Recon Technology, Ltd
Form 10-Q
February 11, 2010
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U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 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 December 31, 2009

¨ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from to .

Commission File Number 001-34409

RECON TECHNOLOGY, LTD

(Exact name of registrant as specified in its charter)

Cayman Islands	**Not Applicable**

(State or other jurisdiction of	**(I.R.S. employer**
incorporation or organization)	**identification number)**

Room 1902, Building C, King Long International Mansion

No. 9 Fulin Road, Beijing, 100107

People s Republic of China

(Address of principal executive offices and zip code)

0086-010-84945799

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date. The Company is authorized to issue 25,000,000 Shares. As of the date of this report, the Company has issued and outstanding 3,951,811 Shares.

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RECON TECHNOLOGY, LTD

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document contains certain statements of a forward-looking nature. Such forward-looking statements, including but not limited to projected growth, trends and strategies, future operating and financial results, financial expectations and current business indicators are based upon current information and expectations and are subject to change based on factors beyond the control of the Company. Forward-looking statements typically are identified by the use of terms such as look, may, should, might, believe, plan, expect, anticipate, estimate and simil although some forward-looking statements are expressed differently. The accuracy of such statements may be impacted by a number of business risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including but not limited to the following:

- the timing of the development of future products;
- projections of revenue, earnings, capital structure and other financial items;
- statements of our plans and objectives;
- statements regarding the capabilities of our business operations;
- statements of expected future economic performance;
- statements regarding competition in our market; and
- assumptions underlying statements regarding us or our business.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The Company undertakes no obligation to update this forward-looking information. Nonetheless, the Company reserves the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this Report. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

See the financial statements following the signature page of this report, which are incorporated herein by reference.

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

The following discussion and analysis of our company s financial condition and results of operations should be read in conjunction with our unaudited consolidated financial statements and the related notes included elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. Actual results and the timing of selected events could differ materially from those anticipated in these forward-looking statements as a result of various factors.

Overview

We are a company focused on production and service for oil field exploitation industry companies in the People s Republic of China. Through our contractual relationships with Beijing BHD Petroleum Technology Co., Ltd. (BHD), Nanjing Recon Technology Co., Ltd. (Nanjing Recon), and Jining ENI Energy Technology Co., Ltd. (ENI and, together with BHD and Nanjing Recon, the Domestic Companies), we provide equipment, tools and other hardware related to oil field production and management and develop and sell our own specialized industrial automation control and information solutions. However, we do not engage in the production of petroleum or petroleum products.

Following our initial public offering and listing on the NASDAQ Capital Market, our business continued to grow due to our efforts to optimize our product portfolio and expand into new business areas. For the six months ended December 31, 2009 and 2008, our total revenues amounted to $10.6 million and $7.3 million, respectively. We derive revenues from hardware sales and software service. For the six months ended December 31, 2009, approximately 91.46% of our revenues came from hardware sales, and approximately 8.54% came from software services. For the same period in 2008, hardware sales and software services constituted 95.88% and 4.12%, respectively, of our revenues.

Our management believes that Chinese oilfields will promote digitization management and stimulation measures in oil and gas wells in the future; as such we are placing a higher emphasis on these areas. To a certain extent, our change in revenue structure reflects this short-term strategy. Under this strategy, our business benefits from sales of high-tech products and software systems. Our management also believes the development and sales of software products facilitated the development of our hardware and service business. We expect our software service revenues to continue to grow, as our customers require continuing service associated with their software purchase. As a result, our management continues to seek to strengthen its competitive position in the oil field service industry by developing software products.

Our solutions and new technology enable our customers to reduce their expenditures and improve their integrated benefit by changing from manual to mechanized production methods. Our major clients, Sinopec and CNPC, are large oil and refinery firms formed following the Chinese government s decision to decentralize the oil and gas industry within China. Both companies are ranked in the Fortune 500. We aim to continue extending our market share in the short-term and to be a leading non-government-owned service provider to the oil field exploitation industry in the long-term. Our mission is to increase the automation and safety levels of industrial petroleum production in China, and improve the under-developed working process and management mode by using high-technology.

Factors Affecting Our Business

Industry Background. As a whole, the Chinese petroleum industry faces four primary challenges: (a) global competition; (b) environment and development; (c) configuration of petroleum resources; and (d) gradually

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increased profit margins. Compared to developed countries, however, there are still certain lags in terms of modernized management levels in China. In particular, with the introduction of computer techniques over the last ten years, the degree of automation in foreign countries has reached a higher level, while China is still in the initial stage.

With deeper development of the oil-field industry, most oil-fields in China have entered the third stage of oil extraction. During this stage, oil well output decreases, water content increases, and costs are higher.

Through application of the automation system we provide, oil well head information such as indicator diagrams, current diagrams, oil pressure, oil temperature and the running status of oil wells, can be accurately passed on to management in real time. Management may see information in the clear human-machine interface and make analysis and decisions enabling the realization of remote controls over oil extraction wells such as auto delayed start-up of the oil extraction well after being switched on/off or intermittent extractions. The system can achieve failure protection and send timely alarms, for instance, the system is equipped with auto stop and alarms in the cases of blocking, breaking of oil extraction rods, and phase breaking to avoid the occurrence of major accidents. The measurement station can realize automatic measurement of liquid and gas and transfer the data to the central control room in real time. With this system, the oil well heads and measurement stations have no need to be monitored by personnel and in addition, in-time and accurate information transfers between the oil extraction well and management have improved labor productivity, brought down manual work and consumptions, lowered costs for oil extractions, eliminated failures in time, increased oil output, actualized automatic management for oil fields and integrated management above and under-ground. The automation system also provides full and accurate data for research and development of petroleum deposit projects as well as a reliable technical basis for oil field productions and decision-making.

