

SMARTHEAT INC.
Form 10-Q
September 08, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

OR

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

Commission file number: 001-34246

SMARTHEAT INC.

(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of incorporation
or organization)

98-0514768
(IRS Employer Identification No.)

A-1, 10, Street 7
Shenyang Economic and Technological
Development Zone
Shenyang, China
(Address of principal executive offices)

110141
(Zip Code)

+86 (24) 2519-7699
(Registrant's telephone number, including area code)

Indicate by checkmark 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 last 90 days.

YES 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. See the definitions of “large accelerated filer,” “accelerated filer,” “non-accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES NO

As of August 22, 2014, there were 6,783,399 shares of common stock outstanding.

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SmartHeat Inc.

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NOTE ABOUT FORWARD-LOOKING STATEMENTS AND OTHER INFORMATION

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, which include, but are not limited to, statements concerning our projected revenues, expenses, gross profit and income, mix of revenue, demand for our products, the benefits and potential applications for our products, the need for additional capital, our ability to obtain and successfully perform additional new contract awards and the related funding and profitability of such awards, the competitive nature of our business and markets and product qualification requirements of our customers. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "predicts," "potential," "believes," "seeks," "hopes," "estimates," "should," "may," "will," "with" variations of these words or similar expressions are intended to identify forward-looking statements. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. Such factors include, but are not limited to the following:

- our goals and strategies;
- our expansion plans;
- our future business development, financial conditions and results of operations;
- the expected growth of the market for PHE products, heat meters and heat pumps in our target markets;
- our expectations regarding demand for our products;
- our expectations regarding keeping and strengthening our relationships with key customers;
- our ability to stay abreast of market trends and technological advances;
- our ability to protect our intellectual property rights effectively and not infringe on the intellectual property rights of others;
- our ability to attract and retain quality employees;
- our ability to pursue strategic acquisitions and alliances;
- competition in our industry in China;
- general economic and business conditions in the regions in which we sell our products;
- relevant government policies and regulations relating to our industry; and
- market acceptance of our products.

Additionally, this report contains statistical data that we obtained from various publicly available government publications and industry-specific third party reports. Statistical data in these publications also include projections based on a number of assumptions. The markets for PHEs, PHE Units, heat meters and heat pumps may not grow at the rates projected by market data, or at all. The failure of these markets to grow at the projected rates may have a material adverse effect on our business and the market price of our common stock. In addition, the changing nature of our customers' industries results in uncertainties in any projections or estimates relating to the growth prospects or future condition of our markets. Furthermore, if any one or more of the assumptions underlying the market data is later found to be incorrect, actual results may differ from the projections based on these assumptions.

Unless otherwise indicated, information in this report concerning economic conditions and our industry is based on information from independent industry analysts and publications, as well as our estimates. Except where otherwise noted, our estimates are derived from publicly available information released by third party sources, as well as data from our internal research, and are based on such data and our knowledge of our industry, which we believe to be reasonable. None of the market data from independent industry publications cited in this report was prepared on our or our affiliates' behalf.

Additional information on the various risks and uncertainties potentially affecting our operating results are discussed in this report and other documents we file with the Securities and Exchange Commission, or the SEC, or available upon written request to our corporate secretary at: A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110141. We undertake no obligation to revise or update publicly any forward-looking statements for any reason, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on these forward-looking statements.

As used in this report, “SmartHeat,” “Company,” “we,” “our” and similar terms refer to SmartHeat Inc. and its subsidiaries, unless the context indicates otherwise.

Our functional currency is the U.S. Dollar, or USD, while the functional currency of our subsidiaries in China are denominated in Chinese Yuan Renminbi, or RMB, the national currency of the People’s Republic of China, which we refer to as the PRC or China, and the functional currency of our subsidiary in Germany is denominated in Euros, or EUR. The functional currencies of our foreign operations are translated into USD for balance sheet accounts using the current exchange rates in effect as of the balance sheet date and for revenue and expense accounts using the average exchange rate during the fiscal year. See Note 2 of the consolidated financial statements included herein.

Effective February 7, 2012, we implemented a one-for-ten reverse stock split of our common stock. Unless otherwise indicated, all share amounts and per share prices in this report were retroactively adjusted to reflect the effect of this reverse stock split. See Note 1 of the consolidated financial statements included herein.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

June 30, 2014
December 31, 2013
(UNAUDITED)

ASSETS

CURRENT ASSETS

| | | |
|---|--------------------|--------------------|
| Cash & equivalents | \$ 18,996,617 | \$ 13,602,399 |
| Restricted cash | 670,830 | 2,458,758 |
| Accounts receivable, net | 15,099,549 | 12,167,565 |
| Retentions receivable, net | 2,597,790 | 4,202,109 |
| Advances to suppliers, net | 5,018,613 | 6,584,833 |
| Other receivables (net), prepayments and deposits | 3,972,878 | 2,644,522 |
| Inventories, net | 54,194,515 | 56,324,363 |
| Taxes receivable | 633,406 | 989,635 |
| Notes receivable - bank acceptances | 683,906 | 2,759,251 |
| Total current assets | 101,868,104 | 101,733,434 |

NONCURRENT ASSETS

| | | |
|--------------------------------|-------------------|-------------------|
| Long term investment | 912,044 | 934,805 |
| Restricted cash | 316,899 | 135,926 |
| Retentions receivable | - | 237,882 |
| Advance for equipment purchase | 1,241,933 | - |
| Construction in progress | 1,362,730 | 1,340,905 |
| Property and equipment, net | 10,041,499 | 10,185,160 |
| Intangible assets, net | 4,381,691 | 14,885,623 |
| Total noncurrent assets | 18,256,796 | 27,720,301 |

| | | |
|---------------------|-----------------------|-----------------------|
| TOTAL ASSETS | \$ 120,124,900 | \$ 129,453,735 |
|---------------------|-----------------------|-----------------------|

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES

| | | |
|--|--------------|--------------|
| Accounts payable | \$ 6,626,668 | \$ 6,683,860 |
| Advance from customers | 2,744,657 | 2,630,061 |
| Taxes payable | 26,761 | 197,078 |
| Accrued liabilities and other payables | 17,531,682 | 17,215,006 |
| Notes payable - bank acceptances | - | 2,590,025 |
| Loans payable | 24,983,580 | 24,462,299 |

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| | | |
|---|----------------|----------------|
| Total current liabilities | 51,913,348 | 53,778,329 |
| CREDIT LINE PAYABLE | 2,149,335 | 1,396,378 |
| LONG-TERM LOAN | 2,112,859 | 2,132,231 |
| DEFERRED TAX LIABILITY | 91,419 | 17,177 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock, \$0.001 par value; 75,000,000 shares authorized, 6,583,399 shares and 6,133,399 shares issued and outstanding as of June 30, 2014 and December 31, 2013, respectively | | |
| | 6,583 | 6,133 |
| Paid-in capital | 81,733,320 | 81,901,266 |
| Statutory reserve | 5,389,057 | 5,389,057 |
| Accumulated other comprehensive income | 8,385,003 | 8,991,269 |
| Accumulated deficit | (57,812,734) | (51,991,839) |
| Total Company stockholders' equity | 37,701,229 | 44,295,886 |
| NONCONTROLLING INTEREST | 26,156,710 | 27,833,734 |
| TOTAL EQUITY | 63,857,939 | 72,129,620 |
| TOTAL LIABILITIES AND EQUITY | \$ 120,124,900 | \$ 129,453,735 |

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

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

| | SIX MONTHS ENDED JUNE 30, | | THREE MONTHS ENDED JUNE 30, | |
|--|------------------------------|---------------|--------------------------------|--------------|
| | 2014 (UNAUDITED) | 2013 | 2014 (UNAUDITED) | 2013 |
| Net sales | \$10,669,833 | \$13,891,423 | \$5,709,867 | \$7,722,992 |
| Cost of goods sold | 12,701,080 | 14,265,228 | 7,337,123 | 5,320,037 |
| Gross loss (income) | (2,031,247) | (373,805) | (1,627,256) | 2,402,955 |
| Operating expenses | | | | |
| Selling | 3,523,056 | 3,242,531 | 1,956,545 | 1,546,589 |
| General and administrative | 4,661,513 | 4,818,674 | 1,747,185 | 2,482,031 |
| Provision for bad debts | (3,399,744) | 12,287,944 | (12,149,019) | 7,524,870 |
| Provision for advance to supplier | 108,270 | 1,529,595 | 33,480 | 288,916 |
| Total operating expenses (income) | 4,893,095 | 21,878,744 | (8,411,808) | 11,842,406 |
| Income (loss) from operations | (6,924,342) | (22,252,549) | 6,784,552 | (9,439,451) |
| Non-operating income (expenses) | | | | |
| Investment (loss) income | (22,891) | 39,345 | (19,282) | 38,784 |
| Interest income | 64,583 | 28,975 | 36,900 | 13,585 |
| Interest expense | (857,146) | (772,242) | (488,004) | (428,431) |
| Financial expense | (276,171) | (150,341) | (224,035) | (87,442) |
| Gain on issuance of stock | 70,000 | - | 70,000 | - |
| Foreign exchange transaction gain | 5,550 | 3,339 | 2,151 | 840 |
| Other income, net | 510,725 | 734,075 | 268,974 | 423,777 |
| Total non-operating expenses, net | (505,350) | (116,849) | (353,296) | (38,887) |
| Income (loss) before income tax | (7,429,692) | (22,369,398) | 6,431,256 | (9,478,338) |
| Income tax (benefit) expense | 75,493 | (45,000) | 90,029 | (22,556) |
| Net income (loss) before noncontrolling interest | (7,505,185) | (22,324,398) | 6,341,227 | (9,455,782) |
| Less: income (loss) attributable to noncontrolling interest | (1,684,289) | (47,297) | 3,086,178 | (2,555) |
| Net income (loss) to SmartHeat Inc. | (5,820,896) | (22,277,101) | 3,255,049 | (9,453,227) |
| Other comprehensive item | | | | |
| Foreign currency translation gain (loss) attributable to SmartHeat Inc. | (606,266) | 1,550,147 | (43,960) | 1,361,630 |
| Foreign currency translation gain (loss) attributable to noncontrolling interest | 7,265 | 17,806 | (16,942) | 15,074 |

| | | | | |
|---|----------------|-----------------|-------------|----------------|
| Comprehensive income (loss) attributable to SmartHeat Inc. | \$(6,427,162) | \$(20,726,954) | \$3,211,089 | \$(8,091,597) |
| Comprehensive income (loss) attributable to noncontrolling interest | \$(1,677,024) | \$(29,491) | \$3,069,236 | \$12,519 |
| Basic and diluted weighted average shares outstanding | 6,364,338 | 5,733,399 | 6,579,003 | 5,733,399 |
| Basic and diluted earnings (loss) per share | \$(0.91) | \$(3.89) | \$0.49 | \$(1.65) |

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

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | SIX MONTHS ENDED JUNE | |
|---|-----------------------|-----------------|
| | 30, | |
| | 2014 | 2013 |
| | (UNAUDITED) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Loss including noncontrolling interest | \$(7,505,185) | \$(22,324,398) |
| Adjustments to reconcile loss including noncontrolling interest to net cash used in operating activities: | | |
| Investment (income) loss | 22,891 | (39,345) |
| Depreciation and amortization | 1,058,204 | 1,071,447 |
| Provision for bad debts | (3,399,743) | 12,287,944 |
| Provision for inventory impairment | 2,775,603 | 4,188,169 |
| Provision for advance to suppliers | 108,270 | 1,529,595 |
| Changes in warranty reserves | 43,848 | 7,945 |
| Gain on issuance of stock | (70,000) | - |
| Gain on disposal fixed asset | (6,926) | 18,829 |
| Stock based compensation for shares issued to officers and director | 37,500 | - |
| Changes in deferred tax | 74,821 | (43,451) |
| (Increase) decrease in assets and liabilities: | | |
| Accounts receivable | 3,495,711 | 2,240,647 |
| Retentions receivable | 244,023 | 92,947 |
| Advances to suppliers | 1,406,693 | (1,363,211) |
| Other receivables, prepayments and deposits | (3,158,078) | (897,047) |
| Inventories | (1,148,034) | (3,274,909) |
| Taxes receivable | 241,227 | (1,421,702) |
| Accounts payable | (2,577,656) | (2,126,638) |
| Advance from customers | (2,838,655) | 570,467 |
| Taxes payable | (60,967) | (687,227) |
| Accrued liabilities and other payables | 3,125,224 | 144,611 |
| Net cash used in operating activities | (8,131,229) | (10,025,327) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Change in restricted cash | 1,592,388 | (387,158) |
| Cash received from assets disposal | 19,614 | - |
| Acquisition of property & equipment | (701,717) | (516,140) |
| Government refund of land use right | 10,364,498 | - |
| Notes receivable | 2,061,939 | 932,185 |
| Construction in progress | (6,908) | - |
| Advance for equipment purchase | (1,248,997) | - |
| Net cash provided by investing activities | 12,080,817 | 28,887 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from short-term loans | 13,716,733 | 13,767,295 |

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| | | |
|--|---------------|---------------|
| Repayment on short-term loans | (12,968,975) | (11,920,593) |
| Credit line payable | 850,000 | - |
| Net cash provided by financing activities | 1,597,758 | 1,846,702 |
| EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS | (153,128) | 148,762 |
| NET INCREASE (DECREASE) IN CASH & EQUIVALENTS | 5,394,218 | (8,000,976) |
| CASH & EQUIVALENTS, BEGINNING OF PERIOD | 13,602,399 | 18,336,163 |
| CASH & EQUIVALENTS, END OF PERIOD | \$18,996,617 | \$10,335,187 |
| Supplemental cash flow data: | | |
| Income tax paid | \$- | \$703,889 |
| Interest paid | \$729,950 | \$878,062 |

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

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2014 (UNAUDITED) AND DECEMBER 31, 2013

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

SmartHeat Inc., formerly known as Pacific Goldrim Resources, Inc. (the “Company” or “SmartHeat”), was incorporated on August 4, 2006, in the State of Nevada. The Company, through its operating subsidiaries in China and Germany, designs, manufactures, sells and services plate heat exchangers (“PHEs”), PHE Units, which combine PHEs with various pumps, temperature sensors, valves and automated control systems, heat meters and heat pumps for use in commercial and residential buildings.

On August 23 2013, the Company formed two new wholly-owned subsidiaries in the State of Nevada, Heat HP Inc., and HEAT PHE Inc. On August 23, 2013, SmartHeat Inc., the Company’s United States parent company entered into Assignment Agreements with Heat HP Inc. and Heat PHE Inc., respectively. Under the Assignment Agreements, the Company agreed to transfer 100% of its right, title and interest in certain subsidiaries to Heat HP Inc. and Heat PHE Inc. The reorganization was performed so the Company’s subsidiaries would be organized along their respective operating segments with Heat HP holding those subsidiaries that operated in the heat pumps and related products segment and Heat PHE holding those subsidiaries that operated in the plate heating equipment, meters and related products segment.

After the assignment, Heat HP Inc. owned 100% of SmartHeat (China) Investment Co., Ltd. (“SmartHeat Investment”), SmartHeat (Shanghai) Trading Co., Ltd. (“SmartHeat Trading”), Beijing SmartHeat Jinhui Energy Technology Co., Ltd. (“Jinhui”), SmartHeat Deutschland GmbH (“SmartHeat Germany”), and 98.8% of SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. (“SmartHeat Pump”).

After the assignment, Heat PHE Inc. owned 100% of SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd. (“Taiyu”), SanDeKe Co., Ltd., (“SanDeKe”), SmartHeat Siping Beifang Energy Technology Co., Ltd. (“SmartHeat Siping”), SmartHeat (Shenyang) Energy Equipment Co., Ltd. (“SmartHeat Energy”), and 51% of Hohhot Ruicheng Technology Co., Ltd. (“Ruicheng”).

On August 23, 2013, the Company entered into a Stock Pledge Agreement with Northtech Holdings Inc. (“Northtech”). The Company agreed to deliver shares certificates to Northtech representing 55% of Heat HP Inc. and Heat PHE Inc. to perfect the security interest in each of the Company’s directly and wholly-owned subsidiaries granted to Northtech as collateral security for all of the obligations of the Company owed to Northtech.

In December 2013, SmartHeat US parent incorporated SmartHeat Heat Exchange Equipment Co. (“Heat Exchange”) in China with register capital of \$3.00 million for manufacturing and sale of PHE and PHE related products.

On December 30, 2013, the Company, closed the transaction contemplated by the Equity Interest Purchase Agreement dated October 10, 2013, whereby the buyers purchased 40% of the Company’s equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohhot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the “Target Companies”). The purchase price was RMB 5,000,000. Urumchi XinRui Technology Limited Liability Company (“XinRui”) was 46% owned by SmartHeat US parent company prior to 40% equity interest sell.

The Company retained an option to repurchase the equity interests of the Target Companies from the buyers at a purchase price of RMB 5,600,000 which terminated on February 28, 2014. On March 27, 2014, the buyers exercised

their option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000. The Company will seek the approval of its shareholders prior to completing the sale. In the event such approval is not obtained, the buyers may terminate the Equity Interest Purchase Agreement. Should the buyers exercise their option to purchase the additional 40% equity interest and the Company's shareholders approve the sale, the Company has the option to require the buyers to purchase the remaining 20% equity interest for a purchase price of RMB 2,500,000. The closing of transaction will be scheduled to occur after satisfaction of the conditions set forth in the Equity Interest Purchase Agreement, including, without limitation, approval of the transaction by a majority of the Company's shareholders entitled to vote.

The buyers consist of a group of 25 natural persons, all of whom are P.R.C. citizens, including Wen Sha, Jun Wang and Xudong Wang, managers of the Company's subsidiaries engaged in the PHE segment of its business, and Huajuan Ai and Yingkai Wang, the Company's Corporate Secretary and Acting Chief Accountant, respectively. Huajuan Ai, Wen Sha, Jun Wang and Xudong Wang are also principals in Northtech Holdings Inc. SmartHeat's subsidiaries made an application to State Administration for Industry and Commerce ("SAIC") to register the ownership transfers as of June 30, 2014.

