Recon Technology, Ltd
Form 10-Q/A
January 31, 2012

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q/A

(Amendment No. 1)

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended December 31, 2010

¨ 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 incorporation or organization)	(I.R.S. employer identification number)

1902 Building C, King Long International Mansion

9 Fulin Road, Beijing 100107

People's Republic of China

(Address of principal executive offices and zip code)

+86 (10) 8494-5799

(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 ordinary shares, as of the latest practicable date. The Company is authorized to issue 25,000,000 ordinary shares. As of the date of this report, the Company has issued and outstanding 3,951,811 shares.

EXPLANATORY NOTE

This first amendment to Quarterly Report on Form 10-Q/A ("Amendment No. 1") is being filed by Recon Technology, Ltd (the "Company") to amend the Company's Quarterly Report on Form 10-Q for the three and six months ended December 31, 2010 originally filed with the Securities and Exchange Commission (the "SEC") on February 14, 2011 (the "Original Filing").

On December 6, 2011, the Audit Committee of the Company concluded that the unaudited consolidated financial statements included in the Original Filing should no longer be relied upon. In particular, the Company's Audit Committee concluded that, in light of a December 16, 2010 change in the equity ownership of Jining ENI Energy Technology Co., Ltd., a Chinese company ("ENI"), the Company ceased to have the power to direct the activities of ENI that most significantly affect its economic performance as of the date of transfer. As a result, ENI ceased to be a variable interest entity ("VIE") of the Company and its financial results should not have been consolidated with those of the Company beginning December 16, 2010. In addition, based on the information that has made available to management subsequent to the Original Filing for the quarter ended December 31, 2010, the Company realized there was an overstatement of reported revenue that was caused by an input error. As a result, the Company is filing this Amendment No. 1 to amend and restate the Original Filing.

RECON TECHNOLOGY, LTD

FORM 10-Q/A

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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 similar words, although so 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.

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 condensed 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 with limited liability incorporated in 2007 under the laws of the Cayman Islands. Headquartered in Beijing, we provide products and services to oil and gas companies and their affiliates through our contractually controlled affiliates ("variable interest entities" or "VIEs"), Beijing BHD Petroleum Technology Co. Ltd. ("BHD"), Nanjing Recon Technology Co., Ltd. ("Nanjing Recon") and Jining ENI Energy Technology Co., Ltd. ("ENI") (through December 15, 2010) (collectively, the "Domestic Companies"). ENI was one of our contractually controlled affiliates until December 16, 2010, when we ceased to have the power to direct its activities following a change of ownership. As a result of such change, ENI ceased to be our VIE starting December 16, 2010.

We are the center of strategic management, financial control and human resources allocation for the Domestic Companies. Through our contractual relationships with the Domestic Companies, we provide equipment, tools and other hardware related to oilfield 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.

We derive our revenues from the sales and provision of (1) hardware products, (2) software products, and (3) services. Our products and services involve most of the key procedures of the extraction and production of oil and gas, and include automation systems, equipment, tools and on-site technical services. For the six months ended December 31, 2010, 96.09% of our revenue came from the sales of hardware and 3.91% from the provision of our services. We did not recognize any revenues from software sales during the six months ended December 31, 2010. For the same period in 2009, hardware sales, software sales, and services constituted 91.46%, 8.22% and 0.31%, respectively, of our revenues.

Our VIEs provide the oil and gas industry with equipment, production technologies and automation and services.

- Nanjing Recon: Nanjing Recon is a high-tech company that specializes in automation services for oilfield companies. It mainly focuses on providing automation solutions to the oil exploration industry, including monitoring wells, automatic metering to the joint station production, process monitor, and a variety of oilfield equipment and control systems.

- BHD: BHD is a high-tech company that specializes in transportation equipment and stimulation productions and services. Possessing proprietary patents and substantial industry experience, BHD has built up stable and strong working relationships with the major oilfields in China.

Products and Services

We provide the following three types of integrated products and services for our customers.

Equipment for Oil and Gas Production and Transportation

High-Efficiency Heating Furnaces. Crude petroleum contains certain impurities that must be removed before it 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. BHD researched, developed and implemented a new oilfield furnace that is advanced, highly automated, reliable, easily operable, and safe and highly heat-efficient (90% efficiency).

Burner. We serve as an agent for the Unigas Burner, which is designed and manufactured by UNIGAS, a European burning equipment production company. The burner we provide has the following characteristics: high degree of automation, energy conservation, high turn-down ratio, high security and environmental safety.

Separator. The test separator is the key measurement device for gas and oil in metering plants. Oil and gas mixture sprays on the oil block cap after entering into the separator through the oil pipeline. The diffused oil falls along the pipe wall to the separator bottom and through the draw-off pipe. The gas rises due to its low density and changes the flow direction after concentrating by the separator umbrella. In the process, the small oil droplets in the gas adhere to the umbrella wall and fall along the wall of the pipe. The de-oiled gas enters the pipeline through the freeing pipe at the top of the separator for measurement.

Oil and Gas Production Improvement Techniques

Packers of Fracturing. This utility model is used in concert with the security joint, hydraulic anchor, and slide brushing of sand spray in the well. It is used for easy seat sealing and sand-up prevention. The utility model reduces desilting volume and prevents sand-up which makes the deblocking processes easier to realize. The back flushing is sand-stick proof.

Production Packer. At varying withdrawal points, the production packer separates different oil layers and protects the oil pipe from sand and permeation, promoting the recovery ratio.

Water Injection Packer. The water injection packer injects water into different layers rather than injecting on a large scale, which can reduce cost and promote effectiveness.

Fissure Shaper. This is our proprietary product that is used along with a perforating gun to effectively increase perforation depth by between 46% and 80%, shape stratum fissures, improve stratum diversion capability and, as a result, improve our ability to locate oilfields and increase the output of oil wells.

Sand Prevention in Oil and Water Well. This technique processes additives that are resistant to elevated temperatures into “resin sand” which is transported to the bottom of the well via carrying fluid. The “resin sand” goes through the borehole, pilling up and compacting at the borehole and oil vacancy layer. An artificial borehole wall is then formed, functioning as a means of sand prevention. This sand prevention technique has been adapted to more than 100 wells, including heavy oil wells, light oil wells, water wells and gas wells, with a 100% success rate and a 98% effective rate.

Water Locating and Plugging Technique. High water cut affects the normal production of oilfields. Previously, there was no sophisticated method for water locating and tubular column plugging in China. The mechanical water locating and tubular column plugging technique we have developed resolves the problem of high water cut wells. This technique conducts a self-sealing test during multi-stage usage and is reliable to separate different production sets effectively. The water location switch forms a complete set by which the water locating and plugging can be finished in one trip. The tubular column is adaptable to several oil drilling methods and is available for water locating and plugging in second and third class layers.

Fracture Acidizing. We inject acid to layers under pressure which can form or expand fissures. The treatment process of the acid is defined as fracture acidizing. The technique is mainly adapted to oil and gas wells that are blocked up relatively deeply, or the ones in the zones of low permeability.

Electronic Break-Down Service. This service resolves block-up and freezing problems by generating heat from the electric resistivity of the drive pipe and utilizing a loop tank composed of an oil pipe and a drive pipe. This technique saves energy and is environment friendly. It can increase the production of oilfields that are in the middle and later periods.

Automation System and Services

Pumping Unit Controller. Functions as a monitor to the pumping unit, and also collects data for load, pressure, voltage, startup and shutdown control.

RTU Monitor. Collects gas well pressure data.

Wireless Dynamometer and Wireless Pressure Gauge. These products replace wired technology with cordless displacement sensor technology. They are easy to install and significantly reduce the work load associated with cable laying.

Electric Multi-way Valve for Oilfield Metering Station Flow Control. This multi-way valve is used before the test separator to replace the existing three valve manifolds. It facilitates the electronic control of the connection of the oil lead pipeline with the separator.

Natural Gas Flow Computer System. The flow computer system is used in natural gas stations and gas distribution stations to measure flow.

Recon SCADA Oilfield Monitor and Data Acquisition System. Recon SCADA is a system which applies to the oil well, measurement station, and the union station for supervision and data collection.

EPC Service of Pipeline SCADA System. A service technique for pipeline monitoring and data acquisition after crude oil transmission.

EPC Service of Oil and Gas Wells SCADA System. A service technique for monitoring and data acquisition of oil wells and natural gas wells.

EPC Service of Oilfield Video Surveillance and Control System. A video surveillance technique for controlling the oil and gas wellhead area and the measurement station area.

Technique Service for "Digital oilfield" Transformation. Includes engineering technique services such as oil and gas SCADA system, video surveillance and control system and communication systems.

Factors Affecting Our Business

Business Outlook

The oilfield engineering and technical service industry is generally divided into five sections: (1) exploration, (2) drilling and completion, (3) testing and logging, (4) production, and (5) oilfield construction. Thus far our businesses have only been involved in production. Our management plans to expand our core business, move into new markets, and develop new businesses. Management anticipates great opportunities both in new markets and our existing markets. We believe that many existing wells and oilfields need to improve or renew their equipment and service to maintain production and techniques and services like ours will be needed as new oil and gas fields are developed. In the next three years, we will focus on:

Measuring Equipment and Service. Our priority is the development of our well, pipeline and oilfield SCADA engineering project contracting service, oilfield video surveillance and control system, and reforming technical support service. According to conservative estimates, the potential market for our wireless indicator and remote monitoring system (SCADA) is approximately RMB 5 billion.

Gathering and Transferring Equipment. (1) Furnace. We estimate the market demand at about 2,000 units per year, of which 500 are expected to come from new wells and 1,500 are expected to come from reconstruction of old wells. The potential market is estimated at RMB 800 million (approximately $121 million) based on an average price of RMB 400,000 (approximately $60,498) per furnace. (2) Oil/water separator. We estimate the market demand at about 800 units per year, of which 300 are expected to come from new wells and 500 are expected to come from reconstruction of old wells. The potential market is about RMB 400 million (approximately $60 million) based on an average price of RMB 500,000 (approximately $75,622). (3) Burner. We estimate the market demand at about 5,000 units per year, of which 1,000 are expected to come from new wells and 4,000 are expected to come from reconstruction of old wells. The potential market is about RMB 300 million (approximately $45 million) based on an average unit price of RMB 60,000 (approximately $9,075).

New Business. Along with the opening of the oilfield service market to private companies, we plan to establish our own service team equipped with work-over rigs (specialized equipment used during the operation of well repairing) and coiled tubing machines. We do not currently have a timeline in place for the establishment of this service team. Only a few companies can provide this business in China at present.

Growth Strategy

As a smaller domestic company, it is our basic strategy to focus on developing our onshore oilfield business, that is, the upstream of the industry. Due to the remote location and difficult environments of China's oil and gas fields, foreign competitors rarely enter those areas.

Large domestic oil companies prefer to focus on their exploration and development businesses to earn higher margins and keep their competitive advantage. With regard to private oilfield service companies, we estimate that approximately 90% specialize in the manufacture of drilling and production equipment. Thus, the market for technical support and project service is still in its early stage. Our management insists on providing high quality products and service in the oilfield where we have a geographical advantage. This allows us to avoid conflicts of interest with bigger suppliers of drilling equipment and keep our position within the market segment. Our mission is to increase the automation and safety levels of industrial petroleum production in China, and improve the underdeveloped working process and management mode by using advanced technologies. At the same time, we are always looking to improve our business and to increase our earning capability.

Industry and Recent Developments

Oilfield drilling and production equipment and engineering technique services are applied in the process of oil and gas extraction. Therefore, the exploration and exploitation activities of petroleum companies directly influences demand for oilfield technical services and corresponding equipment. The number of new oil and gas wells each year is a key indicator of the market and reflects the prosperity of the oilfield service industry. China is the world's second-largest petroleum producing country, with nearly 30,000 wells drilled and annual drill depths of 49,000,000 meters. In the long run, factors affecting the development of petroleum companies include prices of oil and gas, and China’s national energy strategy. In the short to medium term, petroleum companies plan their development activities according to the level of demand.

Thus, the level of demand for oil and gas in the short- to medium-term affects the number of oil and gas wells. Meanwhile, well prospecting is done to ensure the supply of oil and gas in the medium to long term. At present, China is in shortage of oil and gas. The difference between supply and demand is growing. For the three state-owned petroleum companies, the top priority is to ensure the nation supply and to promote stable and increased oilfield production. The capital expenditures are determined by the national energy strategy to a large extent. Under such circumstances, despite the adverse domestic and international market conditions influencing the Chinese oil market in 2009 and 2010, the investment by petroleum companies to upstream prospecting and development continues to increase. Advanced oilfield drill equipment and technique services are in greater demand, as petroleum companies make efforts to promote effectiveness and reduce costs.

The Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment (the “New 36 Guidelines on Non-State-Owned Economy”) promulgated in 2010 by the State encourages private investors to take part in oil and natural gas construction, and supports private enterprise investors entering into the exploration and development of oilfield. As exploration of oil and gas fields involves a wide range of advanced technologies, it is expected that in the future the private investors investing in oil and gas field exploration will seek out general contracting and integrated services. We believe this will bring integrated service projects to our company.

Recently, China's dependence on imported oil exceeded 50%, and an increasingly serious "gas shortage" also put stress on China's energy supply. The government has decided to invest more in the construction of gas storage and long-distance natural gas transportation pipeline. Our management believes our current product lines and experience in pipeline transportation and monitoring and development of automation products could help us grow rapidly and develop to be a leader in this segment of the oilfield service industry.

Factors Affecting Our Results of Operations — Generally

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

- the amount of spending by our 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;
- competition and related pricing pressure from other oilfield service solution providers, especially those targeting the Chinese oil and gas industry;
- the ongoing development of the oilfield service market in China; and
- inflation and other macroeconomic 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, in terms of the proportion of our business dedicated to large companies and our ability to successfully develop, introduce and market new solutions and services;
- our ability to increase our revenues from both old and new customers in the oil and gas industry in China;
- our ability to effectively manage our operating costs and expenses; and
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our ability to effectively implement any targeted acquisitions and/or strategic alliances so as to provide efficient access to markets and industries in the oil and gas industry in China.

Critical Accounting Policies and Estimates

Estimates and Assumptions

We prepare our unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America U.S. GAAP, which require 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 quarterly report. 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.

Consolidation of VIEs

We recognize an entity as a VIE if it either (i) has insufficient equity to permit the entity to finance its activities without additional subordinated financial support or (ii) has equity investors who lack the characteristics of a controlling financial interest. We consolidate a VIE as its primary beneficiary when we have both the power to direct the activities that most significantly impact the entity's economic performance and the obligation to absorb losses or the right to receive benefits from the entity that could potentially be significant to the VIE.

Assets recognized as a result of consolidating VIEs do not represent additional assets that could be used to satisfy claims against our general assets. Conversely, liabilities recognized as a result of consolidating these VIEs do not represent additional claims on our general assets; rather, they represent claims against the specific assets of the consolidated VIEs.

Revenue Recognition

We recognize revenue when the following four criteria are met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services have been provided, (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 the Company has 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.

Software

The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with the provisions of ASC 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. Revenue is not recognized until completion of the contracts and receipt of acceptance statements.

Services

The Company provides services to improve software functions and system requirements on separated fixed-price contracts. Revenue is recognized when services are completed and acceptance is determined by a completion report signed by the customer.

Deferred income represents unearned amounts billed to customers related to sales contracts.

Cost of Revenues

When the criteria for revenue recognition have been met, costs incurred are recognized as cost of revenue. Cost of revenues includes wages, materials, handling charges, the cost of purchased equipment and pipes, and other expenses associated with manufactured products and services provided to customers. 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.

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 customers and notes payable approximate fair value because of the immediate or short-term maturity of these financial instruments.

Allowance for Doubtful Accounts

Trade receivables are carried at original invoiced amount less a provision for any potential uncollectible amounts. Provisions are applied to trade receivables where events or changes in circumstances indicate that the balance may not be collectible. The identification of doubtful accounts 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 ¥1,089,331 and ¥1,550,695 ($234,534) on June 30 and December 31, 2010, respectively.

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:

Items	Useful life
Motor Vehicles	5-10 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.

Depreciation expense was ¥170,864 and ¥201,232 ($30,435) for the six months ended December 31, 2009 and 2010, respectively.

	June 30, 2010 RMB	December 31, 2010 RMB (As Restated)	December 31, 2010 U.S. Dollars (As Restated)
Motor vehicles	¥1,796,955	¥ 1,716,120	$ 259,554
Office equipment and fixtures	450,715	234,473	35,463
Leasehold improvement	426,181	149,243	22,572
Total property and equipment	2,673,851	2,099,836	317,589
Less: Accumulated depreciation	(1,190,970)	(955,045)	(144,445)
Property and equipment, net	¥1,482,881	¥ 1,144,791	$ 173,144

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

The following consolidated results of operations include the result of operations of the Company, all of its subsidiaries and VIEs, including BHD, Nanjing Recon and ENI (through December 15, 2010). The results of operations are of those of the VIEs. On December 16, 2010, ENI changed its equity ownership. We ceased to have the power to direct the activities of ENI which most significantly impact its economic performance as of that date. As a result of the Company's determination to deconsolidate ENI, ENI's results of operations have been consolidated in the Company's results of operations only through December 15, 2010.

Three Months Ended December 31, 2010 Compared to Three Months Ended December 31, 2009

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

Revenue

	For the Three Months Ended December 31,				Change attributable to:	
	2010 (As restated)	2009	Increase (Decrease)	Percentage Change	Deconsolidation of ENI	Operations
Hardware	¥30,072,635	¥47,081,742	¥(17,009,107)	(36.13)%	¥(14,677,491)	¥(2,331,616)
Service	2,111,111	2,992,353	(881,242)	(29.45)%	—	(881,242)
Total Revenue	¥32,183,746	¥50,074,095	¥(17,890,349)	(35.73)%	¥(14,677,491)	¥(3,212,858)

Revenues. Our total revenues were ¥32,183,746 ($4,867,622) for the three months ended December 31, 2010, a decrease of 35.73%, or ¥17,890,348, from ¥50,074,095 during the same period in 2009. During this three-month period, our automation business decreased by 13.23%, sales of transportation equipment decreased by 9.19%, and sales of accessory decreased by to 71.96%, respectively. The decrease in our revenues for the three-month period was due to the following challenges:

(1) The decrease of hardware sales was mainly caused by the deconsolidation of ENI and the sharp decrease of accessory trading business, in which ENI acted as an agent to obtain purchase orders on our behalf. In light of the ownership change of ENI on December 16, 2010, the Company's Audit Committee concluded that ENI is no longer a VIE and the Company should not include ENI's operations in the Company's operating results starting December 16, 2010. ENI's operations also decreased substantially compared to the same period the year before. Some of ENI's clients, such as Sinopec, adjusted their procurement policies to increase direct purchases from brand manufacturers rather than purchase from agency companies, thus decreasing ENI's revenues as an agent for hardware sales. Accordingly, revenue decreased substantially, too. During the three-month reporting period ended

December 15, 2010 when ENI was a VIE of the Company, it contributed ¥5,719,888 ($865,098) in trading business revenue, a decrease of ¥14,677,491 ($2,219,893) from ¥20,397,349 during the three-month period ended December 31, 2009.

(2) To adjust and correct an overstatement of reported revenue, based on information that was made available to management subsequent to the Original Filing for the quarter ended December 31, 2010, the Company realized that there was a double-counting of revenues from 3 specific contracts which amounted to RMB 5,191,897 ($785,247). The double-counting was caused by an input error that was not detected during the normal course of the quarter book close. To determine the nature and extent of this accounting error, the Company performed a thorough review of all revenues recognized during the quarter and concluded that the error identified was a mistake which resulted in the overstatement of the Company's reported revenue, tax payable and accounts receivable as of December 31, 2010. To correct the overstatement, the Company recorded an adjustment in this amended and restated quarterly report on Form 10-Q/A to reduce revenue by RMB 5,191,897, imposed value-added tax by RMB 882,663, and reported accounts receivable by RMB 6,074,520.

(3) Project delays also contributed to the decrease in our revenues. Some of our clients experienced delays in oilfield construction, which in turn caused delays in our projects. Therefore, we could not provide equipment to our clients and could not recognize the corresponding revenue as anticipated.

Even though ENI ceased to be one of our VIEs and its operating results are deconsolidated from ours starting December 16, 2010, management believes such change will not determine our long-term business development for the following reasons:

(1) We continue to develop and expand our operations in oilfields, such as some of the subsidiaries of CNPC and Sinopec, which do not overlap with ENI's existing business and were not affected by its deconsolidation.

(2) ENI was predominantly focused on trading, a business model vulnerable to and subject to frustration by the changes in its major clients' procurement policies.

(3) Our management is placing a greater emphasis on our own branded products and our services. The deconsolidation of ENI allows us to allocate working capital and focus on the growth of our own product offering.

Cost and Margin

	For the Three Months Ended December 31,					
	2010 (As restated)	2009	Increase (Decrease)	Percentage Change	Change attributable to: Deconsolidation of ENI	Operations
Total Revenue	¥32,183,746	¥50,074,095	¥(17,890,349)	(35.73)%	¥(14,677,491)	¥(3,212,858)
Cost of Revenue	20,492,176	25,396,611	(4,904,435)	(19.31)%	(7,465,140)	2,560,704
Gross Profit	¥11,691,570	¥24,677,484	¥(12,985,914)	(52.62)%	¥(7,212,351)	¥(5,773,562)
Margin %	36.33%	49.28%	(12.95)%			

<u>Cost of Revenues</u>. Our cost of revenues includes raw materials and costs related to the design, implementation, delivery and maintenance of products and services. We are a light-asset company, and all materials and components we need can be purchased or manufactured under contract. Usually the price of electronic components does not fluctuate substantially, due to competitive forces, and it will not significantly affect our cost. The sale of specialized equipment and incentive chemical products can be influenced directly if the price for metal and oil changes. Additionally, the price for some imported accessories designated by our clients can also impact our cost.

Our cost of revenues decreased, from ¥25,396,611 in the three months ended December 31, 2009 to ¥20,492,176 ($3,099,334) for the same period of 2010, a decrease of ¥4,904,435 ($741,770), or 19.31%. As a percentage of revenues, our cost of revenues increased from 50.72% in the three months ended December 31, 2009 to 63.67% in the same period of 2010.

