidiaries generated substantially all of its net income from its PRC operation. Shanghai TCH's effective income tax rates for 2008 and 2007 are 18% and 15%, respectively. Xi'an TCH's effective income tax rate for 2008 is 25%. Shanghai TCH and its subsidiaries Xi'an TCH and Xingtai Huaxin filed separate income tax returns.

There is no income tax for companies domiciled in the Cayman Islands. Accordingly, the Company's consolidated financial statements do not present any income tax provisions related to Cayman Islands tax jurisdiction where Sifang Holding is domiciled. The parent company, China Recycling Energy Co., Ltd., is taxed in the US and has a net operating loss for the nine and three months ended September 30, 2008. A 100% valuation allowance has been established due to the uncertainty of its realization.

For the nine and three months ended September 30, 2008 and 2007, the Company's effective income tax rate differs from the US statutory rate because of the effect of the tax holiday, effect of tax on loss on nontaxable jurisdiction and valuation allowance.

### **15. CONVERTIBLE NOTES PAYABLE**

On November 16, 2007, the Company entered into a Stock and Notes Purchase Agreement ("Purchase Agreement") with Carlyle Asia Growth Partners III, L.P. ("CAGP") and CAGP III Co. Investment, L.P. (together with CAGP, the "Investors"). Under the terms of the Purchase Agreement, the Company sold to the Investors a 10% Secured Convertible Promissory Note in the principal amount of \$5,000,000 (the "First Note"). Additionally, the Purchase Agreement provides for two subsequent transactions to be effected by the Company and the Investors, which include (i) the issuance by the Company and subscription by the Investors of a total of 4,066,706 shares of common stock of Company, at the price of \$1.23 per share for an aggregate purchase price of approximately \$5,000,000, and (ii) the issuance and sale by the Company to the Investors of a 5% Secured Convertible Promissory Note in the principal amount of \$15,000,000 (the foregoing transactions, together with sale and purchase of the First Note, are hereinafter referred to as the "Offering"). The subsequent transactions are contingent upon the satisfaction of certain conditions specified in the Purchase Agreement, including entry into specified energy and recycling project contracts and the purchase of certain energy recycling systems.

The First Note bears interest at 10% per annum and matures on November 16, 2009. The principal face amount of the First Note, together with any interest thereon, convert, at the option of the holders at any time on or prior to maturity, into shares of the Company's common stock at an initial conversion price of \$1.23 per share (subject to anti-dilution adjustments). The First Note is subject to mandatory conversion upon the consummation of the aforementioned

issuance and subscription of shares of the Company's common stock under the Purchase Agreement. As more fully described in the First Note, the obligations of the Company under the First Note shall rank senior to all other debt of the Company.

As collateral for the First Note, the President and a major shareholder of the Company pledged 9,653,471 shares of the Company's common stock held by him to secure the First Note.

The First Note was considered to have an embedded beneficial conversion feature because the conversion price was less than the quoted market price at the time of the issuance. Accordingly, the beneficial conversion feature of \$5,000,000 was recorded separately as unamortized beneficial conversion feature based on the intrinsic value method. The First Note is recorded in the balance sheet at face value less the unamortized beneficial conversion feature. The terms for the First Note were amended on April 29, 2008 and the First Note was repaid in full on June 25, 2008, as described below.

On April 29, 2008, the Company entered into an Amendment to the Purchase Agreement with the investors. Under the terms of the Amendment, (i) the Company issued and the Investor subscribed for a total of 4,066,706 shares of common stock of the Company, at the price of \$1.23 per share for an aggregate purchase price of \$5,002,048, as originally contemplated under the Agreement; (ii) the Investors converted the principal amount under the First Note (and waived any accrued interest thereon) into 4,065,040 shares of common stock of the Company at the conversion price per share of \$1.23, pursuant to the terms and conditions of the First Note issued under the Agreement; (iii) the Company issued and sold to the Investors a new 5% Secured Convertible Promissory Note in the principal amount of \$5,000,000 to the Investors (the "Second Note" and collectively with the First Note, the "Notes"); and (iv) the Company granted to the Investors an option to purchase a 5% Secured Convertible Promissory Note in the principal amount of \$10,000,000, exercisable by the Investors at any time within nine (9) months following the date of the closing of the transactions contemplated by the Amendment (the "Option Note").

The Second Note bears interest at 5% per annum and matures on April 29, 2011. The principal face amount of the Second Note, together with any interest thereon, convert, at the option of the holders at any time on or after March 30, 2010 (or such earlier date if the audited consolidated financial statements of the Company for the fiscal year ending December 31, 2009 are available prior to March 30, 2010) and prior to maturity, into shares of the Company's common stock at an initial conversion price that is tied to the after-tax net profits of the Company for the fiscal year ending December 31, 2009, as described in the Second Note. The Second Note is subject to mandatory conversion upon the listing of the Company's common stock on the National Association of Securities Dealers Automated Quotations main-board, the New York Stock Exchange or the American Stock Exchange. As more fully described in the Second Note, the obligations of the Company under the Second Note shall rank senior to all other debt of the Company.

The Second Note and the Option Note are both secured by a security interest granted to the Investors pursuant to the Share Pledge Agreement.

