GOLDMAN SACHS GROUP INC
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The information in this preliminary pricing supplement is not complete and may be changed. This preliminary pricing supplement is not an offer to sell nor does it seek an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Subject to Completion. Dated March 25, 2019.

GS Finance Corp.

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Leveraged Buffered S&P 500® Index-Linked Notes due

guaranteed by

The Goldman Sachs Group, Inc.
The notes do not bear interest. The amount that you will be paid on your notes on the stated maturity date (expected to be the second scheduled business day after the determination date) is based on the performance of the S&P 500® Index as measured from the trade date to and including the determination date (expected to be between 29 and 32 months after the trade date).

If the final index level on the determination date is greater than the initial index level (set on the trade date and may be higher or lower than the actual closing level of the index on that date), the return on your notes will be positive and will equal 2.5 times the index return, subject to the maximum settlement amount (expected to be between $1,163 and $1,191.25 for each $1,000 face amount of your notes). If the final index level declines by up to 20% from the initial index level, you will receive the face amount of your notes.

If the final index level declines by more than 20% from the initial index level, the return on your notes will be negative and you will lose 1.25% of the face amount of your notes for every 1% that the final index level has declined below 80% of the initial index level. See page PS-6. You could lose a significant portion of the face amount of your notes.

To determine your payment at maturity, we will calculate the index return, which is the percentage increase or decrease in the final index level from the initial index level. At maturity, for each $1,000 face amount of your notes, you will receive an amount in cash equal to:

if the index return is positive (the final index level is greater than the initial index level), the sum of (i) $1,000 plus (ii) the product of (a) $1,000 times (b) 2.5 times (c) the index return, subject to the maximum settlement amount;

if the index return is zero or negative but not below -20% (the final index level is equal to the initial index level or is less than the initial index level, but not by more than 20%), $1,000; or

if the index return is negative and is below -20% (the final index level is less than the initial index level by more than 20%), the sum of (i) $1,000 plus (ii) the product of (a) the buffer rate of 125% (see page PS-6) times (b) the sum of the index return plus 20% times (c) $1,000. You will receive less than the face amount of your notes.

You should read the disclosure herein to better understand the terms and risks of your investment, including the credit risk of GS Finance Corp. and The Goldman Sachs Group, Inc. See page PS-13.

The estimated value of your notes at the time the terms of your notes are set on the trade date is expected to be between $950 and $980 per $1,000 face amount. For a discussion of the estimated value and the price at which Goldman Sachs & Co. LLC would initially buy or sell your notes, if it makes a market in the notes, see the following page.

Original issue date:	, 2019	Original issue price:	100% of the face amount
Underwriting discount:	% of the face amount	Net proceeds to the issuer:	% of the face amount

Neither the Securities and Exchange Commission nor any other regulatory body has approved or disapproved of these securities or passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense. The notes are not bank deposits and are not insured by the Federal Deposit Insurance Corporation or any other governmental agency, nor are they obligations of, or guaranteed by, a bank.

Goldman Sachs & Co. LLC

Pricing Supplement No. dated , 2019.

The issue price, underwriting discount and net proceeds listed above relate to the notes we sell initially. We may decide to sell additional notes after the date of this pricing supplement, at issue prices and with underwriting discounts and net proceeds that differ from the amounts set forth above. The return (whether positive or negative) on your investment in notes will depend in part on the issue price you pay for such notes.

GS Finance Corp. may use this prospectus in the initial sale of the notes. In addition, Goldman Sachs & Co. LLC or any other affiliate of GS Finance Corp. may use this prospectus in a market-making transaction in a note after its initial sale. Unless GS Finance Corp. or its agent informs the purchaser otherwise in the confirmation of sale, this prospectus is being used in a market-making transaction.

Estimated Value of Your Notes

The estimated value of your notes at the time the terms of your notes are set on the trade date (as determined by reference to pricing models used by Goldman Sachs & Co. LLC (GS&Co.) and taking into account our credit spreads) is expected to be between $950 and $980 per $1,000 face amount, which is less than the original issue price. The value of your notes at any time will reflect many factors and cannot be predicted; however, the price (not including GS&Co.'s customary bid and ask spreads) at which GS&Co. would initially buy or sell notes (if it makes a market, which it is not obligated to do) and the value that GS&Co. will initially use for account statements and otherwise is equal to approximately the estimated value of your notes at the time of pricing, plus an additional amount (initially equal to $ per $1,000 face amount).

Prior to , the price (not including GS&Co.'s customary bid and ask spreads) at which GS&Co. would buy or sell your notes (if it makes a market, which it is not obligated to do) will equal approximately the sum of (a) the then-current estimated value of your notes (as determined by reference to GS&Co.'s pricing models) plus (b) any remaining additional amount (the additional amount will decline to zero on a straight-line basis from the time of pricing through). On and after , the price (not including GS&Co.'s customary bid and ask spreads) at which GS&Co. would buy or sell your notes (if it makes a market) will equal approximately the then-current estimated value of your notes determined by reference to such pricing models.

About Your Prospectus

The notes are part of the Medium-Term Notes, Series E program of GS Finance Corp. and are fully and unconditionally guaranteed by The Goldman Sachs Group, Inc. This prospectus includes this pricing supplement and the accompanying documents listed below. This pricing supplement constitutes a supplement to the documents listed below, does not set forth all of the terms of your notes and therefore should be read in conjunction with such documents:

Product supplement no. 1,738 dated July 10, 2017

General terms supplement no. 1,734 dated July 10, 2017

Prospectus supplement dated July 10, 2017

Prospectus dated July 10, 2017

The information in this pricing supplement supersedes any conflicting information in the documents listed above. In addition, some of the terms or features described in the listed documents may not apply to your notes.

We refer to the notes we are offering by this pricing supplement as the "offered notes" or the "notes". Each of the offered notes has the terms described below. Please note that in this pricing supplement, references to "GS Finance Corp.", "we", "our" and "us" mean only GS Finance Corp. and do not include its subsidiaries or affiliates, references to "The Goldman Sachs Group, Inc.", our parent company, mean only The Goldman Sachs Group, Inc. and do not include its subsidiaries or affiliates and references to "Goldman Sachs" mean The Goldman Sachs Group, Inc. together with its consolidated subsidiaries and affiliates, including us. The notes will be issued under the senior debt indenture, dated as of October 10, 2008, as supplemented by the First Supplemental Indenture, dated as of February 20, 2015, each among us, as issuer, The Goldman Sachs Group, Inc., as guarantor, and The Bank of New York Mellon, as trustee. This indenture, as so supplemented and as further supplemented thereafter, is referred to as the "GSFC 2008 indenture" in the accompanying prospectus supplement. The notes will be issued in book-entry form and represented by a master global note.

[redacted]

[redacted]

You should be willing to forgo:

- gains greater than a maximum settlement amount of between 116.3% and 119.125% of the face amount in exchange for (i) 2.5x leveraged upside participation if the underlier return is positive and (ii) a buffer against loss of principal in the event of a decline of up to 20% in the final underlier level relative to the initial underlier level.
- interest payments and risk losing your entire investment for the potential to earn 250% of any positive underlier return up to a maximum settlement amount of between 116.3% and 119.125% of the face amount.

Your maximum return on your notes will not be greater than between 16.3% and 19.125%, and you could lose all or a portion of your investment if the underlier return is less than -20%.

[redacted]

At maturity, for each $1,000 face amount, the investor will receive (in each case as a percentage of the face amount):

- if the final underlier level is greater than 100% of the initial underlier level, 100% plus 250% times the underlier return, subject to a maximum settlement amount of between 116.3% and 119.125%;
- if the final underlier level is equal to or less than 100% of the initial underlier level but greater than or equal to 80% of the initial underlier level, 100%; or
- if the final underlier level is less than 80% of the initial underlier level, 100% minus 1.25% for every 1% that the final underlier level has declined below 80% of the initial underlier level

If the final underlier level declines by more than 20% from the initial underlier level, the return on the notes will be negative and the investor could lose their entire investment in the notes.

[redacted]

Issuer:	GS Finance Corp.
Guarantor:	The Goldman Sachs Group, Inc.
Underlier:	The S&P 500® Index (current Bloomberg symbol: “SPX Index”)
Face Amount:	$ in the aggregate; each note will have a face amount equal to $1,000
Trade Date:	
Settlement Date:	Expected to be the fifth scheduled business day following the trade date
Determination Date:	Expected to be between 29 and 32 months following the trade date
Stated Maturity Date:	Expected to be the second scheduled business day following the determination date
Initial Underlier Level:	To be determined on the trade date
Final Underlier Level:	The closing level of the underlier on the determination date
Underlier Return:	The quotient of (i) the final underlier level minus the initial underlier level divided by (ii) the initial underlier level, expressed as a positive or negative percentage
Upside Participation Rate:	250%
Buffer Level:	80% of the initial underlier level (equal to an underlier return of -20%)
Buffer Amount:	20%
Buffer Rate:	The quotient of the initial underlier level divided by the buffer level, which equals 125%
Maximum Settlement Amount:	Expected to be between $1,163 and $1,191.25
Cap Level:	Expected to be between 106.52% and 107.65% of the initial underlier level
CUSIP/ISIN:	40056F5H4 / US40056F5H42

[redacted]

[redacted]	
200.000%	116.300%
175.000%	116.300%
150.000%	116.300%
125.000%	116.300%
106.520%	116.300%
105.000%	112.500%
102.000%	105.000%
100.000%	100.000%
95.000%	100.000%
90.000%	100.000%
85.000%	100.000%
80.000%	100.000%
75.000%	93.750%
50.000%	62.500%
25.000%	31.250%
0.000%	0.000%

*assumes a cap level set at the bottom of the cap level range (between 106.52% and 107.65% of the initial underlier level)

[redacted]

Please read the section entitled "Additional Risk Factors Specific to Your Notes" of this pricing supplement as well as the risks and considerations described in the accompanying prospectus dated July 10, 2017, in the accompanying prospectus supplement dated July 10, 2017, under "Additional Risk Factors Specific to the Underlier-Linked Notes" in the accompanying product supplement no. 1,738 dated July 10, 2017, and under "Additional Risk Factors Specific to the Notes" in the accompanying general terms supplement no. 1,734 dated July 10, 2017.

TERMS AND CONDITIONS

(Terms From Pricing Supplement No. Incorporated Into Master Note No. 2)

These terms and conditions relate to pricing supplement no. dated , 2019 of GS Finance Corp. and The Goldman Sachs Group, Inc. with respect to the issuance by GS Finance Corp. of its Leveraged Buffered S&P 500® Index-Linked Notes due and the guarantee thereof by The Goldman Sachs Group, Inc.