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2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements were prepared in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”).

The consolidated interim financial information as of June 30, 2014 and for the six and three months ended June 30, 2014 and 2013, were prepared without audit, pursuant to the rules and regulations of the SEC (“Security and Exchange Commission”). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with U.S. GAAP are not included. The interim consolidated financial information should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013, previously filed with the SEC.

In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present a fair statement of the Company’s consolidated financial position as of June 30, 2014, its consolidated results of operations and cash flows for the six and three months ended June 30, 2014 and 2013, as applicable, were made. The interim results of operations are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat’s U.S. parent, its subsidiaries Heat HP and Heat PHE, and their subsidiaries Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Shenyang Energy, SmartHeat Trading, Ruicheng, SmartHeat Germany, SmartHeat Shenyang Heat Pump, and Heat Exchange, which are collectively referred to as the “Company.” All significant intercompany accounts and transactions were eliminated in consolidation. After the sale of 40% equity interest of Taiyu, Siping, Shenyang Energy, Ruicheng and Xinrui (See Note 9) on December 30, 2013, the Company now owns 60% of Taiyu, Siping and Shenyang Energy, and 30.6% of Ruicheng, which is accounted for under the equity method of accounting.

Equity Method Investee

Prior to the sale of 40% equity interest of Taiyu, Siping, Shenyang Energy, Ruicheng and Xinrui, the Company owned 46% of XinRui and accounts for this investment under the equity method of accounting (ASC 323-30). The Company recorded its investment at original cost. This investment increased with income and decreased for dividends and losses that accrued to the Company. After 40% equity interest sale on December 30, 2013, the Company now owns 30.6% of Ruicheng (See Note 9) and 27.6% of XinRui, which are accounted for under the equity method of accounting.

Use of Estimates

In preparing the financial statements in conformity with U.S. GAAP, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

Cash and Equivalents

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For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of June 30, 2014 and December 31, 2013, the Company maintained restricted cash deposit in several bank accounts for the purposes described below.

| | 2014 | 2013 |
|-------------------------------------|---------------|---------|
| | (In millions) | |
| Support of performance guarantee | \$ 0.46 | \$ 1.16 |
| Support of bank acceptance | - | 1.29 |
| Support of letter of credit | 0.21 | 0.01 |
| Total restricted cash - current | \$ 0.67 | \$ 2.46 |
| Performance guarantee -- noncurrent | \$ 0.32 | \$ 0.14 |

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The following table presents in U.S. dollars (“USD”) the amount of cash and equivalents held by the Company as of June 30, 2014 and December 31, 2013, based on the jurisdiction of deposit. The Company’s U.S. parent holds cash and equivalents in U.S. bank accounts denominated in USD.

| | United States | | China | | Germany | | Total |
|-------------------|---------------|---------|-------|------------|---------|-----------|---------------|
| June 30, 2014 | \$ | 244,035 | \$ | 17,767,302 | \$ | 985,280 | \$ 18,996,617 |
| December 31, 2013 | \$ | 251,461 | \$ | 11,326,282 | \$ | 2,024,656 | \$ 13,602,399 |

As of June 30, 2014, Taiyu had RMB 10 million (\$1.63 million) deposited in a commercial bank as an investment to the financial product with term from June 20, 2014 to July 23, 2014 and annual yield between 4.5% to 4.7% depending on CSI 300 index at the observation date. SmartHeat Energy had RMB 45 million (\$7.31 million) deposited in a commercial bank as an investment to the financial product with term from June 26, 2014 to July 28, 2014 and annual yield of 5.4%.

Accounts and Retentions Receivable

The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Based on historical collection activity, the Company had allowances of \$41.29 million and \$48.25 million at June 30, 2014 and December 31, 2013, respectively.

At June 30, 2014 and December 31, 2013, the Company had retentions receivable from customers for product quality assurance of \$3.92 and \$4.44 million, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 to 24 months depending on the shipping date, and for PHE Units, the customer acceptance date, of the products and the number of heating seasons that the warranty period covers. The Company had allowances of \$1.56 million and \$0 at June 30, 2014 and December 31, 2013, respectively.

Accounts receivable is net of unearned interest of \$26,413 and \$26,655 at June 30, 2014 and December 31, 2013, respectively. Unearned interest is imputed interest on accounts receivable with due dates over 1 year from the invoice date discounted at the Company’s borrowing rate of 6.15% at December 31, 2012. The Company did not record additional unearned interest after December 31, 2012 due to no long-term accounts receivable.

Bad Debt Allowance

The Company records approximately 50% of accounts receivable aged over 180 days from the payment due date and 100% accounts receivable aged over 360 days from the payment due date as bad debt allowance. Management of the Company’s subsidiaries further analyzes each individual customer for which it was taken a bad debt allowance to further assess the likelihood of collectability. Customers which are either state-owned or have a history of support from the state, or larger companies with long operating histories, that management of the Company’s subsidiaries believe the chance of non-payment will be remote, are excluded for the purpose of calculating bad debt allowance.

Advance to Suppliers

The Company makes advances to certain vendors to purchase raw material and equipment for production. The advances are interest-free and unsecured.

Inventories

Inventories are valued at the lower of cost or market, with cost determined on a moving weighted-average basis. The difference is recorded as a cost of goods sold, if the current market value is lower than their historical cost. In addition, the Company makes an inventory impairment provision analysis at each period end for inventory held over 360 days. Cost of work in progress and finished goods comprises direct material, direct labor and an allocated portion of production overheads.

Certain raw materials, such as stainless steel products, plates, shims, gaskets, and pump valves, require longer than normal procurement periods, or “lead times,” with some procurement periods running longer than six months. To guarantee availability of raw materials for production and sales, the Company’s subsidiaries, based on historical sale patterns, estimate and purchase material for the upcoming period.

As part of inventory impairment analysis, the Company performs an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory can be utilized and will be consumed within the next six months through new customer orders or substitute orders, no impairment is recorded. The Company collects information about delayed and canceled contracts and met with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that the Company does not expect to be reinstated and contracts for which the Company has been unable to find substitute customers become impaired.

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Property and Equipment

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

| | |
|-------------------------|---------------|
| Buildings | 20 years |
| Vehicles | 5 years |
| Office equipment | 5 years |
| Production equipment | 5-10 years |

Land Use Rights

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

Warranties

The Company offers to all customers standard warranties on its products for one or two heating seasons depending on the terms negotiated. The Company accrues for warranty costs based on estimates of the costs that may be incurred under its warranty obligations. The warranty expense and related accrual is included in the Company's selling expenses and other payables respectively, and is recorded when revenue is recognized. Factors that affect the Company's warranty liability include the number of units sold, its estimates of anticipated rates of warranty claims, costs per claim and estimated support labor costs and the associated overhead. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Activity in the Company's warranty reserve from January 1, 2013, to June 30, 2014, is as follows:

| | 2014 | 2013 |
|--|------------|------------|
| Beginning balance | \$ 472,558 | \$ 517,076 |
| Provisions | 406,625 | 331,989 |
| Actual costs incurred | (175,030) | (376,507) |
| Ending balance in current liabilities (Note 13) | \$ 560,924 | \$ 472,558 |

Research and Development Costs

Research and development ("R&D") costs are expensed as incurred and included in general and administrative expenses. These costs primarily consist of cost of materials used, salaries paid for the Company's development department and fees paid to third parties. R&D costs for the six months ended June 30, 2014 and 2013, were \$403,917 and \$238,053, respectively. R&D costs for the three months ended June 30, 2014 and 2013, were \$246,546 and \$115,616, respectively.

Revenue Recognition

The Company's revenue recognition policies comply with SEC Staff Accounting Bulletin ("SAB") 104 (codified in FASB ASC Topic 605). Sales revenue is recognized when PHEs, heat meters and heat pumps are delivered, and for PHE Units when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of the Company exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition met are recorded as unearned revenue under "Advance from customers."

The Company's sales generally provide for 30% of the purchase price on placement of an order, 30% on delivery, 30% upon installation and acceptance of the equipment after customer testing and 10% no later than the termination of the standard warranty period, which ranges from 3 to 24 months from the acceptance date.

Due to the slowdown of the Chinese economy and tightened monetary policy, and to attract and retain customers, the Company's subsidiaries adjusted their contract and payment terms to permit more flexible and longer payment terms.

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Sales revenue is the invoiced value of goods, net of value-added tax (“VAT”). All of the Company’s products sold in the PRC are subject to a VAT of 17% of gross sales price. This VAT may be offset by the VAT paid by the Company on raw materials and other materials purchased in China and included in the cost of producing the Company’s finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The Company files VAT tax returns on line with PRC tax authorities and offsets the payables against the receivables. SmartHeat Germany, the Company’s German subsidiary, is subject to 19% VAT.

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

Sales returns and allowances were \$0 for the six and three months ended June 30, 2014 and 2013. The Company does not provide a right of return, price protection or any other concessions to its customers.

The Company provides a standard warranty to all customers, which is not considered an additional service; rather, an integral part of the product’s sale. The Company believes the existence of its standard product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. The Company believes that accounting for its standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

The Company charges for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. The Company recognizes such revenue when the service is provided. For the six months ended June 30, 2014 and 2013, revenue from after-sales services after the expiration of the warranty period was \$93,784 and \$129,406, respectively. For the three months ended June 30, 2014 and 2013, revenue from after-sales services after the expiration of the warranty period was \$47,540 and \$47,776, respectively, which was recorded in other income.

Cost of Goods Sold

Cost of goods sold (“COGS”) consists primarily of material costs and direct labor and manufacturing overhead that are directly attributable to the products. Write-down of inventories to the lower of cost or market is also recorded in COGS. Company also records inventory reserve for inventories aging over 360 days to COGS.

Advance from Customers

The Company records payments received from customers in advance of their orders to advance account. These orders normally are delivered within a reasonable period of time based upon contract terms and customer demand.

Statement of Cash Flows

In accordance with SFAS No. 95, “Statement of Cash Flows,” codified in FASB ASC Topic 230, cash flows from the Company’s operations are calculated based upon the local currencies. As a result, amounts shown on the statement of cash flows may not necessarily agree with changes in the corresponding asset and liability on the balance sheet.

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

Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed similarly, except that the denominator is

increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted EPS are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to have been exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period.

Basic and diluted shares outstanding are the same for the six and three months ended June 30, 2014 and 2013, because the common stock equivalent of the convertible securities outstanding, consisting of unexercised options issued to the Company's directors and an officer, are anti-dilutive and, accordingly, were excluded from the computation of diluted loss per share. At June 30, 2014 and December 31, 2013, options to purchase 2,500 shares of common stock were outstanding and exercisable, respectively.

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Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the U.S. parent company are maintained in USD. The functional currency of the Company's China subsidiaries is the Chinese Yuan Renminbi ("RMB") and the functional currency of SmartHeat Germany, the Company's subsidiary in Germany, is the Euro ("EUR"). The accounts of the China subsidiaries and German subsidiary were translated into USD in accordance with SFAS No. 52, "Foreign Currency Translation" (codified in FASB ASC Topic 830). According to SFAS No. 52, all assets and liabilities were translated at the exchange rate on the balance sheet date, stockholders' equity was translated at the historical rates and statement of operations items were translated at the average exchange rate for the period. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, "Reporting Comprehensive Income" (codified in FASB ASC Topic 220).

The RMB to USD exchange rates and EUR to USD exchange rates in effect as of June 30, 2014 and December 31, 2013, and the average exchange rates for the six months ended June 30, 2014 and 2013 are as following. The exchange rates used in translation from RMB to USD were published by State Administration of Foreign Exchange of the People's Republic of China ("SAFE"). The exchange rates used in translation from EUR to USD were published by OANDA Rates.

| | Average Exchange Rate For the Six Months Ended | | Balance Sheet Date Exchange Rate | |
|-----------|---|---------|-------------------------------------|----------|
| | 6/30/14 | 6/30/13 | 6/30/14 | 12/31/13 |
| RMB - USD | 6.1180 | 6.2413 | 6.1528 | 6.0969 |
| EUR - USD | 0.7295 | 0.7616 | 0.7329 | 0.7263 |

Segment Reporting

FASB ASC Topic 280, Disclosures about Segments of an Enterprise and Related Information, requires use of the "management approach" model for segment reporting. The management approach model is based on the way a company's management organizes segments within the company for making operating decisions and assessing performance. Reportable segments are based on products and services, geography, legal structure, management structure, or any other manner in which management disaggregates a company.

The Company has two operating segments: 1) plate heating equipment, meters and related products; and 2) heat pumps and related products. These operating segments were determined based on the nature of the products offered. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. The Company's chief executive officer and acting chief accountant were identified as the chief operating decision makers. The Company's chief operating decision makers direct the allocation of resources to operating segments based on the profitability, cash flows, and other measurement factors of each respective segment. Historically they were not segmented because the heat pump business was relatively small compared to the plate heating business and both businesses reported to the same executives; however, the Company's Board and senior management determined that it is useful and efficient to analyze and manage these businesses separately starting from 2013.

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The Company evaluates performance based on several factors, of which the primary financial measure is business segment income before taxes. The following table shows the operations of the Company's reportable segments for the six months ended June 30, 2014 and 2013, and as of June 30, 2014 and December 31, 2013, respectively.

| | Six Months Ended June 30, | |
|---|---------------------------|-----------------|
| | 2014 | 2013 |
| Revenue from unaffiliated customers: | | |
| Plate heating, meters and related | \$ 9,359,142 | \$ 11,808,874 |
| Heat pumps and related | 1,310,691 | 2,082,549 |
| Consolidated | \$ 10,669,833 | \$ 13,891,423 |
| Loss from operations: | | |
| Plate heating, meters and related | \$ (3,731,906) | \$ (19,942,874) |
| Heat pumps and related | (2,493,824) | (1,866,988) |
| Corporation | (698,612) | (442,687) |
| Consolidated | \$ (6,924,342) | \$ (22,252,549) |
| Net loss from continuing operations before non-controlling: | | |
| Plate heating, meters and related | \$ (4,606,347) | \$ (20,406,465) |
| Heat pumps and related | (2,373,653) | (1,433,574) |
| Corporation | (525,185) | (484,359) |
| Consolidated | \$ (7,505,185) | \$ (22,324,398) |
| Depreciation and amortization: | | |
| Plate heating, meters and related | \$ 740,608 | \$ 771,634 |
| Heat pumps and related | 242,495 | 234,432 |
| Corporation | 75,101 | 65,381 |
| Consolidated | \$ 1,058,204 | \$ 1,071,447 |
| Total assets: | | |
| Plate heating, meters and related | \$ 121,769,638 | \$ 126,673,776 |
| Heat pumps and related | 41,671,724 | 14,480,873 |
| Corporation | 4,099,158 | 4,189,018 |
| Inter-segment elimination | (47,415,620) | (15,889,932) |
| Consolidated | \$ 120,124,900 | \$ 129,453,735 |

The following table shows the operations of the Company's reportable segments for the three months ended June 30, 2014 and 2013, respectively.

| | Three Months Ended June 30, | |
|--|-----------------------------|----------------|
| | 2014 | 2013 |
| Revenue from unaffiliated customers | | |
| Plate heating, meters and related | \$ 4,974,000 | \$ 6,137,081 |
| Heat pumps and related | 735,867 | 1,585,911 |
| Consolidated | \$ 5,709,867 | \$ 7,722,992 |
| Operating income (loss): | | |
| Plate heating, meters and related | \$ 8,317,577 | \$ (8,528,664) |
| Heat pumps and related | (1,361,240) | (641,294) |
| Corporation | (171,785) | (269,493) |
| Consolidated | \$ 6,784,552 | \$ (9,439,451) |
| Net income (loss) from continuing operations before non-controlling: | | |

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| | | |
|-----------------------------------|--------------|----------------|
| Plate heating, meters and related | \$ 7,590,477 | \$ (8,806,823) |
| Heat pumps and related | (1,307,874) | (379,331) |
| Corporation | 58,624 | (269,628) |
| Consolidated | \$ 6,341,227 | \$ (9,455,782) |
| Depreciation and amortization: | | |
| Plate heating, meters and related | \$ 7,496 | \$ 388,967 |
| Heat pumps and related | 4,875 | 111,451 |
| Corporation | 21,514 | 47,236 |
| Consolidated | \$ 33,885 | \$ 547,654 |

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New Accounting Pronouncements

In January 2014, FASB issued, Accounting Standards Update 2014-01, Investments—Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects. The objective of this Update is to provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU will not affect the Company's financial statements.

In January 2014, FASB issued, Accounting Standards Update 2014-05, Service Concession Arrangements (Topic 853), The objective of this Update is to specify that an operating entity should not account for a service concession arrangement within the scope of this Update as a lease in accordance with Topic 840, Leases. Service concession arrangements may become more prevalent in the United States as public-sector entities seek alternative ways to provide public services on a more efficient and cost-effective basis. The amendments apply to an operating entity of a service concession arrangement entered into with a public-sector entity grantor when the arrangement meets certain conditions. The amendments in this Update should be applied on a modified retrospective basis to service concession arrangements that exist at the beginning of an entity's fiscal year of adoption. The modified retrospective approach requires the cumulative effect of applying this Update to arrangements existing at the beginning of the period of adoption to be recognized as an adjustment to the opening retained earnings balance for the annual period of adoption. The amendments are effective for a public business entity for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU will not affect the Company's financial statements.

As of June 30, 2014, there is no recently issued accounting standards not yet adopted that would have a material effect on the Company's consolidated financial statements.

Reclassification

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period, which includes the reclassification of a \$2.99 million advance from customers to other payable in the balance sheet.