Our automation system can also be used in connection with the delivery of liquefied natural gas. China is currently diversifying its energy sources, and China imported 15% more liquefied natural gas in 2008 than in 2007. Although the increase from 2.9 to 3.3 million tons for the full year was significant, our optimism about the future of liquefied natural gas in China (as well as the need for our services in the industry) is tempered by a 23% drop from November to December 2008, which coincided with the international market crisis.

Apart from the above-mentioned factors, increasingly intense competition in the oil field market, increasing efficiency by reducing redundant staff and reduction of cost is bound to facilitate the all-around generalization of the automation system.

Accordingly, any significant change in the general demand for oil and liquefied natural gas in China, the PRC government s policy or the strategies of major PRC energy companies may significantly affect the demand for our service and products and, as a result, our revenues and financial condition.

In addition, our oil well water finding/blocking technology, multipurpose fissure shaper, and high-efficiency heating furnace can increase the oil field output, decrease the water content, save energy, lower consumption, reduce the oil extraction cost, and strengthen the competitive force of the domestic oil fields.

Relevant Industry-Wide Trends. Management believes the Chinese oil field service industry is likely to experience rapid growth in the near future. This belief is based on management s experience in the industry and its analysis of the following recent trends:

Management believes that larger companies in China are becoming more sophisticated in managing and implementing their information systems. Management believes that these tendencies are likely to create a strong demand for software integration and customized system development from these larger companies. As a result, management believes that many oil field service providers will attempt to reposition their businesses as development services providers, rather than off-the-rack vendors. In the context of economic transformation, local manufacturers will likely face industrial restructuring as they try to grow to compete and fend off increased pressure from greatly shortened product lives. Management believes that the use of advanced information technologies in management and control of manufacture is becoming more important to success in the market.

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Management believes that a significant number of Chinese manufactures, especially those in the oil and gas industry, still lack sufficient technical applications and services for their needs. These companies tend to be more cost-sensitive. Management believes that such clients would be more likely to use our service and products to reduce expenses by third-parties like us. Management believes this will be an increasingly competitive market.

Management also believes that high-tech and precise instruments will become increasingly prevalent in the oil field service market, as China continues to be more dependent on oil and as oil resources continue to decline.

Dependence on CNPC and Sinopec. We derive substantially all of our revenues from the operating subsidiaries of two customers, (i) CNPC and (ii) Sinopec. In order to grow and to protect our company against the risks associated with our dependence on CNPC and Sinopec, management intends to improve our service and expand our potential market. Management believes that a large number of Chinese petroleum companies are likely to require services and products such as those we provide.

Nature of Operations. Our technicians and solutions were developed with strong industrial expertise in the oil and gas industry. Products and services provided by us mainly include:

RSCADA System. RSCADA is an industrial computerized process control system for monitoring, managing and controlling oil field service extraction. RSCADA integrates the underground, ground and above-ground levels of the oil field service extraction industry. RSCADA connects the above-ground level central control room with the ground level relay station and the relay station with the underground bottom intelligent terminal using the 2.4G wireless frequency. RSCADA has received grants and awards from the State Ministry of Science and Technology and the city of Nanjing.

Water System. We have developed and implemented technology designed to find and block water content in oil field service. As China s extraction of oil has increased, the quantity of available oil has decreased and the water content in remaining oil has increased. In order to improve our efficiency and profitability in extraction, we have developed technology to reduce the amount of water in our extracted oil field service.

Oil Field Furnaces. Crude oil field service contains certain impurities that must be removed before the oil field service can be sold, including water and natural gas. To remove the impurities and to prevent solidification and blockage in transport pipes, companies employ heating furnaces. We have researched, developed and implemented a new oil field furnace that is advanced, highly automated, reliable, easily operable, and comparatively safe and highly heat efficient (90% efficiency).

Multipurpose Fissure Shaper. We have also developed a multipurpose fissure shaper to improve our ability to test for and extract oil field service. Before any oil field service extractor can test for the presence of oil, it must first perforate a hole for testing. The depth of the perforated hole is, of course, extremely important in the testing process: a hole that is too shallow may cause an extractor to miss an oil field entirely. We have developed a proprietary multipurpose fissure shaper that is used with the perforating gun to effectively increase the perforation depth by between 46 and 80%, shape a great number of stratum fissures, improve the stratum diversion capability and, as a result, improve our ability to locate oil fields and increase the output of oil wells.

As a technology development company, we put a priority on research, exploration, design and innovation. For years we have been increasing investments in attracting and training talents to continually improve our research and development capability. We currently have more than 90 employees, 80% of whom graduated from college. We also cooperate with the Oil Field Service & Geology Research Laboratory of Nanjing University.

Factors Affecting Our Results of Operations Generally

Our operating results in any period are subject to general conditions typically affecting the Chinese oil-field service industry including:

the amount of spending by our sophisticated customers, primarily those in the oil and gas industry;

growing demand from large corporations for improved management and software designed to achieve such corporate performance;

the procurement processes of our customers, especially those in the oil and gas industry;

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- competition and related pricing pressure from other oil field service solution providers, especially those targeting the Chinese oil and gas industry;
- the ongoing development of the oil field service market in China; and
- inflation and other factors.