The provisions below are hereby incorporated into master note no. 2, dated August 22, 2018. References herein to "this note" shall be deemed to refer to "this security" in such master note no. 2, dated August 22, 2018. Certain defined terms may not be capitalized in these terms and conditions even if they are capitalized in master note no. 2, dated August 22, 2018. Defined terms that are not defined in these terms and conditions shall have the meanings indicated in such master note no. 2, dated August 22, 2018, unless the context otherwise requires.
CUSIP / ISIN: 40056F5H4 / US40056F5H42

Company (Issuer): GS Finance Corp.

Guarantor: The Goldman Sachs Group, Inc.

Underlier: the S&P 500® Index (current Bloomberg symbol: "SPX Index"), or any successor underlier, as it may be modified, replaced or adjusted from time to time as provided herein

Face amount: $ in the aggregate on the original issue date; the aggregate face amount may be increased if the company, at its sole option, decides to sell an additional amount on a date subsequent to the trade date.

Authorized denominations: $1,000 or any integral multiple of $1,000 in excess thereof

Principal amount: On the stated maturity date, the company will pay, for each $1,000 of the outstanding face amount, an amount, if any, in cash equal to the cash settlement amount.

Cash settlement amount:

if the final underlier level is greater than or equal to the cap level, the maximum settlement amount;
if the final underlier level is greater than the initial underlier level but less than the cap level, the sum of (1) $1,000 plus (2) the product of (i) $1,000 times (ii) the upside participation rate times (iii) the underlier return;
if the final underlier level is equal to or less than the initial underlier level but greater than or equal to the buffer level, $1,000; or
if the final underlier level is less than the buffer level, the sum of (1) $1,000 plus (2) the product of (i) $1,000 times (ii) the buffer rate times (iii) the sum of the underlier return plus the buffer amount

Initial underlier level (set on the trade date and may be higher or lower than the actual closing level of the underlier on that date):

Final underlier level: the closing level of the underlier on the determination date, subject to adjustment as provided in "— Consequences of a market disruption event or non-trading day" and "— Discontinuance or modification of the underlier" below

Cap level (set on the trade date): expected to be between 106.52% and 107.65% of the initial underlier level

Maximum settlement amount (set on the trade date): expected to be between $1,163 and $1,191.25

Upside participation rate: 250%

Underlier return: the quotient of (1) the final underlier level minus the initial underlier level divided by (2) the initial underlier level, expressed as a percentage

Buffer level: 80% of the initial underlier level

Buffer rate: the quotient of the initial underlier level divided by the buffer level, which equals 125%

Buffer amount: 20%

Trade date:

Original issue date (set on the trade date): expected to be the fifth scheduled business day following the trade date

Determination date (set on the trade date): a specified date that is expected to be between 29 and 32 months following the trade date, unless the calculation agent determines that a market disruption event occurs or is continuing on such day or such day is not a trading day. In that event, the determination date will be the first following trading day on which the calculation agent determines that a market disruption event does not occur and is not continuing. However, the determination date will not be postponed to a date later than the originally scheduled stated maturity date or, if the originally scheduled stated maturity date is not a business day, later than the first business day after the originally scheduled stated maturity date. If a market disruption event occurs or is continuing on the day that is the last possible determination date or such last possible day is not a trading day, that day will nevertheless be the determination date.

Stated maturity date (set on the trade date): a specified date that is expected to be the second scheduled business day following the determination date, unless that day is not a business day, in which case the stated maturity date will be postponed to the next following business day. The stated maturity date will also be postponed if the determination date is postponed as described under "— Determination date" above. In such a case, the stated maturity date will be postponed by the same number of business day(s) from but excluding the originally scheduled determination date to and including the actual determination date.

Closing level: for any given trading day, the official closing level of the underlier or any successor underlier published by the underlier sponsor on such trading day

Trading day: a day on which the respective principal securities markets for all of the underlier stocks are open for trading, the underlier sponsor is open for business and the underlier is calculated and published by the underlier sponsor

Successor underlier: any substitute underlier approved by the calculation agent as a successor underlier as provided under "— Discontinuance or modification of the underlier" below

Underlier sponsor: at any time, the person or entity, including any successor sponsor, that determines and publishes the underlier as then in effect. The notes are not sponsored, endorsed, sold or promoted by the underlier sponsor or any of its affiliates and the underlier sponsor and its affiliates make no representation regarding the advisability of investing in the notes.

Underlier stocks: at any time, the stocks that comprise the underlier as then in effect, after giving effect to any additions, deletions or substitutions

Market disruption event: With respect to any given trading day, any of the following will be a market disruption event with respect to the underlier:

a suspension, absence or material limitation of trading in underlier stocks constituting 20% or more, by weight, of the underlier on their respective primary markets, in each case for more than two consecutive hours of trading or during the one-half hour before the close of trading in that market, as determined by the calculation agent in its sole discretion,

a suspension, absence or material limitation of trading in option or futures contracts relating to the underlier or to underlier stocks constituting 20% or more, by weight, of the underlier in the respective primary markets for those contracts, in each case for more than two consecutive hours of trading or during the one-half hour before the close of trading in that market, as determined by the calculation agent in its sole discretion, or

underlier stocks constituting 20% or more, by weight, of the underlier, or option or futures contracts, if available, relating to the underlier or to underlier stocks constituting 20% or more, by weight, of the underlier do not trade on what were the respective primary markets for those underlier stocks or contracts, as determined by the calculation agent in its sole discretion, and, in the case of any of these events, the calculation agent determines in its sole discretion that such event could materially interfere with the ability of the company or any of its affiliates or a similarly situated person to unwind all or a material portion of a hedge that could be effected with respect to this note.

The following events will not be market disruption events:

- a limitation on the hours or numbers of days of trading, but only if the limitation results from an announced change in the regular business hours of the relevant market, and
- a decision to permanently discontinue trading in option or futures contracts relating to the underlier or to any underlier stock.

For this purpose, an "absence of trading" in the primary securities market on which an underlier stock is traded, or on which option or futures contracts relating to the underlier or an underlier stock are traded, will not include any time when that market is itself closed for trading under ordinary circumstances. In contrast, a suspension or limitation of trading in an underlier stock or in option or futures contracts, if available, relating to the underlier or an underlier stock in the primary market for that stock or those contracts, by reason of:

a price change exceeding limits set by that market,
an imbalance of orders relating to that underlier stock or those contracts, or
a disparity in bid and ask quotes relating to that underlier stock or those contracts,
will constitute a suspension or material limitation of trading in that stock or those contracts in that market.

Consequences of a market disruption event or a non-trading day: If a market disruption event occurs or is continuing on a day that would otherwise be the determination date or such day is not a trading day, then the determination date will be postponed as described under "— Determination date" above.

If the calculation agent determines that the closing level of the underlier that must be used to determine the cash settlement amount is not available on the postponed determination date because of a market disruption event, a non-trading day or for any other reason (except as described under "— Discontinuance or modification of the underlier" below), the calculation agent will nevertheless determine the closing level of the underlier based on its assessment, made in its sole discretion, of the level of the underlier on that day.

Discontinuance or modification of the underlier: If the underlier sponsor discontinues publication of the underlier and the underlier sponsor or any other person or entity publishes a substitute underlier that the calculation agent determines is comparable to the underlier and approves as a successor underlier, or if the calculation agent designates a substitute underlier, then the calculation agent will determine the amount payable on the stated maturity date by reference to such successor underlier.

If the calculation agent determines that the publication of the underlier is discontinued and there is no successor underlier, the calculation agent will determine the amount payable on the stated maturity date by a computation methodology that the calculation agent determines will as closely as reasonably possible replicate the underlier.

If the calculation agent determines that the underlier, the underlier stocks or the method of calculating the underlier is changed at any time in any respect — including any split or reverse-split of the underlier and any addition, deletion or substitution and any reweighting or rebalancing of the underlier stocks and whether the change is made by the underlier sponsor under its existing policies or following a modification of those policies, is due to the publication of a successor underlier, is due to events affecting one or more of the underlier stocks or their issuers or is due to any other reason — and is not otherwise reflected in the level of the underlier by the underlier sponsor pursuant to the then-current underlier methodology of the underlier, then the calculation agent will be permitted (but not required) to make such adjustments in the underlier or the method of its calculation as it believes are appropriate to ensure that the final underlier level, used to determine the amount payable on the stated maturity date, is equitable.

All determinations and adjustments to be made by the calculation agent with respect to the underlier may be made by the calculation agent in its sole discretion. The calculation agent is not obligated to make any such adjustments.

Calculation agent: Goldman Sachs & Co. LLC ("GS&Co.")

Tax characterization: The holder, on behalf of itself and any other person having a beneficial interest in this note, hereby agrees with the company (in the absence of a change in law, an administrative determination or a judicial ruling to the contrary) to characterize this note for all U.S. federal income tax purposes as a pre-paid derivative contract in respect of the underlier.

Overdue principal rate: the effective Federal Funds rate

HYPOTHETICAL EXAMPLES

The following examples are provided for purposes of illustration only. They should not be taken as an indication or prediction of future investment results and merely are intended to illustrate the impact that the various hypothetical underlier levels on the determination date could have on the cash settlement amount at maturity assuming all other variables remain constant.

The examples below are based on a range of final underlier levels that are entirely hypothetical; the underlier level on any day throughout the life of the notes, including the final underlier level on the determination date, cannot be predicted. The underlier has been highly volatile in the past — meaning that the underlier level has changed considerably in relatively short periods — and its performance cannot be predicted for any future period.

The information in the following examples reflects hypothetical rates of return on the offered notes assuming that they are purchased on the original issue date at the face amount and held to the stated maturity date. If you sell your notes in a secondary market prior to the stated maturity date, your return will depend upon the market value of your notes at the time of sale, which may be affected by a number of factors that are not reflected in the examples below, such as interest rates, the volatility of the underlier, the creditworthiness of GS Finance Corp., as issuer, and the creditworthiness of The Goldman Sachs Group, Inc., as guarantor. In addition, the estimated value of your notes at the time the terms of your notes are set on the trade date (as determined by reference to pricing models used by GS&Co.) is less than the original issue price of your notes. For more information on the estimated value of your notes, see "Additional Risk Factors Specific to Your Notes — The Estimated Value of Your Notes At the Time the Terms of Your Notes Are Set On the Trade Date (as Determined By Reference to Pricing Models Used By GS&Co.) Is Less Than the Original Issue Price Of Your Notes" on page PS-13 of this pricing supplement. The information in the examples also reflects the key terms and assumptions in the box below.

Key Terms and Assumptions	
Face amount	$1,000
Upside participation rate	250%
Cap level	106.52% of the initial underlier level
Maximum settlement amount	$1,163
Buffer level	80% of the initial underlier level
Buffer rate	125%
Buffer amount	20%
Neither a market disruption event nor a non-trading day occurs on the originally scheduled determination date	
No change in or affecting any of the underlier stocks or the method by which the underlier sponsor calculates the underlier	
Notes purchased on original issue date at the face amount and held to the stated maturity date	

Moreover, we have not yet set the initial underlier level that will serve as the baseline for determining the underlier return and the amount that we will pay on your notes, if any, at maturity. We will not do so until the trade date. As a result, the actual initial underlier level may differ substantially from the underlier level prior to the trade date and may be higher or lower than the actual closing level of the underlier on that date.