The Second Note was not considered to have an embedded beneficial conversion feature, nor included in the computation of diluted earnings per share because the conversion price and convertible shares are contingent upon future net profits, and anti-dilutive for these shares due to the Company's net loss for the nine months ended September 30, 2008.

On June 25, 2008, the Company and the Investors entered into a Rescission and Subscription Agreement to rescind the conversion of the First Note and the issuance of conversion shares of Common Stock at the Second Closing pursuant to Amendment to Stock and Notes Purchase Agreement dated on April 29, 2008. The Company and the Investors rescinded the conversion of the principal amount (\$5,000,000) under the First Note into 4,065,040 shares of Common Stock, and the Investors waived accrued interest on the First Note. Accordingly, the interest expense which had accrued on the note has been recorded as a decrease on interest expense for the period. At the Rescission and Subscription Closing, the Company repaid in full the First Note and issued to the Investors, 4,065,040 shares of Common Stock at the price of \$1.23 per share for an aggregate purchase price of \$5,000,000.

## **16. STOCK-BASED COMPENSATION PLAN**

On November 13, 2007, the Company approved the 2007 Non-statutory Stock Option Plan, which was later amended and restated in August 2008 (the "2007 Plan"), and granted stock options with an aggregate amount of 3,000,000 shares of the stock at \$1.23 per share to acquire the Company's common stock at par value \$0.001 to twenty (20) managerial and non-managerial employees under the 2007 Plan.

The vesting terms of options granted under the 2007 Plan is subject to the Non-Statutory Stock Option Agreements for managerial and non-managerial employees. For managerial employees, no more than 15% of the total stock options shall vest and become exercisable on the six month anniversary of the grant date. An additional 15% and 50% of the

total stock options shall vest and become exercisable on the first and second year anniversary of the grant date, respectively. The remaining 20% of the total stock options shall vest and become exercisable on the third year anniversary of the grant date. For non-managerial employees, no more than 30% of the total stock options shall vest and become exercisable in the first year anniversary of the grant date. An additional 50% of the total stock options shall vest and become exercisable in the second year anniversary of the grant date. The remaining 20% of the total stock options shall vest and become exercisable on the third year anniversary of the grant date. Each stock option shall become vested and exercisable over a period of no longer than five years from the grant date.

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 as no options have been exercised in the Plan to date. The fair value of each option grant to employees 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 100%, risk free interest rate of 3.76%, and dividend yield of 0%. No estimate of forfeitures was made as the Company has a short history of granting options.

Effective June 25, 2008, the Company cancelled all vested shares and accepted optionees' forfeiture of any unvested shares underlying the currently outstanding options.

On August 4, 2008, the Company granted stock options to acquire an aggregate amount of 3,000,000 shares of the Company's common stock, par value \$0.001, at \$0.80 per share to 17 employees under the 2007 Plan. The options vest over a period of three years and have a life of 5 years, volatility of 100%, 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 following table summarizes activity for employees in the Company's Plan for the nine months ended September 30, 2008:

	Number of Shares	Average Exercise Price per Share	Weighed Average Remaining Contractual Term in Years
Outstanding at December 31, 2006	-		
Granted	3,000,000	\$ 1.23	5.00
Exercised	-		
Forfeited	-		
Outstanding at December 31, 2007	3,000,000	\$ 1.23	4.87
Exercisable at December 31, 2007	-		
Granted	-		
Exercised	-		
Forfeited	-		
Outstanding at March 31, 2008	3,000,000	\$ 1.23	4.62
Exercisable at March 31, 2008	-		
Granted	-		
Exercised	-		
Cancelled vested shares	450,000		
Forfeited unvested shares	2,550,000		
Outstanding at June 30, 2008	-	\$ -	-
Exercisable at June 30, 2008	-		
Granted	3,000,000	\$ 0.80	5.00
Exercised	-		

Forfeited	-		
Outstanding at September 30, 2008	3,000,000	\$	0.80
Exercisable at September 30, 2008	-		4.84

The Company recorded \$728,316 of compensation expense for employee stock options during the nine months ended September 30, 2008, of which, \$632,444 was for the options cancelled on June 25, 2008.

The weighted-average grant date fair value of stock options granted to employees for the nine months ended September 30, 2008 was \$0.80 per share. The Company recorded \$95,872 of compensation expense for employee stock options during the quarter ended September 30, 2008. There were no options exercised during the nine months ended September 30, 2008.

## **17. SHAREHOLDERS' EQUITY**

On April 29, 2008, the Company issued and the Investor subscribed for a total of 4,066,706 shares of common stock of the Company, at the price of \$1.23 per share for an aggregate purchase price of \$5,002,048 under the Purchase Agreement.

On June 25, 2008, the Company and the Investors entered into a Rescission and Subscription Agreement to rescind the conversion of the First Note and the issuance of conversion shares of Common Stock pursuant to Amendment to Stock and Notes Purchase Agreement dated on April 29, 2008. The Company and the Investors rescinded the conversion of the principal amount (\$5,000,000) under the First Note into 4,065,040 shares of Common Stock and repaid the First Note in full. At the Rescission and Subscription Closing, the Company issued to the Investors, 4,065,040 shares of Common Stock at the price of \$1.23 per share for an aggregate purchase price of \$5,000,000.