(1) The decrease of costs was mainly caused by the deconsolidation of ENI and its decreasing operation. Cost of revenues actually increased due to the fact that ENI’s sales and cost of sales were not included as part of our operations since December 16, 2010; and

(2) There was also some supplementary equipment used for projects pursuant to our clients’ specific requirement, which also caused the increase in cost.

Gross Profit. For the three months ended December 31, 2010, our gross profit decreased to ¥11,691,570 ($1,768,288) from ¥24,677,484 for the same period in 2009, a decrease of ¥12,985,914 ($1,964,051), or 52.62%. For the three months ended December 31, 2010, our gross profit as a percentage of revenue decreased to 36.33%, from 49.28% for the same period in 2009. The erosion in gross margin was caused mainly by:

(1) The deconsolidation of ENI, accounting for almost half of the drop in gross profit in the amount of ¥7,212,351 ($1,090,830) for the three-month period; and

(2) Project delays as discussed above, which is not expected to have a significant impact on the Company's long-term operating results when these projects are completed.

A higher margin is very important to ensure the growth of our business. Additionally, as more domestic peer companies go public in the Chinese capital markets, the oilfield service industry is becoming more competitive. To maintain our position and profitability in our market, our management plan to focus our efforts on research and development of our products and expansion of service offerings. During the past two years, we have increased our investment of resources in our research and development, and are in the process of obtaining two more patents and other intellectual property rights.

Due to the capital- and technology-intensive nature of our industry, continued capital investment and a higher barrier to entry make it possible for equipment suppliers and service providers to earn high profits. It is our strategy to improve our operating results by winning more projects and increasing both the type and the volume of services we provide. To that end, we aim to increase our registered capital so as to be eligible for bigger projects. We are also developing new products to expand the products and services we offer.

Operating Expenses

	For the Three Months Ended December 31,				Change attributable to:	
	2010 (As restated)	2009	Increase (Decrease)	Percentage Change	Deconsolidation of ENI	Operations
Selling and distribution expenses	¥3,272,318	¥3,863,886	¥(591,568)	(15.31)%	¥(5,997)	¥(585,571)
% of revenue	10.17%	7.72%	2.0%			
General and administrative expenses	19,082,366	3,520,245	15,562,121	442.07%	13,522,537	2,039,584
% of revenue	59.29%	7.03%	52.26%			
Operating expenses	¥22,354,684	¥7,384,131	¥14,970,553	202.74%	¥13,516,540	¥1,454,013

Selling and Distribution Expenses. Selling and distribution expenses consist primarily of salaries and related expenditures for the sales and marketing department, sales commissions, costs of marketing programs (including public relations, advertising and trade shows) and an allocation of our facilities and depreciation expenses. Selling expenses decreased by 15.31%, from ¥3,863,886 for the three months ended December 31, 2009 to ¥3,272,318 ($494,921) for the same period of 2010. This decrease is mainly attributed to the deconsolidation of ENI. The percentage of selling expenses in relation to revenue increased from 7.72% to 10.17%, mainly caused by the decrease in revenue. Our management believes the selling and distribution expenses are reasonable, and, as our revenue returns to a normal level, the percentage of revenue will decrease and remain stable in the long run.

General and Administrative Expenses. General and administrative expenses consist primarily of costs from our human resources, facilities costs, depreciation expenses, professional advisor fees, audit fees and other expenses incurred in connection with general operations. General and administrative expenses increased from ¥3,520,245 for three months ended December 31, 2009 to ¥19,082,366 ($2,886,108) for the same period of 2010. General and administrative expenses were 7.03% of total revenues for the three months ended December 31, 2009 and 59.29% of total revenues for the same period of 2010. The increase was primarily attributable to:

(a) The write-off of ENI's purchase advance that was not deemed recoverable, which amounted to ¥13,662,380 ($2,066,363); and

(b) The increase in R&D expenses for the development of our own branded products and technical improvement, additional expenses related to our annual shareholder meeting, and an increase of expenses related to our planned secondary offering, which was withdrawn due to unfavorable market conditions.

Net Income

	For the Three Months Ended December 31,			
	2010	2009	Increase (Decrease)	Percentage Change
Income (loss) from operations	¥(10,663,115)	¥17,293,353	¥(27,956,468)	(161.66)%
Subsidy income	—	1,131,709	(1,131,709)	(100.00)%
Interest and other loss	(165,551)	(23,199)	(142,352)	(613.61)%
Loss on deconsolidation	(8,989,614)	—	(8,989,614)	(100.00)%
Income (loss) before income taxes and non-controlling interest	(19,818,280)	18,401,863	(38,220,143)	(207.70)%
Provision for income tax	(198,259)	(4,414,087)	4,215,828	(95.51)%
Net income (loss)	(20,016,539)	13,987,776	(34,004,315)	(243.10)%
Net income attributable to non-controlling interest	(660,913)	(1,433,624)	772,711	(53.90)%
Net income attributable to ordinary shareholders	¥(20,677,452)	¥12,554,152	¥(33,231,604)	(264.71)%

Income (loss) from Operations. Due to the deconsolidation of ENI, project delays caused by construction delays experienced by some of our customers, and the extra expenses associated with our annual meeting and our withdrawn second offering, our revenue during the period decreased while our administrative expenses increased, causing our income from operations for the period to decrease by ¥27,956,468 to a loss of ¥10,663,115 ($1,612,740) for the three months ended December 31, 2010, compared to an income of ¥17,293,353 for the same period of 2009.

Subsidy Income. We received grants of ¥1,131,709 during the three months ended December 31, 2009. The grants were given by the government in relation to the initial public offering of the Company's ordinary shares, in the form of income tax return to support local companies in developing high technology and improving existing products. We did not receive this type of grant during the same period of 2010 and do not expect to receive such grants in the future.

Loss on Deconsolidation. As a result of the deconsolidation of ENI, we incurred a deconsolidation loss of ¥8,989,614 ($1,359,632), which amount was measured as the difference between (a) the aggregate of (i) the fair value of any consideration received, (ii) the fair value of the retained non-controlling investment in ENI at the date in which ENI was deconsolidated, and (iii) the carrying amount of any non-controlling interest in ENI; and (b) the carrying value of the net assets and liabilities of ENI as of December 15, 2010. Our management believes this was a one-time loss because we are in the process of taking a series of corporate actions to reinforce the VIE structure to avoid any similar incidents in the future.

Income Tax Expense. Income taxes are provided based upon the liability method of accounting pursuant to ASC No. 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. 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 25%; however, Nanjing Recon and BHD were granted the certification of High Technology Enterprise and are taxed at a rate of 15% for taxable income generated. The applicable tax rate for each of our subsidiaries changed in the past few years because of their qualifications and different local policies. For calendar year 2010, Nanjing Recon and BHD were taxed at a rate of 15% and ENI was taxed at 25%. Our effective EIT burden will vary, depending on which of our domestic companies generate greater revenue.

Income tax expense for three months ended December 31, 2009 and 2010 was ¥4,414,087 and ¥198,259 ($29,986), respectively. This decrease was mainly due to a decrease in taxable operating income and a lower effective tax rate.

Net Income (Loss) Attributable to Ordinary Shareholders. As a result of the factors described above, there was a net loss of ¥20,677,452 ($3,127,356) attributable to ordinary shareholders for the three months ended December 31, 2010, a decrease of 264.71% or ¥33,231,604, from a net income of ¥12,554,153 for the same period of 2009.

Adjusted EBITDA

Adjusted EBITDA. We define adjusted EBITDA as net income (loss) adjusted for income tax expense, interest expense, non-cash stock compensation expense, depreciation, amortization and accretion expense and loss resulting from the deconsolidation of a VIE. We think it is useful to an equity investor in evaluating our operating performance because: (1) it is widely used by investors in our industry to measure a company's operating performance without regard to items such as interest expense, depreciation and amortization, which can vary substantially from company to company depending upon accounting methods and book value of assets, capital structure and the method by which the assets were acquired; and (2) it helps investors more meaningfully evaluate and compare the results of our operations from period to period by removing the impact of our capital structure and asset base from our operating results.

Adjusted EBITDA decreased by ¥29,050,358 ($4,393,913), or 153.16%, to a loss of ¥10,082,623 ($1,524,944) for the three months ended December 31, 2010 compared to the same period in 2009. This was due to adverse operating results of ENI, especially the non-collectable purchase advance, loss of deconsolidation, the delays in projects caused by construction delays at some of our customers, and the extra expenses associated with our annual meeting and our withdrawn secondary offering. These factors caused revenues during the period to decrease and our administrative expenses to increase. Compared to net income attributable to ordinary shareholders, we believe EBITDA more accurately reflects our operations.

	For the Three Months Ended December 31,				
	2010 RMB	2009 RMB	Increase (Decrease)	Percentage Change	2010 USD
Reconciliation of Adjusted EBITDA to Net Income (Loss):					
Net income (loss)	¥(20,016,539)	¥13,987,776	¥(34,004,315)	(243.10)%	$(3,027,396)
Income tax expense	198,259	4,414,087	(4,215,828)	(95.51)%	29,986
Interest expense	212,030	36,069	175,961	487.85%	32,068
Stock compensation expense	431,378	442,613	(11,235)	(2.50)%	65,244
Depreciation, amortization and accretion	102,635	87,790	14,845	16.91%	30,745
Loss of deconsolidation	8,989,614	—	8,989,614	100.00%	1,359,632
Adjusted EBITDA	¥(10,082,623)	¥18,967,735	¥(29,050,358)	(153.16)%	$(1,509,721)

Six Months Ended December 31, 2010 Compared to Six Months Ended December 31, 2009

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

Revenue

	For the Six Months Ended December 31,					
			Increase	Percentage	Change attributable to:	
	2010	2009	(Decrease)	Change	Deconsolidation of ENI	Operations
Hardware	¥51,871,946	¥66,353,385	¥(14,481,439)	(21.82)%	¥(12,321,801)	¥(2,159,638)
Service	2,111,111	5,965,812	(3,854,701)	(64.61)%	—	(3,854,701)
Software	—	226,496	(226,496)	(100.00)%	—	(226,496)
Total Revenue	¥53,983,057	¥72,545,692	¥(18,562,635)	(25.59)%	¥(12,321,801)	¥(6,240,835)

Revenues. Our total revenues were ¥53,983,057 ($8,164,654), a decrease of 25.59% from ¥72,545,692 for the six months ended December 31, 2009. During this six-month period, our automation business decreased by 28.47%, sales of transportation equipment decreased by 12.23% and our accessory sales business decreased by 65.96%. This was mainly attributable to the deconsolidation of ENI's operating results starting December 15, 2010, together with ENI's shrinking accessory agency business prior to such deconsolidation and delays in some of our projects caused by our clients' field construction.

Cost and Margin

	For the Six Months Ended December 31,				Change attributable to:	
	2010	2009	Increase (Decrease)	Percentage Change	Deconsolidation of ENI	Operations
Total Revenue	¥53,983,057	¥72,545,692	¥(18,562,635)	(25.59)%	¥(12,321,801)	¥(6,240,835)
Cost of Revenue	34,573,669	41,469,158	(6,895,489)	(16.63)%	(6,978,512)	83,022
Gross Profit	¥19,409,388	¥31,076,534	¥(11,667,146)	(37.54)%	¥(5,343,289)	¥(6,323,857)
Margin %	35.95%	42.84%	(6.88)%			

Cost of Revenues. Our cost of revenues decreased by 16.63%, or ¥6,895,489 ($1,042,906), from ¥41,469,158 for the six months ended December 31, 2009 to ¥34,573,669 ($5,229,086) for the same period of 2010. As a percentage of revenues, our cost of revenues increased from 57.16% for the six months ended December 31, 2009 to 64.05% for the same period of 2010. This increase was a result of (1) price increase for our raw materials and for the products ENI sells as an agent, and (2) delays in certain key projects.

Gross Profit. For the six months ended December 31, 2010, our gross profit decreased to ¥19,409,388 ($2,935,568) from ¥31,076,535 for the same period in 2009, a decrease of ¥11,667,146 ($1,764,595), or approximately 37.54%. For the six months ended December 31, 2010, our gross profit as a percentage of revenue decreased to 35.95%, from 42.84% for the same period in 2009. Our management believes it is necessary to adjust our business structure to maintain a higher margin ratio. We plan to accomplish this by focusing more on our automation business and our own branded products and services, while shifting our focus away from agency sales, which provide a lower margin. As we deconsolidated ENI as one of our VIEs on December 16, 2010, we believe we are moving more quickly towards such a goal.

Expenses

For the Six Months Ended December 31,				Change attributable to:	
2010	2009	Increase (Decrease)	Percentage Change	Deconsolidation of ENI	Operations
¥5,075,471	¥6,023,098	¥(947,627)	(15.73)%	¥181,532	¥(1,129,159)

Selling and distribution expenses						
% of revenue	9.40 %	8.30 %	1.1 %			
General and administrative expenses	23,304,180	6,465,900	16,838,280	260.42 %	13,847,068	2,991,212
% of revenue	43.17 %	8.91 %	34.26 %			
Operating expenses	¥28,379,651	¥12,488,998	¥15,890,653	127.24 %	¥14,028,600	¥1,862,053

Selling and Distribution Expenses. Selling expenses decreased by 15.73%, from ¥6,023,098 for the six months ended December 31, 2009 to ¥5,075,471 ($767,638) for the same period of 2010. This decrease is mainly attributable to our stable long-term relationship with CNPC and Sinopec, as expenses associated with maintaining their business decreased.

General and Administrative Expenses. General and administrative expenses increased by 260.42%, or ¥16,838,280 ($2,546,701), from ¥6,465,900 for the six months ended December 31, 2009 to ¥23,304,180 ($3,524,635) for the same period of 2010. General and administrative expenses were 8.91% of total revenues for the six months ended December 31, 2009 and 43.17% of total revenues for the same period of 2010. This percentage increase was primarily attributable to (1) the write-off of ENI's non-collectable advanced payment to vendors, (2) higher expenses related to being a public company, particularly those associated with the annual shareholder meeting, director meetings and investor relations services, and (3) an increase of expenses related to our planned secondary offering, which was withdrawn due to unfavorable market conditions.

Net Income

	For the Six Months Ended December 31,			
	2010	2009	Increase (Decrease)	Percentage Change
Income (loss) from operations	¥(8,970,263)	¥18,587,537	¥(27,557,800)	(148.26)%
Subsidy income	451,520	1,158,034	(706,514)	(61.01)%
Interest and other income (loss)	(320,003)	10,705	(330,705)	(308.93)%
Loss on deconsolidation	(8,989,614)	—	(8,989,614)	(100.00)%
Income (loss) before income tax and non-controlling interest	(17,828,361)	19,756,276	(37,584,637)	(190.24)%
Provision for income tax	(1,004,085)	(5,106,765)	4,102,680	(80.34)%
Net income	(18,832,446)	14,649,511	(33,481,957)	(228.55)%
Net income attributable to non-controlling interest	(1,001,243)	(1,670,940)	669,697	(40.08)%
Net income attributable to ordinary shareholders	¥(19,833,689)	¥12,978,571	¥(32,812,260)	(252.82)%

Income (Loss) from Operations. There was a loss from operations in the amount of ¥8,970,264 ($1,356,705) for the six months ended December 31, 2010, compared to an income of ¥18,587,537 for the same period of 2009, due to lower revenue and higher administrative expenses.

Subsidy Income. We received grants of ¥1,158,034 and ¥451,520 ($68,290) from the local government for the six months ended December 31, 2009 and 2010, respectively. These grants were given by the government in the form of income tax return to support local companies in developing advanced technology and improving their products.

Loss on Deconsolidation. As a result of the deconsolidation of ENI, we suffered a loss of ¥8,989,614 ($1,359,632), which amount was measured as the difference between (a) the aggregate of (i) the fair value of any consideration received, (ii) the fair value of the retained non-controlling investment in ENI at the date in which ENI was deconsolidated, and (iii) the carrying amount of any non-controlling interest in ENI; and (b) the carrying value of the net assets and liabilities of ENI as of December 15, 2010. Our management believes it was an unusual loss and is in the process of initiating a series of safeguards to prevent this from happening in the future.

Income Tax Expense. Income tax expense for the six months ended December 31, 2009 and 2010 was ¥5,106,765 and ¥1,004,085 ($151,863), respectively. The decrease was mainly due to a decrease in taxable operating income and lower effective tax rates.

Net Income (Loss) Attributable to Ordinary Shareholders. As a result of the factors described above, there was a net loss attributable to ordinary shareholders in the amount of ¥19,833,689 ($2,999,741) for the six months ended December 31, 2010, a decrease of 252.82% from a net income of ¥12,978,572 for the same period of 2009.

Adjusted EBITDA

	For the Six Months Ended December 31,				
	2010 RMB	2009 RMB	Increase (Decrease)	Percentage Change	2010 USD
Reconciliation of Adjusted EBITDA to Net Income (Loss):					
Net income (loss)	¥(18,832,446)	¥14,649,511	¥(33,481,957)	(228.55 %)	$(2,848,309)
Income tax expense	1,004,085	5,106,765	(4,102,680)	(80.34 %)	151,863
Interest expense	325,469	77,313	248,156	320.98 %	49,225
Stock compensation expense	870,084	736,688	133,396	18.11 %	131,596
Depreciation, amortization and accretion	201,232	170,864	30,368	17.77 %	30,435
Loss on deconsolidation	8,989,614	—	8,989,614	100.00 %	1,359,632
Adjusted EBITDA	¥(7,441,962)	¥20,741,141	¥(28,183,103)	(135.88)%	$(1,125,558)

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Adjusted EBITDA. Adjusted EBITDA decreased by ¥28,183,103, or 135.88%, to a loss of ¥7,441,962 for the six months ended December 31, 2010 compared to the same period of 2009. This was due to the deconsolidation of ENI, delayed projects resulting from construction delays experienced by some of our customers, and the extra expenses we incurred associated with our annual meeting and our withdrawn secondary offering. These factors caused revenues during the period to decrease and the administrative expenses to increase. Compared to net income attributable to ordinary shareholders, we believe adjusted EBITDA more accurately reflects our operations.

Liquidity and Capital Resources

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 six months. As of December 31, 2010, we had cash and cash equivalents in the amount of ¥7,647,870 ($1,156,700).

Indebtedness. As of December 31, 2010, except for ¥5,455,051 ($825,048) of short-term borrowings and a ¥5,000,000 ($756,224) commercial loan from a local bank, we did not have any finance leases or hire purchase commitments, guarantees or other material contingent liabilities.

Holding Company Structure. We are a holding company with no operations of our own. All of our operations are conducted through our Domestic Companies. As a result, our ability to pay dividends and to finance any debt that we may incur is dependent upon the receipt of dividends and other distributions from the Domestic Companies. In addition, Chinese legal restrictions permit payment of dividends to us by our Domestic Companies only out of its accumulated net profit, if any, determined in accordance with Chinese accounting standards and regulations. Under Chinese law, our Domestic Companies are 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 Domestic Companies' registered capital. 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 for 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.

On December 16, 2010, in light of the change of the ownership of ENI, we ceased to have the power to direct the activities of ENI, which as of that date most significantly impact its economic performance. As a result, ENI ceased to be our VIE starting from the same date.

<u>Off-Balance Sheet Arrangements</u>. 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.

<u>Capital Resources</u>. To date we have financed our operations primarily through cash flows from financing operations. As of December 31, 2010 we had total assets of ¥138,438,348 ($20,938,072), which includes cash amounting to ¥7,647,870 ($1,156,700), and net accounts receivable amounting to ¥67,139,709 ($10,154,528). Working capital amounted to ¥82,983,390 ($12,550,764) and shareholders' equity amounted to ¥97,373,147 ($14,727,178).

Cash from Operating Activities. Net cash used in operating activities was ¥5,191,325 ($785,161) for the six months ended December 31, 2010, a decrease of ¥11,720,922 from ¥16,912,247 ($1,772,728) for the six months ended December 31, 2009. For the six-month period, outflows of cash were mainly used in purchase of inventories for coming projects.

Cash from Investing Activities. Net cash used in investing activities was ¥2,281,154 ($345,013) for the six months ended December 31, 2010. As compared to December 31, 2009, we had ¥133,544 of capital expenditure; the difference of ¥2,147,600 was mainly due to the effect on the deconsolidation of the VIE. The foremost factor for the decrease was the loss of cash associated with the deconsolidation of ENI.

Cash from Financing Activities. Cash flows provided by financing activities amounted to ¥3,141,601 ($475,151) for the six months ended December 31, 2010 and cash flows provided by financing activities amounted to ¥59,381,762 for the six months ended December 31, 2009. The decrease was due to the fact that we received IPO fund during the six months ended December 31, 2009, whereas we borrowed funds of ¥5,000,000 ($756,224) from a domestic commercial bank to supplement working capital for the same period of 2010.

Working Capital. As of December 31, 2010, working capital was ¥82,983,139. Total current assets as of December 31, 2010 amounted to ¥124,048,340 ($18,761,659), a decrease of ¥50,840,105 ($7,689,300) compared to ¥174,888,445 at June 30, 2010. The decrease was attributable mainly to the deconsolidation of ENI.

Current liabilities amounted to ¥41,065,201 ($6,210,895) at December 31, 2010, in comparison to ¥57,563,362 at June 30, 2010. This decrease was attributable to the deconsolidation of ENI.

The current ratio remained stable during the six months ended December 31, 2010, decreasing from 3.04 at June 30, 2010 to 3.02 at December 31, 2010.

Recently Enacted Accounting Standards

None.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Not applicable.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

As of December 31, 2010, our company carried out an evaluation, under the supervision of and with the participation of management, including our Company’s chief executive officer and chief financial officer, of the effectiveness of the design and operation of our Company’s disclosure controls and procedures. In light of the nature of the adjustments attributable to the restatement of the Original Filing, the chief executive officer and chief financial officer concluded that our Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) were ineffective in timely alerting them to information required to be included in the Company’s periodic Securities and Exchange Commission filings.