For these reasons, the actual performance of the underlier over the life of your notes, as well as the amount payable at maturity, if any, may bear little relation to the hypothetical examples shown below or to the historical underlier levels shown elsewhere in this pricing supplement. For information about the historical levels of the underlier during recent periods, see "The Underlier — Historical Closing Levels of the Underlier" below. Before investing in the offered notes, you should consult publicly available information to determine the levels of the underlier between the date of this pricing supplement and the date of your purchase of the offered notes.

Also, the hypothetical examples shown below do not take into account the effects of applicable taxes. Because of the U.S. tax treatment applicable to your notes, tax liabilities could affect the after-tax rate of return on your notes to a comparatively greater extent than the after-tax return on the underlier stocks.

The levels in the left column of the table below represent hypothetical final underlier levels and are expressed as percentages of the initial underlier level. The amounts in the right column represent the hypothetical cash settlement amounts, based on the corresponding hypothetical final underlier level, and are expressed as percentages of the face amount of a note (rounded to the nearest one-thousandth of a percent). Thus, a hypothetical cash settlement amount of 100.000% means that the value of the cash payment that we would deliver for each $1,000 of the outstanding face amount of the offered notes on the stated maturity date would equal

100.000% of the face amount of a note, based on the corresponding hypothetical final underlier level and the assumptions noted above.

Hypothetical Final Underlier Level (as Percentage of Initial Underlier Level)	Hypothetical Cash Settlement Amount (as Percentage of Face Amount)
200.000%	116.300%
175.000%	116.300%
150.000%	116.300%
125.000%	116.300%
106.520%	116.300%
105.000%	112.500%
102.000%	105.000%
100.000%	100.000%
95.000%	100.000%
90.000%	100.000%
85.000%	100.000%
80.000%	100.000%
75.000%	93.750%
50.000%	62.500%
25.000%	31.250%
0.000%	0.000%

If, for example, the final underlier level were determined to be 25.000% of the initial underlier level, the cash settlement amount that we would deliver on your notes at maturity would be 31.250% of the face amount of your notes, as shown in the table above. As a result, if you purchased your notes on the original issue date at the face amount and held them to the stated maturity date, you would lose 68.750% of your investment (if you purchased your notes at a premium to face amount you would lose a correspondingly higher percentage of your investment). If the final underlier level were determined to be 0.000% of the initial underlier level, you would lose your entire investment in the notes. In addition, if the final underlier level were determined to be 200.000% of the initial underlier level, the cash settlement amount that we would deliver on your notes at maturity would be capped at the maximum settlement amount, or 116.300% of each $1,000 face amount of your notes, as shown in the table above. As a result, if you held your notes to the stated maturity date, you would not benefit from any increase in the final underlier level over 106.520% of the initial underlier level.

The following chart shows a graphical illustration of the hypothetical cash settlement amounts that we would pay on your notes on the stated maturity date, if the final underlier level were any of the hypothetical levels shown on the horizontal axis. The hypothetical cash settlement amounts in the chart are expressed as percentages of the face amount of your notes and the hypothetical final underlier levels are expressed as percentages of the initial underlier level. The chart shows that any hypothetical final underlier level of less than 80.000% (the section left of the 80.000% marker on the horizontal axis) would result in a hypothetical cash settlement amount of less than 100.000% of the face amount of your notes (the section below the 100.000% marker on the vertical axis) and, accordingly, in a loss of principal to the holder of the notes. The chart also shows that any hypothetical final underlier level of greater than or equal to 106.520% (the section right of the 106.520% marker on the horizontal axis) would result in a capped return on your investment.

The cash settlement amounts shown above are entirely hypothetical; they are based on market prices for the underlier stocks that may not be achieved on the determination date and on assumptions that may prove to be erroneous. The actual market value of your notes on the stated maturity date or at any other time, including any time you may wish to sell your notes, may bear little relation to the hypothetical cash settlement amounts shown above, and these amounts should not be viewed as an indication of the financial return on an investment in the offered notes. The hypothetical cash settlement amounts on notesont>

We believe there are social, economic, environmental and regulatory factors that will drive demand for environmentally friendly solutions over the long-term. These include:

Environmental Conditions in China. According to the report entitled “The Cost of Pollution in China,” published in 2007 by the World Bank, the combined health and non-health cost of air and water pollution in China amounts to an estimated $100 billion a year. Moreover, the report found that air pollution in China, especially in large cities, is leading to higher incidences of lung diseases, cancer, and respiratory problems. According to a report commissioned by the Energy Foundation published in 2008, these problems are directly attributable to the fact that 80% of China’s carbon dioxide emissions come from burning coal.

Growing Demand for Heating Water. China provides heating water to households in most of its northern provinces from centralized heating systems. As cities grow in these provinces along with the emerging middle class, so does the demand to expand this supply into new cities, industrial parks and other provinces. Heating water in China is generated by local power plants that pump emitted hot water through a closed loop system to sub-stations, which then pump the water through a network of pipes to households up to 50 kilometers from the local station. These systems of heating stations and sub-stations utilize numerous PHEs and PHE Units for the dual purpose of providing cooling systems for power plants and heat sources for residents and factories.

Heightened Environmental Awareness. The PRC government’s 12th Five-Year Plan continues to address environmental concerns and emphasize clean energy sources as part of the process towards ensuring sustainable growth in China. The Plan maintains long-term plans to cut CO2 output per unit of Gross Domestic Product, or GDP, by at least 40% by 2020 from 2005 levels. Furthermore, the Plan sets forth clear energy and CO2 emissions targets to help ensure energy policies are implemented with defined carbon goals. The implementation of PHEs and PHE Units in new construction facilities, and as replacements for legacy shell-and-tube heat exchangers, can help meet these goals because of the increased energy efficiency of these products.

Urbanization. According to a 2011 national sample survey conducted by the National Bureau of Statistics of China, over 51% of China’s population lived in urban settings in 2011. Additionally, according to the National Bureau of Statistics of China, 15 cities near and around our sales and service centers have a population of more than five million. Eight of these cities are among the world’s fastest growing, increasing at an estimated annual rate of 2.3% or more according to the CIA World Factbook. China’s urbanization has lead to new infrastructure development and existing infrastructure improvements that require ongoing investment in heating solutions.

Table of Contents

Emerging Wealth. The rapidly expanding middle class in China demands access to quality heating during the winter months. This demand is often met by using hot water supplied from a power station and district heating network that utilizes a system of PHEs and PHE Units.

Our Competitive Strengths

The market for heat transfer products and systems in China is highly competitive, with multiple overseas and domestic producers and no established leader in the fragmented and diverse end markets. We believe our subsidiaries have the following competitive strengths:

Provider of Key Elements Used to Improve Energy Efficiencies and Reduce Coal Pollution. Our subsidiaries offer a full line of PHEs, PHE Units, heat meters and heat pumps. The primary advantages of plate heat exchanger technology, compared to traditional shell-and-tube heat exchanger technology, are efficiency, compact design and ease of customization. PHEs have larger heat transfer surface areas and therefore also have greater thermal conductivity. As a result, PHEs can transfer the same amount of heat as a traditional shell-and-tube heat exchanger, but with the benefit of a smaller size unit.

Quality Engineering, Research and Development. Our subsidiaries emphasize efficiency, durability and quality engineering in all of their products. All of their products utilize the latest technologies, and their designs are created using advanced software systems. Our subsidiaries have 17 registered patents in China for PHE-related products and heat meters. To maintain their competitive edge in the marketplace and keep pace with new technologies, they fund research and development on an ongoing basis to find improved efficiencies in design, cost and energy capture. Research and development costs for 2012 and 2013 were $1.53 million and $1.42 million, respectively. Our subsidiaries plan to continue to invest in research and development to identify new industry applications for PHEs, improve and expand product lines, develop multifunctional PHE Units and modify PHE designs to meet current market demand.

Strong Technical Support. The selection of PHEs and PHE Units requires technical knowledge regarding the operating temperature, pressure, corrosivity, viscosity and purity of the fluid used as well as the pressure loss within the system. Our subsidiaries’ design software enables them to provide high quality and timely technical support to ensure their customers receive the right equipment for each project. They also provide a streamlined and error-free installation process to minimize project complications.

Production and Control Systems for Efficient Pricing and Streamlined Manufacturing. Our subsidiaries’ CAD systems are integrated with real-time enterprise resource planning, or ERP, and finance systems. This platform allows field salespeople to input orders, obtain draft models, access quotes and confirm delivery dates within minutes. The platform also enables inventory and production personnel to accurately schedule and reduce lead production times.

Focus on Quality. Our manufacturing subsidiaries have a PRC National Safety Certification for PHE products, and are an ISO 9001 and ISO 14001 certified manufacturer, which together recognize development and implementation procedures that demonstrate the ability to consistently manufacture products meeting customer specifications, environmental standards and applicable statutory and regulatory requirements.

First-Rate Customer Service and Reliable Product Delivery. We believe that the employees of our subsidiaries provide first-rate customer service, technical expertise and product knowledge to streamline the selection, design and installation processes. Our subsidiaries provide after-sales service principally through local service centers and deliver products on time to meet tight project deadlines.

Diversified End Markets and Customers. PHEs and PHE Units are broadly used across a variety of industrial end markets including the energy, such as conventional and nuclear power plants, HVAC, petroleum refining, petrochemicals, metallurgy, food and beverage and chemical processing. Our subsidiaries also benefit from a diverse customer mix, with no individual customer accounting for greater than 42% of sales in 2013 or 2012. This diversification of end markets and customer base helps to insulate us from sales volatility that would occur if we concentrated in specific industries. The majority of our subsidiaries' customers are state-owned utilities, engineering and construction companies and industrial companies.

Experienced Personnel. The managers of our subsidiaries have extensive business and industry experience. Jun Wang, the general manger of our subsidiaries, was the founder of Taiyu in 2002 and previously was a sales manager for Honeywell International Inc. from 1996 to 1999 and a sales manager for Alfa Laval from 1994 to 1996. Mr. Wang obtained his master's degree in Engineering from Tsinghua University in 1989. Wen Sha, our subsidiaries' Vice President of Marketing, has extensive sales experience and industry contacts. Prior to joining us as a regional sales manager in 2005, he served as the general manager of Nanjing Hui Dun Ltd. and as sales director of APV Accessen in Shanghai, a leading international PHE firm. Feng Chen, Ph.D., our subsidiaries' Chief Technology Officer, joined us in 2008 as part of our SanDeKe acquisition. Prior to founding SanDeKe, he served in a leading engineering position in China with Alfa Laval. Mr. Harald Kumpfert, the general manager of our heat pump business, is an experienced German engineering and marketing professional that has been working and living in China for more than 15 years. Prior to joining our subsidiaries he was the sales director of Siemens China and Honeywell China. Mr. Xu Wen Ke, the sales manager of our heat pump business, used to be the sales director of Haier China, a large manufacturer of air conditioners.