3. INVENTORIES

Inventories at June 30, 2014 and December 31, 2013, were as follows:

| | 2014 | 2013 |
|---------------------|---------------|---------------|
| Raw materials | \$ 48,753,774 | \$ 48,258,773 |
| Work in process | 8,053,865 | 6,822,102 |
| Finished goods | 11,438,961 | 12,639,202 |
| Total | 68,246,600 | 67,720,077 |
| Inventory allowance | (14,052,085) | (11,395,714) |
| Inventories, net | \$ 54,194,515 | \$ 56,324,363 |

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received commercial notes (bank acceptance) from them in lieu of payments for accounts receivable. The Company discounted the commercial notes with the bank or endorsed the commercial notes to vendors for payment of their own obligations or to get cash from third parties. Most of the commercial notes have a maturity of less than six months. As of June 30, 2014, the Company was contingently liable for the notes endorsed to vendors of \$1.47 million.

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5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30, 2014 and December 31, 2013:

| | 2014 | 2013 |
|--------------------------------|---------------|---------------|
| Buildings | \$ 4,934,937 | \$ 4,980,184 |
| Production equipment | 9,054,038 | 8,599,701 |
| Office equipment | 1,126,136 | 1,124,176 |
| Vehicles | 872,964 | 940,624 |
| Total | 15,988,075 | 15,644,685 |
| Less: accumulated depreciation | (5,946,576) | (5,459,525) |
| Property & equipment, net | \$ 10,041,499 | \$ 10,185,160 |

Depreciation for the six months ended June 30, 2014 and 2013, was \$713,770 and \$707,900, respectively. Depreciation expense for the three months ended June 30, 2014 and 2013, was \$358,370 and \$353,400, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at June 30, 2014 and December 31, 2013, respectively:

| | 2014 | 2013 |
|---|---------------|---------------|
| Advance to third party companies | \$ 12,914,392 | \$ 10,059,572 |
| Deposit for public bids of sales contracts | 767,262 | 758,465 |
| Prepayment for freight, related, insurance, advertisement and consulting expenses | 109,299 | 73,773 |
| Other deposits | 86,892 | 53,863 |
| Advance to employees | 519,161 | 926,441 |
| Advance to unrelated individuals | 323,028 | - |
| Others | 649,669 | 680,588 |
| Total | 15,369,703 | 12,552,702 |
| Less: bad debt allowance | (11,396,825) | (9,908,180) |
| Other receivables (net), prepayments & deposits | \$ 3,972,878 | \$ 2,644,522 |

Advance to third party companies were short-term unsecured advances to unrelated parties with payment usually due within a year and includes an advance to Siping Beifang of RMB 22.13 million (\$3.60 million) that is non-interest bearing and with due date extended to September 2014.

Deposits for public bidding represented the deposits for bidding on expected contracts, which will be returned to the Company after the bidding process is completed, usually within three to four months from the payment date. Prepayment for freight, related insurance expenses and advertisement represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products and prepaid advertising expense.

Other deposits mainly consisted of deposits for rents, payroll expense and utilities. Advance to employees represented short-term loans to employees and advances for business trips and related expenses. Other receivables (consisting of

advance to third parties and employees, deposit for public bids and others), prepayments and deposits are reimbursed or settled within 12 months.

7. INTANGIBLE ASSETS

Intangible assets consisted mainly of land use rights, trademarks, computer software, know-how technology, customer lists and covenants not to compete. All land in the PRC is government-owned and cannot be sold to any individual or company. However, the government grants the user a “land use right” to use the land. The Company acquired land use rights during 2005 for RMB 3,549,682 (\$0.44 million). In June 2009, the Company acquired land use rights for \$3.1 million from Siping Beifang. In November 2010, the Company’s subsidiary, SmartHeat Energy, acquired land use rights for \$10.10 million. The Company has the right to use the land for 50 years and is amortizing such rights on a straight-line basis for 50 years.

SmartHeat Energy later cancelled the purchase of the land use right due to the adjustments of the overall development plan of the area by the local authority. On May 21, 2014, SmartHeat Energy and Shenyang City Development and Land Resource Bureau Economy and Technology Development Office entered into an official agreement, whereby full purchase price of the land use right will be returned to SmartHeat Energy in installments within 5 days from the effective date of the official agreement. SmartHeat Energy will make the ownership change of the land use right upon receiving the refund from the local authority. SmartHeat Energy received accumulated amount of \$14.89 million (RMB 91,622,000) as of June 30, 2014 and is in the process of title transfer, which is expected to complete by the end of 2014. Currently the land is used by the third party.

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Intangible assets consisted of the following at June 30, 2014 and December 31, 2013, respectively:

| | Estimated Useful Life (In years) | 2014 | 2013 |
|--------------------------------|---|--------------|---------------|
| Land use rights | 50 | \$ 4,111,874 | \$ 15,167,552 |
| Know-how technology | 5 – 10 | 903,143 | 911,423 |
| Customer lists | 5 | 212,889 | 214,841 |
| Covenants not to compete | 5 | 115,811 | 116,873 |
| Software | 5 | 459,272 | 680,049 |
| Trademarks | 7 | 295,837 | 298,549 |
| Total | | 6,098,826 | 17,389,287 |
| Less: accumulated amortization | | (1,717,135) | (2,503,664) |
| Intangible assets, net | | \$ 4,381,691 | \$ 14,885,623 |

Amortization of intangible assets for the six months ended June 30, 2014 and 2013, was \$269,333 and \$298,209, respectively. Amortization expense of intangible assets for the three months ended June 30, 2014 and 2013, was \$106,733 and \$146,982, respectively. Annual amortization for the next five years from June 30, 2014, is expected to be \$271,930, \$234,260, \$233,290, \$201,430 and \$167,720, and \$3,273,060 thereafter.

8. CONSTRUCTION IN PROGRESS

The Company had construction in progress of \$1.36 million at June 30, 2014, consisting of three ongoing projects.

1) SmartHeat Energy was building a factory for a total estimated cost of \$9.00 million, of which the Company paid \$0.47 million as of June 30, 2014. The Company halted construction of the factory resulting from SmartHeat Energy returning the previously purchased land use right to the local authority where the factory was being built due to the adjustment of the overall development plan of the area by the local authority (see Note 13).

2) SmartHeat Siping has a construction project of \$71,000 for the laying of a foundation for its machinery installation. This foundation project will be completed in the third quarter of 2014.

3) Taiyu paid \$0.83 million for equipment and installation, this project was completed in July 2013 and is in the testing stage with continuous improvements. The Company expects to complete the testing and put into operation in the third quarter of 2014.

9. LONG TERM INVESTMENT

Prior to December 30, 2013, the Company invested \$722,700 to establish XinRui. The Company owned 46% of XinRui and accounted for this investment under the equity method. On December 30, 2013, the Company sold 40% equity interest of XinRui and owns 27.6% of Xinrui after the sale (See Note 2). The investment in Xinrui after the sale was \$612,808. The investment loss from XinRui was \$3,829 during the six months ended June 30, 2014.

The unaudited condensed Statement of Income of XinRui for the six months ended June 30, 2014 is below:

| | |
|-----------------|------------|
| Net revenue | \$ 234,096 |
| Cost of revenue | (140,279) |
| Gross profit | 93,817 |

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| | |
|----------------------|-------------|
| Operating expenses | 105,496 |
| Loss from operations | (11,679) |
| Non-operating loss | (3) |
| Income tax expense | (2,192) |
| Net loss | \$ (13,874) |

Prior to December 30, 2013, the Company invested \$771,600 for 51% of the equity in Ruicheng. The Company sold 40% equity interest of Ruicheng on December 30, 2013, and owns 30.6% of Ruicheng after the sale (See Note 2). The investment in Ruicheng after the sale was \$321,997. The investment loss from Ruicheng was \$19,062 during the six months ended June 30, 2014.

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The unaudited condensed Statement of Income of Ruicheng for the six months ended June 30, 2014 is below:

| | |
|----------------------|-------------|
| Net revenue | \$ 75,127 |
| Cost of revenue | (54,319) |
| Gross profit | 20,808 |
| Operating expenses | 86,369 |
| Loss from operations | (65,561) |
| Non-operating income | 3,269 |
| Income tax expense | - |
| Net loss | \$ (62,292) |

10. MAJOR CUSTOMERS AND VENDORS

One customer accounted for 11% of total sales for the six months ended June 30, 2014. At June 30, 2014, total receivable from the customer was \$0. For the three months ended June 30, 2014, one customer accounted for 17% of total sales.

For the six months ended June 30, 2013, one customer accounted for 16% of the Company's total sales. At June 30, 2013, the total accounts receivable from this customer was \$7,364,488. For the three months ended June 30, 2013, no customer accounted for over 10% of the Company's total sales.

For the six and three months ended June 30, 2014 and 2013, no vendors accounted for over 10% of the Company's total purchases.

11. TAXES RECEIVABLE

Taxes receivable consisted of the following at June 30, 2014 and December 31, 2013:

| | 2014 | 2013 |
|-------------|------------|------------|
| Income | \$ 179,122 | \$ 180,764 |
| Value-added | 436,528 | 787,293 |
| Other | 17,756 | 21,578 |
| Total | \$ 633,406 | \$ 989,635 |

12. TAXES PAYABLE

Taxes payable consisted of the following at June 30, 2014 and December 31, 2013:

| | 2014 | 2013 |
|-------------|-----------|------------|
| Income | \$ - | \$ 516 |
| Value-added | 5,361 | 160,118 |
| Other | 21,400 | 36,444 |
| Total | \$ 26,761 | \$ 197,078 |

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13. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at June 30, 2014 and December 31, 2013:

| | 2014 | 2013 |
|------------------------------------|---------------|---------------|
| Advance from third parties | \$ 3,329,957 | \$ 3,378,167 |
| Payable to Siping Beifang | 2,198,923 | 2,306,184 |
| Payable for equipment purchase | 328,086 | 322,295 |
| Payable to employees | 144,578 | - |
| Deposit from customer | 2,961,091 | 2,988,240 |
| Refund of land use right purchased | 4,790,279 | 4,627,270 |
| Others | 1,551,574 | 1,738,241 |
| Warranty reserve (See Note 2) | 560,924 | 472,558 |
| Accrued expenses | 1,666,270 | 1,382,051 |
| Total | \$ 17,531,682 | \$ 17,215,006 |

Advances from third parties were short-term, non-interest-bearing advances from third parties due on demand. Payable to Siping Beifang represented loans to them without interest and payable upon demand. Deposit from customer represented advance payment from a customer for the Company to execute the sales order; however, the customer wanted to cancel the order after the Company commenced manufacturing and the Company refused to return the deposit claiming breach of the contract by the customer. The dispute was filed with the court and is currently docketed for trial.

Refund of land use right previously purchased represented the refund received for the land use right SmartHeat Energy purchased in November 2010. SmartHeat Energy later cancelled the purchase due to the adjustments of the overall development plan of the area by the local authority. The local government agreed to the cancellation and refunded SmartHeat Energy \$4.59 million as of December 31, 2013, and was committed to refund SmartHeat Energy the remaining purchase price. On May 21, 2014, SmartHeat Energy and Shenyang City Development and Land Resource Bureau Economy and Technology Development Office entered into an official agreement, whereby full purchase price of the land use right will be returned to SmartHeat Energy in installments within 5 days from the effective date of the official agreement. SmartHeat Energy will make the ownership change of the land use right upon receiving the refund from the local authority. As of June 30, 2014, SmartHeat Energy received a total of \$14.89 million (RMB 91,622,000), of which, \$4.79 million was the amount received in excess of the amount paid to acquire land use right. The local government has not yet made qualitative determination about the excess amount and until such time that SmartHeat Energy receives further information, the excess amount from the refund of land use right will be recorded as other payable. The land use right title transfer is expected to complete by the end of 2014. Currently the land is used by the third party.

Others represented payables for the Company's certain construction and installation projects, and miscellaneous expenses including postage, business insurance, employee benefits, project bidding fee, and medical insurance, etc. Accrued expenses mainly consisted of accrued property and land rental fee of \$0.91 million, accrued payroll of \$0.41 million, accrued welfare, interest and utility. The accrued rental of \$0.91 million represented the office and factory lease of HeatPump from Shenyang Economic and Technological Development Zone State-owned Assets Management Co., Ltd, whom is the minority shareholder of HeatPump, there was no contract for the lease and the lease was on month-to-month basis.

14. NOTES PAYABLE – BANK ACCEPTANCES

Notes payable represented the conversion of accounts payable into notes payable, which were issued by a bank. The Company deposited a portion of the acceptance amount into the bank as collateral. The terms of the notes range from 3-6 months and bear no interest. At June 30, 2014 and December 31, 2013, the Company deposited \$0 million and \$1.29 million with the bank as restricted cash for the bank issuing the notes (See note 2). The restricted cash is refundable when the notes are repaid.

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15. LOANS PAYABLE

Short-Term Bank Loans

The Company was obligated for the following short-term loans as of June 30, 2014 and December 31, 2013:

| | 2014 | 2013 | Subsidiary obligated |
|---|--------------|-----------|----------------------|
| From a commercial bank in the PRC for RMB 7,200,000 entered into on February 20, 2014. The loan bore interest at 6% with maturity on February 19, 2015. | \$ 1,170,199 | \$ - | Taiyu |
| From a commercial bank in the PRC for RMB 2,640,565 entered into on January 3, 2014. The loan bore interest at 6.22% with maturity on July 29, 2014. This loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 429,165 | - | Taiyu |
| From a commercial bank in the PRC for RMB 7,935,243 entered into on January 3, 2014. The loan bore interest at 6.22% with maturity on July 29, 2014. The loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 1,289,696 | - | Taiyu |
| From a commercial bank in the PRC for RMB 16,080,000 entered into on January 16, 2014. The loan bore interest at 6.22% with maturity on August 8, 2014. The loan was pledged by Taiyu's accounts receivable. The loan was paid in full at maturity. | 2,613,444 | - | Taiyu |
| From a commercial bank in the PRC for RMB 4,685,723 entered into on January 22, 2014. The loan bore interest at 6.22% with maturity on August 20, 2014. The loan was pledged by Taiyu's accounts receivable. The loan was paid in full at maturity. | 761,559 | - | Taiyu |
| From a commercial bank in the PRC for RMB 5,377,441 entered into on January 22, 2014. The loan bore interest at 6.22% with maturity on August 20, 2014. The loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 873,983 | - | Taiyu |
| From a commercial bank in the PRC for RMB 13,344,190 entered into on June 26, 2012. The loan bore interest at 6.16% with maturity on January 18, 2014. The loan was repaid at maturity. | - | 2,188,684 | Taiyu |
| From a commercial bank in the PRC for RMB 10,000,000 entered into on November 30, 2012. The loan bore interest at 7.87% with maturity on November 22, 2014. The loan was guaranteed by Taiyu. | 1,625,277 | 1,640,178 | Siping |
| From a commercial bank in the PRC for RMB 40,000,000 entered into on March 11, 2013. The loan bore interest at 6.60% with maturity on March 10, 2014. The loan was guaranteed by Siping, HeatPump and management of Chinese subsidiaries. This loan was repaid at maturity. | - | 6,560,711 | Taiyu |

| | | | |
|---|----------------------|----------------------|--------|
| From a commercial bank in the PRC for RMB 10,000,000 entered into on May 21, 2013. The loan bore interest at 6.60% with maturity on May 20, 2014. This loan was repaid at maturity. | - | 1,640,178 | Taiyu |
| From a commercial bank in the PRC for RMB 5,000,000 entered into on August 29, 2013. The loan bore interest at 7.20% with maturity on August 29, 2014. The loan was guaranteed by Taiyu. This loan was repaid at maturity. | 812,638 | 820,089 | Siping |
| From a commercial bank in the PRC for RMB 5,000,000 entered into on September 4, 2013. The loan bore interest at 7.20% with maturity on September 4, 2014. The loan was guaranteed by Taiyu. | 812,638 | 820,089 | Siping |
| From a commercial bank in the PRC for RMB 30,000,000 entered into on August 8, 2013. The loan bore interest at 6.90% with maturity on August 7, 2014. The loan was paid in full at maturity. | 4,875,829 | 4,920,533 | Taiyu |
| From a commercial bank in the PRC for RMB 9,900,000 entered into on September 18, 2013. The loan bore interest at 6.0% with maturity on September 17, 2014. This loan was pledged by Taiyu's accounts receivable. | 1,609,023 | 1,623,776 | Taiyu |
| From a commercial bank in the PRC for RMB 9,900,000 entered into on October 11, 2013. The loan bore interest at 6.0% with maturity on October 10, 2014. This loan was pledged by Taiyu's accounts receivable. | 1,609,023 | 1,623,776 | Taiyu |
| From a commercial bank in the PRC for RMB 16,000,000 entered into on July 10, 2013. The loan bore interest at 6.0% with maturity on January 9, 2014. This loan was pledged by Taiyu's accounts receivable. This loan was repaid at maturity. | - | 2,624,285 | Taiyu |
| From a commercial bank in the PRC for RMB 36,000,000 entered into on April 23, 2014. The loan bore interest at 7.2% with maturity on April 22, 2015. This loan was pledged by Siping, Heat Pump, SanDeKe, and two officers of the Chinese subsidiaries. | 5,850,995 | - | Taiyu |
| From a commercial bank in the PRC for RMB 4,000,000 entered into on April 23, 2014. The loan bore interest at 7.2% with maturity on April 22, 2015. This loan was pledged by Siping, Heat Pump, SanDeKe, and two officers of the Chinese subsidiaries. | 650,111 | - | Taiyu |
| TOTAL | \$ 24,983,580 | \$ 24,462,299 | |

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The banks sometimes require loan guarantee provided by a third party to the Company, the third party loan guarantor was Liaoning Wugang Metal Trading Co., Ltd. (“Liaoning Wugang”), with a maximum guarantee of RMB 46 million (\$7.32 million). The guarantee is for the loans entered from February 20, 2012 to August 16, 2013, with the guarantee length equal to the loan term; the guarantee service was extended for the loans entered or will be entered from September 18, 2013 to September 12, 2014 with the guarantee length equal to the loan term, the maximum guarantee amount was revised to RMB 44 million (\$7.05 million). The Company was not required to pay any guarantee fees. However, the Company has contracted to provide similar guarantees for up to RMB 20 million (\$3.18 million) to Liaoning Guorui Commercial Trading Co., Ltd. (“Guorui”). The guarantee is for the loans entered from January 12, 2012 to January 11, 2013 with the guarantee length equal to the loan term, the Company does not require Guorui to pay any guarantee fees. The Company did not extend the guarantee term for Guorui after January 11, 2013. These arrangements are common to the banking industry in China, and there are no other relationships between the Company and Liaoning Wugang or Guorui, both of whom were referred to the Company by the lending bank. As of June 30, 2014 and December 31, 2013, the Company did not have any loan guarantees from Liaoning Wugang.