Changes in Internal Control over Financial Reporting

In light of the nature of the adjustments attributable to the restatement of the Original Filing, the Company has conducted a preliminary assessment of its accounting organization and the manner in which the accounting and financial reporting functions are being supported. Based on such assessment, the Company has developed a preliminary plan to strengthen its accounting and financial reporting functions as well as the related disclosure controls and procedures. Such plan will require the hiring of additional resources and the deployment of other corporate resources for the accounting department in relation to the financial reporting process. Such additional resources will include the establishment of a work force dedicated to the task of correcting past financial irregularities and maintaining correct financial reporting on an on-going basis. To strengthen the Company’s internal control over financial reporting, the Company has engaged outside consultants that are skilled in SEC reporting and Section 404 compliance to assist in the implementation of the following remedial actions (which are targeted to be completed by June 2012):

- Development and formalization of key accounting and financial reporting policies and procedures;
- Identification and documentation of key controls by business process;
- Enhancement of existing disclosures policies and procedures;
- Formalization of periodic communication between management and the audit committee;
- Implementation of policies and procedures intended to enhance management monitoring and oversight by the Audit Committee; and
- Formalization of a periodic staff training program to enhance their awareness of the key internal control activities.

RECON TECHNOLOGY, LTD

INDEX TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

RECON TECHNOLOGY, LTD

UNaudited condensed Consolidated Balance Sheets

	June 30, 2010 RMB	December 31, 2010 RMB (As Restated)	December 31, 2010 U.S. Dollars (As Restated)
ASSETS			
Current Assets			
Cash and cash equivalents	¥12,142,957	¥7,647,870	$1,156,700
Trade accounts receivable, net	89,425,990	67,139,709	10,154,528
Other receivables, net	12,850,547	16,136,960	2,440,630
Purchase advances	46,551,402	14,990,494	2,267,233
Prepaid expenses	766,638	140,038	21,181
Inventories	13,150,911	17,993,269	2,721,387
Total Current Assets	174,888,445	124,048,340	18,761,659
Other receivables	-	12,971,481	1,961,868
Property and equipment, net	1,482,881	1,144,791	173,144
Deferred tax assets	275,960	273,736	41,401
Total Assets	**¥176,647,286**	**¥138,438,348**	**$20,938,072**
LIABILITIES AND EQUITY			
Current Liabilities			
Trade accounts payable	¥16,536,796	¥14,893,472	$2,252,559
Other payables	3,096,309	2,313,740	349,941
Deferred income	4,267,711	2,387,024	361,025
Advances from customers	439,761	120,650	18,248
Accrued payroll and employees' welfare	360,540	87,169	13,184
Accrued expenses	290,803	278,873	42,178
Taxes payable	20,203,104	10,529,222	1,592,489
Short-term bank loan	-	5,000,000	756,224
Short-term borrowings	5,024,881	4,543,652	687,203
Short-term borrowings - related parties	7,343,457	911,399	137,844
Total Current Liabilities	**¥57,563,362**	**¥41,065,201**	**$6,210,895**
Commitments and Contingencies			
Equity			
Ordinary shares (U.S. $0.0185 par value, 25,000,000 shares authorized; 3,951,811 shares issued and outstanding)	¥529,979	¥529,979	$80,157
Additional paid-in capital	69,257,098	65,341,123	9,882,501
Appropriated retained earnings	3,755,503	2,248,864	340,129

Unappropriated retained earnings	36,034,500	22,401,163	3,388,058
Accumulated other comprehensive loss	(76,997)	(127,075)	(19,219)
Total Controlling Shareholders' Equity	109,500,083	90,394,054	13,671,626
Non-controlling Interest	9,583,841	6,979,093	1,055,551
Total Equity	119,083,924	97,373,147	14,727,177
Total Liabilities and Equity	**¥176,647,286**	**¥138,438,348**	**$20,938,072**

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

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RECON TECHNOLOGY, LTD

UNaudited condensed Consolidated Statements of operations and

Comprehensive Income (loss)

	For the Six Months ended December 31,			For the Three Months ended December 31,		
	2009	**2010**	**2010**	**2009**	**2010**	**2010**
	RMB	**RMB**	**U.S. Dollars**	**RMB**	**RMB**	**U.S. Dollars**
		(As Restated)	(As Restated)		(As Restated)	(As Restated)
Revenues						
Hardware	¥66,353,385	¥51,871,946	$7,845,359	¥47,081,742	¥30,072,635	$4,548,328
Services	5,965,812	2,111,111	319,295	2,992,353	2,111,111	319,294
Software	226,495	-	-	-	-	-
Total revenues	72,545,692	53,983,057	8,164,654	50,074,095	32,183,746	4,867,622
Cost of revenues	41,469,157	34,573,669	5,229,086	25,396,611	20,492,176	3,099,334
Gross profit	31,076,535	19,409,388	2,935,568	24,677,484	11,691,570	1,768,288
Selling and distribution expenses	6,023,098	5,075,471	767,638	3,863,886	3,272,318	494,920
General and administrative expenses	6,465,900	23,304,180	3,524,635	3,520,245	19,082,366	2,886,108
Operating expenses	12,488,998	28,379,651	4,292,273	7,384,131	22,354,684	3,381,028
Income (loss) from operations	18,587,537	(8,970,263)	(1,356,705)	17,293,353	(10,663,114)	(1,612,740)
Subsidy income	1,158,034	451,520	68,290	1,131,709	-	-
Interest income	5,772	407	61	4,096	(979)	(149)
Interest expense	(77,313)	(325,469)	(49,225)	(36,069)	(212,030)	(32,068)
Other income	82,246	5,059	765	8,774	47,457	7,178
Loss on deconsolidation	-	(8,989,614)	(1,359,632)	-	(8,989,614)	(1,359,632)
Net income (loss) before income tax	19,756,276	(17,828,361)	(2,696,446)	18,401,863	(19,818,280)	(2,997,411)
Provision for income tax	(5,106,765)	(1,004,085)	(151,863)	(4,414,087)	(198,259)	(29,986)
Net income (loss)	14,649,511	(18,832,446)	(2,848,309)	13,987,776	(20,016,539)	(3,027,397)
Net (income) loss attributable to non-controlling interest	(1,670,940)	(1,001,243)	(151,432)	(1,433,624)	(660,913)	(99,960)
Net income (loss) attributable to ordinary	**¥12,978,571**	**¥(19,833,689)**	**$(2,999,741)**	**¥12,554,152**	**¥(20,677,452)**	**$(3,127,357)**

shareholders

Net income (loss)	**¥14,649,511**	**¥(18,832,446)**	**$(2,848,309)**	**¥13,987,776**	**¥(20,016,539)**	**$(3,027,397)**
Other comprehensive income (loss)						
Foreign currency translation adjustment	(55,536)	(170,180)	(25,738)	(3,763)	(62,146)	(9,400)
Comprehensive income (loss)	14,593,975	(19,002,626)	(2,874,047)	13,984,013	(20,078,685)	(3,036,797)
Comprehensive income (loss) attributable to non-controlling interests	(1,665,386)	(984,225)	(148,858)	(1,433,624)	(654,698)	(99,020)
Comprehensive income (loss) attributable to ordinary shareholders	**¥12,928,589**	**¥(19,986,851)**	**$(3,022,905)**	**¥12,550,389**	**¥(20,733,383)**	**$(3,135,817)**
Earnings (loss) per ordinary share - basic	¥3.55	¥(5.02)	$(0.76)	¥3.18	¥(5.23)	$(0.79)
Earnings (loss) per ordinary share - diluted	¥3.51	¥(5.02)	$(0.76)	¥3.10	¥(5.23)	$(0.79)
Weighted average shares - basic	3,656,277	3,951,811	3,951,811	3,951,811	3,951,811	3,951,811
Weighted average shares - diluted	3,698,981	3,951,811	3,951,811	4,046,573	3,951,811	3,951,811

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

RECON TECHNOLOGY, LTD

unaudited condensed Consolidated Statements of Cash Flows

	For the Six Months ended December 31,		
	2009	2010	2010
	RMB	RMB	U.S. Dollars
		(As restated)	(As restated)
Cash flows from operating activities:			
Net income (loss)	**¥14,649,511**	**¥(18,832,446)**	**$(2,848,309)**
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Loss on deconsolidation	-	8,989,614	1,359,632
Depreciation	170,864	201,232	30,435
Stock based payment	736,688	870,084	131,596
Provision for doubtful accounts	-	14,258,979	2,156,596
Deferred tax provision (benefit)	3,923,533	(1,547)	(234)
Changes in operating assets and liabilities:			
Trade accounts receivable, net	(41,184,732)	(1,473,514)	(222,861)
Other receivables, net	(1,984,297)	(3,280,285)	(496,126)
Purchase advances, net	(783,333)	11,587,946	1,752,616
Prepaid expenses	(7,160,434)	606,600	91,745
Inventories	(399,430)	(18,704,512)	(2,828,959)
Trade accounts payable	9,877,862	3,825,240	578,547
Other payables	(430,425)	(937,110)	(141,733)
Deferred income	-	(1,829,458)	(276,696)
Advances from customers	2,678,536	(319,111)	(48,264)
Accrued payroll and employees' welfare	(885,846)	(246,891)	(37,341)
Accrued expenses	-	(11,931)	(1,804)
Taxes payable	171,407	105,785	15,999
Interest payable	3,707,849	-	-
Net cash used in operating activities	(16,912,247)	(5,191,325)	(785,161)
Cash flows from investing activities:			
Purchases of property and equipment	(133,554)	(24,849)	(3,758)
Effect on cash due to deconsolidating VIE		(2,256,305)	(341,255)
Net cash used in investing activities	(133,554)	(2,281,154)	(345,013)
Cash flows from financing activities:			
Proceeds from stock issuance	60,209,057	-	-
Proceeds from short-term bank loan	-	5,000,000	756,224
Proceeds from (repayments of) short-term borrowing	1,806,464	(456,341)	(69,019)
Repayments of short-term borrowing - related parties	(2,633,759)	(1,402,058)	(212,054)
Net cash provided by financing activities	59,381,762	3,141,601	475,151

Effect of exchange rate fluctuation on cash and cash equivalents	(76,116)	(164,209)	(24,835)
			-
Net increase (decrease) in cash and cash equivalents	42,259,845	(4,495,087)	(679,858)
Cash and cash equivalents at beginning of period	2,727,735	12,142,957	1,836,558
Cash and cash equivalents at end of period	**¥44,987,580**	**¥7,647,870**	**$1,156,700**
Supplemental cash flow information			
Cash paid during the period for interest	¥-	¥36,000	$5,445
Cash paid during the period for taxes	¥248,176	¥2,337,279	$353,501

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

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RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND BASIS OF PRESENTATION

Organization – Recon Technology, Ltd (the "Company") was incorporated under the laws of the Cayman Islands on August 21, 2007 by Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (the "Founders") as a company with limited liability. The Company provides oilfield specialized equipment, automation systems, tools, chemicals and field services to petroleum companies in the People's Republic of China (the "PRC"). Its wholly owned subsidiary, Recon Technology Co., Limited ("Recon-HK") was incorporated on September 6, 2007 in Hong Kong. Other than the equity interest in Recon-HK, the Company does not own any assets or conduct any operations. On November 15, 2007, Recon-HK established one wholly owned subsidiary, Jining Recon Technology Ltd. ("Recon-JN") under the laws of the PRC. Other than the equity interest in Recon-JN, Recon-HK does not own any assets or conduct any operations.

Through December 15, 2010, the Company conducted its business through the following PRC legal entities that were consolidated as variable interest entities ("VIEs") and operate in the Chinese oilfield equipment & service industry:

- Beijing BHD Petroleum Technology Co., Ltd. ("BHD"),
- Nanjing Recon Technology Co., Ltd. ("Nanjing Recon"), and
- Jining ENI Energy Technology Co., Ltd. ("ENI")

On December 16, 2010, ENI was deconsolidated from the Company and ceased to be a VIE of the Company after the Company's Audit Committee concluded that, in light of a December 16, 2010 change in the equity ownership of ENI, the Company ceased to have the power to direct the activities of ENI. From December 16, 2010 onward, therefore, the Company conducted its business through, and consolidated as variable interest entities ("VIEs"), the two entities of BHD and Nanjing Recon only.

Chinese laws and regulations currently do not prohibit or restrict foreign ownership in petroleum businesses. However, Chinese laws and regulations do prevent direct foreign investment in certain industries. On January 1, 2008, to protect the Company's shareholders from possible future foreign ownership restrictions, the Founders, who also held the controlling interest of BHD, Nanjing Recon and ENI, reorganized the corporate and shareholding structure of these entities by entering into certain exclusive agreements with Recon-JN, which entitles Recon-JN to receive a majority of the residual returns. On May 29, 2009 Recon-JN and BHD, Nanjing Recon, and ENI entered into an operating agreement to provide full guarantee for the performance of such contracts, agreements or transactions entered into by BHD, Nanjing Recon, and ENI. As a result of the new agreement, Recon-JN absorbs 100% of the expected losses and receives 90% of the expected gains of BHD, Nanjing Recon, and ENI, which resulted in Recon-JN being the primary beneficiary of these companies.

Recon-JN also entered into Share Pledge Agreements with the Founders, who pledged all their equity interest in these entities to Recon-JN. The Share Pledge Agreements, which were entered into by each Founder, pledged each of the Founders' equity interest in BHD, Nanjing Recon, and ENI as a guarantee for the service payment under the Service Agreement.

The Service Agreement, entered into on January 1, 2008, between Recon-JN and BHD, Nanjing Recon, and ENI, states that Recon-JN will provide technical consulting services to BHD, Nanjing Recon, and ENI in exchange for 90% of their annual net profits as a service fee, which is to be paid quarterly.

In addition, Recon-HK entered into Option Agreements to allow Recon-HK to acquire the Founders' interest in these entities if or when permitted by the PRC laws.

Based on these exclusive agreements, the Company consolidated BHD, Nanjing Recon and ENI (through December 15, 2010 only) as VIEs as required by Accounting Standards Codification ("ASC") Topic 810, *Consolidation* because the Company was the primary beneficiary of the VIEs.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

On August 28, 2000, a Founder of the Company purchased a controlling interest in BHD which was organized under the laws of the PRC on June 29, 1999. Through December 15, 2010, the Founders held 67.5% ownership in BHD. From December 16, 2010 to December 31, 2010, Messers. Yin Shenping and Chen Guangqiang held 79.99% ownership interest of BHD. BHD is combined with the Company through the date of the exclusive agreements, and is consolidated following January 1, 2008, the date of the agreements based on ASC Topic 810. The Company allocates profits and losses 90% and 100%, respectively, based upon the control agreements. Profits allocated to the minority interest are the remaining amount (10%).

On July 4, 2003, Nanjing Recon was organized under the laws of the PRC. On August 27, 2007, the Founders of the Company purchased a majority ownership of Nanjing Recon from a related party who was a majority owner of Nanjing Recon. Through December 15, 2010, the Founders held 80% ownership interest in Nanjing Recon. From December 16, 2010 to December 31, 2010, Messers. Yin Shenping and Chen Guangqiang held 80% ownership interest of Nanjing Recon. Nanjing Recon is combined with the Company through the date of the exclusive agreements, and is consolidated following January 1, 2008, the date of the agreements based on ASC Topic 810. The Company allocates profits and losses 90% and 100%, respectively, based upon the control agreements. Profits allocated to the minority interest are the remaining amount (10%).

On January 21, 2003, ENI was organized under the laws of the PRC. Founders of the Company owned a controlling interest of ENI through December 15, 2010 by holding 80% ownership interest in ENI. However, from December 16, 2010 to December 31, 2010, the Founders did not own any interest in ENI. On December 16, 2010 in light of the change of the ownership in ENI, the Company ceased to have the power to direct the activities of ENI which most significantly impact its economic performance as of that date. As a result, ENI ceased to be a VIE of the Company on December 16, 2010. Based on ASC Topic 810, ENI was combined and consolidated with the Company from January 1, 2008, the date of the exclusive agreements, through December 15, 2010 when the Company ceased to have control over ENI. From January 1, 2008 through December 15, 2010, the Company allocated profits and losses 90% and 100%, respectively, based upon the control agreements. Profits allocated to the minority interest were the remaining amount (10%).

Nature of Operations – The Company engaged in (1) providing equipment, tools and other hardware related to oilfield production and management, including simple installations in connection with some projects, and (2) developing and selling its own specialized industrial automation control and information solutions. The products and services provided by the Company include:

High-Efficiency Heating Furnaces - High-Efficiency Heating Furnaces are designed to remove the impurities and to prevent solidification blockage in transport pipes carrying crude petroleum. Crude petroleum contains certain impurities including water and natural gas, which must be removed before the petroleum can be sold.

Multi-Purpose Fissure Shaper - Multipurpose fissure shapers improve the extractors' ability to test for and extract petroleum which requires perforation into the earth before any petroleum extractor can test for the presence of oil.

Oil Field Water Finding/Blocking Technology - The Company developed this technology designed to find and block water content in petroleum.

Supervisory Control and Data Acquisition System ("SCADA") - SCADA is an industrial computerized process control system for monitoring, managing and controlling petroleum extraction. SCADA integrates underground and above-ground activities of the petroleum extraction industry. This system can help to manage the oil extraction process in real-time to reduce the costs associated with extraction.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. RESTATEMENT OF PREVIOUSLY REPORTED UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

The Company has restated its quarterly unaudited condensed consolidated financial statements as of and for the period ended December 31, 2010. The determination to restate the aforementioned unaudited condensed consolidated financial statements was made by the Audit Committee of the Company on December 6, 2011, which concluded that the unaudited condensed consolidated financial statements included in the Company's Quarterly Reports on Form 10-Q as of and for the three and six months ended December 31, 2010 (the "Original Filing"), should no longer be relied upon.

The Company had consolidated in its financial statements the accounts of an entity that should not have been consolidated during such periods. In particular, the Company's Audit Committee concluded that, in light of a December 16, 2010 change in the equity ownership of ENI, the Company ceased to have the power to direct the activities of ENI which most significantly impact its economic performance as of the date of transfer. As a result, ENI ceased to be a variable interest entity of the Company at that time, and its financial results should not have been consolidated with those of the Company beginning December 16, 2010.

The general nature and scope of the adjustments are summarized as follows:

(1) *Adjustment to deconsolidate ENI* — The Company has followed the guidance on deconsolidation of a variable interest entity in accordance with ASC 810, and accounted for the deconsolidation of ENI by recognizing the related loss on deconsolidation in its net income attributable to the Company, which is measured as the difference between:

a. the aggregate of (i) the fair value of any consideration received, (ii) the fair value of the retained non-controlling investment in ENI at the date in which ENI is deconsolidated, and (iii) the carrying amount of any non-controlling interest in ENI; and
b. the carrying amount of ENI's net assets and liabilities as of December 15, 2010.

In addition, the restated unaudited condensed consolidated financial statements include all other necessary adjustments, such as the write-off of uncollectible purchase advances in the amount of RMB 13,662,380 and the reclassification of intercompany balances with ENI to other receivables or payables. See Note 5 for further discussion of the amount due from ENI of RMB 17,771,481. As a result of the deconsolidation of ENI, the

Company incurred a deconsolidation loss of ¥8,989,614 ($1,359,632).

(2) *Adjustment to correct an overstatement of reported revenue* — Based on information that was made available to management subsequent to the Original Filing for the quarter ended December 31, 2010, the Company realized that there was a double-counting of revenues from 3 specific contracts which amounted to RMB 5,191,897. The double-counting was caused by an input error that was not detected during the normal course of the quarter book close. To determine the nature and extent of this accounting error, the Company performed a thorough review of all revenues recognized during the quarter and concluded that the error identified was a mistake which resulted in the overstatement of the Company's reported revenue, tax payable and accounts receivable as of December 31, 2010. To correct the overstatement, the Company recorded an adjustment in this Form 10Q to reduce revenue by RMB 5,191,897; reduce imposed value-added tax of RMB 882,663; and reduce the reported accounts receivable by RMB 6,074,520.

The following tables present the adjustments due to the restatements made herein of the Company's previously issued unaudited condensed consolidated balance sheet as of December 31, 2010, statement of operations and comprehensive income (loss) for the three and six months ended December 31, 2010, and statement of cash flows for the six months ended December 31, 2010.