The Company issued 3,278,259 shares of its Common Stock to one of the Company's shareholders who paid \$4,032,258 cash to the Company during the quarter ended June 30, 2008. This purchase was part of an investment agreement by the shareholder entered into in November 2007 to purchase the shares at \$1.23 per share.

## **18. 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 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 shareholdings or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issuance is not less than 25% of the registered capital.

### **Common Welfare Fund**

The common welfare fund is a voluntary fund 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.

## **19. CONTINGENCIES**

The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in the 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 expenses 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.

15

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## 20. COMMITMENTS

### **Zhangzhi Steel New blast furnace TRT Power Generator Project**

On November 11, 2007, the Company entered a Project General Contractor agreement with an independent contactor under contemplation to construct a 1080 cubic meter blast furnace for the third phase of Zhangzhi TRT project which was originally signed on June 22, 2006. The total contract price is approximately \$4,375,000 (RMB 30,000,000); the Company has paid approximately \$2,625,000 (RMB 18,000,000) for the purchase of equipment. This project is expected to produce 45,000,000 KW/h annual energy output upon completion.

### **Shenwei Cement Pure Low Temperature Waste Heat Power Generator Project**

In November 2007, the Company signed a cooperative agreement with Shenwei Group for a Cement Waste Heat Power Generator Project. The Company will build two sets of 12MW pure low temp cement waste heat power generator systems for its two 2500 tons per day cement manufacturing lines in Jin Yang and a 5,000 tons per day cement manufacturing line in Tong Chuan. During the first quarter of 2008, the Company finished the equipment bidding process, selecting the equipment, and commenced construction of the systems. Total investment will be approximately \$12,593,000 (93 million RMB) with estimated annual power generated capacity of 180 million KWH once the two systems are put into operation. The Company will use the BOT (build, operate, transfer) model to build and operate the systems. The operation period will be 5 years. During the operation period, Shenwei Group will pay the Company the monthly electricity fee based on the actual power generated by the systems at 0.4116 RMB per KWH as agreed.

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

### **Note Regarding Forward-Looking Statements**

*This quarterly report on Form 10-Q and other reports filed by the Company from time to time with the Securities and Exchange Commission (collectively the "Filings") contain or may contain forward-looking statements and information that are based upon beliefs of, and information currently available to, Company's management as well as estimates and assumptions made by Company's management. Readers are cautioned not to place undue reliance on these forward-looking statements, which are only predictions and speak only as of the date hereof. When used in the filings, the words "anticipate", "believe", "estimate", "expect", "future", "intend", "plan", or the negative of these terms and similar expressions as they relate to Company or Company's management identify forward-looking statements. Such statements reflect the current view of Company with respect to future events and are subject to risks, uncertainties, assumptions, and other factors (including the risks contained in the section of operations and results of operations, and any businesses that Company may acquire. Should one or more of these risks or uncertainties materialize, or should the underlying assumptions prove incorrect, actual results may differ significantly from those anticipated, believed, estimated, expected, intended, or planned.*

*Although Company believes that the expectations reflected in the forward-looking statements are reasonable, Company cannot guarantee future results, levels of activity, performance, or achievements. Except as required by applicable law, including the securities laws of the United States, the Company does not intend to update any of the forward-looking statements to conform these statements to actual results. Readers are urged to carefully review and consider the various disclosures made throughout the entirety of this quarterly report, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations, and prospects.*

*Our financial statements are prepared in US Dollars and in accordance with accounting principles generally accepted in the United States. See "Foreign Currency Translation and Comprehensive Income (Loss)" below for information concerning the exchange rates at which Renminbi ("RMB") were translated into US Dollars ("USD") at various pertinent dates and for pertinent periods.*

### **OVERVIEW OF BUSINESS BACKGROUND**

China Recycling Energy Corporation (the "Company" or "CREG") (formerly China Digital Wireless, Inc.) was incorporated on May 8, 1980, under the laws of the State of Colorado. On September 6, 2001, the Company re-domiciled its state of incorporation from Colorado to Nevada. The Company, through its subsidiary Shanghai TCH Data Technology Co., Ltd. ("TCH"), is doing the business of selling and leasing energy saving equipment. The businesses of mobile phone distribution and provision of pager and mobile phone value-added information services were discontinued in 2007. On March 8, 2007, the Company changed its name to "China Recycling Energy Corporation".

On June 23, 2004, the Company entered into a stock exchange agreement with Sifang Holdings Co. Ltd. ("Sifang Holdings") and certain shareholders. Pursuant to the stock exchange agreement, the Company issued 13,782,636 shares of its common stock in exchange for a 100% equity interest in Sifang Holdings, making Sifang Holdings a wholly owned subsidiary of the Company. Sifang Holdings was established under the laws of the Cayman Islands on February 9, 2004 for the purpose of holding a 100% equity interest in Shanghai TCH Data Technology Co., Ltd. ("TCH"). TCH was established as a foreign investment enterprise in Shanghai under the laws of the People's Republic of China (the "PRC") on May 25, 2004. Since January 2007, the Company has gradually phased out and substantially scaled down most of its business of mobile phone distribution and provision of pager and mobile phone value-added information services. In the first and second quarters of 2007, the Company did not engage in any substantial transactions or activity in connection with these businesses. On May 10, 2007, the Company ceased and discontinued

the businesses related to mobile phones and pagers. These businesses are reflected in continuing operations for all periods presented based on the criteria for discontinued operations prescribed by Statement of Financial Accounting Standards (“SFAS”) No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”.