Holding Company Credit Agreement – Credit Line Payable

On July 27, 2012, the Company, entered into a secured, revolving credit facility under the terms of a Secured Credit Agreement (the “Credit Facility” or the “Credit Agreement”) with Northtech Holdings Inc., a British Virgin Islands business corporation (“Northtech”), owned by certain members of the Company’s former management, James Wang, Rhett Wang and Wen Sha. Jane Ai, the Company’s Corporate Secretary is also a part owner of Northtech. As amended on December 21, 2012, the Credit Facility provides for borrowings of up to \$2.5 million.

Borrowings under the Credit Facility are secured by the Company’s deposit accounts located in the United States, its trademarks in the PRC and 55% of its equity in each of its wholly-, directly owned subsidiaries. An origination fee of 4% of the Committed Amount was accrued to Northtech upon the signing of the Credit Agreement. As amended, Borrowings bear interest of 10% annually, payable quarterly, and the Credit Facility matured on April 30, 2013, and extended to April 30, 2014 with an extension fee of 4% of the Committed Amount. Generally, borrowings may be prepaid at any time without premium or penalty, provided however that if the Company prepays any amount due under the Credit Facility from the proceeds of another instrument or agreement of indebtedness, the Company shall pay a 10% prepayment fee. All amounts due under the Credit Facility may, at the Company’s option, be paid in either cash or restricted shares of the Company’s common stock.

On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, the Company entered into second amendment to the credit and security agreement with Northtech, which redefined the “base rate”, and adjusted the base rate to 10% annually, compounded quarterly, effective January 1, 2013. The Company delivered to Northtech 100,000 restricted shares of the Company’s common stock as an Amendment Fee (see Note 19), issued in September 2013.

On December 21, 2012, the Company’s BOD approved the issuance of 1,300,000 Restricted Shares of Common Stock to Northtech in cancellation of \$1,301,300 of indebtedness under the Credit Facility. The balance owing to Northtech under the Credit Agreement as of June 30, 2014 and December 31, 2013 was \$2,149,335 and \$1,396,378, respectively, and was recorded as a noncurrent obligation under ASC 470-10-45-12 through ASC 470-10-45-14 due to the Note being secured by 55% of the equity interest in each of HEAT PHE Inc. and HEAT HP Inc., and the Company’s option to repay the note by issuance of the Company’s shares.

The Company had \$100,000 payable to a consulting firm that was paid by a third party on behalf of the Company during 2012, this payable to the third party was assumed by Northtech on August 23, 2013, in exchange for 200,000 shares of the Company’s common stock issued in September 2013, and payable for a credit line balance from Northtech. The stock price was \$0.60 on August 23, 2013, the Company recognized \$20,000 loss for the settlement of

this payable by shares with Northtech.

On March 26, 2014, the Company gave notice to Northtech pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 3, 2015. The Company elected to pay the extension fee of 4% of the credit line amount of \$2.5 million by issuing 200,000 shares of its common stock to Northtech at \$0.50 per share. The BOD approved such extension on March 27, 2014.

Long-Term Bank Loan

Taiyu entered into a long-term loan of \$2,112,859 (RMB 13 million) with China Construction Bank on November 30, 2013 with maturity on November 29, 2015. The interest rate for the loan is variable currently at 6.46%, and to be paid on the 20th of each month. This loan is guaranteed by Taiyu's building and land.

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16. DEFERRED TAX ASSET (LIABILITY)

Deferred tax asset (liability) represented differences between the tax bases and book bases of property and equipment and intangible assets arising from the acquisition of SanDeKe and SmartHeat Pump, and bad debt allowance and provision of inventory impairment booked by the Company which was not allowed per tax purpose. As of June 30, 2014 and December 31, 2013, deferred tax asset (liability) consisted of the following:

| | 2014 | 2013 |
|--|--------------|--------------|
| Deferred tax asset - current (bad debt allowance for accounts receivable) \$ | 6,528,146 | \$ 7,715,041 |
| Deferred tax asset - current (bad debt allowance to retention receivable) | 257,679 | - |
| Deferred tax asset - current (inventory allowance) | 2,903,505 | 2,321,878 |
| Deferred tax asset – current (bad debt allowance for other receivables) | 2,356,665 | 2,099,125 |
| Deferred tax asset – current (allowance for advance to supplier) | 421,520 | 398,224 |
| Deferred tax asset – current (reserve for warranty) | 90,640 | 75,808 |
| Deferred tax asset – noncurrent (NOL) | 2,642,802 | 2,464,239 |
| Less: valuation allowance | (15,200,957) | (15,074,315) |
| Deferred tax assets, net \$ | - | \$ - |
| Deferred tax liability - noncurrent (depreciation of fixed assets) \$ | (91,419) | \$ (17,177) |

17. INCOME TAXES

The Company is subject to income taxes by entity on income arising in or derived from the tax jurisdiction in which each entity is domiciled. The Company's PRC subsidiaries file their income tax returns online with PRC tax authorities.

SmartHeat, the parent company, was incorporated in the U.S. and has net operating losses ("NOL") for income tax purposes, which can be carried forward for up to 20 years from the year the loss is incurred. SmartHeat has NOL carry forwards for income taxes of approximately \$7.77 million at June 30, 2014, which may be available to reduce future years' taxable income. Management believes the realization of benefits from these losses remains uncertain due to SmartHeat's limited operating history and continuing losses. Accordingly, a 100% deferred tax asset valuation allowance was provided.

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at 25% on income reported in the statutory financial statements after appropriate tax adjustments. Under the Income Tax Law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu has been classified as a high-tech enterprise since 2009 and eligible for an income tax rate of 15% through 2014. Local PRC government reviews the high-tech status of such enterprises annually. The income tax rate for SanDeKe was 13% for 2012, because of its foreign-invested enterprise status, and its income tax rate increased to 24% in 2013 and 25% in 2014.

SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Pump, SmartHeat Trading and Heat Exchange are subject to the regular 25% PRC income tax rate. SmartHeat Germany is subject to a 15% corporate

income tax in Germany.

The following table reconciles the U.S. statutory rates to the Company's effective tax (benefit) rate for the six months ended June 30, 2014 and 2013:

| | 2014 | 2013 |
|--------------------------------------|---------|---------|
| U.S. statutory tax (benefit) rates | (34.0)% | (34.0)% |
| Tax rate difference | 8.3% | 8.9% |
| Effect of tax holiday | 3.8% | 2.9% |
| Other | (0.1)% | -% |
| Valuation allowance | 23.0% | 22.0% |
| Tax benefit per financial statements | 1.0% | (0.2)% |

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The following table reconciles the U.S. statutory rates to the Company's effective tax (benefit) rate for the three months ended June 30, 2014 and 2013:

| | 2014 | 2013 |
|--------------------------------------|---------|---------|
| U.S. statutory tax (benefit) rates | 34.0% | (34.0)% |
| Tax rate difference | (9.0)% | 8.7% |
| Effect of tax holiday | (12.2)% | 8.0% |
| Other | (0.1)% | -% |
| Valuation allowance | (11.3)% | 17.1% |
| Tax benefit per financial statements | 1.4% | (0.2)% |

The income tax (benefit) for the six months ended June 30, 2014 and 2013, consisted of the following:

| | 2014 | 2013 |
|---|-----------|-------------|
| Income tax expense (benefit) - current | \$ 672 | \$ (1,549) |
| Income tax expense (benefit) - deferred | 74,821 | (43,451) |
| Total income tax expense (benefit), net | \$ 75,493 | \$ (45,000) |

The income tax (benefit) for the three months ended June 30, 2014 and 2013, consisted of the following:

| | 2014 | 2013 |
|---|-----------|-------------|
| Income tax expense - current | \$ 1,058 | \$ (1,794) |
| Income tax expense (benefit) - deferred | 88,971 | (20,762) |
| Total income tax expense (benefit), net | \$ 90,029 | \$ (22,556) |

18. STATUTORY RESERVES AND RESTRICTED NET ASSETS

The Company's ability to pay dividends primarily depends on the Company receiving funds from its subsidiaries. Relevant PRC statutory laws and regulations permit payments of dividends by the Company's PRC subsidiaries only out of the subsidiary's retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. The results of operations reflected in the financial statements prepared in accordance with U.S. GAAP differ from those reflected in the statutory financial statements of the Company's PRC subsidiaries.

In accordance with the PRC Regulations on Enterprises with Foreign Investment and their articles of association, a foreign-invested enterprise ("FIE") established in the PRC is required to provide certain statutory reserves, which are appropriated from net profit as reported in the FIE's PRC statutory accounts. An FIE is required to allocate at least 10% of its annual after-tax profit to the surplus reserve until such reserve has reached 50% of its respective registered capital based on the FIE's PRC statutory accounts. Appropriations to other funds are at the discretion of the board of directors for all FIEs. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. Additionally, shareholders of an FIE are required to contribute capital to satisfy the registered capital requirement of the FIE. Until such contribution of capital is satisfied, the FIE is not allowed to repatriate profits to its shareholders, unless otherwise approved by the State Administration of Foreign Exchange. Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment and Ruicheng were established as FIEs and therefore are subject to the above-mandated restrictions on distributable profits. As of June 30, 2014, the Company met all registered capital requirements for its FIEs except for SmartHeat Investment, for which the Company is committed to contribute an additional \$40.00 million in registered capital by April 2015 (See note 20).

Additionally, in accordance with the Company Law of the PRC, a domestic enterprise is required to provide surplus reserve at least 10% of its annual after-tax profit until such reserve has reached 50% of its respective registered capital

based on the enterprise's PRC statutory accounts. A domestic enterprise is also required to provide discretionary surplus reserve, at the discretion of the board of directors, from the profits determined in accordance with the enterprise's PRC statutory accounts. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. SmartHeat Energy, SmartHeat Trading and SmartHeat Pump were established as domestic enterprises and therefore are subject to the above-mentioned restrictions on distributable profits.

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As a result of these PRC laws and regulations that require annual appropriations of 10% of after-tax income to be set aside prior to payment of dividends as general reserve fund, the Company's PRC subsidiaries are restricted in their ability to transfer a portion of their net assets to the Company as a dividend.

19. STOCKHOLDERS' EQUITY

Stock Options to Independent Directors and Officer

On February 1, 2010, the Company issued stock options to an officer. The terms of the options were 5,000 shares at an exercise price per share of \$118.50, with a life of five years and vesting over two years as follows: 2,500 shares vested on June 30, 2011, and 2,500 shares vested on June 29, 2012. The options were valued using a volatility of 74%, risk free interest rate of 2.76%, and dividend yield of 0%. The grant-date FV of the options was \$367,107. On May 25, 2012, the officer resigned from his position as VP of Strategy and Development of the Company, and was not entitled to the remaining unvested options. The remaining obligations of the Company to the officer were released pursuant to a severance agreement and mutual release.

Based on the FV method under SFAS No. 123 (Revised), "Share Based Payment" ("SFAS 123(R)") (codified in FASB ASC Financial Instruments, Topic 718 & 505), the FV of each stock option granted is estimated on the date of the grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model has assumptions for risk-free interest rates, dividends, stock volatility and expected life of an option grant. The risk-free interest rate is based upon market yields for U.S. Treasury debt securities at a maturity near the term remaining on the option. Dividend rates are based on the Company's dividend history. The stock volatility factor is based on the historical volatility of the Company's stock price. The expected life of an option grant is based on management's estimate. The FV of each option grant to independent directors is calculated by the Black-Scholes method and is recognized as compensation expense over the vesting period of each stock option award.

Following is a summary of the option activity:

| | Number of Shares | Average Exercise Price per Share | Weighted Average Remaining Contractual Term in Years |
|-------------------------------------|---------------------|---|--|
| Outstanding at January 1, 2013 | 3,500 | 97.80 | 1.65 |
| Exercisable at January 1, 2013 | 3,500 | 97.80 | 1.65 |
| Granted | - | - | - |
| Exercised | - | - | - |
| Forfeited | 1,000 | 46.00 | - |
| Outstanding at December 31, 2013 | 2,500 | 118.5 | 1.34 |
| Exercisable at December 31, 2013 | 2,500 | 118.5 | 1.34 |
| Granted | - | - | - |
| Exercised | - | - | - |
| Forfeited | - | - | - |
| Outstanding at June 30, 2014 | 2,500 | \$ 118.5 | 0.58 |
| Exercisable at June 30, 2014 | 2,500 | \$ 118.5 | 0.58 |

There were no options exercised during the six and three months ended June 30, 2014 and 2013. The Company recorded \$0 as compensation expense for stock options during the six and three months ended June 30, 2014 and 2013.

Common Stock Issued

The Company had \$100,000 payable to a consulting firm that was paid by a third party on behalf of the Company during 2012, this payable to the third party was assumed by Northtech on August 23, 2013, for 200,000 shares of the Company's common stock issued in September 2013. The stock price was \$0.60 on August 23, 2013, the Company recognized \$20,000 loss for the settlement of this payable by shares with Northtech (see Note 15).

On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, the Company entered into second amendment to the credit and security agreement with Northtech, which redefined the "base rate", and adjusted the base rate to 10% annually, compounded quarterly, effective January 1, 2013. The Company delivered Northtech 100,000 restricted shares of the Company's common stock as an Amendment Fee. The FV of the stocks issued for the Amendment fee was \$60,000 (See Note 15).

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On September 17, 2013, the Company's BOD approved the issuance of 100,000 restricted shares of common stock to Northtech for their consent to the Company to enter into an Equity Interest Purchase Agreement as contemplated by the stalking horse proposal and approved by the Company's Board. The stock price on the approval date was \$0.30, the fair value of the shares issued was \$30,000. Under the terms of the Equity Interest Purchase Agreement, the buyers agreed to purchase 40% of the Company's equity interests in the following PHE segment subsidiaries: Taiyu, SmartHeat Siping, SmartHeat Energy, Ruicheng, and XinRui (collectively, the "Target Companies"). The purchase price was RMB 5,000,000 (\$801,000), was paid by the buyers on December 30, 2013.

On March 27, 2014, The Compensation Committee of the Board approved to grant certain individuals the Company's common stock in recognition of their valuable services to the Company and its subsidiaries in 2013. The individual and number of shares granted is as follows: 100,000 shares to Oliver Bialowons, 50,000 shares to Huajun Ai, 50,000 shares to Xudong Wang and 50,000 shares to Kenneth Scipta. The stock price was \$0.15 on grant date, and the FV of the shares granted at the grant date was \$37,500 and was recorded as shares to be issued.

On March 27, 2014, the BOD approved the Company's request to Northtech for extending the maturity date on the Credit Agreement from April 30, 2014 to January 3, 2015, and pay the extension fee of 4% of the credit line amount of \$2.5 million by issuing 200,000 shares of its common stock to Northtech at \$0.50 per share. The FV of 200,000 shares was \$30,000 and the Company recognized \$70,000 gain from such stock issuance.

20. COMMITMENTS

Lease Agreements

The Company leased offices for its sales representative in several different cities under various one-year, non-cancellable and renewable operating lease agreements. Rental expense for the six months ended June 30, 2014 and 2013, was \$199,574 and \$250,912, respectively. Rental expense for the three months ended June 30, 2014 and 2013, was \$115,396 and \$118,553, respectively.

Capital Contribution

The Company formed SmartHeat Investment on April 7, 2010, as an investment holding company with registered capital of \$70 million to enable its establishment and investment in new businesses in China. Under PRC company law, registered capital must be used in the operations of the domestic company within its approved business scope. SmartHeat Investment was established as a separate subsidiary of the Company to allow allocation of capital to new businesses in China separate from its existing subsidiaries and operations. As a PRC investment holding company, the \$70 million in approved registered capital of SmartHeat Investment is deemed a planned investment amount for the entity, not a traditional registered capital requirement under PRC corporate law. The Company contributed \$30 million in capital to SmartHeat Investment on April 15, 2010, from proceeds of its public offering that closed on September 22, 2009. On April 12, 2010, SmartHeat Investment formed SmartHeat Energy, a wholly owned subsidiary in Shenyang with registered capital of \$30 million, subsequently satisfied out of the registered capital of SmartHeat Investment, for the research, development, manufacturing and sale of energy products. As of June 30, 2014, the Company is committed to contributing the remaining \$40 million in registered capital to SmartHeat Investment by April 2015. The Company may satisfy this contribution through cash flow provided by operations, sales of assets, such as physical assets, financial assets, or interests in its subsidiaries, and funds raised through offerings of its securities, if and when the Company determines such offerings are required, and at such time that the Company identifies a new acquisition, investment or business opportunity to be financed through SmartHeat Investment, although no specific investment candidate has been identified to date.

Restructuring Agreement with a Consulting Firm

On April 23, 2012, the Company entered into an agreement (“Agreement”) with Nimbus Restructuring Manager LLC (“Nimbus”), for advice on raising capital and restructuring the Company to maximize value for the benefit of all of the stockholders of the Company.

Upon execution of the Agreement, the Company paid \$200,000 as a deposit and a \$50,000 advance for future expenses incurred by Nimbus. Additionally, the Company paid \$70,000 per month for 6 months. An additional \$600,000 is to be paid upon the completion of the Company’s restructuring to the satisfaction of the Board.

The Company also issued and sold to Nimbus 300,000 shares of the Company’s restricted common stock for \$15,000, or \$0.05 per share, the Company has the right to repurchase such shares for \$0.20 per share until January 31, 2013, \$0.40 per share until September 30, 2013, \$0.60 per share until June 30, 2014, \$0.80 per share until March 31, 2015 and \$1.00 per share until January 31, 2016. On October 12, 2012, the Company issued 300,000 shares of stock to an affiliate of Nimbus at \$0.05 per share in accordance with the restructuring agreement.