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RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Reconciliation of Unaudited Condensed Consolidated Balance Sheet

	December 31, 2010				
	As Previously Reported RMB	Effect of Restatement RMB	Note	As Restated RMB	As Restated U.S. Dollars
ASSETS					
Current Assets					
Cash and cash equivalents	¥12,087,113	(4,439,243)	(1)	¥7,647,870	$1,156,700
Trade accounts receivable, net	104,434,261	(37,294,552)	(1)(2)	67,139,709	10,154,528
Other receivables, net	18,685,512	(2,548,552)	(1)	16,136,960	2,440,630
Purchase advances	27,025,069	(12,034,575)	(1)	14,990,494	2,267,233
Prepaid expenses	140,038	-	(1)	140,038	21,181
Inventories	30,833,264	(12,839,995)	(1)	17,993,269	2,721,387
Total Current Assets	193,205,257	(69,156,917)		124,048,340	18,761,659
Other receivables	-	12,971,481	(1)	12,971,481	1,961,868
Property and equipment, net	1,304,452	(159,661)	(1)	1,144,791	173,144
Deferred tax assets	789,450	(515,714)	(1)	273,736	41,401
Total Assets	**¥195,299,159**	**(56,860,811)**		**¥138,438,348**	**$20,938,072**
LIABILITIES AND EQUITY					
Current Liabilities					
Trade accounts payable	¥21,148,001	(6,254,529)	(1)	¥14,893,472	$2,252,559
Other payables	3,472,063	(1,158,323)	(1)	2,313,740	349,941
Deferred income	2,438,253	(51,229)	(1)	2,387,024	361,025
Advances from customers	120,650	-		120,650	18,248
Accrued payroll and employees' welfare	87,169	-		87,169	13,184
Accrued expenses	278,873	-		278,873	42,178
Taxes payable	24,105,472	(13,576,250)	(1)	10,529,222	1,592,489
Short-term bank loan	5,000,000	-		5,000,000	756,224
Short-term borrowings	4,568,540	(24,888)	(1)	4,543,652	687,203
Short-term borrowings - related parties	5,941,399	(5,030,000)	(1)	911,399	137,844
Total Current Liabilities	**¥67,160,420**	**(26,095,219)**		**¥41,065,201**	**$6,210,895**
Commitments and Contingencies					
Equity					
Ordinary shares (U.S. $0.0185 par value, 25,000,000 shares authorized; 3,951,811 shares	¥529,979	-		¥529,979	$80,157

issued and outstanding)					
Additional paid-in capital	70,141,123	(4,800,000)	(1)	65,341,123	9,882,501
Appropriated retained earnings	4,557,675	(2,308,811)	(1)	2,248,864	340,129
Unappropriated retained earnings	42,209,270	(19,808,107)	(1)	22,401,163	3,388,058
Accumulated other comprehensive loss	(114,367)	(12,708)	(1)	(127,075)	(19,219)
Total Controlling Shareholders' Equity	117,323,680	(26,929,626)		90,394,054	13,671,626
Non-controlling Interest	10,815,059	(3,835,966)		6,979,093	1,055,551
Total Equity	128,138,739	(30,765,592)		97,373,147	14,727,177
Total Liabilities and Equity	**¥195,299,159**	**(56,860,811)**		**¥138,438,348**	**$20,938,072**

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RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Reconciliation of Unaudited Condensed Consolidated Statement of Operations and Comprehensive Income (Loss)

	For the Six Months ended December 31, 2010				
	As Previously Reported RMB	Effect of Restatement RMB	Note	As Restated RMB	As Restated U.S. Dollars
Revenues					
Hardware	¥66,646,385	(14,774,439)	(1)(2)	¥51,871,946	$7,845,359
Services	2,111,111	-		2,111,111	319,295
Total revenues	68,757,496	(14,774,439)		53,983,057	8,164,654
Cost of revenues	41,208,514	(6,634,845)	(1)	34,573,669	5,229,086
Gross profit	27,548,982	(8,139,594)		19,409,388	2,935,568
Selling and distribution expenses	5,096,317	(20,846)	(1)	5,075,471	767,638
General and administrative expenses	11,725,064	11,579,116	(1)	23,304,180	3,524,635
Operating expenses	16,821,381	11,558,270		28,379,651	4,292,273
Income (loss) from operations	10,727,601	(19,697,864)		(8,970,263)	(1,356,705)
Subsidy income	451,520	-		451,520	68,290
Interest income	4,939	(4,532)	(1)	407	61
Interest expense	(326,796)	1,327	(1)	(325,469)	(49,225)
Other income	5,059	-		5,059	765
Loss on deconsolidation	-	(8,989,614)	(1)	(8,989,614)	(1,359,632)
Net income (loss) before income tax	10,862,323	(28,690,684)		(17,828,361)	(2,696,446)
Provision for income tax	(2,650,010)	1,645,925	(1)(2)	(1,004,085)	(151,863)
Net income (loss)	8,212,313	(27,044,759)		(18,832,446)	(2,848,309)
Net (income) loss attributable to non-controlling interest	(1,235,371)	234,128	(1)	(1,001,243)	(151,432)
Net income (loss) attributable to ordinary shareholders	**¥6,976,942**	**(26,810,631)**		**¥(19,833,689)**	**$(2,999,741)**
Net income (loss)	**¥8,212,313**	**(27,044,759)**		**¥(18,832,446)**	**$(2,848,309)**
Other comprehensive income (loss)					
Foreign currency translation adjustment	(41,523)	(128,657)		(170,180)	(25,738)
Comprehensive income (loss)	8,170,790	(27,173,416)		(19,002,626)	(2,874,047)

Comprehensive income (loss) attributable to non-controlling interests	(1,231,219)	246,994	(984,225)	(148,858)
Comprehensive income (loss) attributable to ordinary shareholders	**¥6,939,571**	**(26,926,422)**	**¥(19,986,851)**	**$(3,022,905)**
Earnings (loss) per ordinary share - basic	¥1.77	(6.78)	¥(5.02)	$(0.76)
Earnings (loss) per ordinary share - diluted	¥1.77	(6.78)	¥(5.02)	$(0.76)
Weighted average shares - basic	3,951,811		3,951,811	3,951,811
Weighted average shares - diluted	3,951,811		3,951,811	3,951,811

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Reconciliation of Unaudited Condensed Consolidated Statement of Operations and Comprehensive Income (Loss)

	For the Three Months ended December 31, 2010				
	As Previously Reported RMB	Effect of Restatement RMB	Note	As Restated RMB	As Restated U.S. Dollars
Revenues					
Hardware	¥44,847,074	(14,774,439)	(1)(2)	¥30,072,635	$4,548,328
Services	2,111,111	-		2,111,111	319,294
Total revenues	46,958,185	(14,774,439)		32,183,746	4,867,622
Cost of revenues	27,127,021	(6,634,845)	(1)	20,492,176	3,099,334
Gross profit	19,831,164	(8,139,594)		11,691,570	1,768,288
Selling and distribution expenses	3,293,164	(20,846)	(1)	3,272,318	494,921
General and administrative expenses	7,503,250	11,579,116	(1)	19,082,366	2,886,108
Operating expenses	10,796,414	11,558,270		22,354,684	3,381,029
Income (loss) from operations	9,034,750	(19,697,864)		(10,663,114)	(1,612,740)
Interest income	3,553	(4,532)	(1)	(979)	(149)
Interest expense	(213,357)	1,327	(1)	(212,030)	(32,068)
Other income	47,458	-		47,458	7,178
Loss on deconsolidation	-	(8,989,614)	(1)	(8,989,614)	(1,359,632)
Net income (loss) before income tax	8,872,404	(28,690,684)		(19,818,280)	(2,997,411)
Provision for income tax	(1,844,184)	1,645,925	(1)(2)	(198,259)	(29,986)
Net income (loss)	7,028,220	(27,044,759)		(20,016,539)	(3,027,397)
Net (income) loss attributable to non-controlling interest	(895,041)	234,128	(1)	(660,913)	(99,960)
Net income (loss) attributable to ordinary shareholders	**¥6,133,179**	**(26,810,631)**		**¥(20,677,452)**	**$(3,127,357)**
Net income (loss)	¥7,028,220	(27,044,759)		¥(20,016,539)	$(3,027,397)
Other comprehensive income (loss)					
Foreign currency translation adjustment	66,511	(128,657)		(62,146)	(9,400)
Comprehensive income (loss)	7,094,731	(27,173,416)		(20,078,685)	(3,036,797)

Comprehensive income (loss) attributable to non-controlling interests	(901,692)	246,994	(654,698)	(99,020)
Comprehensive income (loss) attributable to ordinary shareholders	**¥6,193,039**	**(26,926,422)**	**¥(20,733,383)**	**$(3,135,817)**
Earnings (loss) per ordinary share - basic	¥1.55	(6.78)	¥(5.23)	$(0.79)
Earnings (loss) per ordinary share - diluted	¥1.55	(6.78)	¥(5.23)	$(0.79)
Weighted average shares - basic	3,951,811		3,951,811	3,951,811
Weighted average shares - diluted	3,951,811		3,951,811	3,951,811

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RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Reconciliation of Unaudited Condensed Consolidated Statement of Cash Flows

	For the Six Months ended December 31, 2010				
	As Previously Reported RMB	Effect of Restatement RMB	Note	As Restated RMB	As Restated U.S. Dollars
Cash flows from operating activities:					
Net income (loss)	**¥8,212,313**	**(27,044,759)**	(1)(2)	**¥(18,832,446)**	**$(2,848,309)**
Adjustments to reconcile net income (loss) to net cash used in operating activities:					
Loss on deconsolidation	-	8,989,614	(1)	8,989,614	1,359,632
Depreciation	203,278	(2,046)	(1)	201,232	30,435
Stock based payment	870,084	-	(1)	870,084	131,596
Provision for doubtful accounts	2,644,369	11,614,610	(1)	14,258,979	2,156,596
Deferred tax provision (benefit)	(513,490)	511,943	(1)	(1,547)	(234)
Changes in operating assets and liabilities:					
Trade accounts receivable, net	(15,008,271)	13,534,757	(1)(2)	(1,473,514)	(222,861)
Other receivables, net	(8,471,365)	5,191,080	(1)	(3,280,285)	(496,126)
Purchase advances, net	19,526,333	(7,938,387)	(1)	11,587,946	1,752,616
Prepaid expenses	626,600	(20,000)	(1)	606,600	91,745
Inventories	(17,682,353)	(1,022,159)	(1)	(18,704,512)	(2,828,959)
Trade accounts payable	4,611,205	(785,965)	(1)	3,825,240	578,547
Other payables	375,754	(1,312,864)	(1)	(937,110)	(141,733)
Deferred income	(1,829,458)	-		(1,829,458)	(276,696)
Advances from customers	(319,111)	-		(319,111)	(48,264)
Accrued payroll and employees' welfare	(273,371)	26,480	(1)	(246,891)	(37,341)
Accrued expenses	(11,930)	(1)	(1)	(11,931)	(1,804)
Taxes payable	3,902,368	(3,796,583)	(1)(2)	105,785	15,999
Net cash used in operating activities	(3,137,045)	(2,054,280)		(5,191,325)	(785,161)
Cash flows from investing activities:					
Purchases of property and equipment	(24,849)	-	(1)	(24,849)	(3,758)
Effect on cash due to deconsolidating VIE	-	(2,256,305)	(1)	(2,256,305)	(341,255)
Net cash used in investing activities	(24,849)	(2,256,305)		(2,281,154)	(345,013)
Cash flows from financing activities:					
Proceeds from short-term bank loan	5,000,000	-		5,000,000	756,224
Repayments of short-term borrowing	(456,341)	-		(456,341)	(69,019)

Repayments of short-term borrowing - related party	(1,402,058	)	-			(1,402,058	)	(212,054	)
Net cash provided by financing activities	3,141,601		-			3,141,601		475,151	
Effect of exchange rate fluctuation on cash and cash equivalents	(35,551	)	(128,658	)	(1)	(164,209	)	(24,835	)
Net decrease in cash and cash equivalents	(55,844	)	(4,439,243	)	(1)	(4,495,087	)	(679,858	)
Cash and cash equivalents at beginning of period	12,142,957		-			12,142,957		1,836,558	
Cash and cash equivalents at end of period	**¥12,087,113**		**(4,439,243**	**)**		**¥7,647,870**		**$1,156,700**	

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation - The accompanying unaudited consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). The accompanying unaudited condensed consolidated financial statements include the financial statements of the Company, its subsidiaries, and VIEs for which the Company is the primary beneficiary. All inter-company transactions and balances between the Company, its subsidiaries and VIEs are eliminated upon consolidation. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring entries, which are necessary for a fair presentation of the results for the interim periods presented. These financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended June 30, 2010. The results of operations for the interim periods presented are not indicative of the operating results to be expected for the Company's fiscal year ending June 30, 2011.

Reclassifications - Certain amounts from the prior period have been reclassified to conform to the current period presentation.

Principles of Consolidation - The unaudited condensed consolidated financial statements include the financial statements of the Company, all the subsidiaries and VIEs of the Company. All transactions and balances between the Company and its subsidiaries and VIEs have been eliminated upon consolidation.

Variable Interest Entities - A VIE is an entity that either (i) has insufficient equity to permit the entity to finance its activities without additional subordinated financial support or (ii) has equity investors who lack the characteristics of a controlling financial interest. A VIE is consolidated by its primary beneficiary. The primary beneficiary has both the power to direct the activities that most significantly impact the entity's economic performance and the obligation to absorb losses or the right to receive benefits from the entity that could potentially be significant to the VIE.

Assets recognized as a result of consolidating VIEs do not represent additional assets that could be used to satisfy claims against the Company's general assets. Conversely, liabilities recognized as a result of consolidating these VIEs do not represent additional claims on the Company's general assets; rather, they represent claims against the specific assets of the consolidated VIEs.

Currency Translation - The Company's functional currency is the Chinese Yuan ("RMB") and the accompanying unaudited condensed consolidated financial statements have been expressed in Chinese Yuan. The unaudited condensed consolidated financial statements as of and for the three and six months ended December 31, 2010 have been translated into United States dollars ("U.S. dollars"). The translation has been made at the rate of ¥6.6118 = US$1.00, the approximate exchange rate prevailing on December 31, 2010. These translated U.S. dollar amounts should not be construed as representing Chinese Yuan amounts or that the Chinese Yuan amounts have been or could be converted into U.S. dollars.

Accounting Estimates - The preparation of the unaudited condensed consolidated financial statements in conformity with U.S. GAAP requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Estimates are adjusted to reflect actual experience when necessary. Significant accounting estimates reflected in the Company's consolidated financial statements include revenue recognition, allowance for doubtful accounts, and useful lives of property and equipment. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

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 original maturities of no more than three months. Since a majority of the bank accounts are located in the PRC, those bank balances are uninsured.

Trade Accounts and Other Receivables - Accounts receivable are carried at original invoiced amount less a provision for any potential uncollectible amounts. Accounts are considered past due when the related receivables are more than a year old. Provision is made against trade accounts and other receivables to the extent they are considered to be doubtful. Other receivables arise from transactions with non-trade customers.

Purchase Advances - Purchase advances are the amounts prepaid to suppliers for purchases of inventory and are recognized when the final amount is paid to the suppliers and the inventory is delivered.

Inventories - Inventories are stated at the lower of cost or market value, on a weighted average basis for BHD. Inventories are stated at the lower of cost or market value, on a first-in-first-out basis for Nanjing Recon and ENI. The methods of determining inventory costs are used consistently from year to year. Allowance for inventory obsolescence is provided when the market value of certain inventory items are lower than the cost.

Property and equipment - Property and equipment are stated at cost. Depreciation on motor vehicles and office equipment is computed using the straight-line method over the estimated useful lives of the assets, which range from two to ten years. Leasehold improvements are amortized over the shorter of the lease term or the estimated useful life of the assets

Items	Useful life
Motor vehicles	5-10 years
Office equipment	2-5 years

Leasehold improvement 5 years

Long-Lived Assets - The Company applies ASC Topic 360-10 "Property, plant and equipment." ASC 360 requires that long-lived assets, such as property and equipment be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. Fair value is determined based on the estimated discounted future cash flows expected to be generated by the asset.

Advances from Customers - The Company, as is common practice in the PRC, will often receive advance payments from its customers for its products or services. The advances are shown as current liabilities and are recognized as revenue when the products are delivered or service is provided.

Revenue Recognition - The Company recognizes revenue when the following four criteria are met: (1) persuasive evidence of an arrangement, (2) delivery has occurred or services have been provided, (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 the Company has 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.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

Software:

The Company sells self-developed software. For software sales, the Company recognizes revenues in accordance with ASC Topic 985 - 605 "Software Revenue Recognition". 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. Revenue are not recognized until completion of the contracts and receipt of acceptance statements.

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 income represents unearned amounts billed to customers related to sales contracts.

Cost of Revenues - Cost of revenues include wages, materials, handling charges, the cost of purchased equipment and pipes and other expenses associated with manufactured products and service provided to customers.

Subsidy Income - The Company received grants of ¥1,131,709 and ¥0 ($0) from the local government for the three months ended December 31, 2009 and 2010, respectively. The Company received grants of ¥1,158,034 and ¥451,520 ($68,290) from the local government for the six months ended December 31, 2009 and 2010, respectively. Grants given by the government were 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 received. Grants in form of value-added-tax refund for software products are recognized when received.

Advertising Expenses - Advertising expenses, which generally represent the cost of promotions to create or stimulate a positive image of the Company or a desire to buy the Company's products and services, are expensed as incurred. The Company incurred no advertising expenses in each of the periods presented.

Share-Based Compensation - The Company accounts for share-based compensation in accordance with ASC Topic 718, *Share-Based Payment*. Under the fair value recognition provisions of this topic, share-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense with graded vesting on a straight–line basis over the requisite service period for the entire award. The Company has elected to recognize compensation expenses using the Binomial Lattice valuation model estimated at the grant date based on the award's fair value.

Income Taxes - Income taxes are provided based upon the liability method of accounting pursuant to ASC Topic 740, *Accounting for Income Taxes*. Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes. Deferred taxes are provided on differences between the tax bases of assets and liabilities and their reported amounts in the financial statements, and tax carry forwards. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The Company has not been subject to any income taxes in the United States or the Cayman Islands.

Earnings per Share ("EPS") - Basic EPS is computed by dividing net income (loss) attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding. Diluted EPS are computed by dividing net income (loss) attributable to ordinary shareholders by the weighted-average number of ordinary shares and dilutive potential ordinary share equivalents outstanding.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. TRADE ACCOUNTS RECEIVABLE, NET

Accounts receivable consisted of the following at June 30, 2010 and December 31, 2010:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Trade accounts receivable	¥90,515,321	¥68,690,404	$10,389,063
Allowance for doubtful accounts	(1,089,331)	(1,550,695)	(234,535)
Trade accounts receivable, net	¥89,425,990	¥67,139,709	$10,154,528

The Company sold products and services to third-party and related parties during the normal course of business. Included in the above net trade accounts receivable was receivable from related parties (see table below).

Name of Related Party	June 30, 2010 RMB	December 31, 2011 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Beijing Yabei Nuoda Science and Technology Co. Ltd.	¥24,461,800	¥30,646,320	$4,635,095
Beijing Aerda Oil Technology Co. Ltd.	-	2,351,585	355,665
Zhongjiyan Technology (Beijing) Co. Ltd	11,468,484	-	-
Total	¥35,930,284	¥32,997,905	$4,990,760

One of the Founders was a 14% minority owner of Beijing Yabei Nuoda Science and Technology Co. Ltd. (translated name, known herein as “Yabei Nuoda”) as of December 31, 2010. Such ownership in Yabei Nuoda was subsequently reduced to zero on November 29, 2011. The receivable from Yabei Nuoda was generated primarily from the sale of automation system and services based on written contracts.

One of the owners of BHD, a VIE of the Company, is a 2.06% minority owner of Beijing Aerda Oil Technology Co. Ltd. (translated name, known herein as “Aerda”). The receivable from Aerda was generated primarily from the sale of equipment for oil and gas production based on written contracts.

One of the owners of ENI, the Company’s previous VIE which was deconsolidated on December 16, 2010, and his family member collectively controlled Zhongjiyan Technology (Beijing) Co., Ltd, (translated name, known herein as “Zhongjiyan”). The receivable from Zhongjiyan was generated primarily from the sale of equipment for oil and gas production based on written contracts.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. OTHER RECEIVABLES, NET

Other receivables consisted of the following at June 30, 2010 and December 31, 2010:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Due from ENI	¥-	¥17,771,481	$2,687,843
Deposit for inventory purchase	7,930,268	7,930,268	1,199,411
Loans to third-parties	3,653,582	1,496,671	226,363
Loans to related parties (A)	70,400	1,417,486	214,387
Business advance to staff	1,186,807	683,964	103,446
Deposits for projects	80,000	79,600	12,039
Others	83,547	3,179	482
Allowance for doubtful accounts	(154,057)	(274,208)	(41,473)
Total other receivables, net	12,850,547	29,108,441	4,402,498
Less: current portion	(12,850,547)	(16,136,960)	(2,440,630)
Non-current portion	¥-	¥12,971,481	$1,961,868

Due from ENI represents a working capital loan to ENI. The loan balance had been in intercompany balances and was eliminated in the Company's unaudited condensed consolidated financial statements before the deconsolidation of ENI. It was reclassified to other receivables after ENI ceased to be a VIE of the Company on December 16, 2010. In January 2012, ENI agreed to repay the loan on a determined payment schedule, and interest is accrued during the period at an annual rate of 4%. In accordance with the payment schedule, the principal plus accrued interest will be repaid over three years on a quarterly basis. The first four payments are set at RMB 1.2 million each. Accordingly, the current and non-current portion of the amount due from ENI is determined to be RMB 4.8 million and RMB 12,971,481, respectively.

(A) Loans to related parties consisted mainly of working capital advances to entities under common control. Such advances are due-on-demand and non-interest bearing.

	June 30, 2010	December 31, 2010	December 31, 2010

Name of Related Party	RMB	RMB (As restated)	U.S. Dollars (As restated)
Beijing Yabei Nuoda Science and Technology Co. Ltd.	¥-	¥ 620,000	$ 93,772
Beijing Aerda Oil Technology Co. Ltd.	-	727,086	109,968
Beijing Yuandaweiye Technology Development Co., Ltd.	3,086,112	-	-
Xiamen Huasheng Haitian Computer Network Co. Ltd.	70,400	70,400	10,647
Total	¥3,156,512	¥ 1,417,486	$ 214,387

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RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

One of the owners of ENI, the Company's previous VIE which was deconsolidated on December 16, 2010, controlled Beijing Yuandaweiye Technology Development Co., Ltd. (translated name).

One of the Founders and his family member collectively owns 57% minority of Xiamen Huasheng Haitian Computer Co. Ltd.

Deposit for inventory purchase represents the amounts paid to certain agents designated by the end customers to purchase special inventory.

Loans to third-parties are mainly used for short-term fund to support cooperative companies. These loans are due on demand bearing no interest.

Business advance to staff represents advances for business travel and sundry expenses related to oilfield or on-site installation and inspection of products through customer approval and acceptance.

NOTE 6. PURCHASE ADVANCES

Purchase advances consisted of the following at June 30, 2010 and December 31, 2010:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Prepayment for inventory purchase	¥46,293,094	¥14,818,587	$ 2,241,233
Service fee	258,308	171,907	26,000
Purchase advances	¥46,551,402	¥14,990,494	$ 2,267,233

The Company purchased products and services from third-party and related parties during the normal course of business.

Related Party	June 30, 2010 RMB	March 30, 2011 RMB	March 30, 2011 U.S. Dollars
Nanjing Youkong Information Technology Co., Ltd	¥325,628	¥367,628	$ 55,602
Raytheon Energy(Group) Co., Ltd	9,580,400		
Total	¥9,906,028	¥367,628	$ 55,602

One of the Founders is a 20% owner of Nanjing Youkong Information Technology Co. Ltd. (translated name).

One of the owners of ENI, the Company's previous VIE which was deconsolidated on December 15, 2010, and his family member collectively controlled Raytheon Energy (Group) Co., Ltd Co., Ltd.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. INVENTORIES

Inventories consisted of the following at June 30, 2010 and December 31, 2010:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Small component parts	¥310,381	¥262,828	$ 39,751
Purchased goods and raw materials	5,721,871	267,608	40,474
Work in process	-	768,852	116,285
Finished goods	7,118,659	16,693,981	2,524,877
Total inventories	¥13,150,911	¥17,993,269	$ 2,721,387

NOTE 8. PROPERTY AND EQUIPMENT, NET

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

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Motor vehicles	¥1,796,955	¥ 1,716,120	$ 259,554
Office equipment and fixtures	450,715	234,473	35,463
Leasehold improvement	426,181	149,243	22,572
Total property and equipment	2,673,851	2,099,836	317,589
Less: Accumulated depreciation	(1,190,970)	(955,045)	(144,445)
Property and equipment, net	¥1,482,881	¥ 1,144,791	$ 173,144

Depreciation expense was ¥83,074 and ¥102,425 ($15,523) for the three months ended December 31, 2009 and 2010, respectively. Depreciation expense was ¥170,864 and ¥201,232 ($30,435) for the six months ended December 31, 2009 and 2010, respectively.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. OTHER PAYABLES

Other payables consisted of the following at June 30, 2010 and December 31, 2010:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Service	¥-	¥ 890,035	$ 134,613
Freight	-	740,666	112,022
Due to ENI	-	148,000	22,384
Expenses paid by third-parties on behalf of Recon	194,361	535,039	80,922
Loans from third-party companies	2,183,965	-	-
Loans from third-party individuals	223,448	-	-
Rental	441,921	-	-
Others	52,614	-	-
Total other payables	¥3,096,309	¥ 2,313,740	$ 349,941

Loans from third-party companies were borrowed mainly for supplemental working capital by BHD in the amount of ¥1,100,000 and by Nanjing Recon in the amount of ¥1,083,965 as of June 30, 2010. These loans are due on demand bearing no interest. As of December 31, 2010, such loan was reclassified to short-term borrowings in Note 13.