On February 1, 2007, the Company’s subsidiary, TCH entered into two TRT Project Joint-Operation Agreements (“Joint-Operation Agreement”) with Xi’an Yingfeng Science and Technology Co., Ltd. (“Yingfeng”). Yingfeng is a joint stock company registered in Xi’an, Shaanxi Province, the PRC, and engages in the business of designing, installing, and operating TRT systems and sales of other renewable energy products. TRT is an electricity generating system that utilizes the exhaust pressure and heat produced in the blast furnace of a steel mill to generate electricity. In October 2007, the Company terminated the Joint-Operation Agreement with Yingfeng and became fully entitled to the rights, titles, benefits and interests in the TRT Projects.

On September 21, 2007, the Company's subsidiary, TCH changed its name to "Shanghai TCH Energy Technology Co., Ltd."

During the second quarter of 2008, the Company leased two energy recycling power generation equipment systems under one-year, non-cancellable leases with the rents paid in full; at the same time, the Company leased this equipment out for higher rental income under one-year, non-cancellable leases.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported net sales and expenses during the reporting periods. On an ongoing basis, we evaluate our estimates and assumptions. We base our estimates on historical experience and on various other factors that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

While our significant accounting policies are more fully described in Note 2 to our consolidated financial statements, we believe that the following accounting policies are the most critical to aid you in fully understanding and evaluating this management discussion and analysis.

### **Basis of presentation**

These accompanying consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America ("US GAAP") and pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") for annual financial statements.

### **Basis of consolidation**

The consolidated financial statements include the accounts of CREG and, its subsidiaries, Sifang Holdings, TCH, and TCH's newly incorporated subsidiaries Xi'an TCH and Huaxin. Xi'an TCH and Huaxin engage in the same business as TCH. Substantially all of the Company's revenues are derived from the operations of TCH and its subsidiaries, which represent substantially all of the Company's consolidated assets and liabilities. All significant inter-company accounts and transactions have been eliminated in consolidation.

### **Use of estimates**

In preparing these consolidated financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities in the balance sheets and revenues and expenses during the year reported. Actual results may differ from these estimates.

### **Accounts receivable and concentration of credit risk**

Accounts receivable are recorded at the invoiced amounts and do not bear interest. The Company extends unsecured credit to its customers in the ordinary course of business but mitigates the associated risks by performing credit checks and actively pursuing past due accounts. An allowance for doubtful accounts is established and determined based on managements' assessment of known requirements, aging of receivables, payment history, the customer's current credit worthiness and the economic environment.

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.

**Inventory**

Inventory is valued at the lower of cost or market. Cost of work in progress and finished goods comprises direct material cost, 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 over the estimated lives ranging from 5 to 20 years as follows:

Building	20 years
Vehicle	2 - 5 years
Office and Other Equipment	2 - 5 years
Software	2 - 3 years

**Sales-type leasing and related revenue recognition**

The Company invests and leases TRT systems to Xingtai and Zhangzhi. The Company will transfer all benefits, risks and ownership of the TRT systems to Xingtai and Zhangzhi at the end of each lease term. The Company's investment in these projects is recorded as sales-type leases in accordance with SFAS No. 13, "Accounting for Leases" and its various amendments and interpretations. The sales and cost of goods sold is recognized at the point of sale. The investment in sales-type leases consists of the sum of the total minimum lease payments receivable less unearned interest income. Unearned interest income is amortized to income over the lease term as to produce a constant periodic rate of return on the net investment in the lease.

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

**NEW ACCOUNTING PRONOUNCEMENTS****Accounting for Financial Guarantee Insurance Contracts**

In May 2008, the 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, the FASB issued SFAS No. 162, “The Hierarchy of Generally Accepted Accounting Principles.” This Statement 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 US GAAP. This Statement will not have an impact on the Company’s financial statements.

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

In March 2008, the FASB issued SFAS No. 161, “Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133” (“SFAS 133”). This Statement changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (iii) 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.

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

In December 2007, the FASB issued SFAS No. 160, “Noncontrolling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51” (“SFAS 160”). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a noncontrolling 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 noncontrolling 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 noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling 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, the FASB issued SFAS No. 141 (Revised 2007), “Business Combinations” (“SFAS 141R”). 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;
- Noncontrolling 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. We expect 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, the 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" ("SFAS 158"), 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. We 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.