Unfavorable changes in any of these general conditions could negatively affect the number and size of the projects we undertake, the number of products we sell, the amount of services we provide, the price of our products and services and otherwise affect our results of operations.

Our operating results in any period are more directly affected by company-specific factors including:

- our revenue growth;
- the proportion of our business dedicated to large companies;
- our ability to successfully develop, introduce and market new solutions and services;
- our ability to increase our revenues to businesses, both old customers and new in the Chinese oil and gas industry;
- our ability to effectively manage our operating costs and expenses; and
- our ability to effectively implement any targeted acquisitions and/or strategic alliances so as to provide efficient access to markets and industries in the Chinese oil and gas industry.

Critical Accounting Policies and Estimates

Estimates and Assumptions. We prepare our financial statements in conformity with U.S. GAAP, which requires us to make judgments, estimates and assumptions. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. An accounting policy is considered critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time such estimate is made, and if different accounting estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. We believe that the following policies involve a higher degree of judgment and complexity in their application and require us to make significant accounting estimates. The following descriptions of critical accounting policies, judgments and estimates should be read in conjunction with our consolidated financial statements and other disclosures included in this prospectus. Significant accounting estimates reflected in our company s consolidated financial statements include revenue recognition, allowance for doubtful accounts, and useful lives of property and equipment.

Revenue Recognition. We recognize revenue when it is realized and earned. We consider revenue realized or realizable and earned when (1) we have persuasive evidence of an arrangement, (2) delivery has occurred, (3) the sales price is fixed or determinable, and (4) collectability is reasonably assured. Delivery does not occur until products have been shipped or services have been provided to the client and the client has signed a completion and acceptance report, risk of loss has transferred to the client, client acceptance provisions have lapsed, or we have objective evidence that the criteria specified in client acceptance provisions have been satisfied. The sales price is not considered to be fixed or determinable until all contingencies related to the sale have been resolved.

Hardware. Revenue from hardware sales is generally recognized when the product is shipped to the customer and when there are no unfulfilled company obligations that affect the customer s final acceptance of the arrangement.

Services. The Company provides services to improve software functions and system requirements on separated fixed-price contracts. Revenue is recognized on the completed contract method when acceptance is determined by a completion report signed by the customer. Deferred revenue represents unearned amounts billed to customers related to service agreements.

Software. The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with the provisions of Statement of Position No. 97-2 (ASC Topic 985-605), Software Revenue Recognition, and related interpretations. Revenue from software is recognized according to project contracts. Contract costs are accumulated during the periods of installation and testing or commissioning. Usually this is short term. Profits are not recognized until completion of the contracts. Costs included in inventory as work in process include direct materials, labor and related expense. Corporate general and administrative expenses are charged to expense in the period they are incurred.

Revenues applicable to multiple-element fee arrangements are divided among the elements such as software, hardware and post-contract service using vendor-specific objective evidence of fair value. Such evidence consists of pricing of multiple elements when those same elements are sold as separate products or arrangements. Software maintenance for the first year and initial training are included in the purchase price of the software. Initial training is provided at the time of installation and is recognized as income as part of the price of the software since it is minimal in value. Maintenance is valued based on the fee schedule used by us for providing the regular level of maintenance service as sold to customers when renewing their maintenance contracts on a standalone basis. Maintenance revenue is included in the income statement under services and is recognized over the term of the agreement.

Fair Values of Financial Instruments. The carrying amounts reported in the consolidated balance sheets for trade accounts receivable, other receivables, advances to suppliers, trade accounts payable, accrued liabilities, advances from customer and notes payable approximate fair value because of the immediate or short-term maturity of these financial instruments.

Allowance for Doubtful Accounts. Trade receivables and other receivable accounts are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method, less a provision made for impairment of these receivables. Provisions are applied to trade and other receivables where events or change in circumstances indicate that the balance may not be collectible. The identification of doubtful debts requires the use of judgment and estimates of management. Our management must make estimates of the collectability of our accounts receivable. Management specifically analyzes accounts receivable, historical bad debts, customer creditworthiness, current economic trends and changes in our customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. Our allowance for trade accounts receivable was ¥604,953 ($88,570) and ¥995,488 ($145,840) on June 30, 2009 and December 31, 2009 respectively. Our allowance for trade accounts receivable increase primarily because our trade accounts receivable increased, which increased the potential for doubtful accounts. However, the increase in the allowance was relatively low, because even though our business developed significantly, which caused a great increase of accounts receivable, most of the growth occurred between us and our large clients. Because these clients are state-owned companies, our management believes the possibility that these accounts receivable will be uncollectable is relatively low. If the financial condition of our clients were to deteriorate, resulting in their inability to make payments, an additional allowance might be required.

Property and Equipment. We record property and equipment at cost. We depreciate property and equipment on a straight-line basis over their estimated useful lives using the following annual rates:

Motor Vehicles	10 years
Office Equipment	2-5 years
Leasehold Improvements	5 years

We expense maintenance and repair expenditures as they do not improve or extend an asset s productive life. These estimates are reasonably likely to change in the future since they are based upon matters that are highly uncertain such as general economic conditions, potential changes in technology and estimated cash flows from the use of these assets.

Gains or losses on sales or retirements are included in the consolidated statements of operations in the year of disposition. The balance of accumulated depreciation was ¥1,006,761 ($147,398) and ¥993,029 ($145,479) as of June 30, 2009 and December 31, 2009, respectively.