NOTE 10. SHAREHOLDERS' EQUITY

Ordinary Shares - When the Company was incorporated in the Cayman Islands on August 21, 2007, 25,000,000 ordinary shares were authorized, and 2,139,203 ordinary shares were issued to the Founders, at a par value of $0.0185 each. On July 29, 2009, the Company completed its initial public offering (IPO) by offering 1,700,000 ordinary shares at $6.00 per share. In connection with the IPO, all the 112,608 redeemable ordinary shares outstanding were automatically converted into non-redeemable ordinary shares pursuant to an agreement. On July 31, 2009, ordinary shares of the Company commenced trading on NASDAQ Exchange.

Appropriated Retained Earnings - According to the Memorandum and Articles of Association, the Company is required to transfer a certain portion of its net profit, as determined under PRC accounting regulations, from current net income to the statutory reserve fund. In accordance with the PRC Company Law, companies are required to transfer 10% of their profit after tax, as determined in accordance with PRC accounting standards and regulations, to the statutory reserves until such reserves reach 50% of the registered capital or paid-in capital of the companies. As of June 30, 2010 and December 31, 2010, the balance of total statutory reserves was ¥3,755,503 and ¥2,248,864 ($340,129), respectively.

Stock-Based Awards Plan - In June 2009, the Board of Directors and the shareholders of the Company adopted the 2009 Stock Incentive Plan (the "2009 Plan"). The 2009 Plan provides for the granting of stock options and restricted ordinary shares to employees, non-employee directors and consultants of the Company. Options granted under the 2009 Plan may be Incentive Stock Options or Non-statutory Stock Options. Non-employee directors and Consultants are not eligible to receive the award of an Incentive Stock Option. The Compensation Committee of the Board of Director is entitled to establish the term, vesting conditions and exercise price of the options as well as the vesting conditions and transferability of restricted shares. Under the 2009 Plan, 790,362 unissued ordinary shares have been reserved for issuance. As discussed in Note 18, under the 2009 Plan, the Company granted options to purchase 293,000 of ordinary shares to its employees and non-employee directors on July 29, 2009 and 170,000 warrants to placement agent.

RECON TECHNOLOGY, LTD

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. INCOME TAX

The Company is not subject to any income taxes in the United States or the Cayman Islands and had minimal operations in jurisdictions other than the PRC. BHD and Nanjing Recon are subject to PRC's income taxes as PRC domestic companies. Implementing Rules for the Enterprise Income Tax Law ("Implementing Rules"), which took effect on January 1, 2008, unified the income tax rate for domestic-invested and foreign-invested enterprises at 25%.

Thus for the calendar year 2009, Nanjing Recon is subject to an income tax rate of 25%. For calendar year 2010, the Company reapplied for hi-tech approval and has passed all relevant review. Thus, for the calendar year 2010, Nanjing Recon is subject to an income tax rate of 15%.

As approved by the domestic tax authority in the PRC, BHD was recognized as a government-certified high technology company on November 25, 2009 and is subject to an income tax rate of 15% for calendar year 2010. This qualification certificate will stay effective until the certificate matures in 2012.

Deferred tax assets are comprised of the following:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Allowance for doubtful receivables	¥275,960	¥ 273,736	$ 41,401
Total deferred income tax assets	¥275,960	¥ 273,736	$ 41,401

Following is a reconciliation of income tax at the calculated statutory rates:

	For the three months ended December 31, 2009	For the three months ended December 31, 2010	For the three months ended December 31, 2010

	RMB	RMB (As restated)	U.S. Dollars (As restated)
Income tax calculated at statutory rates	¥ 4,994,175	¥ 734,075	$ 111,025
Benefit of favorable rate for high-technology companies	(580,088)	(1,984)	(300)
Benefit of revenue exempted from enterprise income tax	-	(533,832)	(80,739)
Provision for income tax	¥ 4,414,087	¥ 198,259	$ 29,986

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	For the six Months ended December 31, 2009 RMB	For the six months ended December 31, 2010 RMB (As restated)	For the six Months ended December 31, 2010 U.S. Dollars (As restated)
Income tax calculated at statutory rates	¥ 5,760,634	¥ 1,786,357	$ 270,177
Benefit of favorable rate for high-technology companies	(653,869)	(714,544)	(108,071)
Benefit of revenue exempted from enterprise income tax	-	(67,728)	(10,243)
Provision for income tax	¥ 5,106,765	¥ 1,004,085	$ 151,863

The provision for income tax is comprised of the following:

	For the three months ended December 31, 2009 RMB	For the three months ended December 31, 2010 RMB (As restated)	For the three months ended December 31, 2010 U.S. Dollars (As restated)
Current income tax	¥ (253,988)	¥ 198,259	$ 29,986
Deferred income tax	4,668,075	-	-
Provision for income tax	¥ 4,414,087	¥ 198,259	$ 29,986

	For the six months ended December 31, 2009 RMB	For the six months ended December 31, 2010 RMB (As restated)	For the six months ended December 31, 2010 U.S. Dollars (As restated)
Current income tax	¥ 1,183,232	¥ 1,005,632	$ 152,097
Deferred income tax	3,923,533	(1,547)	(234)
Provision for income tax	¥ 5,106,765	¥ 1,004,085	$ 151,863

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12. SHORT-TERM BANK LOAN

Short-term bank loan consists of the following:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Beijing Bank, with a floating interest rate from 5.56% to 6.06% annually (repaid on December 22, 2011)	¥ -	¥ 5,000,000	$ 756,224
Total short-term bank loan	¥ -	¥ 5,000,000	$ 756,224

NOTE 13. SHORT-TERM BORROWINGS

Short-term borrowings are generally extended upon maturity and they consist of the following:

Short-term borrowings due to **non-related parties:**	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Due-on-demand borrowing, no interest	¥1,224,888	¥ -	$ -
Short-term borrowings, no interest, matures on Aug. 25, 2010 and 2011, respectively	140,000	140,000	21,173
Short-term borrowing, 6% annual interest, matures on November 10, 2010 and 2011, respectively	960,000	1,017,600	153,907
Short-term borrowing, 6% annual interest, matures on December 9, 2010 and 2011, respectively	212,911	225,686	34,134
Short-term borrowings, no interest, matures on Dec. 27, 2010	411,500	-	-
Short-term borrowings, no interest, matures on May 24, 2011	1,575,582	1,576,982	238,511
Short-term borrowings, interest at 1.2% per month, matures on Nov. 19, 2010 and 2011, respectively	500,000	500,000	75,622
Other short-term borrowings		1,083,384	163,856
Total short-term borrowings due to non-related parties	¥5,024,881	¥ 4,543,652	$ 687,203

The interest expenses for short-term borrowings due to non-related parties are ¥17,594 and ¥36,649 ($5,543) for the three months ended December 31, 2009 and 2010, respectively, and are ¥35,187 and ¥73,299 ($11,086) for the six months ended December 31, 2009 and 2010, respectively.

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Short-term borrowings due to **related parties:**	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
Due-on-demand borrowings from Founders, no interest	¥376,377	¥ 46,377	$ 7,014
Short-term borrowing from a Founder's family member, 6% annual interest, matures on May 4, 2010 and 2011, respectively	204,495	216,765	32,785
Short-term borrowing from a Founder's family member, no interest, matures on November 15, 2011	-	50,000	7,562
Short-term borrowing from a Founder's family member, 6% annual interest, matures on December 9, 2010 and 2011, respectively	44,605	47,281	7,151
Short-term borrowings from a Founder's family member, 6% annual interest, matures on December 31, 2010	6,200,000	-	-
Short-term borrowings from management, 6% annual interest, matures on December 8, 2010 and 2011, respectively	517,980	550,976	83,332
Total short-term borrowings due to related parties	¥7,343,457	¥ 911,399	$ 137,844

The interest expenses for short-term borrowings due to related parties are ¥18,475 and ¥175,381 ($26,525) for the three months ended December 31, 2009 and 2010, respectively, and are ¥42,126 and ¥252,170 ($38,139) for the six months ended December 31, 2009 and 2010, respectively.

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. NON-CONTROLLING INTEREST

Non-controlling interest consisted of the following:

	As of June 30, 2010				
	ENI	BHD	Nanjing Recon	Total	Total
	RMB	RMB	RMB	RMB	U.S. Dollar
Paid-in capital	¥1,200,000	¥1,651,000	¥200,000	¥3,051,000	$448,110
Unappropriated retained earnings	2,392,177	1,925,052	2,224,168	6,541,397	960,755
Accumulated other comprehensive loss	(3,204)	(3,190)	(2,162)	(8,556)	(1,257)
Total non-controlling interest	¥3,588,973	¥3,572,862	¥2,422,006	¥9,583,841	$1,407,608

	As of December 31, 2010 (as restated)				
	ENI	BHD	Nanjing Recon	Total	Total
	RMB	RMB	RMB	RMB	U.S. Dollar
Paid-in capital	¥-	¥1,651,000	¥200,000	¥1,851,000	$279,954
Unappropriated retained earnings	-	2,412,879	2,737,584	5,150,463	778,980
Accumulated other comprehensive loss	-	(12,984)	(9,386)	(22,370)	(3,383)
Total non-controlling interest	¥-	¥4,050,895	¥2,928,198	¥6,979,093	$1,055,551

NOTE 15. CONCENTRATIONS

For the three months ended December 31, 2009, the largest two customers, China National Petroleum Corporation ("CNPC") and China Petroleum & Chemical Corporation Limited ("SINOPEC"), represented 61.93% and 10.05% of the Company's revenue. For the three months ended December 31, 2010, these two largest customers accounted for 71.55% and 16.3% of its revenue.

For the six months ended December 31, 2009, these two largest customers represented 58.27% and 21.77% of the Company's revenue. For the six months ended December 31, 2010, these two largest customers accounted for 53.17% and 22.56% of its revenue. The Company provided services directly to these two largest customers, but did not sign contracts directly with them. Instead, the Company entered into contracts with agents representing the customers.

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For the three and six months ended December 31, 2009 and 2010, no suppliers accounted for 10% or more of its total purchases.

NOTE 16. COMMITMENTS AND CONTINGENCIES

(a) Office Leases

The Company leased offices for its VIEs in Beijing, Nanjing and Jining through December 31, 2012, July 9, 2012 and June 30, 2012, respectively. Below is a summary of the Company's contractual obligations and commitments as of December 31, 2010:

	Payment Due by Period			
Contractual Obligations	Total	Less than 1 year	1-3 years	More than 3 years
Operating lease	$176,503	$ 153,060	$23,443	-

(b) Contingency

The Labor Contract Law of the PRC requires employers to assure the liability of severance payments if employees are terminated and have been working for the employers for at least two years prior to January 1, 2008. The employers will be liable for one month of severance pay for each year of the service provided by the employees. As of December 31, 2010, the Company estimated its severance payments of approximately ¥771,850 ($116,738) which has not been reflected in its consolidated financial statements, as the probability of payment is remote.

NOTE 17. RELATED PARTY TRANSACTIONS AND BALANCES

Sales to related parties – The Company had sales to related parties which are entities under common ownership. Below is a summary of the sales to related parties for the three and six months ended December 31, 2009 and 2010.

	For the Three Months ended		
	December 31, 2009	December 31, 2010	December 31, 2010
Related Party	RMB	RMB	U.S. Dollars
		(As restated)	(As restated)
Beijing Yabei Nuoda Science and Technology Co. Ltd.	¥-	¥9,393,163	$ 1,420,666
Beijing Aerda Oil Technology Co. Ltd.		2,256,585	341,297
Zhongjiyan Technology (Beijing) Co. Ltd.	-	4,365,812	660,306
Total	¥-	¥16,015,560	$ 2,422,269

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	For the Six Months ended		
	December 31, 2009	December 31, 2010	December 31, 2010
Related Party	RMB	RMB	U.S. Dollars
		(As restated)	(As restated)
Beijing Yabei Nuoda Science and Technology Co. Ltd.	¥10,000,000	¥9,393,163	$ 1,420,666
Beijing Aerda Oil Technology Co. Ltd.	652,649	2,256,585	341,297
Zhongjiyan Technology (Beijing) Co. Ltd.	1,752,137	4,365,812-	660,306
Total	¥12,404,786	¥16,015,560	$ 2,422,269

Leases from related parties - On January 1, 2010, the Company entered into a one-year agreement for the lease of office space owned by the Founders and their family members. The terms of the agreement state that the Company will lease the property for one year at a monthly rent of ¥86,583 with the annual rental expense at ¥1,039,000 ($157,143). Specifically, our former VIE, ENI, leased its office from Mr. Li Hongqi for one year from January 1, 2010 to December 31, 2010 with a monthly rent of ¥40,000.

Short-term borrowings from related parties - The Company borrowed ¥7,343,457 and ¥911,399 ($137,844) from the Founders, their family members and senior officials as of June 30 and December 31, 2010, respectively. For the specific terms and interest rates of the loans, please see Note 13.

NOTE 18. STOCK-BASED COMPENSATION

Stock-based payments - As discussed in Note 10, the Company granted options to purchase 293,000 ordinary shares under the 2009 Plan to its employees and non-employee directors on July 29, 2009. The options have an exercise price of $6.00, equal to the IPO price of the Company's ordinary shares, and will vest over a period of five years, with the first 20% vested on July 29, 2010. The options expire ten years after the date of grant, on July 29, 2019. The fair value was estimated on July 29, 2009 using the Binomial Lattice valuation model, with the following weighted-average assumptions:

Stock price at grant date	$6.00
Exercise price (per share)	$6.00
Risk free rate of interest***	4.6118 %
Dividend yield	0.0 %

Life of option (years)**	10	
Volatility*	78	%
Forfeiture rate****	0	%

* Volatility is projected using the performance of PHLX Oil Service Sector index.

** The life of options represents the period the option is expected to be outstanding.

*** The risk-free interest rate is based on the Chinese international bond denominated in U.S dollar with a maturity that approximates the life of the option.

**** Forfeiture rate is the estimated percentage of options forfeited by employees by leaving or being terminated before vesting.

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company recognizes compensation cost for awards with graded vesting on a straight-line basis over the requisite service period for the entire award. The grant date fair value of the options was ¥30.17 ($4.42) per share. Compensation expense recorded for the three months ended December 31, 2009 and 2010 was ¥294,675 and ¥431,378 ($65,244), and ¥736,688 and ¥870,084 ($131,596) for the six months ended December 31, 2009 and 2010, respectively.

As of December 31, 2010, options to purchase 293,000 of ordinary shares were outstanding, 58,600 of them are vested under the 2009 Plan and no granted stock options were exercised.

Placement Agent Warrants - As discussed in Note 10, the Company completed its initial public offering (IPO) on July 29, 2009, and the gross proceeds received by the Company for the offering were $10,200,000 (1,700,000 ordinary shares at $6.00 per share) before the cash offering costs of ¥9,651,771 ($1,412,896).

In connection with the offering, the Company sold the placement agent warrants to purchase 170,000 ordinary shares at $7.20 per share for a nominal amount. These warrants are exercisable for a period of five years. The Company has agreed to file, during the five year period at its cost, at the request of the holders of a majority of the placement agents warrants and the underlying ordinary shares, and to use its best efforts to cause to become effective a registration statement under the Securities Act, as required to permit the public sale of ordinary shares issued or issuable upon exercise of the placement agent’s warrants. The Company accounted for the warrants as an additional offering cost with an estimated value of $627,341 which was a deduction of the gross proceeds mentioned above. The following table presents the assumptions used in the Black-Scholes valuation model to estimate the fair value of the placement agent warrants sold:

Stock price at grant date	$6.00	
Exercise price (per share)	$7.20	
Risk free rate of interest	3.7679	%
Dividend yield	0	%
Expected volatility	78	%
Expected life (in years)	5	%

The Company had 170,000 of granted placement agent warrants as of December 31, 2010 and no warrants were exercised during the six months then ended.

NOTE 19. EARNINGS PER SHARE

ASC 260 “Earnings Per Share,” requires dual presentation of basic and diluted earnings per share (“EPS”) with a reconciliation of the numerator and denominator of the basic EPS computation to the numerator and denominator of the diluted EPS computation. Basic EPS excludes dilution. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue ordinary shares were exercised or converted into ordinary shares or resulted in the issuance of ordinary shares that then shared in the earnings of the entity.

Basic net income per share is computed by dividing net income available to ordinary shareholders by the weighted average number of shares of ordinary shares outstanding during the period. Diluted income per share is computed by dividing net income by the weighted average number of shares of ordinary shares, ordinary shares equivalents and potentially dilutive securities outstanding during each period. Potentially dilutive ordinary shares consist of ordinary shares issuable upon the conversion of ordinary stock options and warrants (using the treasury stock method). However, the effect from options and warrants would have been anti-dilutive due to the fact that the weighted average exercise price per share of options and warrants is higher than the weighted average market price per share of the ordinary shares during the three months and six months ended December 31, 2010.

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NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations:

	For the three months ended December 31,		
	2009	2010	2010
	RMB	RMB	U.S. Dollars
		(As restated)	(As restated)
Basic weighted average ordinary shares outstanding	3,951,811	3,951,811	3,951,811
Effect of options and warrants	94,762	-	-
Diluted weighted average ordinary shares outstanding	4,046,573	3,951,811	3,951,811
Net income (loss) attributable to ordinary shareholders	¥12,554,152	¥(20,677,452)	$(3,127,357)
Basic earnings (loss) per share	¥3.18	¥(5.23)	$(0.79)
Diluted earnings (loss) per share	¥3.10	¥(5.23)	$(0.79)

	For the six months ended December 31,		
	2009	2010	2010
	RMB	RMB	U.S. Dollars
		(As restated)	(As restated)
Basic weighted average ordinary shares outstanding	3,656,277	3,951,811	3,951,811
Effect of options and warrants	42,704	-	-
Diluted weighted average ordinary shares outstanding	3,698,981	3,951,811	3,951,811
Net income (loss) attributable to ordinary shareholders	¥12,978,571	¥(19,833,689)	$(2,999,741)
Basic earnings (loss) per share	¥3.55	¥(5.02)	$(0.76)
Diluted earnings (loss) per share	¥3.51	¥(5.02)	$(0.76)

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NOTE 20. Variable Interest Entities

The Company reports VIEs' portion of consolidated net income and stockholders' equity as non-controlling interests in the consolidated financial statements, except for ENI which was consolidated only through December 15, 2010 as indicated in Note 2 to the accompanying unaudited condensed consolidated financial statements. Summary information regarding consolidated VIEs is as follows:

	June 30, 2010 RMB	December 31, 2010 RMB (As restated)	December 31, 2010 U.S. Dollars (As restated)
ASSETS			
Current Assets			
Cash and cash equivalents	¥4,689,773	¥3,851,659	$ 582,543
Trade accounts receivable, net	89,425,990	67,139,709	10,154,528
Purchase advances	46,296,079	14,818,587	2,241,233
Other assets	26,530,217	30,290,473	4,581,275
Total Current Assets	**¥166,942,059**	**¥116,100,428**	**$ 17,559,579**
Non-current assets	1,748,151	1,408,807	213,074
Total Assets	¥168,690,210	¥117,509,235	$ 17,772,653
LIABILITIES			
Trade accounts payable	¥16,536,796	¥14,893,472	$ 2,252,560
Taxes payable	20,203,104	11,154,277	1,687,026
Other liabilities	20,629,101	44,181,716	6,682,252
Total current liabilities	¥57,369,001	¥70,229,465	$ 10,621,838
Total Liabilities	¥57,369,001	¥70,229,465	$ 10,621,838

The financial performance of VIEs reported in the consolidated income statement is for the three months ended December 31, 2010, including revenues of ¥32,183,746 ($4,867,622), operating expenses of ¥18,775,740 ($2,839,732), other expense of ¥253,020 ($38,267) and net loss before allocation to non-controlling interests of ¥10,485,581 ($1,585,890).

The financial performance of VIEs reported in the consolidated income statement is for the six months ended December 31, 2010, including revenues of ¥53,983,057 ($8,164,654), operating expenses of ¥17,504,597 ($2,647,478), other income of ¥54,610 ($8,260) and net loss before allocation to non-controlling interests of ¥13,888,883 ($2,100,621).

NOTE 21. SUBSEQUENT EVENTS

In January 2012, the Company and ENI executed an agreement whereby ENI will repay the working capital loan (RMB 17,771,481 plus interest accruable at an annual rate of 4%) on an agreed-upon payment schedule. In accordance with the payment schedule, the principal plus accrued interest will be repaid over three years on a quarterly basis. The first four payments are set at RMB 1.2 million each. Accordingly, the current and non-current portion of the amount due from ENI is determined to be RMB 4.8 million and RMB 12,971,481, respectively.

PART II OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 1A Risk Factors.

Not applicable.

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

(a) None

(b) The section entitled "Use of Proceeds" from our registration statement filed on August 12, 2008, as amended (the "Registration Statement") is incorporated herein by reference. The effective date of the Registration Statement is July 22, 2009, and the Commission file number assigned to the Registration Statement is 333-152964. The Registration Statement registers the offering of up to 1,700,000 ordinary shares (subject to amendment in accordance with the Securities Act of 1933 and the rules and regulations promulgated thereunder) (the Offering"). As of December 31, 2010, the Company has spent proceeds from the Offering in accordance with the following chart:

Description of Use	Proposed Expenditure Amount	Actual Expenditures through December 31, 2010
Product Research and development	$ 1,273,024	$ 166,425
Acquisition and business development in oil-field industry in China and globally	4,073,675	4,200,000
Sarbanes-Oxley compliance	424,341	0
Fixed asset purchases	442,341	0
Employee training	169,736	6,639
General working capital	2,121,706	1,138,268
Due from former VIE	—	$ 2,600,000
Total	$ 8,504,823	$ 8,111,332

(c) None

Item 3. Defaults upon Senior Securities.