Table of Contents

Growth Strategy

Our subsidiaries plan to expand into new distribution channels in China, further penetrating the many market segments throughout China for PHEs, PHE Units and related accessories, and expand sales of heat pumps in both China and Europe.

Continue Organic Growth Initiatives. We believe that the current PHE and related systems markets in China are fragmented and represent excellent opportunities for our subsidiaries to gain additional market share from their competitors. We expanded our business lines in recent years through strategic acquisitions and establishment of subsidiaries, including the acquisitions of SanDeKe, Siping Beifang, SmartHeat Pump and SmartHeat Germany. Each acquisition and new subsidiary has accelerated our strategic plans by: (i) adding manufacturing capacity; (ii) broadening our product offerings to include multiple heat exchange systems; (iii) facilitating access into new geographic regions throughout China; (iv) enhancing our engineering capabilities; and (v) helping us enter new and higher growth end markets both in China and Europe. Our subsidiaries intend to continue to market their brands to expand into new distribution channels, improve the quality of their products through their engineering capabilities and leverage their quality customer service and reliable product delivery to gain incremental business with their existing customers.

Pursue High Growth End Markets in China. Our subsidiaries target their sales efforts on a number of high growth end markets in China, such as the nuclear power, petrochemical and shipbuilding industries. They currently have a presence in these segments but believe there are significant opportunities to improve their market share by leveraging their premium product quality and high quality service. Their solutions are commonly used in many of these industries and customers continue to assess the cost savings and positive environmental attributes of PHEs.

Promote Heat Meters. In response to rising energy costs and an increased focus on energy efficiency, the PRC government and local utility companies made the use of heat meters compulsory in China. In July 2003, heat meters were required nationally by law for new buildings installed with central heating; this requirement was extended in April 2008 by the Energy Conservation Law, Article 38, to cover existing buildings being retrofitted. Our subsidiaries continue to work with the General Administration of Quality Supervision and Quarantine, an administrative organ established under the PRC’s State Council, to establish national heating standards in China. They also intend to leverage their brand names and reputation in the PHE market to gain market share.

Expand Heat Pump Sales. Heat pump systems are a rapidly growing market in China and the leading energy source for new buildings in Germany and Austria. Heat pumps have replaced conventional fossil fuel based technology to a large degree in these European countries for heating, cooling and hot water for residential and commercial buildings. As the PRC government continues to focus on emissions reduction and energy conservation, we believe there are significant opportunities for strong incremental growth in the residential and commercial markets in China. We anticipate our subsidiaries will expand sales of our heat pumps manufactured in China under EU design standards to the European market because our heat pump business has expanded its sales network.

Production

Our subsidiaries currently operate five manufacturing facilities in China, including our Taiyu plant in Shenyang, which is our principal manufacturing facility, and our SanDeKe, Siping Beifang, Ruicheng and SmartHeat Pump plants, and one manufacturing facility for heat pumps in Germany. Our manufacturing facilities, in the aggregate, currently have the capacity to produce approximately 2,000 PHEs, 900 PHE Units, 12,000 heat meters and 400 heat pumps monthly. Our operations in China generally operate on an 8-hour shift, with the exception of the high season from May to November, during which we may operate for 11-12 hours per day. Production is driven by orders from clients and typically is scheduled on a just-in-time delivery basis.

Marketing

Since initiating operations, our subsidiaries have emphasized the development of the SmartHeat and Taiyu brands in China, which are recognized and associated with quality production and first-rate service. Our subsidiaries have long-standing positive relationships with local governments in Beijing, Shenyang, Urumqi, Shandong, Jiangsu and Shanghai, and formed new relationships with local governments in Yingkou, Qingdao, Jiamusi and Harbin. Our subsidiaries regularly appear at industry trade shows, attending HVAC trade fairs in Shanghai and environmental protection forums in China. They also maintain positive relationships with local utilities, oil refiners, steel producers and food and beverage companies. Marketing costs generally are funded through working capital and expensed as incurred.

Suppliers

Plates and components together constituted approximately 42% of our raw material purchases in 2013 and 2012. Plates for PHEs and PHE Units are manufactured in our subsidiaries' facilities and also are purchased from Sondex under the terms of Taiyu's Sondex authorized dealer arrangement. While Taiyu is an authorized dealer of Sondex products, annual or quarterly purchasing prices are not fixed and fluctuate according to Sondex's most recent pricing list. Sondex plate purchases accounted for approximately 4% of our total annual raw material purchases in 2013.

Table of Contents

Components generally include pumps, valves, pipes and electronic meters purchased from a number of premium international and domestic suppliers who have been certified to meet our quality specifications. Representative component suppliers include Siemens, Wilo A.G. and Honeywell, as well as others. Our subsidiaries typically maintain a relatively small inventory of component parts for resale.

Customers

Our subsidiaries sell both directly through their sales force and through a network of national distributors located throughout China. All of their work is performed based on written contracts with customers and there are no oral contracts. Their customer base consists primarily of state-owned enterprises diversified across a number of end markets in China, such as real estate development, with one customer accounting for 10% of our sales in 2013 but no other customer accounting for more than 10% of our sales in 2013.

Intellectual Property

Our subsidiaries use the SmartHeat and Taiyu brand names on their products in China and the SmartHeat brand on their heat pumps in Europe. They have registered trademarks for their brand names with the China Trademark Bureau, which expire in 2020. We believe our subsidiaries' brand names are recognized in China's heating industry for quality and efficiency. In addition, we have registered and maintain numerous internet domain names related to our business, including "smartheatinc.com." Collectively, the trademarks and domain names that we and our subsidiaries hold are of material importance to us. We have 6 new registered patents in China in 2013 related to our products. We have altogether 23 registered patents in China related to our products, of which 4 expire in 2015, 2 in 2017, 2 in 2018, 5 in 2021, 4 in 2022 and 6 in 2023. We intend to apply for additional patents in China to protect our core product designs.

Research and Development

To maintain our subsidiaries' competitive edge in the marketplace and keep pace with new technologies, we believe it is important to devote resources to ongoing research and development to find improved efficiencies in design, cost and energy capture. Research and development costs for 2013 and 2012 were $1.42 million and $1.53 million, respectively. Our subsidiaries plan to continue to invest in research and development to identify new industry applications for PHEs, improve and expand product lines, develop multifunctional PHE Units and modify PHE designs to meet current market demand.

Competition

Our subsidiaries compete principally in the domestic China market. We believe their competitive advantages lie in superior engineering and design skills, the longevity and efficiency of the components they use, their ability to vertically integrate their manufacturing process, their just-in-time delivery and their reliable after-sales provided through local service centers. We also believe our subsidiaries' position as a PRC-based producer of PHEs and PHE Units in a marketplace previously dominated by foreign manufacturers creates an advantage when seeking new customers. They receive contracts for their products through bidding processes and negotiations directly with customers.

Our subsidiaries' principal competitors in the domestic China market for PHEs include Alfa Laval, APV, Tranter, Accessen, Lanshi and Juyuan, and foreign producers hold an approximately 50% market share. We believe the quality of our subsidiaries' PHEs is equal to those sold by Alfa Laval, as are their prices. In comparison with other domestic producers, our subsidiaries' prices for PHEs are approximately 10%-15% higher, reflecting a premium we believe attributable to the quality of their products and after-sales services.

The market for heat meters is extremely fragmented with multiple overseas and domestic producers and no established leader. Our subsidiaries continue to seek to become a leading supplier of heat meters in China.

We expanded into the heat pump market in China and Europe with our acquisitions of SmartHeat Pump and SmartHeat Germany in 2011. The markets for heat pumps in these markets are highly fragmented. These subsidiaries intend to focus on the middle high-end market for heat pumps in China, competing on price and customization capabilities with foreign and joint venture producers by leveraging their domestic manufacturing and engineering skills and advanced technology from SmartHeat Germany.

Seasonality

Our subsidiaries typically experience stronger sales in the third and fourth calendar quarters, which is the start of fall and winter in China. Our quarterly revenues may fluctuate significantly due to the seasonal nature of central heating services in China, where the equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall. We believe that as our subsidiaries expand their presence into other industries and sectors, this seasonality will be partially mitigated.

Table of Contents

Governmental and Environmental Regulation

Product and Business Regulations

Our business and company registrations are in compliance in all material respects with the laws and regulations of their respective governing municipal and provincial authorities. Our subsidiaries and manufacturing facilities in China are subject to the national and local laws of the PRC. Other than as described following, our subsidiaries are not subject to any other government regulations that would require them to obtain a special license or approval from the PRC government to operate their business or manufacturing facilities in China.

Our subsidiaries' PHEs and PHE Units are not subject to material regulation by the PRC government or other national agencies. They have obtained PRC National Safety Certification for PHE products and are ISO 9001 quality management certified, which together recognizes their commitment to safety and quality in the manufacturing processes. Although not required for the production and sale of PHE products in China, the PRC National Safety Certification is of critical importance in choosing a PHE provider for companies in industries utilizing high temperatures or pressure in their production processes.

Manufacture and sale of heat meters and heat pumps in China require licenses issued by the PRC government. Our subsidiaries that manufacture these products received these licenses in 2005 and 2008, respectively, and continue to maintain them through renewals. The Safety Bureau overseeing heat meter and heat pump production conducts site visits and inspections of documents on a periodic basis to verify adherence to PRC manufacturing standards. Additionally, due to rising energy costs and the increased sensitivity to environmental issues, PRC government and local utility companies have made the use of heat meters compulsory in China. As of July 2003, heat meters were required nationally by law for new construction installed with central heating and. In April 2008, the Energy Conservation Law, Article 38, extended the requirement to cover retrofitted buildings. SmartHeat Germany is not required to maintain any license for the manufacture and sale of heat pumps in Germany. The European Commission has promulgated standards, such as EN 378 Safety and Environmental Requirements, for heat pumps and products sold in the European Union must carry CE marking, indicating conformity with such requirements. We believe that SmartHeat Germany's heat pumps sold in Europe comply with all currently applicable standards.