**RESULTS OF OPERATIONS**

**Comparison of Nine Months Ended September 30, 2008 and September 30, 2007**

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

Nine Months Ended September 30	2008		2007	
	\$	% of Sales	\$	% of Sales
<b>Sales</b>	<b>6,876,223</b>	<b>100%</b>	<b>9,075,999</b>	
<b>Sales of products</b>	-	-	<b>9,075,999</b>	<b>100%</b>
<b>Rental income</b>	<b>6,876,223</b>	<b>100%</b>	-	-
<b>Cost of sales</b>	<b>(4,810,011)</b>	<b>70%</b>	<b>(6,981,537)</b>	<b>77%</b>
<b>Cost of products</b>	-	-	<b>(6,981,537)</b>	<b>77%</b>
<b>Rental expense</b>	<b>(4,810,011)</b>	<b>70%</b>	-	-
<b>Gross profit</b>	<b>2,066,212</b>	<b>30%</b>	<b>2,094,462</b>	<b>23%</b>
<b>Interest income on sales-type lease</b>	<b>1,716,544</b>	<b>25%</b>	<b>473,075</b>	<b>5%</b>
<b>Total operating income</b>	<b>3,782,756</b>	<b>55%</b>	<b>2,567,537</b>	<b>28%</b>
<b>Total Operating expenses</b>	<b>(2,142,728)</b>	<b>31%</b>	<b>(358,726)</b>	<b>4%</b>
<b>Income from operation</b>	<b>1,690,028</b>	<b>24%</b>	<b>2,208,811</b>	<b>24%</b>
<b>Total non-operating income (expenses)</b>	<b>(1,316,551)</b>	<b>19%</b>	<b>210,346</b>	<b>2.3%</b>
<b>Income (loss) before income tax</b>	<b>323,477</b>	<b>5%</b>	<b>2,419,157</b>	<b>27%</b>
<b>Income tax expense</b>	<b>(796,458)</b>	<b>11.6%</b>	<b>(399,049)</b>	<b>4.4%</b>
<b>Minority interest</b>	<b>(83)</b>	-	-	-
<b>Income from operations of discontinued component</b>	-	-	<b>28,457</b>	<b>0.3%</b>
<b>Net income (loss)</b>	<b>(473,064)</b>	<b>(6.9)%</b>	<b>2,048,565</b>	<b>23%</b>

*SALES.* Net sales for the nine months ended September 30, 2008 were \$6.88 million while our net sales for the nine months ended September 30, 2007 were approximately \$9.08 million, a decrease in revenues of \$2.2 million. The decrease was due to changing of our business type during 2007. We discontinued our mobile phone business and commenced the selling, manufacturing and construction of energy saving systems during 2007. We sell our systems through sales-type leasing. Sales and cost of sales are recorded at the time of leasing; the interest income from the sales-type leasing is our major revenue source in addition to the sales revenue. We sold two TRT systems through sales-type leasing during the nine months ended September 30, 2007, while we had interest income of \$1.7 million from sales-type leasing and rental income of \$6.88 million from leasing out two power generating systems for the same period of 2008.

*COST OF SALES.* Cost of sales for the nine months ended September 30, 2008 was \$4.81 million while our cost of sales for the same period of 2007 was approximately \$6.98 million, a decrease of \$2.17 million. The decrease in cost of sales is attributed to changing our business type from a mobile phone business to manufacturing, selling, constructing and leasing the energy saving systems in 2007. We leased two power generating systems under one-year, non-cancellable leases with options to renew at a favorable price during the nine months ended September 30, 2008. We paid the lease payments in full and leased the equipment out for higher monthly rental income under one-year, non-cancellable lease.

**GROSS PROFIT.** Gross profit was \$2.07 million for the nine months ended September 30, 2008 as compared to \$2.09 million for the same period of 2007, representing gross margins of approximately 30% and 23% for the nine months ended September 30, 2008 and 2007, respectively. The increase in our gross profit was mainly due to a decreased cost of sales derived from changing our business type from a mobile phone business to manufacturing, selling, constructing and leasing the energy saving systems during 2007. We sold two TRT systems through sales-type leasing with gross profit recognized during the nine months ended September 30, 2007, while we had interest income from sales-type leasing and rental income for the same period of 2008.

**OPERATING INCOME.** Operating income was \$3.78 million for the nine months ended September 30, 2008 while our operating income for the same period of 2007 was \$2.57 million, an increase of \$1.21 million. The growth in operating income was mainly due to (i) changing of our business type and (ii) commencing selling and leasing our energy saving systems through sales-type leasing. Two TRT systems sold since the inception of sales-type leases in 2007 now generate additional interest income. Interest income on sales-type lease over the nine months ended September 30, 2008 was \$1.72 million, an approximately \$1.25 million increase from \$473,000 for the same period of 2007.

**OPERATING EXPENSES.** Operating expenses consisted of selling, general and administrative expenses totaling approximately \$2.14 million for the nine months ended September 30, 2008 as compared to \$0.36 million for the same period of 2007, an increase of approximately \$1.78 million or 494%. This increase was mainly due to the compensation expense of approximately \$730,000 related to the fair value of the stock options to employees, and increased payroll, marketing and traveling expense due to the expansion of our business.

**NET INCOME (LOSS).** Our net income (loss) for the nine months ended September 30, 2008 was \$(473,064) as compared to \$2,048,565 net income for the same period of 2007, a decrease of \$2.52 million. This decrease in net income was mainly due to interest expense on our amortized beneficial conversion feature for the convertible note of approximately \$1,250,000 and compensation expense of the fair value of stock options of \$730,000 for nine months ended September 30, 2008. The convertible note that was issued on November 16, 2007 was repaid on June 25, 2008 and all the vested and non-vested options that were granted on November 13, 2007 were cancelled on June 25, 2008, but reissued on August 4, 2008.