None.

Item 4. (Removed and Reserved).

Item 5. Other Information.

None.

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Item 6. Exhibits.

The following exhibits are filed herewith:

Exhibit Number	Document
3.1	Amended and Restated Articles of Association of the Registrant (1)
3.2	Amended and Restated Memorandum of Association of the Registrant (1)
4.1	Specimen Share Certificate (1)
10.1	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.2	Translation of Power of Attorney for rights of Chen Guangqiang in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.3	Translation of Power of Attorney for rights of Yin Shenping in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.4	Translation of Power of Attorney for rights of Li Hongqi in Beijing BHD Petroleum Technology Co., Ltd. (1)
10.5	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.6	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.7	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.8	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.9	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Beijing BHD Petroleum Technology Co., Ltd. (1)
10.10	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Beijing BHD Petroleum Technology Co., Ltd. (1)

10.11	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Jining ENI Energy Technology Co., Ltd. (1)
10.12	Translation of Power of Attorney for rights of Chen Guangqiang in Jining ENI Energy Technology Co., Ltd. (1)
10.13	Translation of Power of Attorney for rights of Yin Shenping in Jining ENI Energy Technology Co., Ltd. (1)
10.14	Translation of Power of Attorney for rights of Li Hongqi in Jining ENI Energy Technology Co., Ltd. (1)
10.15	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Jining ENI Energy Technology Co., Ltd. (1)
10.16	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Jining ENI Energy Technology Co., Ltd. (1)
10.17	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Jining ENI Energy Technology Co., Ltd. (1)
10.18	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Jining ENI Energy Technology Co., Ltd. (1)

10.19	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Jining ENI Energy Technology Co., Ltd. (1)
10.20	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Jining ENI Energy Technology Co., Ltd. (1)
10.21	Translation of Exclusive Technical Consulting Service Agreement between Recon Technology (Jining) Co., Ltd. and Nanjing Recon Technology Co., Ltd. (1)
10.22	Translation of Power of Attorney for rights of Chen Guangqiang in Nanjing Recon Technology Co., Ltd. (1)
10.23	Translation of Power of Attorney for rights of Yin Shenping in Nanjing Recon Technology Co., Ltd. (1)
10.24	Translation of Power of Attorney for rights of Li Hongqi in Nanjing Recon Technology Co., Ltd. (1)
10.25	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Chen Guangqiang and Nanjing Recon Technology Co., Ltd. (1)
10.26	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Yin Shenping and Nanjing Recon Technology Co., Ltd. (1)
10.27	Translation of Exclusive Equity Interest Purchase Agreement between Recon Technology (Jining) Co. Ltd., Li Hongqi and Nanjing Recon Technology Co., Ltd. (1)
10.28	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Chen Guangqiang and Nanjing Recon Technology Co., Ltd. (1)
10.29	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Yin Shenping and Nanjing Recon Technology Co., Ltd. (1)
10.30	Translation of Equity Interest Pledge Agreement between Recon Technology (Jining) Co., Ltd., Li Hongqi and Nanjing Recon Technology Co., Ltd. (1)
10.33	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Yin Shenping (1)
10.34	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Chen Guangqiang (1)
10.35	Employment Agreement between Recon Technology (Jining) Co., Ltd. and Mr. Li Hongqi (1)
10.36	Operating Agreement among Recon Technology (Jining) Co. Ltd., Nanjing Recon Technology Co., Ltd. and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
10.37	Operating Agreement among Recon Technology (Jining) Co. Ltd., Jining ENI Energy Technology Co., Ltd., and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
10.38	Operating Agreement among Recon Technology (Jining) Co. Ltd., Beijing BHD and Mr. Yin Shenping, Mr. Chen Guangqiang and Mr. Li Hongqi (1)
21.1	Subsidiaries of the Registrant (2)

99.1 Stock Option Plan [1]

99.2 Code of Business Conduct and Ethics [1]

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31.1	Certifications pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
31.2	Certifications pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2)
32.1	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)
32.1	Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)

(1) Incorporated by reference to the Company’s Registration Statement on Form S-1, Registration No. 333-152964.
(2) Filed herewith.

SIGNATURES

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

RECON TECHNOLOGY, LTD

January 31, 2012 By: /s/ Liu Jia
Liu Jia
Chief Financial Officer
(Principal Financial and Accounting Officer)

Signature-1

nt-family:times;">

Net interest income

$2,713

(1) Reflects tax equivalent adjustment for tax exempt income based on a 35% tax rate.

The Company's net interest margin (FTE), expressed as a percentage of average earning assets, increased 18 basis points to 4.07% for the second quarter of 2014, from 3.89% for the second quarter of 2013. For the six months ended June 30, 2014, net interest margin increased 26 basis points to 4.06%, from 3.80% for the six months ended June 30, 2013. The increase in the net interest margin for the second quarter and for the six months ended June 30, 2014, compared to the same periods in 2013, was primarily due to loan growth, higher yields on securities, and a lower cost of funds.

Net interest income increased 13% to $13.7 million for the second quarter of 2014, compared to $12.2 million for the second quarter of 2013. Net interest income increased 11% to $27.0 million for the six months ended June 30, 2014, compared to $24.3 million the six months ended June 30, 2013. The increase in the net interest income for the second quarter and for the six months ended June 30, 2014, compared to the same periods in 2013, was primarily due to loan growth and an increase in core deposits.

A substantial portion of the Company's earning assets are variable-rate loans that re-price when the Company's prime lending rate is changed, compared to a large base of core deposits that are generally slower to re-price. This causes the Company's balance sheet to be asset-sensitive, which means that all else being equal, the Company's net interest margin will be lower during periods when short-term interest rates are falling and higher when rates are rising.

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Provision for Loan Losses

Credit risk is inherent in the business of making loans. The Company establishes an allowance for loan losses through charges to earnings, which are presented in the statements of income as the provision for loan losses. Specifically identifiable and quantifiable known losses are promptly charged off against the allowance. The provision for loan losses is determined by conducting a quarterly evaluation of the adequacy of the Company's allowance for loan losses and charging the shortfall or excess, if any, to the current quarter's expense. This has the effect of creating variability in the amount and frequency of charges to the Company's earnings. The provision for loan losses and level of allowance for each period are dependent upon many factors, including loan growth, net charge-offs, changes in the composition of the loan portfolio, delinquencies, management's assessment of the quality of the loan portfolio, the valuation of problem loans and the general economic conditions in the Company's market area.

There was a credit to the provision for loan losses of $198,000 for the second quarter of 2014, compared to a credit to the provision for loan losses of $270,000 for the second quarter of 2013. The credit to the provision for loan losses for the six months ended June 30, 2014 was $208,000, compared to a credit to the provision for loan losses $270,000 for the six months ended June 30,2013.

The allowance for loan losses totaled $18.6 million, or 1.88% of total loans at June 30, 2014, compared to $19.3 million, or 2.30% of total loans at June 30, 2013, and $19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at June 30, 2014, compared to June 30, 2013, and December 31, 2013, primarily due to increasing loan balances with no default histories, improving the quality of the loan portfolio overall. Net charge-offs totaled $27,000 for the second quarter of 2014, compared to net recoveries of $270,000 for the second quarter of 2013, and net charge-offs of $166,000 for the fourth quarter of 2013. Provisions for loan losses are charged to operations to bring the allowance for loan losses to a level deemed appropriate by the Company based on the factors discussed under "Allowance for Loan Losses".

Noninterest Income

The following table sets forth the various components of the Company's noninterest income for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	**2013**	**Amount**	**Percent**
	(Dollars in thousands)			
Service charges and fees on deposit accounts	$ 646	$ 618	$ 28	5%
Gain on sales of SBA loans	442	134	308	230%
Increase in cash surrender value of life insurance	397	410	(13)	-3%
Servicing income	313	385	(72)	-19%
Gain on sales of securities		7	(7)	-100%
Other	249	361	(112)	-31%
Total noninterest income	$ 2,047	$ 1,915	$ 132	7%

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	For the Six Months Ended June 30,				Increase (decrease) 2014 versus 2013	
	2014		2013		Amount	Percent
	(Dollars in thousands)					
Service charges and fees on deposit accounts	$ 1,266		$ 1,195		$ 71	6%
Gain on sales of SBA loans	599		270		329	122%
Increase in cash surrender value of life insurance	795		826		(31)	-4%
Servicing income	661		750		(89)	-12%
Gain on sales of securities	50		38		12	32%
Other	693		499		194	39%
Total noninterest income	$ 4,064		$ 3,578		$ 486	14%

The increase in noninterest income in the second quarter and six months ended June 30, 2014, compared to the same periods in 2013 was primarily attributable to a higher gain on sales of SBA loans.

Historically, a significant percentage of the Company's noninterest income has been associated with its SBA lending activity, as gains on the sale of loans sold in the secondary market and servicing income from loans sold with servicing rights retained. For the three months ended June 30, 2014, SBA loan sales resulted in a $442,000 gain, compared to a $134,000 gain on sale of SBA loans for the three months ended June 30, 2013. For the six months ended June 30, 2014, SBA loan sales resulted in a $599,000 gain, compared to a $270,000 gain on sale of SBA loans for the six months ended June 30, 2013.

The servicing assets that result from the sales of SBA loans with servicing retained are amortized over the expected term of the loans using a method approximating the interest method. Servicing income generally declines as the respective loans are repaid.

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Noninterest Expense

The following table sets forth the various components of the Company's noninterest expense for the periods indicated:

	For the Three Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 6,819	$ 5,864	$ 955	16%
Occupancy and equipment	987	1,028	(41)	-4%
Data processing	273	327	(54)	-17%
Insurance expense	269	253	16	6%
FDIC deposit insurance premiums	220	207	13	6%
Software subscriptions	191	294	(103)	-35%
Correspondent bank charges	183	179	4	2%
Low income housing investment losses	165	300	(135)	-45%
Professional fees	126	400	(274)	-69%
Subordinated debt redemption charges		167	(167)	-100%
Foreclosed assets, net		(96)	96	-100%
Other	1,701	1,466	235	16%
Total noninterest expense	$ 10,934	$ 10,389	$ 545	5%

	For the Six Months Ended June 30,		Increase (decrease) 2014 versus 2013	
	2014	2013	Amount	Percent
	(Dollars in thousands)			
Salaries and employee benefits	$ 13,062	$ 11,875	$ 1,187	10%
Occupancy and equipment	1,932	2,096	(164)	-8%
Data processing	502	579	(77)	-13%
Insurance expense	538	508	30	6%
FDIC deposit insurance premiums	454	466	(12)	-3%
Software subscriptions	438	585	(147)	-25%
Correspondent bank charges	365	343	22	6%
Low income housing investment losses	353	611	(258)	-42%
Professional fees	712	1,382	(670)	-48%
Subordinated debt redemption charges		167	(167)	-100%
Foreclosed assets, net	(19)	(251)	232	-92%
Other	3,331	2,809	522	19%
Total noninterest expense	$ 21,668	$ 21,170	$ 498	2%

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The following table indicates the percentage of noninterest expense in each category for the periods indicated:

Noninterest Expense by Category

	For the Three Months Ended June 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 6,819	62%	$ 5,864	56%
Occupancy and equipment	987	9%	1,028	10%
Data processing	273	2%	327	3%
Insurance expense	269	2%	253	2%
FDIC deposit insurance premiums	220	2%	207	2%
Software subscriptions	191	2%	294	3%
Correspondent bank charges	183	2%	179	2%
Low income housing investment losses	165	2%	300	3%
Professional fees	126	1%	400	4%
Subordinated debt redemption charges		0%	167	2%
Foreclosed assets, net		0%	(96)	-1%
Other	1,701	16%	1,466	14%
Total noninterest expense	$ 10,934	100%	$ 10,389	100%

	For the Six Months Ended June 30,			
	2014	Percent of Total	2013	Percent of Total
	(Dollars in thousands)			
Salaries and employee benefits	$ 13,062	60%	$ 11,875	56%
Occupancy and equipment	1,932	9%	2,096	10%
Data processing	502	2%	579	3%
Insurance expense	538	3%	508	2%
FDIC deposit insurance premiums	454	2%	466	2%
Software subscriptions	438	2%	585	3%
Correspondent bank charges	365	2%	343	2%
Low income housing investment losses	353	2%	611	3%
Professional fees	712	3%	1,382	6%
Subordinated debt redemption charges		0%	167	1%
Foreclosed assets, net	(19)	0%	(251)	-1%
Other	3,331	15%	2,809	13%
Total noninterest expense	$ 21,668	100%	$ 21,170	100%

Noninterest expense for the second quarter of 2014 increased to $10.9 million, from $10.4 million for the second quarter of 2013. Noninterest expense for the six months ended June 30, 2014 was $21.7 million, compared to $21.2 million for the six months ended June 30, 2013. The increase in noninterest expense for the second quarter and six months ended June 30, 2014 compared to the same periods in 2013 was primarily due to increased salaries and employee benefits expense, partially offset by lower professional fees, data processing and software subscriptions, low income housing investment losses, and a $167,000 charge in the second quarter of 2013 related to the redemption of floating-rate subordinated debt. Higher salaries and employee benefits expense reflected the growth in staffing for business initiatives, the impact of merit increases, and costs associated with the reorganization of administrative responsibilities in the second quarter of 2014. Professional fees were lower due to net recoveries in legal fees as a result of the resolution or payoff of certain problem loans in the second quarter of 2014. Data processing and software subscriptions were lower mainly due to system conversion costs in the second quarter of 2013. Full time equivalent employees were 203 at June 30, 2014 and 191 at June 30, 2013.

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In the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans, or through commercial or standby letters of credit, and financial guarantees. These instruments represent varying degrees of exposure to risk in excess of the amounts included in the accompanying condensed consolidated balance sheets. The Company calculates an off-balance sheet credit risk reserve for all unfunded commitments.

Income Tax Expense

The Company computes its provision for income taxes on a monthly basis. The effective tax rate is determined by applying the Company's statutory income tax rates to pre-tax book income as adjusted for permanent differences between pre-tax book income and actual taxable income. These permanent differences include, but are not limited to, increases in the cash surrender value of life insurance policies, California Enterprise Zone deductions, certain expenses that are not allowed as tax deductions, and tax credits.

The Company's Federal and state income tax expense for the quarter and six months ended June 30, 2014 was $1.7 million and $3.2 million, respectively. The income tax expense was $1.2 million and $2.0 million for the same periods in 2013. The following table shows the Company's effective income tax rates for the periods indicated:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	**2013**	**2014**	**2013**
Effective income tax rate	33.5%	29.3%	33.5%	28.8%

The difference in the effective tax rate compared to the combined Federal and state statutory tax rate of 42% is primarily the result of tax exempt securities, the Company's investment in life insurance policies whose earnings are not subject to taxes, tax credits related to investments in low income housing limited partnerships, Enterprise Zone tax credits, and hiring credits.

The Company has net investments of $874,000 in low-income housing limited partnerships as of June 30, 2014, generating tax credits of approximately $412,000 for 2014, compared to tax credits of approximately $727,000 for 2013. The Company had California Enterprise Zone tax savings of approximately $162,000 for 2013. The California state legislature eliminated the Enterprise Zone tax deductions beginning January 1, 2014.

Some items of income and expense are recognized in different years for tax purposes than when applying generally accepted accounting principles leading to timing differences between the Company's actual tax liability, and the amount accrued for this liability based on book income. These temporary differences comprise the "deferred" portion of the Company's tax expense or benefit, which is accumulated on the Company's books as a deferred tax asset or deferred tax liability until such time as they reverse.

Realization of the Company's deferred tax assets is primarily dependent upon the Company generating sufficient future taxable income to obtain benefit from the reversal of net deductible temporary differences and utilization of tax credit carryforwards and the net operating loss carryforwards for Federal and California state income tax purposes. The amount of deferred tax assets considered realizable is subject to adjustment in future periods based on estimates of future taxable income. Under generally accepted accounting principles a valuation allowance is required to be recognized if it is "more likely than not" that a deferred tax asset will not be realized. The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions.

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The Company had net deferred tax assets of $19.1 million and $23.3 million at June 30, 2014, and December 31, 2013, respectively. After consideration of the matters in the preceding paragraph, the Company determined that it is more likely than not that the net deferred tax asset at June 30, 2014 and December 31, 2013 will be fully realized in future years.

FINANCIAL CONDITION

As of June 30, 2014, total assets increased to $1.48 billion, compared to $1.40 billion at June 30, 2013, and decreased from $1.49 billion at December 31, 2013. Securities available-for-sale (at fair value) were $261.5 million at June 30, 2014, a decrease of 11% from $293.8 million at June 30, 2013, and a decrease of 7% from $280.1 million at December 31, 2013. Securities held-to-maturity (at amortized cost) were $96.0 million at June 30, 2014, compared to $81.7 million at June 30, 2013, and $95.9 million at December 31, 2013. The total loan portfolio, excluding loans held-for-sale, was $990.3 million at June 30, 2014, an increase of 18% from $842.0 million at June 30, 2013, and an increase of 8% from $914.9 million at December 31, 2013.

Deposits totaled $1.27 billion at June 30, 2014, compared to $1.19 billion at June 30, 2013, and $1.29 billion at December 31, 2013. Deposits (excluding all time deposits and CDARS deposits) increased $129.6 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013, and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013. There was no subordinated debt at June 30, 2014, compared to $9.3 million at June 30, 2013, and no subordinated debt at December 31, 2013.

Securities Portfolio

The following table reflects the balances for each category of securities at the dates indicated:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Securities available-for-sale (at fair value):			
Agency mortgage-backed securities	$ 158,996	$ 225,397	$ 207,644
Asset-backed securities	27,313		
Corporate bonds	53,868	47,646	52,046
Trust preferred securities	21,312	20,735	20,410
Total	$ 261,489	$ 293,778	$ 280,100
Securities held-to-maturity (at amortized cost):			
Agency mortgage-backed securities	$ 16,037	$ 14,211	$ 15,932
Municipals Tax Exempt	79,935	67,520	79,989
	$ 95,972	$ 81,731	$ 95,921

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The following table summarizes the weighted average life and weighted average yields of securities at June 30, 2014:

	Weighted Average Life									
	Within One Year or Less		After One and Within Five Years		After Five and Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
Securities available-for-sale (at fair value):										
Agency mortgage-backed securities	$		$ 60,833	2.69%	$ 98,163	2.84%	$		$ 158,996	2.78%
Asset-backed securities	1,790	1.13%	12,015	0.81%	13,508	0.68%			27,313	0.77%
Corporate bonds			6,677	2.77%	47,191	3.09%			53,868	3.05%
Trust preferred securities							21,312	4.87%	21,312	4.87%
	$ 1,790	1.13%	$ 79,525	2.41%	$ 158,862	2.73%	$ 21,312	4.87%	$ 261,489	2.80%
Securities held-to-maturity (at amortized cost):										
Agency mortgage-backed securities	$		$ 7,174	3.20%	$		$ 8,863	3.23%	$ 16,037	3.22%
Municipals Tax Exempt(1)			3,791	4.36%	22,031	4.08%	54,113	3.82%	79,935	3.92%
	$		$ 10,965	3.61%	$ 22,031	4.08%	$ 62,976	3.73%	$ 95,972	3.80%

(1) Reflects tax equivalent yield based on a 35% tax rate.

The securities portfolio is the second largest component of the Company's interest-earning assets, and the structure and composition of this portfolio is important to an analysis of the financial condition of the Company. The portfolio serves the following purposes: (i) it provides a source of pledged assets for securing certain deposits and borrowed funds, as may be required by law or by specific agreement with a depositor or lender; (ii) it provides liquidity to even out cash flows from the loan and deposit activities of customers; (iii) it can be used as an interest rate risk management tool, since it provides a large base of assets, the maturity and interest rate characteristics of which can be changed more readily than the loan portfolio to better match changes in the deposit base and other funding sources of the Company; and (iv) it is an alternative interest-earning use of funds when loan demand is weak or when deposits grow more rapidly than loans.

The Company's portfolio may include: (i) U.S. Treasury securities and U.S. Government sponsored entities' debt securities for liquidity and pledging; (ii) mortgage-backed securities, which in many instances can also be used for pledging, and which generally enhance the yield of the portfolio; (iii) municipal obligations, which provide tax free income and limited pledging potential; (iv) collateralized mortgage obligations, which generally enhance the yield of the portfolio; and (v) single entity issue trust preferred securities, which generally enhance the yield on the portfolio.

The Company classifies its securities as either available-for-sale or held-to-maturity at the time of purchase. Accounting guidance requires available-for-sale securities to be marked to fair value with an offset to accumulated other comprehensive income (loss), a component of shareholders' equity. Monthly adjustments are made to reflect changes in the fair value of the Company's available-for-sale securities. The investment securities available-for-sale portfolio totaled $261.5 million at June 30, 2014, a decrease of 11% from $293.8 million at June 30, 2013, and a decrease of 7% from $280.1 million at December 31, 2013. At June 30, 2014, the investment securities available-for-sale portfolio was comprised of $159.0 million of agency mortgage-backed securities (all issued by U.S. Government sponsored entities), $53.9 million of corporate bonds, $27.3 million of asset-backed securities, and $21.3 million of single entity issue trust preferred securities.

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The investment securities held-to-maturity portfolio, at amortized cost, totaled $96.0 million at June 30, 2014, compared to $81.7 million at June 30, 2013, and $95.9 million at December 31, 2013. At June 30, 2014, the investment securities held-to-maturity portfolio was comprised of $80.0 million of tax-exempt municipal bonds, and $16.0 million of agency mortgage-backed securities.

The Company has not used interest rate swaps or other derivative instruments to hedge fixed rate loans or securities to otherwise mitigate interest rate risk.

Loans

The Company's loans represent the largest portion of invested assets, substantially greater than the securities portfolio or any other asset category, and the quality and diversification of the loan portfolio is an important consideration when reviewing the Company's financial condition.

Gross loans, excluding loans held-for-sale, represented 67% of total assets at June 30, 2014, 60% at June 30, 2013, and 61% of total assets at December 31, 2013. The ratio of loans to deposits increased to 78.11% at June 30, 2014, from 70.81% at June 30, 2013, and from 71.13% at December 31, 2013.