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	Chinese Yuan (Renminbi)		U.S. Dollars
	June 30, 2009	December 31, 2009 (Unaudited)	December 31, 2009 (Unaudited)
Motor vehicles	¥ 1,464,918	¥ 1,544,114	$ 226,214
Office equipment and fixtures	779,257	541,543	79,336
Leasehold improvement	169,462	276,938	40,572
Total property and equipment	2,413,637	2,362,595	346,122
Less: Accumulated depreciation	(1,006,761)	(993,029)	(145,480)
Property and equipment, net	¥ 1,406,876	¥ 1,369,566	$ 200,643

Software Development Costs. We charge all of our development costs to research and development until we have established technological feasibility. We acknowledge technological feasibility of our software when a detailed program design has been completed, or upon the completion of a working model. Upon reaching technological feasibility, we capitalize additional software costs until the software is available for general release to customers. Although we have not established a budget or time table for software development, we anticipate the need to continue the development of our software products in the future and the cost could be significant. We believe that, as in the past, the costs of development will result in new products that will increase revenue and therefore justify costs. There is, however, a reasonable possibility that we may be unable to realize the carrying value of our software, and the amount not so realized may adversely affect our financial position, results of operation or liquidity in the future.

Cost of Revenues. Cost of revenues includes wages, materials, handling charges, and other expenses associated with manufactured products and service provided to customers; the cost of purchased raw materials such as steel products and chemical materials. We expect cost of revenues to grow as our revenues grow. It is possible that we could incur development costs with little revenue recognition, but based upon our past history, we expect our revenues to grow.

Valuation of Long-Lived Assets. We review the carrying values of our long-lived assets for impairment whenever events or changes in circumstances indicate that they may not be recoverable. When such an event occurs, we project undiscounted cash flows to be generated from the use of the asset and its eventual disposition over the remaining life of the asset. If projections indicate that the carrying value of the long-lived asset will not be recovered, we reduce the carrying value of the long-lived asset, by the estimated excess of the carrying value over the projected discounted cash flows. In the past, we have not had to make significant adjustments to the carrying values of our long-lived assets, and we do not anticipate a need to do so in the future. However, circumstances could cause us to have to reduce the value of our capitalized software more rapidly than we have in the past if our revenues were to significantly decline. Estimated cash flows from the use of the long-lived assets are highly uncertain and therefore the estimation of the need to impair these assets is reasonably likely to change in the future. Should the economy or acceptance of our software change in the future, it is likely that our estimate of the future cash flows from the use of these assets will change by a material amount.

Results of Operations

Three Months Ended December 31, 2009 Compared to Three Months Ended December 31, 2008

Our historical reporting results are not necessarily indicative of the results to be expected for any future period.

Revenues. Our total revenues increased by approximately 26.90% or ¥10,615,787, from ¥39,458,307 ($5,780,675) for the three months ended December 31, 2008 to ¥50,074,094 ($7,335,896) for the three months ended December 31, 2009. The sales of our oil field furnaces drove our revenue growth. We believe our software and service business are likely to play a large role in future revenues. Most of the increase of revenue was a result of our cooperation with new clients.

We believe the worldwide economic crisis made companies, including our clients, more cautious about their finances and encouraged those companies to seek ways to reduce costs and maximize output by investing in technological solutions that would enable them to improve revenues and reduce expenses. Because our solutions are designed to help oil companies operate more efficiently, our customers ordered more of our products and services. As a result, we were able to continue to grow in a very difficult year for industry. In addition, this increase also resulted directly from our growing relationships with CNPC and Sinopec.

Specifically, the Chinese government has attached great importance to the safety problems that exist in the Chinese energy industry by implementing numerous new projects and initiatives designed to increase safety and security in the Chinese energy industry. This replacement project is a Chinese reform project designed to eliminate hidden security dangers and develop key projects for saving energy and materials. As a result of the new policies, the Chinese government has increased spending to replace equipment with potential safety problems. As such, we have experienced increased sales and a greater demand for our maintenance services, which has increased our revenue. Additionally, as we have provided services to CNPC and Sinopec and our relationships have grown, they have chosen to continue to use our solutions. During the period ended December 31, 2009, substantially all of our revenues were generated through our business engagements with these companies operating subsidiaries. These significant engagements made it possible for us to improve our service quality, products popularity and adaptability for a very limited number of customers. Further, this long-term cooperation provides us more preferences for collecting receivables on time. We expect that our gross revenues will continue to increase over time as we:

- expand the adoption of our solutions into other markets outside the Chinese oil and gas industry; and

- introduce our solutions to businesses located outside of China.

Cost of Revenues. Our cost of revenues includes costs related to the design, implementation, delivery and maintenance of our software solutions and raw materials. We have set up service and maintenance centers in Xinjiang, Jidong, Qinghai district, and other locations which can provide our customers with technical consulting, repair and maintenance services. We purchase equipment based on each client s needs. Raw materials used to produce our hardware products consist largely of steel products and chemical products.

Our cost of revenues increased from ¥22,338,687 ($3,272,636) in the three months ended December 31, 2008 to ¥25,396,611 ($3,720,625) for the same period of 2009, an increase of ¥3,057,924 or 13.69%. As a percentage of revenues, our cost of revenues decreased from 56.61% in 2008 to 50.72% in 2009. Our focus on solutions with comparatively higher margins, such as our software and service solutions, allowed our cost of revenues to decrease as a percentage of revenues, even as our business grew.