The Company shall reimburse Nimbus and its affiliates for all reasonable and appropriate out-of-pocket expenses actually incurred in performance of the services specified in the Agreement.

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On May 9, 2013, the Company entered a Restated Restructuring Agreement with Nimbus, which was intended to be a legally binding restatement of the Restructuring Agreement entered on April 23, 2012. Pursuant to the Restated Restructuring Agreement, the term was extended for an additional 12 monthly periods from original expiration date of January 23, 2013 to January 22, 2014. A monthly service fee of \$30,000 is to be paid on the first day of each month for 10 months through November 2013. In addition, a \$300,000 termination fee will be paid on the earlier of the expiration of the stated term or the termination by the Company.

On September 18, 2013, the Company entered Amendment #1 to the Restated Restructuring Agreement with Nimbus, pursuant to the Amendment, the service term was revised after the initial expiration date of January 23, 2013, for an extension of 10 additional month until November 2013, and thereafter extended for 4 additional months until March 2014. The termination fee of \$300,000 will be paid in 4 equal monthly payments of \$75,000 each commencing in December 2013 and running through March 2014 or on the earlier of the expiration of the Stated Term or the earlier termination by the Company.

As of June 30, 2014, the Company owed \$75,000 to Nimbus, which was included in other payable.

21. CONTINGENCIES

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

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

Legal Proceedings

On August 31, 2012, a putative class action lawsuit, Steven Leshinsky v. James Wang, et. al., which purported to allege federal securities law claims against the Company and certain of its former officers and directors, was filed in the United States District Court for the Southern District of New York. Thereafter, two plaintiffs filed competing motions to be appointed lead plaintiff in the proceeding. A lead plaintiff was appointed and an amended complaint was filed on January 28, 2013, by the Rosen Law Firm. The amended complaint included Oliver Bialowons, our President, and Michael Wilhelm, our former Chief Financial Officer, as defendants in the proceeding though they were not officers of the Company during the alleged class period. A second amended complaint was filed on April 8, 2013, under the caption Stream Sicav, Dharanendra Rai et al. v. James Jun Wang, SmartHeat, Inc. et al., removing Messrs. Wilhelm and Bialowons as defendants. The second amended complaint alleges two counts against the Company, both asserting violations of the federal securities laws arising from alleged insider sales or management sales of securities and alleged false disclosures relating to those sales. On May 8, 2013, we filed a motion to dismiss the second amended complaint which was denied. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice. On August 6, 2014, the lead plaintiffs once again filed a motion for class certification, which we will be opposing. Discovery is also proceeding. The pleadings and court orders are publicly available. We intend to vigorously defend this action, as we believe the allegations against us are without merit.

22. PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS

On December 30, 2013, the Company, closed the transaction contemplated by the Equity Interest Purchase Agreement dated October 10, 2013, whereby the buyers purchased 40% of the Company's equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the "Target Companies"). The purchase price was RMB 5,000,000. Hohot Ruicheng Technology Co., Ltd. was 51% owned and Urumchi XinRui Technology Limited Liability Company ("XinRui") was 46% owned by SmartHeat US parent company prior to 40% equity interest sell.

On March 27, 2014, the buyers exercised their option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000. The Company will seek the approval of its shareholders prior to completing the sale. As of June 30, 2014, the Company evaluated it is highly probably the shareholders will approve the additional 40% equity sale, and accordingly, the pro forma consolidated financial statements reflecting the total of 80% equity interest sale of Target Companies were presented as following.

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The following pro forma consolidated statements of operations present the SmartHeat Inc. for the six and three months ended June 30, 2014 and 2013, as if the 80% equity sale occurred on January 1, 2013, and January 1, 2014, for the purpose of the statements of operations, respectively. The accompanying pro forma consolidated balance sheet presents the accounts of SmartHeat Inc. as if the 80% equity sale occurred on June 30, 2014. The 80% equity sales results in deconsolidation of disposed entities and the remaining 20% investment in these entities is accounted for under equity method of accounting (ASC Topic 323-10-15) as a result of SmartHeat Inc. having significant influence over the disposed entities' operational and financial policies..

SMARTHEAT INC. AND SUBSIDIARIES
UNAUDITED PRO FORMA CONSOLIDATED BALANCE SHEETS
REFLECTING THE SALE OF CERTAIN ENTITIES OF PHE SEGMENT

| | AS OF JUNE 30, 2014 | | | |
|--|---------------------------|-----------------------------|--------------------------|----------------------|
| | Company Historical (1) | Sales of PHE segment (2) | Pro Forma adjustments | Company Pro Forma |
| ASSETS | | | | |
| CURRENT ASSETS | | | | |
| Cash & equivalents | \$ 18,996,617 | \$ 15,470,662 | \$ - | \$ 3,525,955 |
| Restricted cash | 670,830 | 426,713 | | 244,117 |
| Accounts receivable, net | 15,099,549 | 18,910,294 | 5,824,393 a | 2,013,648 |
| Retentions receivable, net | 2,597,790 | 2,539,455 | | 58,335 |
| Advances to suppliers, net | 5,018,613 | 3,319,356 | | 1,699,257 |
| Other receivables (net), prepayments and deposits | 3,972,878 | 28,060,221 | 39,106,268 a, b | 15,018,925 |
| Inventories, net | 54,194,515 | 46,604,713 | | 7,589,802 |
| Taxes receivable | 633,406 | 604,594 | | 28,812 |
| Notes receivable - bank acceptances | 683,906 | 460,660 | | 223,246 |
| Total current assets | 101,868,104 | 116,396,668 | 44,930,661 | 30,402,097 |
| NONCURRENT ASSETS | | | | |
| Long term investment | 912,044 | - | 11,770,769 b | 12,682,813 |
| Restricted cash | 316,899 | 304,485 | | 12,414 |
| Advance to supplier for equipment | 1,241,933 | 1,241,933 | | - |
| Construction in progress | 1,362,730 | 1,362,730 | | - |
| Property and equipment, net | 10,041,499 | 8,581,833 | | 1,459,666 |
| Intangible assets, net | 4,381,691 | 3,738,189 | | 643,502 |
| Total noncurrent assets | 18,256,796 | 15,229,170 | 11,770,769 | 14,798,395 |
| TOTAL ASSETS | \$ 120,124,900 | \$ 131,625,838 | \$ 56,701,431 | \$ 45,200,493 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | |

CURRENT LIABILITIES

| | | | | | |
|--|-------------------|-------------------|-------------------|---|-------------------|
| Accounts payable | \$ 6,626,668 | \$ 7,538,394 | \$ 5,824,393 | a | \$ 4,912,667 |
| Advance from customers | 2,744,657 | 2,077,258 | | | 667,399 |
| Taxes payable | 26,761 | 19,502 | | | 7,259 |
| Accrued liabilities and other payables | 17,531,682 | 31,100,294 | 38,514,800 | a | 24,946,188 |
| Notes payable - bank acceptances | - | - | | | - |
| Loans payable | 24,983,580 | 24,983,580 | | | - |
| Total current liabilities | 51,913,348 | 65,719,028 | 44,339,192 | | 30,533,512 |

| | | | | | |
|---------------------|-----------|---|--|--|-----------|
| CREDIT LINE PAYABLE | 2,149,335 | - | | | 2,149,335 |
|---------------------|-----------|---|--|--|-----------|

| | | | | | |
|----------------|-----------|-----------|--|--|---|
| LONG-TERM LOAN | 2,112,859 | 2,112,859 | | | - |
|----------------|-----------|-----------|--|--|---|

| | | | | | |
|------------------------|--------|---|--|--|--------|
| DEFERRED TAX LIABILITY | 91,419 | - | | | 91,419 |
|------------------------|--------|---|--|--|--------|

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY

| | | | | | |
|---|-------------------|-------------------|-------------------|---|-------------------|
| Common stock | 6,583 | - | | | 6,583 |
| Paid-in capital | 81,733,320 | 53,849,023 | 62,001,549 | b | 89,885,846 |
| Statutory reserve | 5,389,057 | 4,608,375 | | | 780,682 |
| Accumulated other comprehensive income | 8,385,003 | 6,904,897 | (383,697) | a | 1,096,409 |
| Accumulated deficit | (57,812,734) | (27,508,314) | (49,255,614) | | (79,560,034) |
| Total Company stockholders' equity | 37,701,229 | 37,853,981 | 12,362,238 | | 12,209,486 |

| | | | | | |
|-------------------------|------------|------------|--|--|---------|
| NONCONTROLLING INTEREST | 26,156,710 | 25,939,970 | | | 216,740 |
|-------------------------|------------|------------|--|--|---------|

| | | | | | |
|---------------------|-------------------|-------------------|-------------------|--|-------------------|
| TOTAL EQUITY | 63,857,939 | 63,793,951 | 12,362,238 | | 12,426,226 |
|---------------------|-------------------|-------------------|-------------------|--|-------------------|

| | | | | | |
|-------------------------------------|-----------------------|-----------------------|----------------------|--|----------------------|
| TOTAL LIABILITIES AND EQUITY | \$ 120,124,900 | \$ 131,625,838 | \$ 56,701,431 | | \$ 45,200,493 |
|-------------------------------------|-----------------------|-----------------------|----------------------|--|----------------------|

(a) Includes the inter-company transactions between disposed entities and other subsidiaries of SmartHeat Inc.

(b) Reflects the sale of 80% equity interest, and loss on sale; equity method accounting applied after the sale of total 80% equity interest of Taiyu, Siping, SmartHeat Energy, Ruicheng and XinRui.

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SMARTHEAT INC. AND SUBSIDIARIES
 UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
 REFLECTING THE SALE OF CERTAIN ENTITIES OF PHE SEGMENT

| | SIX MONTHS ENDED JUNE 30, 2014 | | | |
|--|--------------------------------|-----------------------------|--------------------------|----------------------|
| | Company Historical (1) | Sales of PHE segment (2) | Pro Forma adjustments | Company Pro Forma |
| Net sales | \$ 10,669,833 | \$ 9,758,593 | \$ 710,191 | a \$ 1,621,431 |
| Cost of goods sold | 12,701,080 | 11,597,686 | 710,191 | a 1,813,585 |
| Gross loss | (2,031,247) | (1,839,093) | - | (192,154) |
| Operating expenses | | | | |
| Selling | 3,523,056 | 2,733,056 | | 790,000 |
| General and administrative | 4,661,513 | 2,451,050 | | 2,210,463 |
| Provision for bad debts | (3,399,744) | (3,688,822) | | 289,078 |
| Provision for advance to supplier | 108,270 | 83,740 | | 24,530 |
| Total operating expenses | 4,893,095 | 1,579,024 | | 3,314,071 |
| Loss from operations | (6,924,342) | (3,418,117) | | (3,506,225) |
| Non-operating income (expenses) | | | | |
| Investment loss | (22,891) | (22,891) | (849,243) | b (849,243) |
| Interest income | 64,583 | 54,813 | | 9,770 |
| Interest expense | (857,146) | (771,993) | | (85,153) |
| Financial expense | (276,171) | (227,835) | | (48,336) |
| Gain on issuance of stock | 70,000 | - | | 70,000 |
| Foreign exchange transaction gain | 5,550 | 5,550 | | - |
| Other income, net | 510,725 | 134,256 | | 376,469 |
| Total non-operating expenses, net | (505,350) | (828,100) | | (526,493) |
| Loss before income tax | (7,429,692) | (4,246,217) | | (4,032,718) |
| Income tax expense | 75,493 | - | | 75,493 |
| Net loss before noncontrolling interest | (7,505,185) | (4,246,217) | | (4,108,211) |
| Less: loss attributable to noncontrolling interest | (1,684,289) | (1,654,200) | | (30,089) |
| Net loss to SmartHeat Inc. | (5,820,896) | (2,592,017) | | (4,078,122) |
| Basic and diluted weighted average shares outstanding | 6,364,338 | | | 6,364,338 |

| | | |
|----------------------------------|------------|------------|
| Basic and diluted loss per share | \$ (0.91) | \$ (0.64) |
|----------------------------------|------------|------------|

(a) Includes the inter-company sales between disposed entities and other subsidiaries of SmartHeat Inc.

(b) Includes investment loss from equity method investees.

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SMARTHEAT INC. AND SUBSIDIARIES
 UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
 REFLECTING THE SALE OF CERTAIN ENTITIES OF PHE SEGMENT

| | SIX MONTHS ENDED JUNE 30, 2013 | | | |
|--|--------------------------------|-----------------------------|--------------------------|----------------------|
| | Company Historical (1) | Sales of PHE segment (2) | Pro Forma adjustments | Company Pro Forma |
| Net sales | \$13,891,423 | \$11,991,263 | \$869,450 | a \$2,769,610 |
| Cost of goods sold | 14,265,228 | 9,049,804 | 869,450 | a 6,084,874 |
| Gross profit (loss) | (373,805) | 2,941,459 | - | (3,315,264) |
| Operating expenses | | | | |
| Selling | 3,242,531 | 2,311,227 | | 931,304 |
| General and administrative | 4,818,674 | 14,777,592 | | (9,958,918) |
| Provision for bad debts | 12,287,944 | 734,665 | | 11,553,279 |
| Provision for advance to supplier | 1,529,595 | 2,383,389 | | (853,794) |
| Total operating expenses | 21,878,744 | 20,206,873 | | 1,671,871 |
| Loss from operations | (22,252,549) | (17,265,414) | | (4,987,135) |
| Non-operating income (expenses) | | | | |
| Investment income (loss) | 39,345 | 39,345 | (3,545,777) | b (3,545,777) |
| Interest income | 28,975 | 22,901 | | 6,074 |
| Interest expense | (772,242) | (757,611) | | (14,631) |
| Financial expense | (150,341) | (49,295) | | (101,046) |
| Foreign exchange transaction gain | 3,339 | 3,345 | | (6) |
| Loss on sale of equity interest | - | - | (50,737,017) | c (50,737,017) |
| Other income, net | 734,075 | 277,844 | | 456,231 |
| Total non-operating expenses, net | (116,849) | (463,471) | | (53,936,172) |
| Loss before income tax | (22,369,398) | (17,728,885) | | (58,923,307) |
| Income tax benefit | (45,000) | - | | (45,000) |
| Net loss before noncontrolling interest | (22,324,398) | (17,728,885) | | (58,878,307) |
| Less: loss attributable to noncontrolling interest | (47,297) | (37,268) | | (10,029) |
| Net loss to SmartHeat Inc. | (22,277,101) | (17,691,617) | | (58,868,278) |
| Basic and diluted weighted average shares outstanding | 5,733,399 | | | 5,733,399 |

| | | |
|----------------------------------|------------|-------------|
| Basic and diluted loss per share | \$ (3.89) | \$ (10.27) |
|----------------------------------|------------|-------------|

(a) Includes the inter-company sales between disposed entities and other subsidiaries of SmartHeat Inc.

(b) Includes investment loss from equity method investees.

(c) Reflects the sale of 80% equity interest and loss on sale; equity method accounting applied after the sale of total 80% equity interest of Taiyu, Siping, SmartHeat Energy, Ruicheng and XinRui.

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SMARTHEAT INC. AND SUBSIDIARIES
 UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
 REFLECTING THE SALE OF CERTAIN ENTITIES OF PHE SEGMENT

| | THREE MONTHS ENDED JUNE 30, 2014 | | | |
|--|----------------------------------|-----------------------------|--------------------------|----------------------|
| | Company Historical (1) | Sales of PHE segment (2) | Pro Forma adjustments | Company Pro Forma |
| Net sales | \$ 5,709,867 | \$ 5,015,289 | \$ 101,503 | a \$ 796,081 |
| Cost of goods sold | 7,337,123 | 6,511,501 | 101,503 | a 927,125 |
| Gross loss | (1,627,256) | (1,496,212) | - | (131,044) |
| Operating expenses | | | | |
| Selling | 1,956,545 | 1,526,645 | | 429,900 |
| General and administrative | 1,747,185 | 1,028,093 | | 719,092 |
| Provision for bad debts | (12,149,019) | (12,426,875) | | 277,856 |
| Provision for advance to supplier | 33,480 | 24,677 | | 8,803 |
| Total operating income | (8,411,808) | (9,847,460) | | 1,435,652 |
| Income from operations | 6,784,552 | 8,351,248 | | (1,566,696) |
| Non-operating income (expenses) | | | | |
| Investment (loss) income | (19,282) | (19,282) | 1,538,215 | b 1,538,215 |
| Interest income | 36,900 | 30,172 | | 6,728 |
| Interest expense | (488,004) | (438,080) | | (49,924) |
| Financial expense | (224,035) | (195,119) | | (28,916) |
| Gain on issuance of stock | 70,000 | - | | 70,000 |
| Foreign exchange transaction gain | 2,151 | 2,151 | | - |
| Other income, net | 268,974 | (40,014) | | 308,988 |
| Total non-operating expenses, net | (353,296) | (660,172) | | 1,845,091 |
| Income before income tax | 6,431,256 | 7,691,076 | | 278,395 |
| Income tax expense | 90,029 | - | | 90,029 |
| Net income before noncontrolling interest | 6,341,227 | 7,691,076 | | 188,366 |
| Less: income attributable to noncontrolling interest | 3,086,178 | 3,102,197 | | (16,019) |
| Net income to SmartHeat Inc. | 3,255,049 | 4,588,879 | | 204,385 |
| Basic and diluted weighted average shares outstanding | 6,579,003 | | | 6,579,003 |

| | | |
|--------------------------------------|---------|---------|
| Basic and diluted earnings per share | \$ 0.49 | \$ 0.03 |
|--------------------------------------|---------|---------|

- (a) Includes the inter-company sales between disposed entities and other subsidiaries of SmartHeat Inc.
- (b) Includes investment income from equity method investees.