Loan Distribution

The Loan Distribution table that follows sets forth the Company's gross loans, excluding loans held-for-sale, outstanding and the percentage distribution in each category at the dates indicated:

	June 30, 2014		June 30, 2013		December 31, 2013	
	Balance	% of Total	Balance	% of Total	Balance	% of Total
	(Dollars in thousands)					
Commercial	$ 415,557	42%	$ 383,068	46%	$ 393,074	43%
Real estate:						
Commercial and residential	454,676	46%	370,620	44%	423,288	46%
Land and construction	47,758	5%	26,705	3%	31,443	3%
Home equity	56,743	6%	48,667	6%	51,815	6%
Consumer	16,112	1%	13,097	1%	15,677	2%
Total loans	990,846	100%	842,157	100%	915,297	100%
Deferred loan (fees) costs, net	(505)		(207)		(384)	
Loans, including deferred fees and costs	990,341	100%	841,950	100%	914,913	100%
Allowance for loan losses	(18,592)		(19,342)		(19,164)	
Loans, net	$ 971,749		$ 822,608		$ 895,749	

The Company's loan portfolio is concentrated in commercial loans, primarily manufacturing, wholesale, and services, and commercial real estate, with the remaining balance in land development and construction, home equity and consumer loans. The Company does not have any concentrations by industry or group of industries in its loan portfolio, however, 57% of its gross loans were secured by real property at June 30, 2014, compared to 53% at June 30, 2013, and 55% at December 31, 2013. While no specific industry concentration is considered significant, the Company's lending operations are located in areas that are dependent on the technology and real estate industries and their supporting companies.

The Company has established concentration limits in its loan portfolio for commercial real estate loans, commercial loans, construction loans and unsecured lending, among others. All loan types are within established limits. The Company uses underwriting guidelines to assess the borrowers' historical cash flow to determine debt service, and we further stress test the debt service under higher interest rate scenarios. Financial and performance covenants are used in commercial lending to allow the Company to react to a borrower's deteriorating financial condition should that occur.

The Company's commercial loans are made for working capital, financing the purchase of equipment or for other business purposes. Commercial loans include loans with maturities ranging from thirty days to one year and "term loans" with maturities normally ranging from one to five years. Short-term business loans are generally intended to finance current transactions and typically provide for periodic principal payments, with interest payable monthly. Term loans normally provide for floating interest rates, with monthly payments of both principal and interest.

The Company is an active participant in the SBA and U.S. Department of Agriculture guaranteed lending programs, and has been approved by the SBA as a lender under the Preferred Lender Program. The Company regularly makes such guaranteed loans (collectively referred to as "SBA loans"). The guaranteed portion of these loans is typically sold in the secondary market depending on market conditions. When the guaranteed portion of an SBA loan is sold the Company retains the servicing rights for the sold portion. During the second quarter and the six months ended June 30, 2014, loans were sold resulting in a gain on sale of SBA loans of $442,000 and $599,000, respectively.

As of June 30, 2014, commercial and residential real estate mortgage loans of $454.7 million consist primarily of adjustable and fixed-rate loans secured by deeds of trust on commercial and residential property. The real estate mortgage loans at June 30, 2014, consist of $222.1 million, or 49%, of commercial owner occupied properties, $232.6 million, or 51%, of commercial investment properties, and $473,000 (less than 1%) in residential properties. Properties securing the commercial real estate mortgage loans are generally located in the Company's primary market, which is the Greater San Francisco Bay Area.

The Company's commercial real estate loans consist primarily of loans based on the borrower's cash flow and are secured by deeds of trust on commercial and residential property to provide a secondary source of repayment. The Company generally restricts real estate term loans to no more than 75% of the property's appraised value or the purchase price of the property during the initial underwriting of the credit, depending on the type of property and its utilization. The Company offers both fixed and floating rate loans. Maturities on real estate mortgage loans are generally between five and ten years (with amortization ranging from fifteen to twenty-five years and a balloon payment due at maturity); however, SBA and certain other real estate loans that can be sold in the secondary market may be granted for longer maturities.

The Company's land and construction loans are primarily to finance the development/construction of commercial and single family residential properties. The Company utilizes underwriting guidelines to assess the likelihood of repayment from sources such as sale of the property or availability of permanent mortgage financing prior to making the construction loan. Construction loans are provided only in our market area, and we have extensive controls for the disbursement process. The projects are typically infill construction in strong markets. Land and construction loans increased $21.1 million to $47.8 million, at June 30, 2014, from $26.7 million, at June 30, 2013, and increased $16.4 million from $31.4 million, at December 31, 2013, primarily as a result of strong housing demand within the Company's lending area.

The Company makes home equity lines of credit available to its existing customers. Home equity lines of credit are underwritten initially with a maximum 75% loan to value ratio. Home equity lines are reviewed at least semiannually, with specific emphasis on loans with a loan to value ratio greater than 70%. The Company takes measures to work with customers to reduce line commitments and minimize potential losses. There have been no adverse classifications to date as a result of the review.

Additionally, the Company makes consumer loans for the purpose of financing automobiles, various types of consumer goods, and other personal purposes. Consumer loans generally provide for the monthly payment of principal and interest. Most of the Company's consumer loans are secured by the personal property being purchased or, in the instances of home equity loans or lines, real property.

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With certain exceptions, state chartered banks are permitted to make extensions of credit to any one borrowing entity up to 15% of the bank's capital and reserves for unsecured loans and up to 25% of the bank's capital and reserves for secured loans. For HBC, these lending limits were $27.9 million and $46.4 million at June 30, 2014, respectively.

Loan Maturities

The following table presents the maturity distribution of the Company's loans (excluding loans held-for-sale) as of June 30, 2014. The table shows the distribution of such loans between those loans with predetermined (fixed) interest rates and those with variable (floating) interest rates. Floating rates generally fluctuate with changes in the prime rate as reflected in the Western Edition of The Wall Street Journal. As of June 30, 2014, approximately 58% of the Company's loan portfolio consisted of floating interest rate loans.

	Due in One Year or Less	Over One Year But Less than Five Years	Over Five Years	Total
	(Dollars in thousands)			
Commercial	$ 357,659	$ 50,967	$ 6,931	$ 415,557
Real estate:				
Commercial and residential	64,677	224,312	165,687	454,676
Land and construction	47,277	481		47,758
Home equity	51,828	1,703	3,212	56,743
Consumer	15,720	321	71	16,112
Loans	$ 537,161	$ 277,784	$ 175,901	$ 990,846
Loans with variable interest rates	$ 490,869	$ 73,356	$ 6,891	$ 571,116
Loans with fixed interest rates	46,292	204,428	169,010	419,730
Loans	$ 537,161	$ 277,784	$ 175,901	$ 990,846

Loan Servicing

As of June 30, 2014 and 2013, $136.1 million and $143.1 million, respectively, in SBA loans were serviced by the Company for others. Activity for loan servicing rights was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Beginning of period balance	$ 500	$ 670	$ 525	$ 709
Additions	185	29	224	58
Amortization	(79)	(68)	(143)	(136)
End of period balance	$ 606	$ 631	$ 606	$ 631

Loan servicing rights are included in accrued interest receivable and other assets on the unaudited consolidated balance sheets and reported net of amortization. There was no valuation allowance as of June 30, 2014 and 2013, as the fair value of the assets was greater than the carrying value.

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Activity for the I/O strip receivable was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Beginning of period balance	$ 1,664	$ 1,777	$ 1,647	$ 1,786
Unrealized holding loss	(31)	(51)	(14)	(60)
End of period balance	$ 1,633	$ 1,726	$ 1,633	$ 1,726

Credit Quality

Financial institutions generally have a certain level of exposure to credit quality risk, and could potentially receive less than a full return of principal and interest if a debtor becomes unable or unwilling to repay. Since loans are the most significant assets of the Company and generate the largest portion of its revenues, the Company's management of credit quality risk is focused primarily on loan quality. Banks have generally suffered their most severe earnings declines as a result of customers' inability to generate sufficient cash flow to service their debts and/or downturns in national and regional economies and declines in overall asset values including real estate. In addition, certain debt securities that the Company may purchase have the potential of declining in value if the obligor's financial capacity to repay deteriorates.

The Company's policies and procedures identify market segments, set goals for portfolio growth or contraction, and establish limits on industry and geographic credit concentrations. In addition, these policies establish the Company's underwriting standards and the methods of monitoring ongoing credit quality. The Company's internal credit risk controls are centered in underwriting practices, credit granting procedures, training, risk management techniques, and familiarity with loan customers as well as the relative diversity and geographic concentration of our loan portfolio.

The Company's credit risk may also be affected by external factors such as the level of interest rates, employment, general economic conditions, real estate values, and trends in particular industries or geographic markets. As an independent community bank serving a specific geographic area, the Company must contend with the unpredictable changes in the general California market and, particularly, primary local markets. The Company's asset quality has suffered in the past from the impact of national and regional economic recessions, consumer bankruptcies, and depressed real estate values.

Nonperforming assets are comprised of the following: loans for which the Company is no longer accruing interest; restructured loans which have been current under six months; loans 90 days or more past due and still accruing interest (although they are generally placed on nonaccrual when they become 90 days past due, unless they are both well-secured and in the process of collection); and foreclosed assets. Management's classification of a loan as "nonaccrual" is an indication that there is reasonable doubt as to the full recovery of principal or interest on the loan. At that point, the Company stops accruing interest income, and reverses any uncollected interest that had been accrued as income. The Company begins recognizing interest income only as cash interest payments are received and it has been determined the collection of all outstanding principal is not in doubt. The loans may or may not be collateralized, and collection efforts are pursued. Loans may be restructured by management when a borrower has experienced some change in financial status causing an inability to meet the original repayment terms and where the Company believes the borrower will eventually overcome those circumstances and make full restitution. Foreclosed assets consist of properties acquired by foreclosure or similar means that management is offering or will offer for sale.

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The following table summarizes the Company's nonperforming assets at the dates indicated:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Nonaccrual loans held-for-investment	$ 7,688	$ 13,868	$ 11,326
Restructured and loans over 90 days past due and still accruing	454	510	492
Total nonperforming loans	8,142	14,378	11,818
Foreclosed assets	525	659	575
Total nonperforming assets	$ 8,667	$ 15,037	$ 12,393
Nonperforming assets as a percentage of loans plus foreclosed assets	0.87%	1.78%	1.35%
Nonperforming assets as a percentage of total assets	0.59%	1.07%	0.83%

The following table presents nonperforming loans by class at the dates indicated:

	June 30, 2014			December 31, 2013		
	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total	Nonaccrual	Restructured and Loans Over 90 Days Past Due and Still Accruing	Total
	(Dollars in thousands)					
Commercial	$ 3,729	$ 454	$ 4,183	$ 4,414	$ 492	$ 4,906
Real estate:						
Commercial and residential	1,693		1,693	4,363		4,363
Land and construction	1,688		1,688	1,761		1,761
Home equity	546		546	666		666
Consumer	32		32	122		122
Total	$ 7,688	$ 454	$ 8,142	$ 11,326	$ 492	$ 11,818

Nonperforming assets were $8.7 million, or 0.59% of total assets, at June 30, 2014, compared to $15.0 million, or 1.07% of total assets, at June 30, 2013, and $12.4 million, or 0.83% of total assets, at December 31, 2013. Included in total nonperforming assets were foreclosed assets of $525,000 at June 30, 2014, compared to $659,000 at June 30, 2013, and $575,000 at December 31, 2013. The decline in nonperforming assets at June 30, 2014 was primarily due to loan payoffs, charge-offs, and upgrades in nonperforming loans' risk categories.

The following table provides a summary of the loan portfolio by loan type and credit quality classification at the dates indicated:

	June 30, 2014			June 30, 2013			December 31, 2013		
	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total	Nonclassified	Classified*	Total
	(Dollars in thousands)								
Commercial	$ 405,575	$ 9,982	$ 415,557	$ 372,077	$ 10,991	$ 383,068	$ 380,806	$ 12,268	$ 393,074

Real estate:									
Commercial and residential	446,287	8,389	454,676	363,222	7,398	370,620	416,992	6,296	423,288
Land and construction	46,070	1,688	47,758	24,576	2,129	26,705	29,682	1,761	31,443
Home equity	53,885	2,858	56,743	45,974	2,693	48,667	48,818	2,997	51,815
Consumer	15,872	240	16,112	12,729	368	13,097	15,336	341	15,677
Total	$ 967,689	$ 23,157	$ 990,846	$ 818,578	$ 23,579	$ 842,157	$ 891,634	$ 23,663	$ 915,297

* Classified loans in the table above are gross of SBA guarantees.

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The following provides a rollforward of troubled debt restructurings ("TDRs"):

	Six Months Ended June 30, 2014		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2014	$ 492	$ 3,230	$ 3,722
Principal repayments/advances/upgrades	(8)	(560)	(568)
Net charge-offs	(30)		(30)
Change in TDR classification	1,180	(1,180)	
Balance at June 30, 2014	$ 1,634	$ 1,490	$ 3,124

	Six Months Ended June 30, 2013		
	Performing TDRs	Nonperforming TDRs	Total
	(Dollars in thousands)		
Balance at January 1, 2013	$ 2,309	$ 1,798	$ 4,107
Principal repayments/advances/upgrades	(914)	(62)	(976)
Net charge-offs		(372)	(372)
Change in TDR classification	(217)	217	
Balance at June, 2013	$ 1,178	$ 1,581	$ 2,759

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable incurred losses in the loan portfolio. Loans are charged-off against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses. Management's methodology for estimating the allowance balance consists of several key elements, which include specific allowances on individual impaired loans and the formula driven allowances on pools of loans with similar risk characteristics. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

Specific allowances are established for impaired loans. Management considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement, including scheduled interest payments. Loans for which the terms have been modified with a concession granted, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. When a loan is considered to be impaired, the amount of impairment is measured based on the fair value of the collateral less costs to sell if the loan is collateral dependent, or on the present value of expected future cash flows or values that are observable in the secondary market. If the measure of the impaired loans is less than the investment in the loan, the deficiency will be charged off against the allowance for loan losses if the amount is a confirmed loss, or, alternatively, a specific allocation within the allowance will be established. Loans that are considered impaired are specifically excluded from the formula portion of the allowance for loan losses analysis.

The estimated loss factors for pools of loans that are not impaired are based on determining the probability of default and loss given default for loans within each segment of the portfolio, adjusted for significant factors that, in management's judgment, affect collectability as of the evaluation date. The Company's historical delinquency experience and loss experience are utilized to determine the probability of default and loss given default for segments of the portfolio where the Company has experienced losses in the past. For segments of the portfolio where the Company has no significant

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prior loss experience, the Company uses quantifiable observable industry data to determine the probability of default and loss given default.

Loans that demonstrate a weakness for which there is a possibility of loss if the weakness is not corrected, are categorized as "classified." Classified assets include all loans considered as substandard, substandard-nonaccrual, and doubtful and may result from problems specific to a borrower's business or from economic downturns that affect the borrower's ability to repay or that cause a decline in the value of the underlying collateral (particularly real estate), and foreclosed assets. The principal balance of classified assets, net of SBA guarantees, was $23.1 million at June 30, 2014, $23.8 million at June 30, 2013, and $23.6 million at December 31, 2013. Loans held-for-sale are carried at the lower of cost or estimated fair value, and are not allocated an allowance for loan losses.

It is the policy of management to maintain the allowance for loan losses at a level adequate for risks inherent in the loan portfolio. On an ongoing basis, we have engaged an outside firm to perform independent credit reviews of our loan portfolio. The FRB and the California Department of Business Oversight Division of Financial Institutions also review the allowance for loan losses as an integral part of the examination process. Based on information currently available, management believes that the allowance for loan losses is adequate. However, the loan portfolio can be adversely affected if California economic conditions and the real estate market in the Company's market area were to weaken. Also, any weakness of a prolonged nature in the technology industry would have a negative impact on the local market. The effect of such events, although uncertain at this time, could result in an increase in the level of nonperforming loans and increased loan losses, which could adversely affect the Company's future growth and profitability. No assurance of the ultimate level of credit losses can be given with any certainty.

The following tables summarize the Company's loan loss experience, as well as provisions and charges to the allowance for loan losses and certain pertinent ratios for the periods indicated:

	Three Months Ended June 30, 2014			
	Commercial	**Real Estate**	**Consumer**	**Total**
	(Dollars in thousands)			
Balance, beginning of period	$ 11,846	$ 6,894	$ 77	$ 18,817
Charge-offs	(187)			(187)
Recoveries	144	16		160
Net (charge-offs) recoveries	(43)	16		(27)
Provision (credit) for loan losses	(349)	159	(8)	(198)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592
RATIOS:				
Annualized net charge-offs (recoveries) to average loans(1)	0.02%	-0.01%	0.00%	0.01%
Allowance for loan losses to total loans(1)	1.16%	0.71%	0.01%	1.88%
Allowance for loan losses to nonperforming loans	140.68%	86.82%	0.85%	228.35%

(1) Average loans and total loans exclude loans held-for-sale.

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	Three Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,455	$ 6,770	$ 117	$ 19,342
Charge-offs	(119)	(56)		(175)
Recoveries	188	257		445
Net recoveries	69	201		270
Provision (credit) for loan losses	287	(583)	26	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342
RATIOS:				
Annualized net recoveries to average loans(1)	0.03%	0.10%	0.00%	0.13%
Allowance for loan losses to total loans(1)	1.52%	0.76%	0.02%	2.30%
Allowance for loan losses to nonperforming loans	89.10%	44.43%	0.99%	134.52%

	Six Months Ended June 30, 2014			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,533	$ 6,548	$ 83	$ 19,164
Charge-offs	(595)			(595)
Recoveries	188	43		231
Net (charge-offs) recoveries	(407)	43		(364)
Provision (credit) for loan losses	(672)	478	(14)	(208)
Balance, end of period	$ 11,454	$ 7,069	$ 69	$ 18,592
RATIOS:				
Annualized net charge-offs (recoveries) to average loans(1)	0.09%	-0.01%	0.00%	0.08%
Allowance for loan losses to total loans(1)	1.16%	0.71%	0.01%	1.88%
Allowance for loan losses to nonperforming loans	140.68%	86.82%	0.85%	228.35%

	Six Months Ended June 30, 2013			
	Commercial	Real Estate	Consumer	Total
	(Dollars in thousands)			
Balance, beginning of period	$ 12,866	$ 6,034	$ 127	$ 19,027
Charge-offs	(959)	(56)		(1,015)
Recoveries	1,338	262		1,600

Net (charge-offs) recoveries	379	206		585
Provision (credit) for loan losses	(434)	148	16	(270)
Balance, end of period	$ 12,811	$ 6,388	$ 143	$ 19,342
RATIOS:				
Annualized net charge-offs (recoveries) to average loans(1)	0.10%	0.05%	0.00%	0.15%
Allowance for loan losses to total loans(1)	1.52%	0.76%	0.02%	2.30%
Allowance for loan losses to nonperforming loans	89.10%	44.43%	0.99%	134.52%

(1) Average loans and total loans exclude loans held-for-sale.

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The following table provides a summary of the allocation of the allowance for loan losses by class at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each category represents the total amount available for charge-offs that may occur within these classes.

Allocation of Allowance for Loan Losses

	June 30,				December 31,	
	2014		2013		2013	
	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans	Allowance	Percent of Loans in each category to total loans
	(Dollars in thousands)					
Commercial	$ 11,454	42%	$ 12,811	46%	$ 12,533	43%
Real estate:						
Commercial and residential	4,862	46%	4,949	44%	4,922	46%
Land and construction	755	5%	280	3%	356	3%
Home equity	1,452	6%	1,159	6%	1,270	6%
Consumer	69	1%	143	1%	83	2%
Total	$ 18,592	100%	$ 19,342	100%	$ 19,164	100%

The allowance for loan losses totaled $18.6 million, or 1.88% of total loans at June 30, 2014, compared to $19.3 million, or 2.30% of total loans at June 30, 2013, and $19.2 million, or 2.09% of total loans at December 31, 2013. The allowance for loan losses to total loans decreased at June 30, 2014, compared to June 30, 2013, and December 31, 2013, primarily due to increasing loan balances with no default histories, improving the quality of the loan portfolio overall. Loan charge-offs reflect the realization of losses in the portfolio that were partially recognized previously through the provision for loan losses. The Company had net charge-offs of $27,000, or 0.01% of average loans, for the second quarter of 2014, compared to net recoveries of $270,000, or 0.13% of average loans, for the second quarter of 2013, and net charge-offs of $166,000, or 0.07% of average loans, for the fourth quarter of 2013.

The allowance for loan losses related to the commercial portfolio decreased $1.1 million at June 30, 2014 from December 31, 2013, as a result of a credit to the provision for loan losses of $672,000 and net charge-offs of $407,000. The decrease in the allowance for loan losses was primarily due to a decline in problem loans. The allowance for loan losses related to the real estate portfolio increased $521,000 at June 30, 2014 from December 31, 2013, as a result of a provision for loan losses of $478,000 and net recoveries of $43,000. The increase in the allowance for loan losses was primarily due to an increase in the balance of real estate loans outstanding, partially offset by a decline in problem loans.

Deposits

The composition and cost of the Company's deposit base are important components in analyzing the Company's net interest margin and balance sheet liquidity characteristics, both of which are discussed in greater detail in other sections herein. The Company's liquidity is impacted by the volatility of deposits from the propensity of that money to leave the institution for rate-related or other reasons. Deposits can be adversely affected if economic conditions in California, and the Company's market area in particular, weaken. Potentially, the most volatile deposits in a financial institution are jumbo certificates of deposit, meaning time deposits with balances that equal or exceed $100,000, as customers with balances of that magnitude are typically more rate-sensitive than customers with smaller balances.