### Comparison of Three Months Ended September 30, 2008 and September 30, 2007

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

Three Months Ended September 30	2008		2007	
	\$	% of Sales	\$	% of Sales
Sales	4,259,807	100%	4,294,836	100%
Sales of products	-	-	4,294,836	100%
Rental income	4,259,807	100%	-	-
Cost of sales	(2,977,402)	70%	(3,303,719)	77%
Cost of products	-	-	(3,303,719)	77%
Rental expense	(2,977,402)	70%	-	-
Gross profit	1,282,405	30%	991,117	23%
Interest income on sales-type lease	576,817	13.5%	274,689	6.4%
Total operating income	1,859,222	44%	1,265,806	29.5%
Total Operating expenses	(638,949)	15%	(15,183)	0.35%
Income (loss) from operation	1,220,273	29%	1,250,623	29%
Total non-operating income (expenses)	(59,774)	1.4%	1,428	0.03%
Income (loss) before income tax	1,160,499	27%	1,252,051	29%
Income tax expense	(427,960)	10%	(187,456)	4.36%

<b>Minority interest</b>	<b>(27)</b>	<b>-%</b>	<b>-</b>	<b>-%</b>
<b>Income from operations of discontinued component</b>	<b>-</b>	<b>-</b>	<b>5,352</b>	<b>0.12%</b>
<b>Net income (loss)</b>	<b>732,512</b>	<b>17%</b>	<b>1,069,947</b>	<b>25%</b>

22

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**SALES.** Net sales for the quarter ended September 30, 2008 were \$4.26 million while our net sales for the quarter ended September 30, 2007, were \$4.29 million, a decrease in revenues of \$35,029. The decrease was due to changing our business type during 2007. We discontinued our mobile phone business and commenced selling, manufacturing and construction of energy saving systems during 2007. We sell our systems through sales-type leasing. Sales and cost of sales are recorded at the time of leasing; the interest income from the sales-type leasing is our major revenue source in addition to the sales revenue. We sold one TRT system through sales-type leasing during the quarter ended September 30, 2007 which brought us both gross sales and interest income for the third quarter of 2007, while we had interest income from sales-type leasing and rental income from operating lease during the third quarter ended September 30, 2008.

**COST OF SALES.** Cost of sales for the quarter ended September 30, 2008 was \$2.98 million while our cost of sales for the quarter ended September 30, 2007 was \$3.3 million, a decrease of \$0.32 million. The decrease in cost of sales is attributed to changing our business type from a mobile phone business to manufacturing, selling, constructing and leasing the energy saving systems in 2007. We leased two power generating systems under one-year, non-cancellable leases with options to renew at favorable prices, we paid the lease payments in full and lease them out for higher monthly rental income under one-year, non-cancellable leases. The cost of sales for the nine months ended September 30, 2008 was only the amortization of the prepaid leasing expense while the cost of sales was only the cost of manufacturing and selling a TRT system through the sales-type leasing for the same period of 2007.

**GROSS PROFIT.** Gross profit was \$1.28 million for the quarter ended September 30, 2008 as compared to \$0.99 million gross profit for the quarter ended September 30, 2007, representing gross margins of approximately 30% and 23% for the third quarter ended 2008 and 2007, respectively. The increase in our gross profit was mainly due to changing our business type from a mobile phone business to manufacturing, selling, constructing and leasing the energy saving systems in 2007. We sold one TRT system through sales-type leasing during the third quarter of 2007, which resulted in a lower gross profit, while we had rental income from operating leasing with higher gross profit margin for the same period of 2008.

**OPERATING INCOME.** Operating income was \$1.86 million for the three months ended September 30, 2008, while our operating income for the same period of 2007 was \$1.27 million, an increase of \$0.59 million. The growth in operating income was mainly due to the increase of \$290,000 in gross profit and the increase of \$300,000 in interest income on sales-type lease over the same three months ended September 30 between 2008 and 2007.

**OPERATING EXPENSES.** Operating expenses consisted of selling, general and administrative expenses totaling approximately \$638,949 for the quarter ended September 30, 2008 as compared to \$15,183 for the quarter ended September 30, 2007, an increase of approximately \$623,766 or 4108%. This increase was mainly due to increased payroll, marketing, traveling and consulting expenses associated with expanding our business by getting more leasing and project contracts as well as amortized compensation expenses for employee stock options.

**NET INCOME (LOSS).** Our net income (loss) for the quarter ended September 30, 2008 was \$732,512 as compared to \$1,069,947 net income for the quarter ended September 30, 2007, a decrease of \$337,435. This decrease in net income was mainly due to interest expense on our convertible note of approximately \$105,000, compensation expenses of \$95,872 for employee stock options and increased operating expense due to expansion of our business.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Nine months ended September 30, 2008 as compared to nine months ended September 30, 2007**

As of September 30, 2008, the Company had cash and cash equivalents of approximately \$1,705,940. At September 30, 2008, other current assets consisted of approximately \$19.5 million and current liabilities consisted of approximately \$11.5 million, working capital amounted to \$9.68 million at September 30, 2008. The ratio of current

assets to current liabilities was 1.84:1 at the nine months ended September 30, 2008.