SMARTHEAT INC. AND SUBSIDIARIES
UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
REFLECTING THE SALE OF CERTAIN ENTITIES OF PHE SEGMENT

THREE MONTHS ENDED JUNE 30, 2013

| | Company Historical (1) | Sales of PHE segment (2) | Pro Forma adjustments | Company Pro Forma |
|---|---------------------------|-----------------------------|--------------------------|----------------------|
| Net sales | \$ 7,722,992 | \$ 6,434,153 | \$ 820,348 | a \$ 2,109,187 |
| Cost of goods sold | 5,320,037 | 751,453 | 820,348 | a 5,388,932 |
| Gross profit | 2,402,955 | 5,682,700 | - | (3,279,745) |
| Operating expenses | | | | |
| Selling | 1,546,589 | 1,167,747 | | 378,842 |
| General and administrative | 2,482,031 | 5,435,742 | | (2,953,711) |
| Provision for bad debts | 7,524,870 | 7,517,482 | | 7,388 |
| Provision for advance to supplier | 288,916 | 223,554 | | 65,362 |
| Total operating expenses | 11,842,406 | 14,344,525 | | (2,502,119) |
| Loss from operations | (9,439,451) | (8,661,825) | | (777,626) |
| Non-operating income (expenses) | | | | |
| Investment income (loss) | 38,784 | 38,784 | (1,785,423) | b (1,785,423) |
| Interest income | 13,585 | 11,169 | | 2,416 |
| Interest expense | (428,431) | (417,472) | | (10,959) |
| Financial expense | (87,442) | (42,302) | | (45,140) |
| Foreign exchange transaction gain | 840 | 846 | | (6) |
| Loss on sale of equity interest | - | - | (50,737,017) | c (50,737,017) |
| Other income, net | 423,777 | 143,683 | | 280,094 |
| Total non-operating expenses, net | (38,887) | (265,292) | | (52,296,035) |
| Loss before income tax | (9,478,338) | (8,927,117) | | (53,073,661) |
| Income tax benefit | (22,556) | - | | (22,556) |
| Net loss before noncontrolling interest | (9,455,782) | (8,927,117) | | (53,051,105) |
| Less: loss attributable to noncontrolling interest | (2,555) | (40) | | (2,515) |
| Net loss to SmartHeat Inc. | (9,453,227) | (8,927,077) | | (53,048,590) |
| | 5,733,399 | | | 5,733,399 |

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CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

The comments made throughout this Quarterly Report should be read in conjunction with our Financial Statements and the Notes thereto, and other financial information appearing elsewhere in this document. In addition to historical information, the following discussion and other parts of this document contain certain forward-looking information. When used in this discussion, the words, “believes,” “anticipates,” “expects” and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from projected results, due to a number of factors beyond our control. We do not undertake to publicly update or revise any of our forward-looking statements, even if experience or future changes show that the indicated results or events will not be realized. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Readers are also urged to carefully review and consider our discussions regarding the various factors that affect our business, which are described in this section and elsewhere in this report, and those listed in our other SEC filings.

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

Overview

Through our subsidiaries we design, manufacture and sell clean technology plate heat exchangers (“PHE”), heat pumps (“HPs”) and related systems marketed principally in the People’s Republic of China (“PRC”). Our subsidiaries’ products are used in the industrial, residential and commercial markets to improve energy utilization and efficiencies, and to reduce pollution by reducing the need for coal-fired boilers. Our subsidiaries design, manufacture, sell and service PHEs, PHE Units, which combine PHEs with various pumps, temperature sensors, valves and automated control systems in systems custom designed by our in-house engineers, heat meters and heat pumps for use in commercial and residential buildings. Our subsidiaries also design, manufacture and sell spiral heat exchangers and tube heat exchangers. Our subsidiaries’ products and systems are an increasingly important element in providing a clean technology, mission-critical solution to energy consumption and air pollution problems in China and are commonly used in a wide variety of industrial processes where heat transfer is required. Common applications include energy conversion for heating, ventilation and air conditioning, or HVAC, and industrial use in petroleum refining, petrochemicals, metallurgy, food and beverage and chemical processing. Our subsidiaries sell their products under the SmartHeat and Taiyu brand names and also sell PHEs under the Sondex brand name as an authorized dealer of Sondex PHEs in China.

In addition, we offer HPs in China and in Germany under the Gustrower brand name. Our subsidiaries design and build HPs specific to customer specifications and particular operating conditions and are known for their high quality and efficiency. Our subsidiaries produce HPs in sizes that have applications in both the industrial and residential settings. We believe our subsidiaries’ HPs reduce the cost of heating and cooling by using recycled air as a heat source thereby reducing heat loss promoting energy saving and efficiency.

We are a U.S. holding company with no material assets other than the ownership interests of our subsidiaries through which we design, manufacture and sell our clean technology PHEs, HPs and related systems. We were incorporated in the State of Nevada on August 4, 2006, under the name Pacific Goldrim Resources, Inc., as an exploration stage corporation with minimal operations to engage in the exploration for silver, lead and zinc. On April 14, 2008, we changed our name to SmartHeat Inc. and entered into a Share Exchange Agreement to acquire Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd., subsequently renamed SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd., or Taiyu, a privately held Sino-foreign joint venture (“JV”) company formed under the laws of the PRC on July 24, 2002, and engaged in the design, manufacture, sale and servicing of plate heat exchange products in China. The Share Exchange Agreement was entered into by SmartHeat, Taiyu and the shareholders of Taiyu. We received PRC government approval on May 28, 2008, of our subscription for 71.6% of the registered capital of Taiyu,

and approval on June 3, 2009, of the transfer of the remaining 28.4% ownership of Taiyu from the original JV shareholders who received shares of our common stock in the Share Exchange. As a result of the Share Exchange Agreement and subsequent transactions contemplated thereby, and receipt of the above PRC government approvals, Taiyu became our wholly foreign-owned enterprise, or WFOE.

As an expansion of our business following our acquisition of Taiyu, we acquired and established subsidiaries in China and Germany.

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The following chart displays our subsidiaries according to which operating segment they operate in:

| Plate Heat Exchangers (PHE) | Heat Pumps (HP) |
|---|--|
| SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd. SanDeKe Co., Ltd. | SmartHeat (China) Investment Co., Ltd. |
| SmartHeat (Shenyang) Energy Equipment Co., Ltd. | SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. |
| SmartHeat Siping Beifang Energy Technology Co., Ltd. | SmartHeat (Shanghai) Trading Co., Ltd. |
| SmartHeat Heat Exchange Equipment Co. | Beijing SmartHeat Jinhui Energy Technology Co., Ltd. |

Principal Factors Affecting Our Financial Performance

Our revenues are subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry, changes in PRC government fiscal policies, inflation in China and other unpredictable factors that may affect customer ordering patterns. Our revenues may fluctuate due to the seasonal nature of central heating services in the PRC because the equipment used in residential buildings must be delivered prior to the beginning of the heating season in late fall, which occurs during the third and fourth calendar quarters in China. We also anticipate decreased sales volume in the first calendar quarter compared to other quarters, as our customers generally install and test our products during this period, and are in the process of budgeting their new projects. Additionally, any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a decline in quarterly revenue.

In response to inflationary concerns, the PRC government tightened fiscal policies beginning in 2011 that contributed to a slowdown in many sectors of China's economy and restricted bank lending practices. China's economy continues the growing at a very slow pace. Historically, approximately 40% of our customers, representing the majority of our total sales, consist of state-owned enterprises in China. Many of these customers, the majority of which are real estate developers, encountered difficulties in recent years in obtaining grants from the PRC government and faced an extended bank loan application process, both of which typically are used to finance the purchase of our products. These conditions continued into 2014. Accordingly, the continued deflationary policy of the PRC government affected the number of new sales of our PHEs and PHE Units as certain state-owned enterprises deferred bidding for new projects because of their working capital difficulties or abandoned existing projects. The decline in new projects among state-owned enterprises and increased peer competition contributed to a decline in sales of our PHEs and PHE Units in 2011 through the first quarter of 2014. We also canceled contracts in 2011 with certain of these state-owned customers that were unable to make payments or that had requested adjustments to their payment terms in response to their financial difficulties. Although these events caused a decrease in our sales in 2011 through the first quarter of 2014, a portion of the canceled year 2011 PHE and PHE Unit orders were reinstated in 2012, and additional orders and contracts that were canceled or partially delayed are performed in 2013 and first half of 2014, which reduced the

impact of the drop in our sales over the long term. Furthermore, the PRC government remains committed to the construction of affordable housing projects and emission-reduction and energy-saving policies, which we believe will continue to drive demand for our clean technology heat transfer products.

Our revenues also may fluctuate significantly due to material costs; we experienced and anticipate continued fluctuation in raw material costs as a result of world economic conditions, such as the price of stainless steel used to produce plates, our PHEs and PHE Units. We monitor the commodities markets for pricing trends and changes, but do not engage in hedging to protect against raw material fluctuations. Instead, we attempt to mitigate the short-term risks of price swings by purchasing raw materials in advance based on production needs and projected sales. We typically experience stronger sales during the second half of the year, which is the start of fall and winter in China, during which we historically generate the majority of our revenue. Accordingly, we increased our inventory and advances to suppliers during the first three quarters of each year in anticipation of our historical high season for production. Management believes our current levels of increased inventory resulting from the unexpected abandonment of projects and cancelation of orders by certain customers in 2011 and 2012 was consumed gradually in 2013 and 2014 and the following years as we fulfill new orders and delayed and reinstated contracts. Although we currently are able to obtain adequate supplies of raw materials, it is impossible to predict future availability or cost. Unfavorable fluctuations in the price, quality or availability of required raw materials could negatively affect our cash flows and ability to meet the demands of our customers, which could result in the loss of future sales.

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Our profitability depends upon the margin between the cost to us of goods used in the manufacturing process, such as plates, pumps, water tanks, sensors, control systems and other raw materials, as well as our fabrication costs associated with converting such goods and raw materials compared to the selling price of our products, and the overall supply of raw materials. We intend to base the selling prices of our products upon the associated raw materials costs to us. We may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of raw materials through to our customers, however, and there may be a time lag as we bid on new projects and renegotiate pricing with our existing customers. Furthermore, to ease inflationary pressure on our costs, we implemented new controls over our purchasing process and raw material pricing by adopting a new budgetary control system to monitor our fixed costs and continued improvements to our manufacturing process to decrease labor cost and improve manufacturing efficiency.

The economic conditions our subsidiaries faced in recent years, made it impossible for our subsidiaries to pay dividends to our U.S. parent company, which is dependent upon such dividends to meet its financial obligations. Relevant PRC statutory laws and regulations permit payments of dividends by the Company's PRC subsidiaries only out of the subsidiary's retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. Further, the Company's PRC subsidiaries are required to take certain reserves as detailed in Note 18 to our financial statements. As a result, we sought alternative sources of capital for our U.S. parent company. On July 27, 2012, we entered into a secured, revolving credit facility with Northtech Holdings Inc., a British Virgin Islands business corporation owned by certain members of our former management, James Wang, Rhett Wang and Wen Sha. Jane Ai, our Corporate Secretary, is also a part owner of Northtech. As amended on December 21, 2012, the Credit Agreement provides for borrowings of up to \$2,500,000 with any amounts borrowed maturing on April 30, 2014. Borrowings under the Credit Agreement are secured by 55% of the equity interest in each of our wholly, directly-owned subsidiaries and are repayable, at our option, in shares of our common stock. On December 21, 2012, we repaid \$1,300,000 of the \$1,384,455 outstanding under the Credit Agreement with 1,300,000 restricted shares of our common stock, approximately 22.67% of our total issued and outstanding shares of Common Stock, as authorized by the Credit Agreement and approved by our shareholders. On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, we entered into second amendment to the credit and security agreement with Northtech, which redefined the "base rate", and adjusted the base rate to 10% annually, compounded quarterly, effective January 1, 2013. On March 26, 2014, we gave notice to Northtech pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 31, 2015. On July 14, 2014, we entered the third amendment to the Credit Agreement with Northtech, the Amendment modifies the definition of "Average Share Price" in the Credit Agreement to decrease the minimum and maximum values for the "Average Share Price," by 20% each from \$0.50 to \$0.40 and from \$3.50 to \$2.80, respectively. The Amendment also increases the maximum line which may be borrowed under the Credit Agreement from \$2,500,000 to \$3,250,000 and extends the maturity date for amounts borrowed from April 30, 2014 to January 31, 2015.

On December 30, 2013, we closed the transaction contemplated by the Equity Interest Purchase Agreement dated October 10, 2013, whereby the buyers purchased 40% of the Company's equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the "Target Companies"). The purchase price was RMB 5,000,000. Urumchi XinRui was 46% owned by SmartHeat US parent company.

We retain an option to repurchase the equity interests of the Target Companies from the buyers at a purchase price of RMB 5,600,000 which terminated on February 28, 2014. In the event we do not exercise the option to repurchase the equity interest, the buyers shall have the option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000. We did not exercise the option to repurchase the equity interest of the Target Companies and such option was terminated on February 28, 2014. On March 27, 2014, the buyers gave

notice of their intent to exercise their option to purchase the additional 40% equity interest upon satisfaction of the terms and conditions set forth in the Equity Interest Purchase Agreement, including, without limitation the approval of our shareholders prior to completion of the sale. In the event such approval is not obtained, the buyers may terminate the Equity Interest Purchase Agreement. Should the buyers exercise their option to purchase the additional 40% equity interest, and the Company's shareholders approve the sale, we have the option to require the Buyers to purchase the remaining 20% equity interest for a purchase price of RMB 2,500,000.

Significant Accounting Policies

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

Basis of Presentation

Our financial statements are prepared in accordance with generally accepted accounting principles in the U.S., or U.S. GAAP.

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Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat's U.S. parent and its subsidiaries, Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Energy, SmartHeat Trading, SmartHeat Heat Exchange, SmartHeat Germany and SmartHeat Pump. All significant inter-company accounts and transactions were eliminated in consolidation.

In preparing the financial statements in conformity with U.S. GAAP, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the dates of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts, and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

Accounts Receivable

We maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year. Based on historical collection activity, we had bad debt allowances of \$41.29 million and \$48.25 million at June 30, 2014 and December 31, 2013, respectively.

Revenue Recognition

Our revenue recognition policies are in compliance with SEC Staff Accounting Bulletin ("SAB") 104 (codified in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605). Sales revenue is recognized when PHEs, heat meters and HPs are delivered, and for PHE Units when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of ours exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue under "Advance from customers."

Our agreements with our customers generally provide that 30% of the purchase price is due upon placement of an order, 30% upon delivery and 30% upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment of the final 10% of the purchase price is due no later than the termination date of the standard warranty period, which ranges from 3 to 24 months from the acceptance date. Due to the slowdown of the Chinese economy and tightened monetary policy, and in order to attract and retain customers, the Company's subsidiaries have adjusted their contract and payment terms on a case-by-case basis to permit for more flexible and longer payment terms.

Our standard warranty is provided to all customers and is not considered an additional service; rather, it is an integral part of the product sale. We believe the existence of the standard warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. We believe accounting for our standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

We charge for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. We recognize such revenue when service is provided. For the six months ended June, 2014 and 2013, revenue from after-sales services after the expiration of the warranty period was \$93,784 and \$129,406, respectively. For the three months ended June 30, 2014 and 2013, revenue from after-sales services after the expiration of the warranty period was \$47,540 and \$47,776, respectively.

Foreign Currency Translation and Comprehensive Income (Loss)

The functional currency of our subsidiaries in China is RMB. The functional currency of SmartHeat Germany, our German subsidiary, is EUR. For financial reporting purposes, RMB and EUR were translated into USD as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of stockholders' equity as "Accumulated other comprehensive income." Gains and losses resulting from foreign currency transactions are included in income. There was no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

We use Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income" (codified in FASB ASC Topic 220). Comprehensive income is comprised of net income and all changes to the statements of stockholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

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Recent Accounting Pronouncements

In January 2014, FASB issued, Accounting Standards Update 2014-01, Investments—Equity Method and Joint Ventures (Topic 323), Accounting for Investments in Qualified Affordable Housing Projects. The objective of this Update is to provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments in this Update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The amendments in this Update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this Update are effective for public business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU will not affect the Company's financial statements.

In January 2014, FASB issued, Accounting Standards Update 2014-05, Service Concession Arrangements (Topic 853), The objective of this Update is to specify that an operating entity should not account for a service concession arrangement within the scope of this Update as a lease in accordance with Topic 840, Leases. Service concession arrangements may become more prevalent in the United States as public-sector entities seek alternative ways to provide public services on a more efficient and cost-effective basis. The amendments apply to an operating entity of a service concession arrangement entered into with a public-sector entity grantor when the arrangement meets certain conditions. The amendments in this Update should be applied on a modified retrospective basis to service concession arrangements that exist at the beginning of an entity's fiscal year of adoption. The modified retrospective approach requires the cumulative effect of applying this Update to arrangements existing at the beginning of the period of adoption to be recognized as an adjustment to the opening retained earnings balance for the annual period of adoption. The amendments are effective for a public business entity for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The adoption of this ASU will not affect the Company's financial statements.