Gross Margin. For the three months ended December 31, 2009, our gross margin increased to ¥24,677,484 ($3,615,272) from ¥17,119,620 ($2,508,039) for the same period in 2008, an increase of ¥7,557,864, or approximately 44.15%. For the three months ended December 31, 2009, our gross margin as a percentage of revenue increased to 49.28%, from 43.39% for the same period ended December 31, 2008. This increase in gross margin can be attributed primarily to the increase in sales volume to CNPC and Sinopec, combined with the development of our lower cost software and service business. During this period, the company achieved many new software contracts in Sichuan province of China and the JiDong oilfield.

Expenses.

General and Administrative Expenses. General and administrative expenses consist primarily of costs from our human resources organization, facilities costs, depreciation expenses, professional advisor fees, audit fees, options expenses and other expenses incurred in connection with general operations. General and administrative expenses increased 114.17%, or ¥1,876,566, from ¥1,643,679 ($240,800) in the three months ended December 31, 2008 to ¥3,520,245 ($515,719) for the same period of 2009. General and administrative expenses were 4.17% of total revenues in 2008 and 7.03% of total revenues in 2009. This percentage increase was primarily attributable to increases in our audit fees and expenses associated with our incentive share options.

Selling and Distribution Expenses. Selling and distribution expenses consist primarily of salaries and related expenditures of our sales and marketing organization; sales commissions; costs of our marketing programs, including public relations, advertising and trade shows; and an allocation of our facilities and depreciation expenses. Selling expenses increased by 48.21%, from ¥2,606,958 ($381,921) for the three months ended December 31, 2008 to ¥3,863,886 ($566,062) for the same period of 2009. This increase resulted primarily from our business expansion activities. Because of the rapid growth of sales of furnaces, sales commissions for such sales also increased quickly. As we continued to solidify our business relationships with other companies, we required extensive marketing efforts and incurred the costs associated therewith. At present, we are expanding our business in the Sichuan district and Tuha oilfield. In order to successfully increase the scope of our client base, we established new local offices in different areas of China. We expect that our selling expenses will correspondingly increase. Selling expenses were 6.61% of total revenues in the three months ended December 31, 2008 and 7.72% of total revenues in same period of 2009. As we increase the scope of our client base over the next several years, we expect to see our selling expenses as a percentage of revenue increase as a result, in part, of our expanded marketing efforts. We expect that our marketing efforts will require a period of time before resulting in additional sales.

Income from Operations. Income from operations was ¥17,293,353 ($2,533,491) for the three months ended December 31, 2009, compared to ¥12,868,984 ($1,885,317) for the same period of 2008, an increase of ¥4,424,369 ($648,174) or 34.38%. This increase in income from operations can be attributed primarily to the increase in sales volume to CNPC and Sinopec.

Subsidy Income. We received grants from the local government. For the three months ended December 31, 2009, we received ¥1,131,709 ($165,796) in subsidy income. These grants were given by the government to support local software companies operation and research and development. Grants related to research and development projects are recognized as subsidy income in the consolidated statements of operations when related expenses are recorded. This income typically increases at the end of the year.

Income Tax Expense. Income taxes are provided based upon the liability method of accounting pursuant to SFAS No. 109 (ASC Topic 740), Accounting for Income Taxes. Under this approach, deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financial reporting amounts. A valuation allowance is recorded against deferred tax assets if it is not likely that the asset will be realized. In June 2006, the Financial Accounting Standards Board issued Financial Interpretation No. 48 (ASC Topic 740), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition classification, interest and penalties, accounting in interim periods, disclosure, and transition. The interpretation is effective for the fiscal years beginning after December 15, 2006. The adoption of this interpretation had no material effect on the Company s financial statements.

We have not been subject to any income taxes in the United States or the Cayman Islands. Enterprises doing business in the PRC are generally subject to federal (state) enterprise income tax at a rate of 30% and a local income tax at a rate of 3% before calendar year 2008 and subject to a rate of 25% after calendar year 2008; however, due to Nanjing Recon s location in a State Standard High Technology Development Zone, it was granted a certification of High Technology Enterprise and was taxed at a rate of 15% for taxable income generated and was 50% exempt from this income tax from 2005 to 2007. Due to ENI s designation as a Qualifying High Technology company, ENI is subject to a 25% earned income tax (EIT) rate. BHD also pays the statutory rate of 25%. We had minimal operations in jurisdictions other than the PRC. Income tax expense for three months ended December 31, 2008 and 2009 were ¥3,231,050 ($473,352) and ¥4,414,087 ($646,667), respectively. This resulted from our increased revenues from sales and our profitable operation. We expect that our effective EIT rate will vary, depending on which of our Domestic Companies generate greater revenues, as an increased percentage of revenues from ENI or BHD will result in our effective rate moving closer to BHD s and ENI s 25% rate and away from Nanjing Recon s 15% rate.

Income from continuing operations. As a result of the factors described above, income from continuing operations was ¥13,987,777 ($2,049,221) for the three months ended December 31, 2009, an increase of ¥3,228,541 ($472,984) or 30.01% over the same period of 2008.

Net Income Available for Common Shareholders. As a result of the factors described above, net income available for common shareholders was ¥12,554,153 ($1,839,194) for the three months ended December 31, 2009, an increase of ¥2,979,929 ($436,562) or 31.12% over the same period of 2008.

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Six Months Ended December 31, 2009 Compared to Six Months Ended December 31, 2008

Our historical reporting results are not necessarily indicative of the results to be expected for any future period.