Environmental Regulations

Our subsidiaries' manufacturing facilities in China are subject to the national environmental regulations of the PRC as well as local laws regarding pollutant discharge, air, water and noise pollution, including the Environmental Protection Law of the PRC, the Environmental Impact Appraisal Law of the PRC, the Law of the PRC on the Prevention and Control of Water Pollution, the Law of the PRC on Prevention and Control of Environmental Pollution Caused by Solid Waste, the Law of the PRC on Prevention and Control of Air Pollution and the Law of the PRC on Prevention and Control of Environmental Noise Pollution. The Environmental Protection Law of the PRC sets out the legal framework for environmental protection in the PRC. The Ministry of Environmental Protection of the PRC, or the MEP, is primarily responsible for the supervision and administration of environmental protection work nationwide and formulating national waste discharge limits and standards. Local environmental protection authorities at the county level and above are responsible for environmental protection in their jurisdictions. Companies that discharge contaminants must report and register with the MEP or the relevant local environmental protection authorities. Companies discharging contaminants in excess of the discharge limits prescribed by the central or local authorities must pay discharge fees for the excess in accordance with applicable regulations and are also responsible for the treatment of the excessive discharge. Companies that directly or indirectly discharge industrial wastewater into the water or are required by law to obtain the pollutant discharge permit before discharging wastewater or sewage shall also obtain the pollutant discharge permit.

Our subsidiaries in China have received PRC government certification of their operating facilities in China indicating that their businesses are in material compliance with the relevant PRC environmental laws and regulations. Our manufacturing subsidiaries are ISO 9001 quality management and ISO 14001 environmental management systems certified, which together recognize their development and implementation of procedures that demonstrate an ability to consistently manufacture products meeting customer specifications, environmental standards and applicable statutory and regulatory requirements. Our subsidiaries' production processes mainly generate noise, wastewater and solid wastes. They currently do not incur any material costs in connection with their compliance with the applicable PRC environmental laws as our manufacturing processes generate minimal discharge. Furthermore, the cost of maintaining compliance has not, and we believe, in the future, will not, have a material adverse effect on our business, consolidated results of operations and consolidated financial condition.

Table of Contents

Labor Protection Regulations

The Labor Contract Law of the PRC, effective on January 1, 2008, governs the establishment of employment relationships between employers and employees, and the conclusion, performance, termination of and the amendment to employment contracts. To establish an employment relationship, a written employment contract must be signed by the employer and employee. In the event that no written employment contract was signed at the time of establishment of an employment relationship, a written employment contract must be signed within one month after the date on which the employer first engaged the employee. The Labor Contract Law also imposes greater liabilities on employers and significantly affects the cost of an employer's decision to reduce its workforce. Further, it requires that certain terminations be based upon seniority and not merit. We believe that our subsidiaries in the PRC are in material compliance with the requirements of this law.

On June 29, 2002, the Work Safety Law of the PRC was adopted by the Standing Committee of the 9th National People's Congress and came into effect on November 1, 2002, as amended on August 27, 2009. The Work Safety Law provides general work safety requirements for entities engaging in manufacturing and business activities within the PRC. We believe our PRC subsidiaries are in material compliance with all applicable laws and regulations related to work safety.

Foreign Currency Regulations

The principal regulations governing foreign currency exchange in China are the Foreign Exchange Administration Regulations promulgated by the State Council, as amended on August 5, 2008, or the Foreign Exchange Regulations. Under the Foreign Exchange Regulations, the RMB, the national currency of the PRC, is freely convertible for current account items, including the distribution of dividends, interest payments, trade and service-related foreign exchange transactions, but not for capital account items, such as direct investments, loans, repatriation of investments and investments in securities outside of China, unless the prior approval of the State Administration of Foreign Exchange, or the SAFE, is obtained and prior registration with the SAFE is made.

On October 21, 2005, the SAFE issued Circular 75, the Relevant Issues Concerning Foreign Exchange Control on Domestic Residents' Corporate Financing and Roundtrip Investment through Offshore Special Purpose Vehicles, which became effective as of November 1, 2005. Please refer to "Risk Factors – Risks Related to Business in China – PRC regulations relating to the registration requirements for PRC resident shareholders owning shares in offshore companies may subject our PRC resident shareholders to personal liability and limit our ability to acquire companies in China or to inject capital into our operating subsidiaries in China, limit our subsidiaries' ability to distribute profits to us or otherwise materially and adversely affect our business" for a discussion of Circular 75.

On August 29, 2008, the SAFE promulgated Circular 142, the Notice on Perfecting Practices Concerning Foreign Exchange Settlement Regarding the Capital Contribution by Foreign-invested Enterprises, regulating the conversion by a foreign-invested company of foreign currency into RMB by restricting how the converted RMB may be used. Please refer to "Risk Factors – Risks Related to Business in China – Restrictions on currency exchange may limit our ability to receive and use our revenues effectively" for a discussion of Circular 142.

Dividend Distribution

Our ability to pay dividends is affected by the complex currency and capital transfer regulations in China that restrict the payment of dividends to us by our PRC subsidiaries. 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 net income after taxes based on PRC accounting standards each year to statutory surplus reserves until the cumulative amount of such reserves reaches 50% of registered capital.

These reserves are not distributable as cash dividends. Our PRC subsidiaries also may allocate a portion of their after-tax profits to their staff welfare and bonus funds, which may not be distributed to equity owners except in the event of liquidation. If any of our subsidiaries incur debt, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us.

Employees

We do not have direct employees. However, as of December 31, 2013, our subsidiaries had 569 full time employees and 46 seasonal employees in China and Germany, among which 432 employees work in PHE segment while 183 employees work in HP segment. Our subsidiaries maintain strong ties with their employees and staff and retention is stable. Employee contracts in China adhere to both state and provincial employment regulations and all social security regulations. All compensation, including social insurance, is paid in a timely manner to authorities and employees. There have been no disputes to date and there are no collective bargaining agreements.

Table of Contents

Item 1A. Risk Factors

Our business and an investment in our securities are subject to a variety of risks. The following risk factors describe the most significant events, facts or circumstances that could have a material adverse effect upon our business, financial condition, results of operations, ability to implement our business plan, and the market price for our securities. Many of these events are outside of our control. If any of these risks actually occurs, our business, financial condition or results of operation may be materially adversely affected. In such case, the trading price of our common stock could decline and investors in our common stock could lose all or part of their investment.

Risks Related to Our Business

We are a holding company that depends on cash flow from our wholly owned subsidiaries to meet our obligations, and any inability of our subsidiaries to pay us dividends or make other payments to us when needed could disrupt or have a negative impact on our business.

After our acquisition of Taiyu in 2008, we became a holding company with no material assets other than the ownership interests of our subsidiaries through which we conduct operations. We rely on dividends paid by our subsidiaries 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. China has currency and capital transfer regulations that require us to comply with complex regulations for the movement of capital. 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 net income after taxes based on PRC accounting standards each year to statutory surplus reserves until the cumulative amount of such reserves reaches 50% of registered capital. These reserves are not distributable as cash dividends. Our PRC subsidiaries also may allocate a portion of their after-tax profits to their staff welfare and bonus funds, which may not be distributed to equity owners except in the event of liquidation. Furthermore, if any of our subsidiaries incur debt, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us. Accordingly, if our subsidiaries are unable to pay us dividends and make other payments to us when needed because of regulatory restrictions or otherwise, we may be materially and adversely limited in our ability to make investments or acquisitions that could be beneficial to our business, pay dividends or otherwise fund and conduct our business.

Our subsidiaries have generated losses from operations in the fiscal years ended December 31, 2012 and 2011. As such, our subsidiaries have been unable to remit funds to us for the payment of our obligations. To fulfill our need for short-term financing, on July 27, 2012, we executed a Credit Agreement with Northtech, which, as amended, provides us with a $2,500,000 revolving line of credit with amounts borrowed due April 30, 2014. We believe this line of credit will be sufficient to satisfy our operating costs through mid 2014.

We are also pursuing other options, including restructuring operations at the subsidiary level to regain profitability and entering into management and services agreements with our subsidiaries, subject to the approval of regulatory agencies in China. However, we cannot provide any assurances that these measures will be adequate to satisfy our liquidity needs, and if we are not able to obtain sufficient funds from our subsidiaries to pay our obligations as they come due, our business could be negatively impacted.

We face risks associated with a purported securities class action lawsuit, which if successful, could have a material adverse effect on our results of operations and could harm our reputation.

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 offers 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 for 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 on the grounds that the plaintiffs did not, in fact, allege that a member of our senior management team had sold their shares. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice to move again for such certification pending (1) the resolution of Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. 2014)by the Supreme Court of the United States regarding the viability of the efficient market theory andthe plaintiffs' claim that reliance, and therefore injury, can be determined on a classwide basis and(2) defendants' compliance with their discovery obligations. Any adverse decision in this action, requiring us to pay substantial damages to the plaintiffs could result in a material adverse effect on our results of operations and could harm our reputation. We believe this lawsuit is frivolous and without merit and will contest it vigorously. Please see Item 3 "Legal Proceedings" for additional information with respect to this matter.

Table of Contents

The markets served by our subsidiaries are subject to seasonality and cyclical demand, which could harm our business and make it difficult to project long-term performance.

Demand for our subsidiaries' products depends in part upon the level of capital and maintenance expenditures of their customers and end users. These expenditures historically have been cyclical in nature and vulnerable to economic downturns. Decreased capital and maintenance spending by our subsidiaries' customers could have a material adverse effect on the demand for their products and our business, financial condition and results of operations. In particular, an economic slowdown in the domestic China economy may result in reduced orders for PHEs from the steel processing and petrochemical sectors and lower orders for PHE Units from the HVAC sector. In response to inflationary concerns, the PRC government instituted tightened fiscal policies in 2011 that contributed to a general slowdown in many sectors of China's economy and restricted bank lending practices. Accordingly, many state-owned enterprises in China, including real estate developers, encountered difficulties in 2011 and 2012 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 subsidiaries' products. If the PRC government continues its deflationary policies and efforts to stabilize economic growth in China, such disruptions may continue to adversely impact the capital needs of our subsidiaries' customers, which, in turn, could adversely affect our results of operations, cash flows and financial condition. Additionally, the historically cyclical nature of the demand for our subsidiaries' products limits our ability to make accurate long-term predictions about our performance, however.

Furthermore, sales of heat exchangers and related systems may fluctuate significantly due to the seasonal nature of central heating services in the PRC because the equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall, which occurs during the third and fourth calendar quarters in China. To date, our subsidiaries have not been adversely affected by these seasonality trends and, given the current demand visibility, we do not currently foresee weakening in the demand for their products going forward in the next year. However, the seasonality of our subsidiaries' business may result in significant operational challenges to their production and inventory control functions.

Our subsidiaries' accounts receivables remain outstanding for a significant period of time, which has a negative impact on our cash flow and liquidity.

Our subsidiaries' agreements with their 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. 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 been forced to adjust their contract terms to permit for more flexible and longer payment terms.