Results of Operations

Six months ended June 30, 2014 Compared to the Six months ended June 30, 2013

The following table sets forth the consolidated results of our operations for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|------------------------------|----------------|------------|-----------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 10,669,833 | | \$ 13,891,423 | |
| Cost of sales | 12,701,080 | 119% | 14,265,228 | 103% |
| Gross loss | (2,031,247) | (19)% | (373,805) | (3)% |
| Operating expenses | 4,893,095 | 46% | 21,878,744 | 157% |
| Loss from operations | (6,924,342) | (65)% | (22,252,549) | (160)% |
| Non-operating expenses, net | (505,350) | (5)% | (116,849) | (1)% |
| Income tax expense (benefit) | 75,493 | 1% | (45,000) | (0.3)% |
| Noncontrolling interest | (1,684,289) | (16)% | (47,297) | (0.3)% |
| Net Loss to SmartHeat Inc. | \$ (5,820,896) | (55)% | \$ (22,277,101) | (160)% |

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The following table sets forth the results of our operations for our PHE and heat meter segment for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|------------------------------|----------------|------------|-----------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 9,359,142 | | \$ 11,808,874 | |
| Cost of sales | 11,274,378 | 120% | 12,675,200 | 107% |
| Gross loss | (1,915,236) | (20)% | (866,326) | (7)% |
| Operating expenses | 1,816,667 | 19% | 19,076,548 | 162% |
| Loss from operations | (3,731,903) | (40)% | (19,942,874) | (169)% |
| Non-operating expenses, net | (771,406) | (8)% | (475,961) | (4)% |
| Income tax expense (benefit) | 103,037 | 1% | (12,370) | (0.1)% |
| Noncontrolling interest | (1,654,200) | (18)% | (37,268) | (0.3)% |
| Net Loss to SmartHeat Inc. | \$ (2,952,146) | (32)% | \$ (20,369,197) | (172)% |

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The following table sets forth the results of our operations for our HP segment for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|----------------------------|----------------|------------|----------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 1,310,691 | | \$ 2,082,549 | |
| Cost of sales | 1,426,703 | 109% | 1,590,028 | 76% |
| Gross profit (loss) | (116,012) | (9)% | 492,521 | 24% |
| Operating expenses | 2,377,813 | 181% | 2,359,509 | 113% |
| Loss from operations | (2,493,825) | (190)% | (1,866,988) | (90)% |
| Non-operating income, net | 92,599 | 7% | 400,784 | 19% |
| Income tax benefit | (27,574) | (2)% | (32,631) | (2)% |
| Noncontrolling interest | (30,089) | (2)% | (10,029) | (0.5)% |
| Net Loss to SmartHeat Inc. | \$ (2,343,563) | (179)% | \$ (1,423,544) | (68)% |

Sales. Net sales in the six months ended June 30, 2014, were \$10.67 million, consisting of \$3.13 million for PHEs, \$5.74 million for PHE Units, \$0.49 million for heat meters and \$1.31 million for HPs, while net sales in the six months ended June 30, 2013, were \$13.89 million, consisting of \$4.49 million for PHEs, \$6.93 million for PHE Units, \$0.39 million for heat meters and \$2.08 million for HPs, an overall decrease of \$3.22 million or 23%. The 23% decrease in total revenue was due primarily to the decrease in sales of PHE units in the six months ended June 30, 2014, compared to the same period of 2013. However, sales of heat meters increased 26% in the six months ended June 30, 2014 compared to the same period of 2013. The overall slow-down of the PRC economy and tight fiscal policy including restricted lending practice continued in 2014, which caused decline in new projects among state-owned enterprises and increased peer competition, despite a portion of the previously canceled or delayed orders were reinstated and performed in the six months ending June 30, 2014, we obtained less new sales contracts in 2013 and 2014 for PHE unit which is more commonly used in real estate industry; the real estate industry is very slow in PRC in recent years with supply outpacing demand, decreased newly constructed properties put into market, and decreased trading volumes resulting from slow PRC economy, government control on real estate price increasing and tight bank lending policies.

We have a review process for approving each sales contract, including sales price. Sales price is determined under each contract in proportion to our estimated cost in order to ensure our gross profit. Our sales price varies according to each sale depending primarily on each customer's specific requirements and our negotiation of the contract amount and term.

Cost of Sales. Cost of sales ("COS") was \$12.70 million in the six months ended June 30, 2014, compared to \$14.27 million in the same period of 2013, a decrease of \$1.56 million or 12%. The decrease in our COS is attributable to a decreased inventory impairment provision. We reserved \$2.78 million for inventory impairment provision for PHEs and PHE Units during the six months ended June 30, 2014, compared with \$4.19 million for the same period of 2013. COS mainly consisted of the cost of materials, factory overhead and labor. Materials cost was 37% of total cost, while factory overhead cost was 56% and labor was 7% during the six months ended June 30, 2014, as compared to 69%, 23% and 8%, respectively, for the same period of 2013. Our materials cost as a percentage of total costs decreased to 37% from 69% as a result of decreased raw material price. Our products are custom-made; the raw material price varies based on the place of origin, which was chosen at customers' choice. The COS as a percentage of sales was 119% in the six months ended June 30, 2014 compared with 103% for the same period of 2013 due to increased factory overhead cost by \$1.3 million despite decreased raw material cost.

We performed an inventory impairment assessment as of June 30, 2014 and December 31, 2013, for the write-down of raw materials and finished goods in inventory. We stock inventory, consisting of raw materials and finished goods, according to projected sales and customer orders, with steel plates and components for our products generally ordered

two to three months in advance of anticipated production needs. As part of our impairment analysis, we performed an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory can be utilized and will be consumed within the next few months through new customer orders or substitute orders, no impairment is recorded. We collected information about delayed and canceled contracts and met with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that we do not expect to be reinstated and contracts for which we have been unable to find substitute customers become impaired. We performed an evaluation of these finished goods stored over one year and recorded an impairment accordingly. We also analyzed whether to take a reserve for conversion costs of finished goods in inventory for resale to substitute customers. Following the completion of our impairment analysis, we had inventory impairment provision of \$14,052,085 and \$11,395,714 as of June 30, 2014 and December 31, 2013, respectively.

Gross Loss. Gross loss was \$2.03 million in the six months ended June 30, 2014, compared to \$0.37 million in the same period of 2013. Gross margin was (19)% and (3)% for the six months ended June 30, 2014 and 2013 respectively. The increase in loss margin in the six months ended June 30, 2014 was primarily due to decreased sales.

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Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled \$4.89 million in the six months ended June 30, 2014, compared to \$21.88 million in the same period of 2013, a decrease of \$16.99 million or 78%. Operating expenses as a percentage of sales were 46% in the six months ended June 30, 2014, compared to 157% in the same period of 2013. The decrease in operating expenses was mainly due to a reversal for the provision for bad debts of \$(3.40) million and general and administrative expense of \$4.66 million for the six months ended June 30, 2014, compared with \$12.29 million provision for bad debts and \$4.82 million general and administrative expense for the six months ended June 30, 2013.

We recorded a reversal of bad debt allowance of \$(4.97) million for accounts and retention receivable (consisting of \$(5.19) million for reversal of bad debt allowance for PHEs and related products and \$0.22 bad debt allowance for HPs and related products), \$1.57 million for bad debt allowance for other receivables (consisting of \$1.42 million for PHEs and related products and \$0.15 for HPs and related products), and \$108,270 for allowance for advances to suppliers (consisting of \$83,740 for PHEs related and \$24,530 for HPs related), respectively, for the six months ended June 30, 2014, compared with \$6.45 million for bad debt allowance for accounts receivable (consisting of \$6.26 million for PHEs and related products and \$0.19 million for HPs and related products), \$5.84 million for bad debt allowance for other receivables (consisting of \$5.81 million for PHEs and related products and \$27,960 for HPs and related products), and \$1.53 million for allowance for advance to suppliers (consisting of \$1.45 million for PHEs related and \$83,140 for HPs related), respectively, for the six months ended June 30, 2013. The reversal of provision for bad debt allowance for accounts receivables was primarily due to our accounting policy on bad debt reserves, which we will adjust from time to time. Generally, we reserve for 50% of accounts receivable with aging over 180 days and 100% of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and continue to work to collect all amounts due. We believe the stringent fiscal policy impacting our customers in China will be temporary and the expansion and training of our marketing team and other employees will increase sales and improve the efficiency of our operations.

Non-operating expenses, net. Our net non-operating expenses for the six months ended June 30, 2014 was \$0.51 million compared to \$0.12 million for the same period of 2013, an increase of expenses of \$0.39 million or 332%. The increase in non-operating expenses was due mainly to increased interest expense of \$857,146 for the six months ended June 30, 2014, compared with \$772,242 for the same period of 2013, and decreased net other income of \$510,725 for the six months ended June 30, 2014, compared with \$734,075 for the same period of 2013. The net other income of \$510,725 for the six months ended June 30, 2014 mainly consisted of income (net), from selling of raw material of \$264,526, government subsidy of \$46,372, after-sales services expense of \$(102,755), and other non-operating income of \$302,582. The net other income of \$734,075 for the six months ended June 30, 2013, mainly consisted of income (net), from selling of raw material of \$289,039; income (net) from after-sales services of \$63,041, government subsidy of \$173,041 and other non-operating income of \$208,954.

Income tax benefit. We had income tax expense of \$75,493 for the six months ended June 30, 2014, compared to income tax benefit of \$45,000 for the same period of 2013. The effective income tax rate to taxable loss for the six months ended June 30, 2014, was 1.0% compared to (0.2)% for the same period of 2013.

Net Loss. Our net loss for the six months ended June 30, 2014, was \$5.82 million compared to net loss of \$22.28 million for the same period of 2013, a decrease of \$16.46 million or 74%. Net loss as a percentage of sales was 55% in the six months ended June 30, 2014, and net loss as a percentage of sales was 160% in the same period of 2013. This decrease in net loss was attributable to decreased bad debt allowance and more loss attributable to noncontrolling interest resulting from the sale of 40% equity interest on Taiyu, Siping and Shenyang Energy on December 30, 2013.

Three months ended June 30, 2014, Compared to the Three months ended June 30, 2013

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The following table sets forth the results of our operations for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|-------------------------------------|--------------|------------|----------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 5,709,867 | | \$ 7,722,992 | |
| Cost of sales | 7,337,123 | 128% | 5,320,037 | 69% |
| Gross profit (loss) | (1,627,256) | (28)% | 2,402,955 | 31% |
| Operating income (expenses) | 8,411,808 | 147% | (11,842,406) | (153)% |
| Income (loss) from operations | 6,784,552 | 119% | (9,439,451) | (122)% |
| Non-operating expenses, net | (353,296) | (6)% | (38,887) | (1)% |
| Income tax expense (benefit) | 90,029 | 2% | (22,556) | (0.3)% |
| Noncontrolling interest | 3,086,178 | 54% | (2,555) | (0.03)% |
| Net Income (loss) to SmartHeat Inc. | \$ 3,255,049 | 57% | \$ (9,453,227) | (122)% |

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The following table sets forth the results of our operations for our PHE and heat meter segment for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|-------------------------------|--------------|------------|----------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 4,974,000 | | \$ 6,137,081 | |
| Cost of sales | 6,417,619 | 129% | 4,136,874 | 67% |
| Gross profit (loss) | (1,443,619) | (29)% | 2,000,207 | 33% |
| Operating income (expenses) | 9,761,199 | 196% | (10,545,639) | (172)% |
| Income (loss) from operations | 8,317,580 | 167% | (8,545,432) | (139)% |
| Non-operating expenses, net | (624,124) | (13)% | (284,382) | (5)% |
| Income tax expense (benefit) | 102,977 | 2% | (6,223) | (0.1)% |
| Noncontrolling interest | 3,102,198 | 62% | (40) | (0.001)% |
| Net Loss to SmartHeat Inc. | \$ 4,488,281 | 90% | \$ (8,823,551) | (144)% |

The following table sets forth the results of our operations for our HP segment for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

| | 2014 | | 2013 | |
|----------------------------|----------------|------------|--------------|------------|
| | \$ | % of Sales | \$ | % of Sales |
| Sales | \$ 735,867 | | \$ 1,585,911 | |
| Cost of sales | 919,505 | 125% | 1,183,163 | 75% |
| Gross profit (loss) | (183,638) | (25)% | 402,748 | 25% |
| Operating expenses | 1,177,603 | 160% | 1,027,275 | 65% |
| Loss from operations | (1,361,241) | (185)% | (624,527) | (39)% |
| Non-operating income, net | 40,418 | 5% | 245,632 | 15% |
| Income tax benefit | (12,948) | (2)% | (16,334) | (1)% |
| Noncontrolling interest | (16,020) | (2)% | (2,515) | (0.2)% |
| Net Loss to SmartHeat Inc. | \$ (1,291,854) | (176)% | \$ (360,046) | (23)% |

Sales. Net sales in the three months ended June 30, 2014, were \$5.71 million, consisting of \$1.16 million for PHEs, \$3.54 million for PHE Units, \$0.27 million for heat meters and \$0.74 million for HPs, while net sales in the three months ended June 30, 2013, were \$7.72 million, consisting of \$2.49 million for PHEs, \$3.06 million for PHE Units, \$0.24 million for heat meters and \$1.93 million for HPs, an overall decrease of \$2.01 million or 26%. The 26% decrease in total revenue was due primarily to the decrease in sales volume of PHEs and Heat Pumps in the three months ended June 30, 2014, compared to the same period of 2013. Sales volume of PHEs and Heat Pumps, decreased 75% and 52%, respectively, in the three months ended June 30, 2014 compared to the same period of 2013. The decrease in sales volume in the three months ended June 30, 2014 compared to 2013 resulted from the overall slow-down of the PRC economy and tight fiscal policy including restricted lending practice, which caused decline in new projects among state-owned enterprises. In addition, our product price decreased because of increased peer competition, which caused lower sales.

Cost of Sales. Cost of sales ("COS") was \$ 7.34 million in the three months ended June 30, 2014, compared to \$5.32 million in 2013, an increase of \$2.02 million or 38%. The increase in our COS is attributable to increased inventory impairment provision by \$2.47 million. COS mainly consisted of the cost of materials, factory overhead and labor. Materials cost was 38% of total cost, while factory overhead cost was 57% and labor was 5% during the three months ended June 30, 2013 as compared to 79%, 14% and 7%, respectively, for the same period of 2013. Our materials cost as a percentage of total costs decreased to 38% from 79% as a result of decreased raw material price. Combined with a

significant increase in inventory impairment provision as well as increased constant factory overhead cost as a percentage of total cost from less production, the COS as a percentage of sales was 128% in the three months ended June 30, 2014 compared with 69% for the same period of 2013.

We performed an inventory impairment assessment as of June 30, 2014, and December 31, 2013, for the write-down of raw materials and finished goods in inventory. We reserved \$ 1.72 million and \$(0.74) million for inventory impairment provision during the three months ended June 30, 2014 and 2013, respectively.

Gross Profit (Loss). Gross loss was \$1.63 million in the three months ended June 30, 2014, compared to \$2.40 million gross profit in 2013. Loss margin and profit margin were (28)% and 31% for the three months ended June 30, 2014 and 2013 respectively. The decrease in gross profit margin in the three months ended June 30, 2014 was primarily due to decreased sales and increased COS in the second quarter of 2014.

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Operating Income (Expenses). Operating income consisting of selling, general and administrative expenses totaled \$(8.41) million in three months ended June 30, 2014, compared to \$11.84 million operating expense in the same period of 2013, an increase of \$20.25 million or 171%. Operating income as a percentage of sales were (147)% in the three months ended June 30, 2014, compared to operating expense as a percentage of sales of 153% in 2013. The increase in operating income mainly resulted from a reversal of bad debt allowance for accounts receivable of \$14.12 million for the three months ended June 30, 2014 compared with provision for bad debt allowance for accounts receivable of \$5.3 million for the same period of 2013.

We recorded a reversal of bad debt allowance of \$(12.53) million (consisting of \$(12.78) million for PHEs and related products and \$0.25 million for HPs and related products), bad debt allowance of \$0.38 million (consisting of \$0.23 million for PHEs and related products and \$0.15 for HPs and related products), and allowance of \$33,480 (consisting of \$24,677 for PHEs related and \$8,803 for HPs related), for accounts and retention receivable, other receivables and advances to suppliers, respectively, for the three months ended June 30, 2014, compared with bad debt allowance of \$5.3 million (consisting of \$5.32 million for PHEs and related products and \$(20,000) for HPs and related products), \$2.22 million (consisting of \$2.25 million for PHEs and related products and \$(28,041) for HPs and related products), and \$0.29 million (consisting of \$2.53 million for PHEs related and \$(2.24) million for HPs related), for accounts and retention receivable, other receivables and advances to suppliers, respectively, for the same period of 2013. The reversal of bad debt allowance for accounts receivable was primarily attributable to our accounting policy on bad debt reserves, which we will adjust from time to time. Generally, we reserve for 50% of accounts receivable with aging over 180 days and 100% of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and continue to work to collect all amounts due. We believe the stringent fiscal policy impacting our customers in China will be temporary and the expansion and training of our marketing team and other employees will increase sales and improve the efficiency of our operations.

Non-operating expenses, net. Our net non-operating expenses for the three months ended June 30, 2014 was \$353,296 compared to \$38,887 for 2013, an increase of expenses of \$0.31 million or 809%. The increase was due mainly to decreased net other income of \$0.27 million compared with net other income of \$0.42 million in the same period of 2013. The net other income of \$268,974 for the three months ended June 30, 2014 mainly consisted of income (net), from selling of raw material of \$123,666; expense (net) from after-sales services of \$127,394, and others of \$272,702. The net other income of \$423,777 for the three months ended June 30, 2013 mainly consisted of income (net), from selling of raw material of \$155,583; income (net) from after-sales services of \$29,798, government subsidy of \$133,223 and others of \$105,173.

Income tax expense (benefit). We had income tax expense of \$90,029 for the three months ended June 30, 2014, compared to income tax benefit of \$22,556 for the same period of 2013. The effective income tax rate to taxable income (loss) for the three months ended June 30, 2014 and 2013 was 1.4% and (0.2)%.

Net Income (Loss). Our net income for the three months ended June 30, 2014, was \$3.26 million compared to net loss of \$9.45 million for the same period of 2013, an increase of \$12.71 million or 134%. Net income (loss) as a percentage of sales were 57% and 122% in the three months ended June 30, 2014 and 2013, respectively. This significant increase in net income was mainly attributable to increased operating income as a percentage of sales, including decreased provision for bad debts, in spite of our decreased sales for the three months ended June 30, 2014.

Liquidity and Capital Resources

As of June 30, 2014, we had cash and equivalents of \$19.00 million. Working capital was \$49.95 million at June 30, 2014. The ratio of current assets to current liabilities was 1.96:1 at June 30, 2014.

Presently, the Company's U.S. parent company is experiencing difficulty up streaming cash. As a consequence, the Company obtained a revolving line of credit providing for borrowings of up to \$2.5 million, and increased to \$3.25 million on July 14, 2014, to address the cash needs of the Company's U.S. parent. The outstanding balance under the Credit Agreement as of June 30, 2014 was \$2.15 million.