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

	<b>2008</b>	<b>2007</b>
<b>Cash provided by (used in):</b>		
Operating Activities	\$ (3,721,969)	\$ (302,825)
Investing Activities	<b>(10,924,213)</b>	<b>-</b>
Financing Activities	<b>14,387,174</b>	<b>48,015</b>



Net cash flow used in operating activities was \$3.72 million during the nine months ended September 30, 2008, as compared to \$0.3 million in same period of 2007. The increase in net cash used in operating activities was mainly due to the net loss for the period, decrease in accounts payable, and prepaid equipment rents.

Net cash flow used in investing activities was \$10.9 million for the nine months ended September 30, 2008, as compared to no net cash used in investing activities for the nine months ended September 30, 2007. The increase of net cash flow used in investing activities was mainly due to the acquisition of equipment of \$113,906 and payment for construction in progress of approximately \$9.99 million for constructing a power generating system. We will use the BOT (build, operate, transfer) model to build and operate a system and charge the user of this system monthly electricity fees based on the actual power generated by the systems.

Net cash flow provided by financing activities was \$14.39 million for the nine months ended September 30, 2008 as compared to net cash provided by financing activities of \$48,015 for the nine months ended September 30, 2007. The increase of net cash flow provided by financing activities was mainly due to the issuance of common stock to an accredited investor for \$5 million, issuance of a convertible note to the same investor for \$5 million, and issuance of common stock to one of our major shareholders for \$4,032,258.

We believe we have sufficient cash to continue our current business throughout September of 2009 due to increased sales, interest revenue and rental income from operating activity.

We do not believe that inflation had a significant negative impact on our results of operations during 2008.

### **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 stockholder'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**

#### **Restricted Cash in Bank**

During the quarter ended September 30, 2008, we issued a bank acceptance to our vendor in the amount of approximately \$440,000 (RMB 3,000,000); the bank acceptance has a term of three months. We deposited the same amount of cash in the bank to secure the payment of this bank acceptance.

In September of 2008, we entered into a contract to install a 7-Megawatt capacity electricity-generation system for a world-class nickel-iron manufacturing company. We deposited approximately \$403,000 (RMB 2,750,000) into the bank to secure the execution of this contract.

#### **Convertible Notes Payable**

On November 16, 2007, the Company entered into a Stock and Notes Purchase Agreement ("Purchase Agreement") with Carlyle Asia Growth Partners III, L.P. ("CAGP") and CAGP III Co. Investment, L.P. (together with CAGP, the "Investors"). Under the terms of the Purchase Agreement, the Company sold to the Investors a 10% Secured Convertible Promissory Note in the principal amount of \$5,000,000 (the "First Note"). Additionally, the Purchase Agreement

provides for two subsequent transactions to be effected by the Company and the Investors, which include (i) the issuance by the Company and subscription by the Investors of a total of 4,066,706 shares of common stock of Company, at the price of \$1.23 per share for an aggregate purchase price of approximately \$5,000,000, and (ii) the issuance and sale by the Company to the Investors of a 5% Secured Convertible Promissory Note in the principal amount of \$15,000,000 (the foregoing transactions, together with sale and purchase of the First Note, are hereinafter referred to as the "Offering"). The subsequent transactions are contingent upon the satisfaction of certain conditions specified in the Purchase Agreement, including entry into specified energy and recycling project contracts and the purchase of certain energy recycling systems.

The First Note bears interest at 10% per annum and matures on November 16, 2009. The principal face amount of the First Note, together with any interest thereon, convert, at the option of the holders at any time on or prior to maturity, into shares of the Company's common stock at an initial conversion price of \$1.23 per share (subject to anti-dilution adjustments). The First Note is subject to mandatory conversion upon the consummation of the aforementioned issuance and subscription of shares of the Company's common stock under the Purchase Agreement. As more fully described in the First Note, the obligations of the Company under the First Note shall rank senior to all other debt of the Company.

As collateral for the First Note, the President and a major shareholder of the Company pledged 9,653,471 shares of the Company's common stock held by him to secure the First Note.

The First Note was considered to have an embedded beneficial conversion feature because the conversion price was less than the quoted market price at the time of the issuance. Accordingly, the beneficial conversion feature of \$5,000,000 was recorded separately as unamortized beneficial conversion feature based on the intrinsic value method. The First Note is recorded in the balance sheet at face value less the unamortized beneficial conversion feature. The terms for the First Note were amended on April 29, 2008 and the First Note was repaid in full on June 25, 2008, as described below.

On April 29, 2008, the Company entered into an Amendment to the Purchase Agreement with the investors. Under the terms of the Amendment, (i) the Company issued and the Investor subscribed for a total of 4,066,706 shares of common stock of the Company, at the price of \$1.23 per share for an aggregate purchase price of \$5,002,048, as originally contemplated under the Agreement; (ii) the Investors converted the principal amount under the First Note (and waived any accrued interest thereon) into 4,065,040 shares of common stock of the Company at the conversion price per share of \$1.23, pursuant to the terms and conditions of the First Note issued under the Agreement; (iii) the Company issued and sold to the Investors a new 5% Secured Convertible Promissory Note in the principal amount of \$5,000,000 to the Investors (the "Second Note" and collectively with the First Note, the "Notes"); and (iv) the Company granted to the Investors an option to purchase a 5% Secured Convertible Promissory Note in the principal amount of \$10,000,000, exercisable by the Investors at any time within nine (9) months following the date of the closing of the transactions contemplated by the Amendment (the "Option Note").