Revenues. Our total revenues increased by approximately 45.89% or ¥22,820,809, from ¥49,724,883 ($7,284,737) for the six months ended December 31, 2008 to ¥72,545,692 ($10,628,004) for the six months ended December 31, 2009. The sales of our oil field furnaces drove our revenue growth. We believe our software and service business are likely to play a large role in future revenues. Most of the increase of revenue was a result of our cooperation with new clients.

Cost of Revenues. Our cost of revenues increased from ¥31,141,366 ($4,562,236) in the six months ended December 31, 2008 to ¥41,469,158 ($6,075,266) for the same period of 2009, an increase of ¥10,327,792 or 33.16%. As a percentage of revenues, our cost of revenues decreased from 62.63% in 2008 to 57.16% in 2009. Our focus on solutions with comparatively higher margins, such as our software and service solutions, allowed our cost of revenues to decrease as a percentage of revenues, even as our business grew. We expect this trend will continue, provided we are able to continue to grow our higher-margin solution revenues.

Gross Margin. For the six months ended December 31, 2009, our gross margin increased to ¥31,076,535 ($4,552,738) from ¥18,583,517 ($2,722,501) for the same period in 2008, an increase of ¥12,493,018, or approximately 67.23%. For the six months ended December 31, 2009, our gross margin as a percentage of revenue increased to 42.84%, from 37.37% for the same period ended December 31, 2008. This increase in gross margin can be attributed primarily to the increase in sales volume, combined with the development of our lower cost software and service business. During this period, the company achieved many new software contracts in Sichuan province of China. The growth of our market share and increase in average revenues per contract has made it possible for us to take advantage of economies of scale. We believe this increase in sales volume resulted, in part, from the Chinese government s policy of improving safety and security in the energy industry.

Expenses.

General and Administrative Expenses. General and administrative expenses increased 100.33%, or ¥3,238,285, from ¥3,227,615 ($472,848) in the six months ended December 31, 2008 to ¥6,465,900 ($947,260) for the same period of 2009. General and administrative expenses were 6.49% of total revenues in 2008 and 8.91% of total revenues in 2009. This percentage increase was primarily attributable to an increase in audit fees and expenses associated with our incentive share options.

Selling and Distribution Expenses. Selling expenses increased by 80.46%, from ¥3,337,674 ($488,972) for the six months ended December 31, 2008 to ¥6,023,098 ($882,389) for the same period of 2009. This increase resulted primarily from our business expansion activities. Because of the rapid growth of sales of furnaces, sales commissions for such sales also increased quickly. As we continued to solidify our business relationships with other companies, we required extensive marketing efforts and incurred the costs associated therewith. At present, we are expanding our business in Sichuan district and Tuha oilfield. In order to successfully increase the scope of our client base, we established new local offices in different areas of China. We expect that our selling expenses will correspondingly increase. Selling expenses were 6.71% of total revenues in the six months ended December 31, 2008 and 8.30% of total revenues in same period of 2009.

Income from Operations. Income from operations was ¥18,587,537 ($2,723,090) for the six months ended December 31, 2009, compared to ¥12,018,229 ($1,760,680) for the same period of 2008, an increase of ¥6,569,308 or 54.66%. This increase in income from operations can be attributed primarily to the increase in sales volume to CNPC and Sinopec. In spite of (i) the seasonality of our business, (ii) our historical performance in the first half of our fiscal year and (iii) the increase in expenses during the period, we recognized a significant increase in income from operations.

Subsidy Income. We received grants from the local government. For the six months ended December 31, 2009, we received ¥1,158,034 ($169,653) in subsidy income. These grants were given by the government to support local software companies operation and research and development. Grants related to research and development projects are recognized as subsidy income in the consolidated statements of operations when related expenses are recorded. This income typically increases at the end of the year.

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Income Tax Expense. Income tax expense for six months ended December 31, 2008 and 2009 were ¥3,251,109 ($476,290) and ¥5,106,765 ($748,145), respectively. This resulted from our increased revenues from sales and our profitable operation.

Income from continuing operations. As a result of the factors described above, income from continuing operations was ¥14,649,512 ($2,146,166) for the six months ended December 31, 2009, an increase of ¥4,227,715 ($619,364) or 40.57% over the same period of 2008.

Discontinued Operations. At the end of the fiscal year 2008, our Company completed the sale of Inner Mongolia Adar Energy Technology, Ltd. and Beijing Weigu Windows Co. which were both the majority-owned subsidiaries of BHD as well as Xiamen Recon Technology Development, Ltd., which was the majority-owned subsidiary of Nanjing Recon. In the fourth quarter of 2008, we determined that these three subsidiaries met the criteria for classification as discontinued operations. The gain on the disposal of these subsidiaries and the financial results associated with 2008 and prior periods are included in discontinued operations.

Net Income Available for Common Shareholders. As a result of the factors described above, net income available for common shareholders was ¥12,978,572 ($1,901,372) for the six months ended December 31, 2009, an increase of ¥4,152,031 ($608,276) or 47.04% over the same period of 2008.

Liquidity and Capital Resources.

General

Cash and Cash Equivalents. Cash and cash equivalents are comprised of cash on hand, demand deposits and highly liquid short-term debt investments with stated maturities of no more than three months. On December 31, 2009, we had cash and cash equivalents in the amount of ¥44,987,580 ($6,590,718). We believe that current cash, cash equivalents, anticipated cash flow from operations and the proceeds from our initial public offering will be sufficient to meet our anticipated cash needs, including cash needs for working capital and capital expenditures for at least the next 12 months.