The following is a summary of cash provided by or used in each of the indicated types of activities during the six months ended June 30, 2014 and 2013:

| | 2014 | 2013 |
|-----------------------------|----------------|-----------------|
| Cash provided by (used in): | | |
| Operating activities | \$ (8,131,229) | \$ (10,025,327) |
| Investing activities | \$ 12,080,817 | \$ 28,887 |
| Financing activities | \$ 1,597,758 | \$ 1,846,702 |

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Net cash flow used in operating activities was \$8.13 million in the six months ended June 30, 2014, compared to net cash flow used in operating activities of \$10.03 million in the same period of 2013. The decrease in net cash outflow in operating activities was due mainly to increased cash inflow from accounts receivable of \$3.50 million in the six months ended June 30, 2014, compared with \$2.24 million received in the same period of 2013; increased cash inflow from advance to suppliers of \$1.41 million in the six months ended June 30, 2014, compared with cash outflow of \$1.36 million in the same period of 2013; decreased cash outflow of \$1.15 million for inventory in the six months ended June 30, 2014 compared with \$3.27 million outflow in the same period of 2013; cash inflow of \$0.24 million from tax receivable in the six months ended June 30, 2014 compared with cash outflow of \$1.42 million in the same period of 2013; and cash inflow of \$3.13 million resulted from accrued liabilities and other payables in the six months ended June 30, 2014 compared with \$0.14 million in the same period of 2013.

Net cash flow provided by investing activities was \$12.08 million in the six months ended June 30, 2014, compared to net cash provided by investing activities of \$0.03 million in the same period of 2013. In the six months ended June 30, 2014, we had \$2.06 million cash inflow from note receivable, \$1.59 million cash inflow from changes in restricted cash, \$10.36 million cash inflow from government refund of land use right, offset with \$0.70 million cash outflows for purchase of fixed assets and \$1.25 million cash outflows from advance for equipment purchase; while in the same period of 2013, we had \$0.93 million cash inflow from notes receivable, offset with \$0.39 million cash outflow from changes in restricted cash and \$0.52 million cash outflow for purchase of fixed assets.

Net cash flow provided by financing activities was \$1.60 million in the six months ended June 30, 2014, compared to net cash used in financing activities of \$1.85 million in the same period of 2013. The cash inflow in the six months ended June 30, 2014 consisted primarily of proceeds from a credit line of \$0.85 million and proceeds from short-term loans of \$13.72 million, but offset with repayment on short-term loans of \$12.97 million. In the six months ended June 30, 2013, we had \$13.77 million in proceeds from short-term loans, but offset with \$11.92 million repayment on short-term loans.

Our agreements with our customers generally provide that 30% of the purchase price is due upon the placement of an order, 30% upon delivery and 30% upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment of the final 10% of the purchase price is due no later than the termination date of the standard warranty period, which ranges from 3 to 24 months from the acceptance date, or up to 2 heating seasons. Our receipts from sales of our products depend on the complexity of the equipment ordered, which impacts manufacturing, delivery, installation, testing times and warranty periods. For example, PHEs and HPs are less complex than PHE Units and therefore have a shorter manufacturing, acceptance, warranty and payment schedule. We experience payment delays from time to time, which historically have been from 1 to 3 months from the due date, but given the temporary financial difficulties of some of our state-owned customers resulting from tightened fiscal policies in China, we have experienced longer payment delays from these customers. Our accounts receivable and inventory turnover are relatively low and days sales outstanding ratio relatively high. Consequently, collection on our sales is slow and capital is tied up in inventories, which may result in pressure on cash flows. The low accounts receivable turnover and high days outstanding in the six months ended June 30, 2014, was due primarily to the financial difficulties of some of our state-owned customers that resulted in delays in payment. The low inventory turnover rate in the six months ended June 30, 2014, was due to overall less purchase orders received from our state-owned customers in China who are having temporary financial difficulties.

As of June 30, 2014, we had gross accounts receivable of \$60,575,050, of which \$1,267,490 was with aging within 30 days, \$2,559,114 with aging between 31 and 90 days, \$11,982,683 with aging between 91 and 180 days, \$14,570,945 with aging between 181 and 360 days, and \$30,194,818 with aging over 360 days. At June 30, 2014, net accounts receivable was \$15,099,549, or gross accounts receivable of \$60,575,050 less bad debt allowance of \$41,292,079, unearned interest of \$26,413, and total retention receivables of \$4,157,009.

Our accounts receivable typically remain outstanding for a significant period of time based on the standard payment terms with our customers described above. The increase in amount of accounts receivable outstanding for more than 180 days was due mainly to payment delays from certain state-owned customers that experienced working capital difficulties because of the current deflationary fiscal policy of the PRC government. Bad debt allowance was reserved in accordance with the Company's accounting policy, though the Company continues to work to collect all funds due.

We recognize the final 5-10% of the purchase price as retention receivable, which is due no later than the termination of our warranty period. The deferral of the final payment is a common practice in the heating manufacturing business in China. Sometimes our customers are required to deposit 5-10% of the sales price on high value products, like an assembled heat exchanger unit or the main part of a PHE, into designated bank accounts as restricted cash for securing the payment after such period expires. Based on our historical experience, there have been no defaults on such deferrals. Therefore, we believe the potential risks and uncertainty associated with defaults on such receivables are not material. As of this report date, the Company collected 62% of the accounts receivable that were outstanding as of December 31, 2012, and collected 18% of the accounts receivable that were outstanding as of December 31, 2013.

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Dividend Distribution

We are a U.S. holding company that conducts substantially all of our business through our wholly owned and other consolidated operating entities in China and Germany. We rely in part on dividends paid by our subsidiaries in China for our cash needs, including the funds necessary to pay dividends and other cash distributions to our shareholders, to service any debt we may incur and to pay our operating expenses. The payment of dividends by entities organized in China is subject to limitations. In particular, PRC regulations currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in China. Our PRC subsidiaries also are required to set aside at least 10% of their after-tax profit based on PRC accounting standards each year to a statutory surplus reserve fund until the accumulative amount of such reserve reaches 50% of registered capital. These reserves are not distributable as cash dividends. In addition, our PRC subsidiaries, at their discretion, may allocate a portion of their after-tax profit to their staff welfare and bonus fund, which may not be distributed to equity owners except in the event of liquidation. Moreover, if any of our subsidiaries incur debt on its own behalf in the future, the instruments governing the debt may restrict such subsidiary's ability to pay dividends or make other distributions to us. Any limitation on the ability of one of our subsidiaries to distribute dividends and other distributions to us could materially and adversely limit our ability to make investments or acquisitions that could be beneficial to our businesses, pay dividends or otherwise fund and conduct our business.

Off-Balance Sheet Arrangements

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

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Contractual Obligations

The Company was obligated for the following short-term loans as of June 30, 2014 and December 31, 2013:

| | 2014 | 2013 | Subsidiary obligated |
|---|--------------|-----------|----------------------|
| From a commercial bank in the PRC for RMB 7,200,000 entered into on February 20, 2014. The loan bore interest at 6% with maturity on February 19, 2015. | \$ 1,170,199 | \$ - | Taiyu |
| From a commercial bank in the PRC for RMB 2,640,565 entered into on January 3, 2014. The loan bore interest at 6.22% with maturity on July 29, 2014. This loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 429,165 | - | Taiyu |
| From a commercial bank in the PRC for RMB 7,935,243 entered into on January 3, 2014. The loan bore interest at 6.22% with maturity on July 29, 2014. The loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 1,289,696 | - | Taiyu |
| From a commercial bank in the PRC for RMB 16,080,000 entered into on January 16, 2014. The loan bore interest at 6.22% with maturity on August 8, 2014. The loan was pledged by Taiyu's accounts receivable. The loan was paid in full at maturity. | 2,613,444 | - | Taiyu |
| From a commercial bank in the PRC for RMB 4,685,723 entered into on January 22, 2014. The loan bore interest at 6.22% with maturity on August 20, 2014. The loan was pledged by Taiyu's accounts receivable. The loan was paid in full at maturity. | 761,559 | - | Taiyu |
| From a commercial bank in the PRC for RMB 5,377,441 entered into on January 22, 2014. The loan bore interest at 6.22% with maturity on August 20, 2014. The loan was pledged by the Taiyu's accounts receivable. The loan was paid in full at maturity. | 873,983 | - | Taiyu |
| From a commercial bank in the PRC for RMB 13,344,190 entered into on June 26, 2012. The loan bore interest at 6.16% with maturity on January 18, 2014. The loan was repaid at maturity. | - | 2,188,684 | Taiyu |
| From a commercial bank in the PRC for RMB 10,000,000 entered into on November 30, 2012. The loan bore interest at 7.87% with maturity on November 22, 2014. The loan was guaranteed by Taiyu. | 1,625,277 | 1,640,178 | Siping |
| From a commercial bank in the PRC for RMB 40,000,000 entered into on March 11, 2013. The loan bore interest at 6.60% with maturity on March 10, 2014. The loan was guaranteed by Siping, HeatPump and management of Chinese subsidiaries. This loan was repaid at maturity. | - | 6,560,711 | Taiyu |
| From a commercial bank in the PRC for RMB 10,000,000 entered into on May 21, 2013. The loan bore interest at 6.60% with maturity on May 20, 2014. This | - | 1,640,178 | Taiyu |

loan was repaid at maturity.

From a commercial bank in the PRC for RMB 5,000,000 entered into on August 29, 2013. The loan bore interest at 7.20% with maturity on August 29, 2014. The loan was guaranteed by Taiyu. The loan was paid in full at maturity.

| | | |
|---------|---------|--------|
| 812,638 | 820,089 | Siping |
|---------|---------|--------|

From a commercial bank in the PRC for RMB 5,000,000 entered into on September 4, 2013. The loan bore interest at 7.20% with maturity on September 4, 2014. The loan was guaranteed by Taiyu.

| | | |
|---------|---------|--------|
| 812,638 | 820,089 | Siping |
|---------|---------|--------|

From a commercial bank in the PRC for RMB 30,000,000 entered into on August 8, 2013. The loan bore interest at 6.90% with maturity on August 7, 2014.

The loan was paid in full at maturity.

| | | |
|-----------|-----------|-------|
| 4,875,829 | 4,920,533 | Taiyu |
|-----------|-----------|-------|

From a commercial bank in the PRC for RMB 9,900,000 entered into on September 18, 2013. The loan bore interest at 6.0% with maturity on September 17, 2014. This loan was pledged by Taiyu's accounts receivable.

| | | |
|-----------|-----------|-------|
| 1,609,023 | 1,623,776 | Taiyu |
|-----------|-----------|-------|

From a commercial bank in the PRC for RMB 9,900,000 entered into on October 11, 2013. The loan bore interest at 6.0% with maturity on October 10, 2014. This loan was pledged by Taiyu's accounts receivable.

| | | |
|-----------|-----------|-------|
| 1,609,023 | 1,623,776 | Taiyu |
|-----------|-----------|-------|

From a commercial bank in the PRC for RMB 16,000,000 entered into on July 10, 2013. The loan bore interest at 6.0% with maturity on January 9, 2014. This loan was pledged by Taiyu's accounts receivable. This loan was repaid at maturity.

| | | |
|---|-----------|-------|
| - | 2,624,285 | Taiyu |
|---|-----------|-------|

From a commercial bank in the PRC for RMB 36,000,000 entered into on April 23, 2014. The loan bore interest at 7.2% with maturity on April 22, 2015. This loan was pledged by Siping, Heat Pump, SanDeKe, and two officers of the Chinese subsidiaries.

| | | |
|-----------|---|-------|
| 5,850,995 | - | Taiyu |
|-----------|---|-------|

From a commercial bank in the PRC for RMB 4,000,000 entered into on April 23, 2014. The loan bore interest at 7.2% with maturity on April 22, 2015. This loan was pledged by Siping, Heat Pump, SanDeKe, and two officers of the Chinese subsidiaries.

| | | |
|---------|---|-------|
| 650,111 | - | Taiyu |
|---------|---|-------|

| | | | |
|-------|---------------|---------------|--|
| TOTAL | \$ 24,983,580 | \$ 24,462,299 | |
|-------|---------------|---------------|--|

The banks sometimes require loan guarantee provided by a third party to the Company, the third party loan guarantor was Liaoning Wugang Metal Trading Co., Ltd. ("Liaoning Wugang"), with a maximum guarantee of RMB 46 million (\$7.32 million). The guarantee is for the loans entered from February 20, 2012 to August 16, 2013, with the guarantee length equal to the loan term; the guarantee service was extended for the loans entered or will be entered from September 18, 2013 to September 12, 2014 with the guarantee length equal to the loan term, the maximum guarantee amount was revised to RMB 44 million (\$7.05 million). The Company was not required to pay any guarantee fees. However, the Company has contracted to provide similar guarantees for up to RMB 20 million (\$3.18 million) to Liaoning Guorui Commercial Trading Co., Ltd. ("Guorui"). The guarantee is for the loans entered from January 12, 2012 to January 11, 2013 with the guarantee length equal to the loan term, the Company does not require Guorui to pay any guarantee fees. The Company did not extend the guarantee term for Guorui after January 11, 2013. These arrangements are common to the banking industry in China, and there are no other relationships between the

Company and Liaoning Wugang or Guorui, both of whom were referred to the Company by the lending bank. As of June 30, 2014 and December 31, 2013, the Company did not have any loan guarantees from Liaoning Wugang.

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The Company was obligated for the following long-term loan as of June 30, 2014:

Taiyu entered into a long-term loan of \$2.11 million (RMB 13 million) with China Construction Bank on November 30, 2013 with maturity on November 29, 2015. The interest rate for the loan is variable currently at 6.46%, and to be paid on the 20th of each month. This loan is guaranteed by Taiyu's building and land.

Contingencies

On August 31, 2012, a putative class action lawsuit, *Steven Leshinsky v. James Wang, et. al.*, which purported to allege federal securities law claims against the Company and certain of its former officers and directors, was filed in the United States District Court for the Southern District of New York. Thereafter, two plaintiffs filed competing motions to be appointed lead plaintiff in the proceeding. A lead plaintiff was appointed and an amended complaint was filed on January 28, 2013, by the Rosen Law Firm. The amended complaint included Oliver Bialowons, our President, and Michael Wilhelm, our former Chief Financial Officer, as defendants in the proceeding though they were not officers of the Company during the alleged class period. A second amended complaint was filed on April 8, 2013, under the caption *Stream Sicav, Dharanendra Rai et al. v. James Jun Wang, Smartheat, Inc. et al.*, removing Messrs. Wilhelm and Bialowons as defendants. The second amended complaint alleges two counts against the Company, both asserting violations of the federal securities laws arising from alleged insider sales or management sales of securities and alleged false disclosures relating to those sales. On May 8, 2013, we filed a motion to dismiss the second amended complaint which was denied. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice. On August 6, 2014, the lead plaintiffs once again filed a motion for class certification, which we will be opposing. Discovery is also proceeding. The pleadings and court orders are publicly available. We intend to vigorously defend this action, as we believe the allegations against us are without merit.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

Our management, with the participation of our President and Acting Chief Accountant, our principal executive officer and principal financial officer, respectively, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our President and Acting Chief Accountant, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our President and Acting Chief Accountant concluded that, as of June 30, 2014, our disclosure controls and procedures were not effective as of such date because of a material weakness identified in our internal control over financial reporting related to our internal level of U.S. GAAP expertise. We lack sufficient personnel with the appropriate level of knowledge, experience and training in U.S. GAAP for the preparation of financial statements in accordance with U.S. GAAP. None of our internal accounting staff, including our Acting Chief Accountant, that are primarily responsible for the preparation of our books and records and financial statements in compliance with U.S. GAAP holds a license such as Certified Public Accountant in the U.S., nor have any attended U.S. institutions or extended educational programs that would provide enough of the relevant education relating to U.S. GAAP.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2014, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On August 31, 2012, a putative class action lawsuit, Steven Leshinsky v. James Wang, et. al., which purported to allege federal securities law claims against the Company and certain of its former officers and directors, was filed in the United States District Court for the Southern District of New York. Thereafter, two plaintiffs filed competing motions to be appointed lead plaintiff in the proceeding. A lead plaintiff was appointed and an amended complaint was filed on January 28, 2013, by the Rosen Law Firm. The amended complaint included Oliver Bialowons, our President, and Michael Wilhelm, our former Chief Financial Officer, as defendants in the proceeding though they were not officers of the Company during the alleged class period. A second amended complaint was filed on April 8, 2013, under the caption Stream Sicav, Dharanendra Rai et al. v. James Jun Wang , Smartheat, Inc. et al., removing Messrs. Wilhelm and Bialowons as defendants. The second amended complaint alleges two counts against the Company, both asserting violations of the federal securities laws arising from alleged insider sales or management sales of securities and alleged false disclosures relating to those sales. On May 8, 2013, we filed a motion to dismiss the second amended complaint which was denied. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice. On August 6, 2014, the lead plaintiffs once again filed a motion for class certification, which we will be opposing. Discovery is also proceeding. The pleadings and court orders are publicly available. We intend to vigorously defend this action, as we believe the allegations against us are without merit.

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

Item 1A. Risk Factors

You should consider carefully the factors discussed in the "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See the Exhibit Index following the signature page to this Quarterly Report on Form 10-Q for a list of exhibits filed or furnished with this report, which Exhibit Index is incorporated herein by reference.

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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.

SMARTHEAT INC.
(Registrant)

Date: September 8, 2014

By: /s/ Oliver Bialowons
Oliver Bialowons
President
(Principal Executive Officer and Duly Authorized Signatory)

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EXHIBIT INDEX

| Exhibit No. | Document Description |
|-------------|--|
| 31.1 † | <u>Certification of President pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 31.2 † | <u>Certification of Acting Chief Accountant pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 32.1 ‡ | <u>Certifications of President and Acting Chief Accountant pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
| 101.INS† | XBRL Instance Document |
| 101.SCH† | XBRL Schema Document |
| 101.CAL† | XBRL Calculation Linkbase Document |
| 101.DEF† | XBRL Definition Linkbase Document |
| 101.LAB† | XBRL Label Linkbase Document |
| 101.PRE† | XBRL Presentation Linkbase Document |

† Filed herewith

‡ Furnished herewith