The following table summarizes the distribution of deposits and the percentage of distribution in each category of deposits for the periods indicated:

	June 30, 2014		June 30, 2013		December 31, 2013	
	Balance	% to Total	Balance	% to Total	Balance	% to Total
	(Dollars in thousands)					
Demand, noninterest-bearing	$ 456,235	36%	$ 407,516	34%	$ 431,085	34%
Demand, interest-bearing	193,041	15%	171,027	14%	195,451	15%
Savings and money market	354,175	28%	295,336	25%	347,052	27%
Time deposits under $100	20,379	2%	23,062	2%	21,646	2%
Time deposits $100 and over	195,619	15%	197,718	17%	195,005	15%
Time deposits brokered	33,614	3%	76,800	6%	55,524	4%
CDARS money market and time deposits	14,785	1%	17,580	2%	40,458	3%
Total deposits	$ 1,267,848	100%	$ 1,189,039	100%	$ 1,286,221	100%

The Company obtains deposits from a cross-section of the communities it serves. The Company's business is not generally seasonal in nature. Public funds were 8% of deposits at June 30, 2014, 8% at June 30, 2013, and 9% at December 31, 2013.

Total deposits increased $78.8 million to $1.27 billion at June 30, 2014, from $1.19 billion at June 30, 2013, while brokered deposits decreased $43.2 million during this period. Total deposits decreased $18.4 million at June 30, 2014 from $1.29 billion at December 31, 2013, primarily due to a decrease in brokered deposits of $21.9 million and a decrease of $25.7 million in CDARS deposits, partially offset by an increase in core deposits. During the fourth quarter of 2013, the Company received $27.5 million in deposits from a law firm which were placed in a CDARS money market account. All of the $27.5 million in deposits from the law firm were withdrawn in January, 2014. Deposits (excluding all time deposits and CDARS deposits) increased $126.9 million, or 15%, to $1.0 billion at June 30, 2014, from $873.9 million at June 30, 2013, and increased $29.9 million, or 3%, from $973.6 million at December 31, 2013.

At June 30, 2014, the Company had $108.1 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California. At June 30, 2013, the Company had $108.4 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California. At December 31, 2013, the Company had $108.0 million (at fair value) of securities pledged for $98.0 million in certificates of deposits from the State of California.

CDARS deposits were comprised of $6.9 million of money market accounts and $7.9 million of time deposits at June 30, 2014. CDARS deposits were comprised of $9.0 million of money market accounts and $8.6 million of time deposits at June 30, 2013. CDARS deposits were comprised of $34.8 million of money market accounts and $5.7 million of time deposits at December 31, 2013.

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The following table indicates the contractual maturity schedule of the Company's time deposits of $100,000 and over, and all CDARS time deposits and brokered deposits as of June 30, 2014:

	Balance	% of Total
	(Dollars in thousands)	
Three months or less	$ 104,913	44%
Over three months through six months	63,407	27%
Over six months through twelve months	34,801	15%
Over twelve months	34,047	14%
Total	$ 237,168	100%

The Company focuses primarily on providing and servicing business deposit accounts that are frequently over $100,000 in average balance per account. As a result, certain types of business clients that the Company serves typically carry average deposits in excess of $100,000. The account activity for some account types and client types necessitates appropriate liquidity management practices by the Company to help ensure its ability to fund deposit withdrawals.

Return on Equity and Assets

The following table indicates the ratios for return on average assets and average equity, and average equity to average assets for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Annualized return on average assets	0.91%	0.82%	0.88%	0.71%
Annualized return on average tangible assets	0.91%	0.82%	0.88%	0.71%
Annualized return on average equity	7.45%	6.53%	7.28%	5.88%
Annualized return on average tangible equity	7.51%	6.60%	7.33%	5.94%
Dividend payout ratio(1)	38.51%	N/A	39.97%	N/A
Average equity to average assets ratio	12.18%	12.49%	12.12%	12.12%

(1) Percentage is calculated based on dividends paid on common stock and Series C Preferred Stock (on an as converted basis) divided by net income.

Off-Balance Sheet Arrangements

In the normal course of business, the Company makes commitments to extend credit to its customers as long as there are no violations of any conditions established in the contractual arrangements. These commitments are obligations that represent a potential credit risk to the Company, but are not reflected on the Company's consolidated balance sheets. Total unused commitments to extend credit were $396.0 million June 30, 2014, compared to $349.4 million at June 30, 2013, and $377.2 million at December 31, 2013. Unused commitments represented 40%, 41%, and 41% of outstanding gross loans at June 30, 2014, June 30, 2013, and December 31, 2013, respectively.

The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no certainty that

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lines of credit and letters of credit will ever be fully utilized. The following table presents the Company's commitments to extend credit for the periods indicated:

	June 30, 2014		June 30, 2013		December 31, 2013	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
	(Dollars in thousands)					
Unused lines of credit and commitments to make loans	$ 8,104	$ 376,558	$ 5,683	$ 330,870	$ 6,136	$ 359,955
Standby letters of credit		11,370	2,775	10,030		11,099
	$ 8,104	$ 387,928	$ 8,458	$ 340,900	$ 6,136	$ 371,054

Liquidity and Asset/Liability Management

Liquidity refers to the Company's ability to maintain cash flows sufficient to fund operations and to meet obligations and other commitments in a timely and cost effective fashion. At various times the Company requires funds to meet short-term cash requirements brought about by loan growth or deposit outflows, the purchase of assets, or liability repayments. An integral part of the Company's ability to manage its liquidity position appropriately is the Company's large base of core deposits, which are generated by offering traditional banking services in its service area and which have historically been a stable source of funds. To manage liquidity needs properly, cash inflows must be timed to coincide with anticipated outflows or sufficient liquidity resources must be available to meet varying demands. The Company manages liquidity to be able to meet unexpected sudden changes in levels of its assets or deposit liabilities without maintaining excessive amounts of balance sheet liquidity. Excess balance sheet liquidity can negatively impact the Company's interest margin. In order to meet short-term liquidity needs the Company utilizes overnight Federal funds purchase arrangements and other borrowing arrangements with correspondent banks, solicits brokered deposits if cost effective deposits are not available from local sources and maintains collateralized lines of credit with the FHLB and FRB. In addition, the Company can raise cash for temporary needs by selling securities under agreements to repurchase and selling securities available-for-sale.

One of the measures we analyze for liquidity is our loan to deposit ratio. Our loan to deposit ratio was 78.11% at June 30, 2014, compared to 70.81% at June 30, 2013, and 71.13% at December 31, 2013.

FHLB and FRB Borrowings and Available Lines of Credit

The Company has off-balance sheet liquidity in the form of Federal funds purchase arrangements with correspondent banks, including the FHLB and FRB. The Company can borrow from the FHLB on a short-term (typically overnight) or long-term (over one year) basis. The Company had no overnight borrowings from the FHLB at June 30, 2014, June 30, 2013 and December 31, 2013. The Company had $261.2 million of loans pledged to the FHLB as collateral on an available line of credit of $137.7 million at June 30, 2014.

The Company can also borrow from the FRB's discount window. The Company had $339.9 million of loans pledged to the FRB as collateral on an available line of credit of $253.6 million at June 30, 2014, none of which was outstanding.

At June 30, 2014, the Company had Federal funds purchase arrangements available of $55.0 million. There were no Federal funds purchased outstanding at June 30, 2014, June 30, 2013 and December 31, 2013.

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The Company may also utilize securities sold under repurchase agreements to manage our liquidity position. There were no securities sold under agreements to repurchase June 30, 2014, June 30, 2013, and December 31, 2013.

The following table summarizes the Company's borrowings under its Federal funds purchased, security repurchase arrangements and lines of credit for the periods indicated:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Average balance year-to-date	$ 773	$	$ 58
Average interest rate year-to-date	0.12%	N/A	0.20%
Maximum month-end balance during the quarter	$ 5,000	$	$
Average rate at period-end	N/A	N/A	N/A

Capital Resources

The Company uses a variety of measures to evaluate capital adequacy. Management reviews various capital measurements on a regular basis and takes appropriate action to ensure that such measurements are within established internal and external guidelines. The external guidelines, which are issued by the Federal Reserve Board and the FDIC, establish a risk-adjusted ratio relating capital to different categories of assets and off-balance sheet exposures. There are two categories of capital under the Federal Reserve Board and FDIC guidelines: Tier 1 and Tier 2 Capital. Our Tier 1 Capital currently consists of total shareholders' equity (excluding accumulated other comprehensive income or loss), less intangible assets and disallowed deferred tax assets. Our Tier 2 Capital includes the allowances for loan losses and off-balance sheet credit losses.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of the consolidated Company:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Capital components:			
Tier 1 Capital	$ 176,058	$ 166,820	$ 165,162
Tier 2 Capital	15,893	13,885	14,754
Total risk-based capital	$ 191,951	$ 180,705	$ 179,916
Risk-weighted assets	$ 1,268,215	$ 1,105,051	$ 1,175,813
Average assets for capital purposes	$ 1,461,252	$ 1,350,489	$ 1,477,082

				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
Capital ratios:					
Total risk-based capital	15.1%	16.4%	15.3%	10.00%	8.00%
Tier 1 risk-based capital	13.9%	15.1%	14.0%	6.00%	4.00%
Leverage(1)	12.0%	12.4%	11.2%	N/A	4.00%

(1)
Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

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The table above presents the capital ratios of the consolidated Company computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements for bank holding companies.

The following table summarizes risk-based capital, risk-weighted assets, and risk-based capital ratios of HBC:

	June 30, 2014	June 30, 2013	December 31, 2013
	(Dollars in thousands)		
Capital components:			
Tier 1 Capital	$ 163,447	$ 158,552	$ 149,037
Tier 2 Capital	15,932	13,911	14,790
Total risk-based capital	$ 179,379	$ 172,463	$ 163,827
Risk-weighted assets	$ 1,271,329	$ 1,107,207	$ 1,178,719
Average assets for capital purposes	$ 1,464,302	$ 1,352,479	$ 1,477,168

				Well-Capitalized Regulatory Requirements	Minimum Regulatory Requirements
Capital ratios:					
Total risk-based capital	14.1%	15.6%	13.9%	10.00%	8.00%
Tier 1 risk-based capital	12.9%	14.3%	12.6%	6.00%	4.00%
Leverage(1)	11.2%	11.7%	10.1%	5.00%	4.00%

(1) Tier 1 capital divided by quarterly average assets (excluding intangible assets and disallowed deferred tax assets).

The table above presents the capital ratios of HBC computed in accordance with applicable regulatory guidelines and compared to the standards for minimum capital adequacy requirements under the FDIC's prompt corrective action authority.

Due primarily to the redemption of $9 million floating-rate subordinated debt in the third quarter of 2013, the Company's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at June 30, 2014 decreased to 15.1%, 13.9%, and 12.0%, compared to 16.4%, 15.1%, and 12.4% at June 30, 2013, respectively. Due primarily to distributions from HBC to HCC totaling $16 million during 2013, HBC's total risk-based capital ratio, Tier 1 risk-based capital ratio, and leverage ratio at June 30, 2014 decreased to 14.1%, 12.9%, and 11.2%, compared to 15.6%, 14.3%, and 11.7% at June 30, 2013, respectively. However, at June 30, 2014, the Company's and HBC's capital ratios exceed the highest regulatory capital requirement of "well-capitalized" under prompt corrective action provisions.

Quantitative measures established by regulation to help ensure capital adequacy require the Company and HBC to maintain minimum amounts and ratios of total risk-based capital and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of June 30, 2014, June 30, 2013, and December 31, 2013, the Company and HBC met all capital adequacy guidelines to which they were subject. There are no conditions or events since June 30, 2014 that management believes have changed the categorization of the Company or HBC as well-capitalized.

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At June 30, 2014, the Company had total shareholders' equity of $181.5 million, including $19.5 million in preferred stock, $132.9 million in common stock, $29.2 million in retained earnings, and ($92,000) of accumulated other comprehensive loss.

The accumulated other comprehensive loss was ($92,000) at June 30, 2014, compared to accumulated other comprehensive loss of ($4.7) million at June 30, 2013, and an accumulated other comprehensive loss of ($4.0) million at December 31, 2013. The unrealized gain (loss) on securities available-for-sale included in accumulated other comprehensive income was an unrealized gain of $2.6 million, net of taxes, at June 30, 2014, compared to an unrealized loss of ($507,000) , net of taxes, at June 30, 2013, and an unrealized loss of ($1.4) million, net of taxes, at December 31, 2013. The components of other comprehensive loss, net of taxes, at June 30, 2014 include the following: an unrealized gain on available-for-sale securities of $2.6 million; the remaining unamortized unrealized gain on securities available-for-sale transferred to held-to-maturity of $449,000; a liability adjustment on split dollar insurance contracts of ($1.9) million; a liability adjustment on the supplemental executive retirement plan of ($2.2) million; and an unrealized gain on interest-only strip from SBA loans of $948,000.

Mandatory Redeemable Cumulative Trust Preferred Securities

To enhance regulatory capital and to provide liquidity, the Company, through unconsolidated subsidiary grantor trusts, issued mandatory redeemable cumulative trust preferred securities of subsidiary grantor trusts. The subordinated debt was recorded as a component of long-term debt and included the value of the common stock issued by the trusts to the Company. The common stock was recorded as other assets for the amount issued. Under applicable regulatory guidelines, the trust preferred securities qualified as Tier I capital. The subsidiary trusts were not consolidated in the Company's consolidated financial statements.

During the third quarter of 2012, the Company redeemed its 10.875% fixed-rate subordinated debentures in the amount of $7 million issued to Heritage Capital Trust I and the Company's 10.600% fixed-rate subordinated debentures in the amount of $7 million issued to Heritage Statutory Trust I. The related trust securities issued by Capital Trust I and Statutory Trust I were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

During the third quarter of 2013, the Company redeemed its Company's variable-rate subordinated debentures in the amount of $5 million issued to Heritage Statutory Trust II and the Company's variable-rate subordinated debentures in the amount of $4 million issued to Heritage Statutory Trust III. The related trust securities issued by Statutory Trust II and Statutory Trust III were also redeemed in connection with the subordinated debt redemption and the trusts were dissolved.

U.S. Treasury Capital Purchase Program

The Company received $40 million in November 2008 through the issuance of its Series A Preferred Stock and a warrant to purchase 462,963 shares of its common stock to the Treasury through the U.S. Treasury Capital Purchase Program. The Series A Preferred Stock qualified as a component of Tier 1 capital.

On March 7, 2012, in accordance with approvals received from the U.S. Treasury and the Federal Reserve, the Company repurchased all of the Series A Preferred Stock and paid the related accrued and unpaid dividends. On June 12, 2013, the Company completed the repurchase of the common stock warrant for $140,000.

Series C Preferred Stock

On June 21, 2010, the Company issued to various institutional investors 21,004 shares of newly issued Series C Preferred Stock. The Series C Preferred Stock is mandatorily convertible into 5,601,000

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shares of common stock at a conversion price of $3.75 per share upon a subsequent transfer of the Series C Preferred stock to third parties not affiliates with the holder in a widely dispersed offering. The Series C Preferred Stock is non-voting except in the case of certain transactions that would affect the rights of the holders of the Series C Preferred Stock or applicable law. The holders of Series C Preferred Stock receive dividends on an as converted basis when dividends are also declared for holders of common stock. The Series C Preferred Stock is not redeemable by the Company or by the holders and has a liquidation preference of $1,000 per share. The Series C Preferred Stock ranks senior to the Company's common stock.

Market Risk

Market risk is the risk of loss of future earnings, fair values, or future cash flows that may result from changes in the price of a financial instrument. The value of a financial instrument may change as a result of changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market risk sensitive instruments. Market risk is attributed to all market risk sensitive financial instruments, including securities, loans, deposits and borrowings, as well as the Company's role as a financial intermediary in customer-related transactions. The objective of market risk management is to avoid excessive exposure of the Company's earnings and equity to loss and to reduce the volatility inherent in certain financial instruments.

Interest Rate Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company's market risk exposure is primarily that of interest rate risk, and it has established policies and procedures to monitor and limit earnings and balance sheet exposure to changes in interest rates. The Company does not engage in the trading of financial instruments, nor does the Company have exposure to currency exchange rates.

The principal objective of interest rate risk management (often referred to as "asset/liability management") is to manage the financial components of the Company in a manner that will optimize the risk/reward equation for earnings and capital in relation to changing interest rates. The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk while at the same time maximizing income. Management realizes certain risks are inherent, and that the goal is to identify and manage the risks. Management uses two methodologies to manage interest rate risk: (i) a standard GAP analysis; and (ii) an interest rate shock simulation model.

The planning of asset and liability maturities is an integral part of the management of an institution's net interest margin. To the extent maturities of assets and liabilities do not match in a changing interest rate environment, the net interest margin may change over time. Even with perfectly matched repricing of assets and liabilities, risks remain in the form of prepayment of loans or securities or in the form of delays in the adjustment of rates of interest applying to either earning assets with floating rates or to interest bearing liabilities. The Company has generally been able to control its exposure to changing interest rates by maintaining primarily floating interest rate loans and a majority of its time certificates with relatively short maturities.

Interest rate changes do not affect all categories of assets and liabilities equally or at the same time. Varying interest rate environments can create unexpected changes in prepayment levels of assets and liabilities, which may have a significant effect on the net interest margin and are not reflected in the interest sensitivity analysis table. Because of these factors, an interest sensitivity GAP report may not provide a complete assessment of the exposure to changes in interest rates.

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The Company uses modeling software for asset/liability management in order to simulate the effects of potential interest rate changes on the Company's net interest margin, and to calculate the estimated fair values of the Company's financial instruments under different interest rate scenarios. The program imports current balances, interest rates, maturity dates and repricing information for individual financial instruments, and incorporates assumptions on the characteristics of embedded options along with pricing and duration for new volumes to project the effects of a given interest rate change on the Company's interest income and interest expense. Rate scenarios consisting of key rate and yield curve projections are run against the Company's investment, loan, deposit and borrowed funds portfolios. These rate projections can be shocked (an immediate and parallel change in all base rates, up or down) and ramped (an incremental increase or decrease in rates over a specified time period), based on current trends and econometric models or stable economic conditions (unchanged from current actual levels).

The following table sets forth the estimated changes in the Company's annual net interest income that would result from the designated instantaneous parallel shift in interest rates noted, as of June 30, 2014. Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions including relative levels of market interest rates, loan prepayments and deposit decay, and should not be relied upon as indicative of actual results.

	Increase/(Decrease) in Estimated Net Interest Income	
	Amount	Percent
	(Dollars in thousands)	
Change in Interest Rates (basis points)		
+400	$ 13,039	24.2%
+300	$ 9,747	18.1%
+200	$ 6,430	11.9%
+100	$ 3,072	5.7%
0	$	0.0%
-100	$ (4,238)	-7.9%
-200	$ (8,695)	-16.2%

This data does not reflect any actions that we may undertake in response to changes in interest rates such as changes in rates paid on certain deposit accounts based on local competitive factors, which could reduce the actual impact on net interest income.

As with any method of gaging interest rate risk, there are certain shortcomings inherent to the methodology noted above. The model assumes interest rate changes are instantaneous parallel shifts in the yield curve. In reality, rate changes are rarely instantaneous. The use of the simplifying assumption that short-term and long-term rates change by the same degree may also misstate historic rate patterns, which rarely show parallel yield curve shifts. Further, the model assumes that certain assets and liabilities of similar maturity or period to repricing will react in the same way to changes in rates. In reality, certain types of financial instruments may react in advance of changes in market rates, while the reaction of other types of financial instruments may lag behind the change in general market rates. Additionally, the methodology noted above does not reflect the full impact of annual and lifetime restrictions on changes in rates for certain assets, such as adjustable rate loans. When interest rates change, actual loan prepayments and actual early withdrawals from certificates may deviate significantly from the assumptions used in the model. Finally, this methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan clients' ability to service their debt. All of these factors are considered in monitoring the Company's exposure to interest rate risk.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information concerning quantitative and qualitative disclosure or market risk called for by Item 305 of Regulation S-K is included as part of Item 2 above.

ITEM 4 CONTROLS AND PROCEDURES

Disclosure Control and Procedures

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of June 30, 2014. As defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), disclosure controls and procedures are controls and procedures designed to reasonably assure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Based upon their evaluation, our Chief Executive Officer and Chief Financial Officer concluded the Company's disclosure controls were effective as of June 30, 2014, the period covered by this report on Form 10-Q.

During the three and six months ended June 30, 2014, there were no changes in our internal controls over financial reporting that materially affected, or are reasonably likely to affect, our internal controls over financial reporting.

Part II OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

The Company is involved in certain legal actions arising from normal business activities. Management, based upon the advice of legal counsel, believes the ultimate resolution of all pending legal actions will not have a material effect on the financial statements of the Company.

ITEM 1A RISK FACTORS

In addition to the other information set forth in this Report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition and/or operating results. There were no material changes from risk factors previously disclosed in our 2013 Annual Report on Form 10-K. The risk factors identified are in addition to those contained in any other cautionary statements, written or oral, which may be made or otherwise addressed in connection with a forward-looking statement or contained in any of our subsequent filings with the Securities and Exchange Commission.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

None

ITEM 5 OTHER INFORMATION

None

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ITEM 6 EXHIBITS

Exhibit	Description
3.1	Heritage Commerce Corp Restated Articles of Incorporation, as amended (incorporated by reference to Exhibit 3.1 to the Registrant's Annual Report on Form 10-K filed on March 4, 2010)
3.2	Certificate of Amendment of Articles of Incorporation of Heritage Commerce Corp as filed with the California Secretary of State on June 1, 2010 (incorporated by reference to Exhibit 3.1 to the Registrant's Registration Statement on Form S-1 filed July 23, 2010).
3.3	Heritage Commerce Corp Bylaws, as amended (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 28, 2013)
4.1	Certificate of Determination for Series C Convertible Perpetual Preferred Stock (incorporated by reference to the Registrant's Current Report on Form 8-K filed on June 22, 2010)
12.1	Calculation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Fixed Charges and Preferred Stock Dividends
31.1	Certification of Registrant's Chief Executive Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Registrant's Chief Financial Officer Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Registrant's Chief Executive Officer Pursuant To 18 U.S.C. Section 1350
32.2	Certification of Registrant's Chief Financial Officer Pursuant To 18 U.S.C. Section 1350
101.INS	XBRL Instance Document, furnished herewith
101.SCH	XBRL Taxonomy Extension Schema Document, furnished herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document, furnished herewith
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document, furnished herewith
101.LAB	XBRL Taxonomy Extension Label Linkbase Document, furnished herewith
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith

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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.

	Heritage Commerce Corp (Registrant)
Date: August 6, 2014	/s/ WALTER T. KACZMAREK
	Walter T. Kaczmarek *Chief Executive Officer*
Date: August 6, 2014	/s/ LAWRENCE D. MCGOVERN
	Lawrence D. McGovern *Chief Financial Officer*

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101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document, furnished herewith