We may, however, require additional cash due to changing business conditions or other future developments, including any investments or acquisitions we may decide to pursue. If our existing cash is insufficient to meet our requirements, we may seek to sell additional equity securities or borrow from banks. However, financing may not be available in the amounts we need or on terms acceptable to us, if at all. The sale of additional equity securities, including convertible debt securities, would dilute our shareholders. The incurrence of debt would divert cash from working capital and capital expenditures to service debt obligations and could result in operating and financial covenants that would restrict our operations and our ability to pay dividends to our shareholders. If we are unable to obtain additional equity or debt financing as required, our business, operations and prospects may suffer.

Indebtedness. As of December 31, 2009, except for ¥5,660,874 ($829,322) of notes payable, we did not have any other outstanding loan capital issued or agreed to be issued, bank overdrafts, loans, debt securities or similar indebtedness, liens, liabilities under acceptance (other than normal trade bills) or acceptance credits, debentures, mortgages, charges, finance leases or hire purchase commitments, guarantees or other material contingent liabilities. In addition, there has not been any material change in our indebtedness, commitments and contingent liabilities since June 30, 2009.

Holding Company Structure. We are a holding company with no operations of our own. All of our operations are conducted through our Chinese subsidiary. As a result, our ability to pay dividends and to finance any debt that we may incur is dependent upon dividends and other distributions paid. In addition, Chinese legal restrictions permit payment of dividends to us by our Chinese subsidiary only out of its accumulated net profit, if any, determined in accordance with Chinese accounting standards and regulations. Under Chinese law, our subsidiary is required to set aside a portion (at least 10%) of its after-tax net income (after discharging all cumulated loss), if any, each year for compulsory statutory reserve until the amount of the reserve reaches 50% of our subsidiaries registered capital.

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These funds may be distributed to shareholders at the time of its wind up. When we were incorporated in the Cayman Islands in August 2007, 5,000,000 ordinary shares were authorized, and 50,000 ordinary shares were issued to Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi, at a par value of $0.01 each. On December 10, 2007, our company sold 2,632 ordinary shares to an investor at an aggregate consideration of $200,000. On June 8, 2009, in connection with our initial public offering, the Board of Directors approved a 42.7840667-to-1 split of ordinary shares and redeemable ordinary shares to shareholders of record as of such date. After giving effect to the share split of our ordinary shares and the completion of our initial public offering, we had 3,951,811 ordinary shares outstanding.

Off-Balance Sheet Arrangements. We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of any third parties. In addition, we have not entered into any derivative contracts that are indexed to our own shares and classified as shareholders equity, or that are not reflected in our 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. Moreover, we do not have any variable interest in an 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.

Capital Resources. To date we have financed our operations primarily through cash flows from financing operations. As of December 31, 2009 we had total assets of ¥170,986,668 ($25,049,689), of which cash amounted to ¥44,987,580 ($6,590,718), and net accounts receivable (including related party amounts) amounted to ¥92,747,015 ($13,587,514). Working capital amounted to ¥108,597,021 ($15,909,554) and shareholders equity amounted to ¥101,456,032 ($14,863,392). The current ratio equaled 2.78, up from 1.90 at June 30, 2009.

Cash from Operating Activities. Net cash used in operating activities was ¥16,912,247 ($2,477,658) in the six months ended December 31, 2009. Compared to the cash amount used in the operating activities, this was an increase of ¥16,225,746 ($2,381,480) compared to ¥656,501 ($96,178) cash used in operating activities for the six months ended December 31, 2008. The increase of receivables reflects the seasonal nature of our business. Our receivables typically increase in the first half calendar year, and we typically receive payments near the end of year, decreasing receivables. The reason for this seasonality is that most of our customers are Chinese state-owned companies and their payment of purchase follows the national budget, which only allows allocation to the operating oil field subsidiaries after July.

The increase in receivables was primarily due to an increase in business contracts in fiscal 2009. The increase in inventory purchased in advance was due to hardware purchases. The increase in accounts payable and accrued liabilities was due to increased purchases of raw materials and other goods. To protect our liquidity, we seek to pay our suppliers as shortly before payments are due as practicable. Both changes in account receivables and payables reflect the seasonal nature of our business. Our revenue has been subject to high seasonality and the revenue recognized in the first quarter is usually the smallest in proportion to that for the whole year in most cases, due to our clients budgeting and planning schedule. Nevertheless, we continued to experience steady demand for our services from our oil industrial client base.

Cash from Investing Activities. Net cash used in investing activities was ¥133,554 ($19,566) for the six months ended December 31, 2009, a decrease of ¥3,256,038 ($477,012) compared to the same period in 2008. This decrease in cash used in investing activities was primarily due to the operations we discontinued in 2008.

Cash from Financing Activities. Cash flows provided by financing activities amounted to ¥59,381,762 ($8,699,477) for the six months ended December 31, 2009 and cash flows used in financing activities amounted to ¥453,322 ($66,412) for the six months ended December 31, 2008. Our financing activities during this period included payback of notes payable and receipt of proceeds from our IPO.

Working Capital. Total current assets at December 31, 2009 amounted to ¥169,617,102 ($24,849,046), an increase of approximately ¥94,391,280 ($13,828,401) compared to ¥75,225,822 at June 30, 2009. The increase was attributable mainly to an increase in the amount of trade receivables resulting from higher revenues, increased inventories and our IPO.