We record revenue and corresponding accounts receivable when products are delivered to customers, and for PHE Units, when customer acceptance occurs following delivery. Payments received prior to product delivery, or customer acceptance for PHE Units, are recorded as unearned revenue. Our subsidiaries may experience payment delays from time to time, which historically have ranged from 1 to 3 months from the due date. While these payment delays are common in the heating manufacturing industry in China, such delays cause capital to be tied up in receivables, which may result in pressure on our cash flows and liquidity. In 2013, we had accounts receivable turnover of 1.94, with days sales outstanding of 186 and inventory turnover of 0.61. In 2012, we had accounts receivable turnover of 1.21, with days sales outstanding of 303 and inventory turnover of 0.58. The low accounts receivable turnover and high days outstanding in 2013 is due to an unexpected abandonment of projects, cancelation of orders and delays in the performance of PHE and PHE Unit contracts from certain state-owned customers due to the tightened fiscal policy in China during 2012. The low inventory turnover in 2013 was due to increased raw materials inventory on hand for the readiness of the high production season during the second half of 2013 and increased finished goods inventory resulting from orders that have been delayed or canceled in 2013. While historically collections have been reasonably assured, delays in collections and the significant period of time our subsidiaries' accounts receivable remain outstanding may negatively impact our cash flow and liquidity.

Our subsidiaries acquire most components for the manufacture of their products from a limited number of suppliers, and if they are unable to obtain these components, they would experience manufacturing delays and our financial results could be adversely affected.

Our subsidiaries acquire most of the components for the manufacture of their products from a limited number of suppliers. To manufacture their products, these components must be available when needed, at the right level of quality and at the right price. If they are unable to obtain these components accordingly, they would experience delays in manufacturing their products and our financial results could be adversely affected. Suppliers of some of these components require our subsidiaries to place orders with significant lead-time to assure supply in accordance with their requirements. Certain of these suppliers are currently the sole source of one or more components upon which our subsidiaries are dependent and alternative sources would not be available for those components unless our subsidiaries were to redesign their products. Other components could be obtained from alternate suppliers without redesign, but only at higher prices than our subsidiaries currently pay or for delivery later than required by their production schedule. Our subsidiaries maintain a relatively small inventory of component parts for resale and their parts services business would suffer if the supply of replacement parts was reduced or terminated by their suppliers. If suppliers are not able to provide these critical components on the dates and at the prices scheduled, our subsidiaries may not be able to manufacture their products promptly and cost-effectively to meet customer orders, which could harm their credibility and the market acceptance and sales of their products.

Table of Contents

Our subsidiaries are a major purchaser of certain goods and raw materials that they use in the manufacturing process of their products, and price changes for the commodities they depend on may adversely affect our profitability.

Our profitability depends upon the margin between the cost to our subsidiaries of certain goods used in the manufacturing process, such as plates, pumps, water tanks, sensors, controlling systems and other raw materials, as well as their fabrication costs associated with converting such goods and raw materials compared to the selling price of their products, and the overall supply of raw materials. Our subsidiaries have 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 for their PHEs and PHE Units. Our subsidiaries monitor the commodities markets for pricing trends and changes, but do not engage in hedging transactions to protect against raw material fluctuations. Instead, our subsidiaries attempt to mitigate the short-term risks of price swings by purchasing raw materials in advance based on production needs and projected sales. However, they may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of the raw materials through to their customers. Although they are currently able to obtain adequate supplies of raw materials, it is impossible to predict future availability or cost. With the rapid growth of China’s economy, the demand for certain raw materials is great while the supply may be more limited. This may affect our subsidiaries ability to secure the necessary raw materials in a cost-effective manner for production of their products at the volume of purchase orders that they anticipate receiving. The inability to offset price increases of raw materials by sufficient product price increases, and an inability to obtain raw materials, would have a material adverse effect on our consolidated financial condition, results of operations and cash flows.

Our subsidiaries may experience material disruptions to their manufacturing operations in China that could result in material delays, quality control issues, increased costs and loss of business opportunities, which may negatively impact our sales and financial results.

Our subsidiaries rely on our manufacturing facilities in China to operate our business and produce our products. While they seek to operate their facilities in compliance with applicable rules and regulations and take measures to minimize the risks of disruption at their facilities, a material disruption at one of our subsidiaries’ manufacturing facilities could prevent them from meeting customer demand, reduce their sales and negatively impact our financial results. Any of their manufacturing facilities, or any of their machines within an otherwise operational facility, could cease operations unexpectedly due to a number of events, including: prolonged power failures; equipment failures; disruptions in the transportation infrastructure including roads, bridges, railroad tracks; fires, floods, earthquakes or other catastrophes; and other operational problems. Any such material disruption may prevent our subsidiaries from shipping their products on a timely basis, reduce their sales and market share and negatively impact our financial results.

Our subsidiaries may not be able to obtain regulatory approvals for their products, which could result in a decrease in clients and revenue, unexpected expenses and loss of market share.

Some of our subsidiaries products are subject to PRC and international regulations related to the heating manufacturing industry. Manufacturers of heat meters and heat pumps in China require licenses issued by the PRC government to produce and sell these products in the domestic market. The Safety Bureau overseeing heat meter and heat pump production conducts site visits and inspections of documents on a periodic basis to verify adherence to the standards. PHEs and PHE Units are not subject to material regulation by the PRC government or other national agencies, but many purchasers of these products in industries utilizing high temperatures or pressure in the production process prefer to source from manufactures that have obtained a PRC National Safety Certification for their PHE products. The European Commission has promulgated standards, such as EN 378 Safety and Environmental Requirements, for heat pumps and products sold in the European Union must carry CE marking, indicating conformity with such requirements. As of December 31, 2013, our subsidiaries had no regulatory approvals pending for our products or that we need to obtain to conduct our business. Our subsidiaries received licenses to manufacture and sell heat meters and heat pumps in China in 2005 and 2008, respectively, which are continuing to be maintained through renewals. Our subsidiaries seek to manufacture all products to customer specifications and believe that their products meet all currently applicable national test standards. Any failure to manufacture and deliver products in compliance with all applicable standards and regulations for the markets in which our subsidiaries' products are distributed may subject them to fines, penalties or business interruptions and could result in a decrease in clients or loss of market share. In addition, new or revised standards and regulations applicable to our subsidiaries' products could require them to redesign existing and planned products, acquire new manufacturing equipment or incur other significant expenses. If our subsidiaries are not able to obtain regulatory approvals for our products based on the applicable standards and regulations, it could have material and adverse effects on our business, financial condition and prospects.

Table of Contents

We cannot be certain that our subsidiaries' product innovations will continue or that their technology will continue to satisfy the changing needs of their customers, which could result in a decrease in clients and revenue, unexpected expenses and loss of market share.

We believe that our subsidiaries' past performance has been based on, and that their future success will depend, in part, upon their ability to continue to improve their existing products through product innovation and to develop, market and produce new products. We cannot assure you our subsidiaries will be successful in introducing, marketing and producing any new products or product innovations, or that they will develop and introduce in a timely manner innovations to their existing products which satisfy customer needs or achieve market acceptance. Our subsidiaries' failure to develop new products and introduce them successfully and in a timely manner could harm our ability to grow our business and could have a material adverse effect on our business, results of operations and financial condition.

As with any technology, including the technology of our subsidiaries' current and proposed products, there are risks that the technology may not successfully address all of customers' needs. While our subsidiaries have already established successful relationships with their customers, customers needs may change or vary. This may affect the ability of our subsidiaries' present or proposed products to address all of their customers' ultimate technology needs in an economically feasible manner. Our success depends upon their ability to anticipate and respond in a timely manner to changes in the heating manufacturing industry. If they fail to identify and respond to these changes, their sales could decline and they could lose clients and market share, any of which could materially harm our business. Furthermore, if they are unable to continue to meet their clients' needs with their current product lines, they may be required to redesign existing and planned products, acquire new manufacturing equipment or incur other significant expenses.

Our subsidiaries may not be able to keep pace with rapid technological changes and competition in their industry, which could adversely impact our business, revenues and operations.

Our subsidiaries believe they have hired or engaged personnel and outside consultants who have the experience and ability necessary to help them keep pace with advances in technology in the heating manufacturing industry. While they continue to seek out and develop "next generation" technology through their research and development efforts, there is no guarantee that they will be able to keep pace with technological developments and market demands in an evolving industry and market. In addition, our subsidiaries' industry is highly competitive. Although we believe they have developed strategic relationships that will assist them to best penetrate the domestic China market, they face competition from other manufacturers of products similar to their products. Some of our competitors' advantages over our subsidiaries in the areas of products, marketing and services include: substantially greater revenues and financial resources; stronger brand names and consumer recognition; the capacity to leverage marketing expenditures across a broader portfolio of products; pre-existing relationships with potential customers; more resources to make acquisitions; lower labor and development costs; and broader geographic presence. Furthermore, our subsidiaries may experience delays in bringing new products to market, due to design, manufacturing or distribution problems. Any such delays could adversely affect their ability to compete effectively and may adversely affect their relationship with their customers. If our subsidiaries are unable to keep pace with the rapid technological changes and competition in their industry and market, our business, revenues and operations could be adversely impacted.

Our subsidiaries products may contain defects, which if subject to product liability and warranty claims, could adversely affect our subsidiaries reputation and cause us to incur significant costs.

Due to the high pressures and temperatures at which many of our subsidiaries' products are used, and the fact that some of their products are relied upon by customers or end users in their facilities or operations, or are manufactured for relatively broad consumer use, our subsidiaries face an inherent risk of exposure to claims in the event that the failure, use or misuse of our products results, or is alleged to result, in bodily injury, property damage or economic loss. We believe our subsidiaries meet or exceed existing professional specification standards recognized or required in the industries in which they operate. Despite testing, however, defects may be found in our subsidiaries' existing or new products. If they deliver products with defects, their credibility and the market acceptance and sales of their products could be harmed. Any such defects could cause them to undertake a product recall program, which would result in significant return and exchange costs, re-engineering costs, divert the attention of their engineering personnel from product development efforts and cause significant problems with customer relations and business reputation. Our subsidiaries have been subject to product liability and warranty claims in the past, none of which has had a material adverse effect on our financial condition or results of operations, and our subsidiaries may be subject to claims in the future. Although our subsidiaries currently maintain product liability coverage, which our subsidiaries believe is adequate for the continued operation of their business, such insurance may become difficult to obtain or may become unobtainable in the future on terms acceptable to our subsidiaries and may not cover warranty claims. A successful product liability claim or series of claims against our subsidiaries, including one or more consumer claims purporting to constitute class actions, in excess of our subsidiaries insurance coverage or a significant warranty claim or series of claims against our subsidiaries could materially decrease our liquidity and impair our financial condition.

Table of Contents

Our subsidiaries could be subject to environmental liabilities in China, which could result in them incurring significant remediation costs, fines and loss of our business license.