The Second Note bears interest at 5% per annum and matures on April 29, 2011. The principal face amount of the Second Note, together with any interest thereon, convert, at the option of the holders at any time on or after March 30, 2010 (or such earlier date if the audited consolidated financial statements of the Company for the fiscal year ending December 31, 2009 are available prior to March 30, 2010) and prior to maturity, into shares of the Company's common stock at an initial conversion price that is tied to the after-tax net profits of the Company for the fiscal year ending December 31, 2009, as described in the Second Note. The Second Note is subject to mandatory conversion upon the listing of the Company's common stock on the National Association of Securities Dealers Automated Quotations main-board, the New York Stock Exchange or the American Stock Exchange. As more fully described in the Second Note, the obligations of the Company under the Second Note shall rank senior to all other debt of the Company.

The Second Note and the Option Note are both secured by a security interest granted to the Investors pursuant to the Share Pledge Agreement.

The Second Note was not considered to have an embedded beneficial conversion feature, nor included in the computation of diluted earnings per share because the conversion price and convertible shares are contingent upon future net profits, and anti-dilutive for these shares due to the Company's net loss for the nine months ended September 30, 2008.

On June 25, 2008, the Company and the Investors entered into a Rescission and Subscription Agreement to rescind the conversion of the First Note and the issuance of conversion shares of Common Stock at the Second Closing pursuant to Amendment to Stock and Notes Purchase Agreement dated on April 29, 2008. The Company and the Investors rescinded the conversion of the principal amount (\$5,000,000) under the First Note into 4,065,040 shares of Common Stock, and the Investors waived accrued interest on the First Note. Accordingly, the interest expense which had accrued on the note has been recorded as a decrease on interest expense for the period. At the Rescission and Subscription Closing, the Company repaid in full the First Note and issued to the Investors, 4,065,040 shares of Common Stock at the price of \$1.23 per share for an aggregate purchase price of \$5,000,000.

### **Zhangzhi Steel New blast furnace TRT Power Generator Project**

On November 11, 2007, the Company entered a Project General Contractor agreement with an independent contractor to construct a 1080 cubic meter blast furnace for the third phase of the Zhangzhi TRT project which was originally signed on June 22, 2006. The total contract price is approximately \$4,375,000 (RMB 30,000,000); the Company has paid approximately \$2,625,000 (RMB 18,000,000) for the purchase of the equipment. This project is expected to produce 45,000,000 KW/h annual energy output upon completion.

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

Not Applicable.

**Item 4. Controls and Procedures**

*Evaluation of disclosure controls and procedures*

Prior to the conclusion of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13(a)-14(c). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to information relating to us (including our consolidated subsidiaries) required to be included in our periodic SEC filings.

***Changes in internal control over financial reporting***

Management has previously disclosed in the Company's Form 10-KSB for the fiscal year ended December 31, 2007, that the Company's internal control over financial reporting was subject to certain material weaknesses and set forth the Company's planned steps to address these weaknesses. During the nine-month period ended September 30, 2008, the Company made the following changes in its internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting:

- Reorganized the accounting and finance department and hired additional accounting and operations personnel with adequate experience, skills and knowledge relating to complex, non-routine transactions;
- Engaged a new accounting firm that has experience working with U.S. public companies;
- Hired a Certified Public Accountant with expertise in U.S. accounting principles to prepare the Company's annual report and quarterly reports;
- Established a complete management system based upon the Company's internal accounting process to ensure that internal control over financial reporting is effective;
  - Established an internal audit system with a senior accountant serving as the Company's internal auditor; and
- Made amendments to the Company's accounting system and working process (including internal audit and material transaction review and verification process) to strengthen the timeliness and efficiency of the Company's internal controls.
- Retained an outside consultant to provide the company with independent internal control risk consulting services related to the company's Sarbanes-Oxley Section 404 compliance efforts.

## PART II - OTHER INFORMATION

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

The Company is not currently involved in any material pending legal proceedings.

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

Not applicable.

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

None.

### **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**

#### **Number Description**

- |      |  |
|------|--|
| 10.1 | Form of Nonstatutory Stock Option Agreement - Manager Employee under the China Recycling Energy Corporation 2007 Nonstatutory Stock Option Plan (incorporated by reference to Exhibit 10.1 to China Recycling Energy Corporation's Current Report on Form 8-K filed August 8, 2008).     |
| 10.2 | Form of Nonstatutory Stock Option Agreement - Non-Manager Employee under the China Recycling Energy Corporation 2007 Nonstatutory Stock Option Plan (incorporated by reference to Exhibit 10.2 to China Recycling Energy Corporation's Current Report on Form 8-K filed August 8, 2008). |
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a).*  |
| 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a).*  |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350.*  |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350.*  |

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\* Filed herewith.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CHINA RECYCLING ENERGY CORPORATION  
(Registrant)

Date: November 6, 2008

/s/ Guangyu Wu  
Guangyu Wu  
Chief Executive Officer

Date: November 6, 2008

/s/ Xinyu Peng  
Xinyu Peng  
Chief Financial Officer

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**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
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\* Filed herewith.

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