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Current liabilities amounted to ¥61,020,081 ($8,939,492) at December 31, 2009, in comparison to ¥39,594,476 ($5,800,369) at June 30, 2009. This increase is attributable an increase in the number of projects we have undertaken and our need to order materials for those projects. Also, taxes payable increased significantly, and if we paid that amount at the end of 2009, our working capital might have been affected negatively. In addition, contracts signed during this period featured more guaranteed amounts. The deferred income also increased, leading to an increase of current liabilities.

The current ratio increased from 1.90 at June 30, 2009 to 2.78 at December 31, 2009. The change in our current ratio was primarily due to the IPO. We believe that this changing trend in the current ratio indicates strong operating liquidity for us.

Recently Enacted Accounting Standards

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51* (ASC Topic 810), which changes the accounting and reporting for minority interests. Minority interests will be recharacterized as noncontrolling interests and will be reported as a component of equity separate from the parent s equity, and purchases or sales of equity interests that do not result in a change in control will be accounted for as equity transactions. In addition, net income attributable to the noncontrolling interest will be included in net income and, upon a loss of control, the interest sold, as well as any interest retained, will be recorded at fair value with any gain or loss recognized in net income. SFAS No. 160 is effective for the Company beginning July 1, 2009, and will apply prospectively, except for the presentation and disclosure requirements, which will apply retrospectively. The Company believes the adoption of SFAS No. 160 will not have a material impact on the financial statements.

In December 2007, the FASB issued SFAS No. 141(R) (ASC Topic 805), *Business Combinations*, which replaces SFAS No. 141 (ASC Topic 805). The statement retains the fundamental requirements in SFAS No. 141 that the acquisition method of accounting (previously referred to as the purchase method of accounting) be used for all business combinations, but requires a number of changes, including changes in the way assets and liabilities are recognized as a result of business combinations. It also requires the capitalization of in-process research and development at fair value and requires the expensing of acquisition-related costs as incurred. In April 2009, the FASB issued FSP FAS 141(R)-1 (ASC Topic 805-10) which amends SFAS No. 141(R) (ASC Topic 805) by establishing a model to account for certain pre-acquisition contingencies. Under the FSP, an acquirer is required to recognize at fair value an asset acquired or a liability assumed in a business combination that arises from a contingency if the acquisition-date fair value of that asset or liability can be determined during the measurement period. If the acquisition-date fair value cannot be determined, then the acquirer should follow the recognition criteria in SFAS No. 5, *Accounting for Contingencies*, and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss an interpretation of FASB Statement No. 5*. SFAS No. 141(R) (ASC Topic 805) and FSP FAS 141(R)-1 (ASC Topic 805-10) are effective for us beginning July 1, 2009, and will apply prospectively to business combinations completed on or after that date. The impact of the adoption of SFAS No. 141(R) (ASC Topic 805-10) and FSP FAS 141(R)-1 (ASC Topic 805-10) will depend on the nature of acquisitions completed after the date of adoption.

In December 2008, the FASB issued FSP 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (ASC Topic 860), which promptly improves disclosures by public companies until the pending amendments to SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (ASC Topic 860) and FIN No. 46, *Consolidation of Variable Interest Entities* (revised December 2003) an interpretation of ARB No. 51 (FIN 46(R)) (ASC Topic 810), are finalized and approved by the Board. The FSP amends SFAS No. 140 to require public companies to provide additional disclosures about transfers of financial assets and variable interests in qualifying special-purpose entities. It also amends FIN 46(R) to require public companies to provide additional disclosures about their involvement with variable interest entities. This FSP is effective for reporting periods ending after December 15, 2008. The Company is currently assessing the effect of SFAS 140-4 (ASC Topic 860-10) and FIN 46(R)-8 (ASC Topic 810-10) on its consolidated financial position and results of operations.

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, which is effective for the Company beginning July 1, 2010. This Statement amends Financial Accounting Standards Board

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Interpretation (FIN) No. 46(R), *Consolidation of Variable Interest Entities an interpretation of ARB No. 51*, to require revised evaluations of whether entities represent variable interest entities, ongoing assessments of control over such entities, and additional disclosures for variable interests. The Company believes the adoption of this pronouncement will not have a material impact on the financial statements.

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* or SFAS No. 168. SFAS No. 168 (ASC Topic 105) will become the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related accounting literature. SFAS No. 168 (ASC Topic 105) reorganizes the thousands of GAAP pronouncements into roughly 90 accounting topics and displays them using a consistent structure. Also included is relevant SEC guidance organized using the same topical structure in separate sections. SFAS No. 168(ASC Topic 105) will be effective for financial statements issued for reporting periods ending after September 15, 2009. This will have an impact on the Company s financial disclosures since all future references to authoritative accounting literature will be references in accordance with SFAS No. 168.

In June 2009, the FASB issued Accounting Standards Update No. 2009-01, Generally Accepted Accounting Principles (ASC Topic 105) which establishes the FASB Accounting Standards Codification (the Codification or ASC) as the official single source of authoritative U.S. generally accepted accounting principles (GAAP). All existing accounting standards are superseded. All other accounting guidance not included in the Codification will be considered non-authoritative. The Codification also includes all relevant Securities and Exchange Commission (SEC) guidance organized using the same topical structure in separate sections within the Codification.

Following the Codification, the Board will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates (ASU) which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

The Codification is not intended to change GAAP, but it will change the way GAAP is organized and presented. The Codification is effective for our third-quarter 2009 financial statements and the principal impact on our financial statements is limited to disclosures as all future references to authoritative accounting literature will be referenced in accordance with the Codification. In order to ease the transition to the Codification, we are providin