As is the case with manufacturers of similar products, our subsidiaries use certain hazardous substances in our operations in China. Currently, their business is subject to the Environmental Protection Law of the PRC as well as other national and local laws in China regarding pollutant discharge, air, water and noise pollution. Although we believe our subsidiaries are in compliance in all material respects with the applicable PRC environmental laws and regulations, if it is determined that they are in violation of these regulations, they could be subject to financial penalties as well as the loss of their business license. Furthermore, if the national or local government in China adopts more stringent environmental regulations, our subsidiaries may incur significant costs in complying with such regulations. If our subsidiaries fail to comply with present or future environmental regulations, they may be required to pay substantial fines and remediation costs, suspend production or cease operations and may be subject to adverse publicity. Our subsidiaries currently do not incur any material costs in connection with their compliance with the applicable PRC environmental laws. However, the risk of environmental liability and charges associated with maintaining compliance with PRC environmental laws is inherent in the nature of their business, and there is no assurance that material environmental liabilities and compliance charges will not arise in the future.

Our subsidiaries insurance coverage in China may be inadequate to protect them from potential losses.

The insurance industry in China is in its early stage of development and the business interruption insurance and the product liability insurance available currently in China offers limited coverage compared to that offered in many other countries, especially in the U.S. Any business disruption or natural disaster could result in substantial costs and a diversion of resources, which would have a material and adverse effect on our business and results of operations. Our subsidiaries in China, particularly their production facilities in Shenyang, involve risks and hazards that could result in damage to, or destruction of, property and machinery, personal injury, business interruption and possible legal liability. Our subsidiaries currently carry property and casualty insurance for their buildings, plant and equipment, but we cannot assure you that the coverage will be adequate to fully replace damage to any of the foregoing. Should any natural catastrophes such as earthquakes, floods or any acts of terrorism occur where our subsidiaries' primary operations are located and most of their employees are based, or elsewhere, our subsidiaries might suffer not only significant property damage, but also loss of revenues due to interruptions in their business operations. Our subsidiaries are unable to acquire product liability insurance in China because it is not currently available for their product lines, but our German subsidiary does maintain product liability coverage in that we believe is adequate for the continued operation of our business in Europe, but such insurance may become difficult to obtain or may become unobtainable in the future on terms acceptable to us and may not cover warranty claims. A successful product liability claim or series of claims against any of our subsidiaries, including one or more consumer claims purporting to constitute class actions, in excess of our subsidiaries' insurance coverage or a significant warranty claim or series of claims against us could materially decrease our liquidity and impair our financial condition. The occurrence of a significant event for which our subsidiaries are not fully insured or indemnified, or the failure of a party to meet its underwriting or indemnification obligations, could materially and adversely affect our operations and financial condition. Moreover, no assurance can be given that our subsidiaries will be able to maintain adequate insurance in the future at rates they consider reasonable.

If our subsidiaries lose their key personnel or are unable to attract and retain additional qualified personnel, the quality of their services may decline and our business may be adversely impacted.

Our subsidiaries rely heavily on the expertise, experience and continued services of their management, including our former Chairman, President and Chief Executive Officer, Jun Wang, who is now solely general manager of our subsidiaries in China. Loss of his services could adversely affect our subsidiaries ability to achieve their business objectives. Mr. Wang is a key factor in our subsidiaries success at developing and introducing new products and establishing new customer relationships because of his industry experience and reputation. The continued development of our subsidiaries' business depends upon his continued employment. Our subsidiary Taiyu has entered into an employment agreement with Mr. Wang, which contains provisions prohibiting competition with our subsidiaries should he leave their employ.

We believe our future success will depend upon our subsidiaries' ability to retain Mr. Wang and other key employees and their ability to attract and retain other skilled personnel. The rapid growth of the economy in China has caused intense competition for qualified personnel. We cannot guarantee that any employee will remain employed by our subsidiaries for any period of time or that they will be able to attract, train or retain qualified personnel in the future. Such loss of personnel could have a material adverse effect on our business and company. Qualified employees periodically are in great demand and may be unavailable in the time frame required to satisfy our subsidiaries' customers' requirements. There is no assurance our subsidiaries will be able to attract and retain sufficient numbers of highly skilled employees in the future. The loss of personnel or our subsidiaries inability to hire or retain sufficient personnel at competitive rates could impair the growth of their business.

Table of Contents

Our subsidiaries' bank accounts in China are not insured or protected against loss, and the failure of any bank in which our subsidiaries deposit funds could affect their ability to continue in business.

Our subsidiaries maintain their cash in China with various national banks in China. These cash accounts are not insured or otherwise protected against loss. Should any bank holding our cash deposits become insolvent, or if our subsidiaries are otherwise unable to withdraw funds, they would lose the cash on deposit with that particular bank. Depending upon the amount of cash our subsidiaries maintain in a bank that fails, their inability to have access to such cash deposits could impair their operations, and, if they are not able to access funds to pay their suppliers, employees and other creditors, they may be unable to continue in business.

We may need additional capital to execute our business plan and fund operations and may not be able to obtain such capital on acceptable terms or at all.

In connection with the ongoing development and expansion of our business, we may incur significant expenses. We believe that we can increase our sales and net income by implementing a growth strategy that focuses on increasing sales of our subsidiaries' products in China by targeting high growth end markets and expanding sales of heat pumps in China and Europe. Management anticipates that our existing capital resources and proceeds from amounts borrowed under our Credit Agreement with Northtech will satisfy the liquidity requirements of our business until the middle of 2014. However, if available funds are not sufficient to meet our current operating expenses, our plans include pursuing alternative financing arrangements, including bank loans based on our good credit rating or funds raised through offerings of our equity or debt, if and when we determine such offerings are required. Our ability to obtain additional capital on acceptable terms or at all is subject to a variety of uncertainties, including:

- investors' perceptions of, and demand for, companies in our industry;
- investors' perceptions of, and demand for, companies operating in China;
- conditions of the U.S. and other capital markets in which we may seek to raise funds;
- our future results of operations, financial condition and cash flows;
- governmental regulation of foreign investment in companies in particular countries;
- economic, political and other conditions in the U.S., China and other countries; and
- governmental policies relating to foreign currency borrowings.

There is no assurance we will be successful in locating a suitable financing transaction in a timely fashion or at all. In addition, there is no assurance we will obtain the capital we require by any other means. Future financings through equity investments are likely to be dilutive to our existing shareholders. Also, the terms of securities we may issue in future capital transactions may be more favorable for our new investors. Newly-issued securities may include preferences or superior voting rights, be combined with the issuance of warrants or other derivative securities, or be the issuances of incentive awards under equity employee incentive plans, which may have additional dilutive effects. Furthermore, we may incur substantial costs in pursuing future capital and financing, including investment banking fees, legal fees, accounting fees, printing and distribution expenses and other costs. We may also be required to recognize non-cash expenses in connection with certain securities we may issue, such as convertible notes and warrants, which will adversely impact our financial condition.

If we cannot raise additional funds on favorable terms or at all, we may not be able to carry out all or parts of our strategy to maintain our growth and competitiveness or to fund our subsidiaries' operations. If the amount of capital we are able to raise from financing activities, together with our revenues from operations, is not sufficient to satisfy our capital needs, even to the extent that we reduce our operations accordingly, we may be required to cease operations.

Our subsidiaries may not be able to protect their technology and other proprietary rights adequately, which could adversely affect their competitive position and reduce the value of their products and brands, and litigation to protect their intellectual property rights may be costly.

Our subsidiaries attempt to strengthen and differentiate their product lines by developing new and innovative product designs and functionality. As a result, their patents, trademarks and other intellectual property rights are important assets to their business. Our success will depend in part on our subsidiaries ability to obtain and protect their products, methods, processes and other technologies, to preserve their trade secrets and to operate without infringing on the proprietary rights of third parties in China and abroad. Despite our subsidiaries' efforts to preserve their intellectual property rights, any of the following occurrences may reduce the value of their intellectual property:

Table of Contents

- Issued patents and trademarks may not provide our subsidiaries with any competitive advantages;

- Our subsidiaries' efforts to protect their proprietary rights may not be effective in preventing misappropriation of their intellectual property;

- Our subsidiaries' efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those they develop; or

- Another party may obtain a blocking patent and our subsidiaries would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in their products.

Effective protection of our subsidiaries intellectual property rights may be unavailable or limited in China or certain other countries. Policing the unauthorized use of our subsidiaries proprietary technology can be difficult and expensive. Litigation might be necessary to protect their intellectual property rights, which may be costly and may divert management's attention away from their core business. Furthermore, there is no guarantee that litigation would result in an outcome favorable to our subsidiaries. If our subsidiaries are unable to protect their proprietary rights adequately, it would have a negative impact on our operations.

Our subsidiaries may be subject to claims that we have infringed the proprietary rights of others, which could require them to obtain a license or change their designs.

Although our subsidiaries do not believe any of their products infringe upon the proprietary rights of others, there is no assurance that infringement or invalidity claims, or claims for indemnification resulting from infringement claims, will not be asserted or prosecuted against them or that any such assertions or prosecutions will not have a material adverse effect on their business. Regardless of whether any such claims are valid or can be asserted successfully, defending against such claims could cause our subsidiaries to incur significant costs and could divert resources away from other activities. In addition, assertion of infringement claims could result in injunctions that prevent our subsidiaries from distributing their products. If any claims or actions are asserted against them, our subsidiaries may seek to obtain a license to the intellectual property rights that are in dispute. Such a license may not be available on reasonable terms, or at all, which could force our subsidiaries to change their designs.

If we fail to maintain an effective system of internal controls, we may not be able to report our financial results accurately. Any inability to report and file our financial results accurately and timely could harm our business and adversely affect the trading price of our common stock.

We are required to establish and maintain internal controls over financial reporting, disclosure controls and procedures and to comply with other requirements of the Sarbanes-Oxley Act and the rules promulgated by the SEC. Our management, including our President and Acting Chief Accountant, cannot guarantee our internal controls and disclosure controls will prevent all possible errors. Because of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the possibility that judgments in decision-making can be faulty and subject to simple error or mistake. Furthermore, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may become inadequate because of changes in conditions or the degree of compliance with policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected. Our inability or failure to report and file our financial results accurately and timely could harm our business and the trading price of our common stock.

Our management carried out an evaluation of the effectiveness of our internal control over financial reporting and concluded that our internal control over financial reporting was not effective as of December 31, 2013, because of one identified material weakness in our internal control over financial reporting. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of our financial statements will not be prevented, or detected and corrected on a timely basis. The material weakness identified relates to the lack of sufficient internal accounting personnel with appropriate levels of knowledge, experience and training in generally accepted accounting principles in the U.S., or U.S. GAAP, for the preparation of financial statements in accordance with U.S. GAAP. Furthermore, our management concluded that, as of December 31, 2013 our disclosure controls and procedures were not effective because of this identified material weakness in our internal control over financial reporting. See "Item 9A. Controls and Procedures." Our Board of Directors and management are evaluating remediation measures that we will undertake to address this material weakness and will continue this evaluation in order to implement a comprehensive remediation plan. Until such time as we hire qualified accounting staff or train our current accounting staff with the requisite U.S. GAAP experience, however, it is unlikely we will be able to remediate this material weakness in our internal control over financial reporting.

Table of Contents

Our accounting personnel who are primarily responsible for the preparation and supervision of the preparation of our financial statements under U.S. GAAP have limited relevant education and training in U.S. GAAP and SEC rules and regulations pertaining to financial reporting, which could impact our ability to prepare our financial statements and convert our books and records to U.S. GAAP.

Our operations principally are in China and we have maintained our books and records in accordance with generally accepted accounting principles in the PRC, or PRC GAAP. Our accounting personnel in the PRC who have the primary responsibilities of preparing and supervising the preparation of financial statements under U.S. GAAP have limited relevant education and training in U.S. GAAP and related SEC rules and regulations. As such, they may be unable to identify potential accounting and disclosure issues that may arise upon the conversion of our books and records from PRC GAAP to U.S. GAAP, which could affect our ability to prepare our financial statements in accordance with U.S. GAAP. We have taken steps to ensure that our financial statements are prepared in accordance with U.S. GAAP, including our hiring of a U.S. accounting firm to work with our PRC accounting personnel and management to convert our books and records to U.S. GAAP and prepare our financial statements. However, the measures we have taken may not be sufficient to mitigate the foregoing risks associated with the limited education and training of our accounting personnel in U.S. GAAP and related SEC rules and regulations.

Risks Related to Doing Business in China

Changes in China's political and economic policies could have a material adverse effect on the overall economic growth of China, which could reduce the demand for our subsidiaries' products and adversely affect our business.

Substantially all of our manufacturing and productive assets are located in China and a significant percentage of our revenue is derived from our operations in China. Accordingly, our results of operations and prospects are subject to the economic, political and legal developments in China. While China's economy has experienced significant growth in the past twenty years, such growth has been uneven, both geographically and among various sectors of the economy. The PRC government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures may have a negative effect on us. For example, our operating results and financial condition may be adversely affected by PRC government control over capital investments or changes in tax regulations. In recent years, the PRC government has implemented measures emphasizing the utilization of market forces for economic reform and the reduction of state ownership of productive assets, and the establishment of corporate governance in business enterprises; however, a substantial portion of productive assets in China are still owned by the PRC government. In addition, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, the control of payment of foreign currency-denominated obligations, the setting of monetary policy, the control of the housing and real estate market and the provision of preferential treatment to particular industries or companies. Any adverse change in the economic conditions or government policies in China could have a material adverse effect on the overall economic growth and level of capital expenditures in China, which in turn could lead to reduced demand for our subsidiaries' products and consequently have a material adverse effect on our business. Furthermore, changes in policies, laws and regulations or in their interpretation or the imposition of confiscatory taxation, restrictions on currency conversion, restrictions or prohibitions on dividend payments to shareholders, or devaluations of currency could cause a decline in the price of our common stock.

We may have difficulty establishing adequate management, legal and financial controls in China, which could affect our ability to report our financial results accurately and timely.

Historically, China has not adopted an international style of management or financial reporting concepts and practices, nor modern banking, computer and other control systems. We may have difficulty in hiring and retaining a sufficient number of qualified employees to work in China. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls, collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices for our subsidiaries in China that meet international standards.

If relations between the U.S. and China worsen, our business could be adversely affected and investors may be unwilling to hold or buy our stock and our stock price may decrease.

At various times during recent years, the U.S. and China have had significant disagreements over political and economic issues. Controversies may arise in the future between these two countries. Any political or trade controversies between the U.S. and China, whether or not directly related to our business, could reduce the price of our common stock.

Table of Contents

The nature and application of many laws of China create an uncertain environment for business operations and they could have a negative effect on our subsidiaries.

The legal system in China is a civil law system. Unlike the common law system, the civil law system is based on written statutes in which decided legal cases have little value as precedents. In 1979, China began to promulgate a comprehensive system of laws and has since introduced many laws and regulations to provide general guidance on economic and business practices in China and to regulate foreign investment. Progress has been made in the promulgation of laws and regulations dealing with economic and commercial matters, but these recently enacted laws and regulations may not cover all aspects of business activities in China sufficiently. In particular, because these laws and regulations are relatively new, the interpretation and enforcement of these laws and regulations involve uncertainties, which may limit legal protections available to our subsidiaries. In addition, the PRC legal system is based in part on government policies and internal rules (some of which are not published on a timely basis or at all) that may have a retroactive effect. As a result, there may be certain instances when we may not be aware of our subsidiaries violation of these policies and rules until some time after such violation. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention.

The PRC government has enacted some laws and regulations dealing with matters such as corporate organization and governance, foreign investment, commerce, taxation and trade. Our subsidiaries' ability to enforce commercial claims or to resolve commercial disputes under these laws and regulations is unpredictable, however, because the implementation, interpretation and enforcement of these laws and regulations is limited and, given their relative newness, involve uncertainties. For example, contracts governed by PRC law tend to contain less detail than those under U.S. law and generally are not as comprehensive in defining the rights and obligations of the contracting parties. Consequently, contracts in China are more vulnerable to disputes and legal challenges than those in the U.S. In addition, contract interpretation and enforcement in China is not as developed as in the U.S., and the result of any contract dispute is subject to significant uncertainties. Our subsidiaries currently are not subject to any contract dispute, but we cannot assure you that our subsidiaries will not be subject to future contract disputes with our suppliers, franchisees and other customers under contracts governed by PRC law, and if such disputes arise, we cannot assure you that our subsidiaries will prevail.

Furthermore, the political, governmental and judicial systems in China sometimes are impacted by corruption. There is no assurance our subsidiaries will be able to obtain recourse in any legal disputes with the suppliers, customers or other parties with whom they conduct business, if desired, through China's developing and sometimes corrupt judicial systems. Any rights our subsidiaries may have under PRC law to specific performance or to seek an injunction are severely limited, and without a means of recourse by virtue of the PRC legal system, our subsidiaries may be unable to prevent these situations from occurring. The occurrence of any such events could have a material adverse effect on our business, financial condition and results of operations.

It will be extremely difficult to acquire jurisdiction and enforce liabilities against our directors and assets based in China.

As several of our directors are citizens of the PRC, it may be difficult, if not impossible, to acquire jurisdiction over these persons in the event a lawsuit is initiated against us or our officers and directors by a shareholder or group of shareholders in the U.S. Also, because many of our operating subsidiaries and assets are located in China, it may be extremely difficult or impossible for individuals to access those assets to enforce judgments rendered against us or our directors or executive offices by U.S. courts. In addition, the courts in China may not permit the enforcement of judgments arising out of U.S. federal and state corporate, securities or similar laws. Accordingly, U.S. investors may not be able to enforce judgments against us for violation of U.S. securities laws.

Fluctuation of the Renminbi and Euro may affect our financial condition and the value of our securities.

Although we use the USD for financial reporting purposes, transactions effected by our subsidiaries in China are denominated in RMB and those by our subsidiary in Germany are denominated in EUR. The value of the RMB and EUR fluctuates and are subject to changes in the political and economic conditions in China and Europe, respectively. In particular, from June 2008 to June 2010, the RMB was pegged to the USD, but it has since been managed more flexibly. Because the PBOC regularly intervenes in the foreign exchange market to prevent significant short-term fluctuations in the exchange rate, the RMB may appreciate or depreciate significantly in value against the USD in the medium to long term. Moreover, it is possible that in the future the PRC authorities may lift restrictions on fluctuations in the RMB exchange rate and lessen intervention in the foreign exchange market.

Future movements in the exchange rate of the RMB could adversely affect our financial condition as substantially all of our operations and sales are transacted in RMB and we may suffer financial losses when transferring money raised outside of China into the country or paying vendors for services performed outside of China. Historically, we have not engaged in hedging activities to mitigate this risk of fluctuating exchange rates and have no current intention of doing so. Moreover, fluctuations in the exchange rate between the USD and RMB will affect our financial results reported in USD terms without giving effect to any underlying change in our business, financial condition or results of operations. The value of our common stock likewise will be affected by the foreign exchange rate between the USD and RMB, and between those currencies and other currencies in which our sales may be denominated. Fluctuations in the exchange rate will also affect the relative value of any dividend we may issue in the future that will be exchanged into USD and earnings from, and the value of, any USD-denominated investments we make in the future. For example, if we need to convert USD into RMB for our operational needs and the RMB appreciates against the USD at that time, our financial position, our business and the price of our common stock may be harmed. Conversely, if we decide to convert our RMB into USD for the purpose of declaring dividends on our common stock or for other business purposes and the USD appreciates against the RMB, the USD equivalent of our earnings from our subsidiaries in China would be reduced.

PRC regulations relating to mergers, offshore companies and PRC shareholders, if applied to us, may limit our ability to operate our business as we see fit.

PRC regulations govern the process by which we may participate in an acquisition of assets or equity interests and may make loans and direct investments to our subsidiaries in China. Depending on the structure of the transaction, these regulations require involved parties to make a series of applications and supplemental applications to various government agencies. In some instances, the application process may require the presentation of economic data concerning a transaction, including appraisals of the target business and evaluations of the acquirer, which are designed to allow the government to assess the transaction. Government approvals will have expiration dates by which a transaction must be completed and reported to the government agencies. Compliance with the new regulations is likely to be more time consuming and expensive than in the past and the government can now exert more control over the combination of two businesses. Accordingly, due to PRC regulations, our ability to engage in business combination transactions in China through our PRC subsidiaries has become significantly more complicated, time consuming and expensive, and we may not be able to negotiate transactions that are acceptable to us or sufficiently protective of our interests. Furthermore, loans and capital contributions from an offshore holding company such as us to its subsidiaries in China are subject to PRC regulations and approval. For example, loans by us to our subsidiaries in China, which are foreign-invested enterprises, to finance their activities cannot exceed statutory limits and must be registered with the SAFE. Similarly, the PRC Ministry of Commerce, or MOFCOM, or its local counterpart must approve any capital contribution by us to our PRC subsidiaries. We cannot assure you that we will be able to obtain these government approvals on a timely basis, if at all, with respect to future loans or capital contributions by us to our subsidiaries.

Restrictions on currency exchange may limit our ability to receive and use our revenues effectively.

The RMB is currently convertible under the “current account,” which includes dividends, trade and service-related foreign exchange transactions, but not under the “capital account,” which includes foreign direct investment and loans. Currently, our subsidiaries in China may purchase foreign currencies for settlement of current account transactions, including payments of dividends to us, without the approval of the SAFE. However, the relevant PRC government authorities may limit or eliminate their ability to purchase foreign currencies in the future. Since a significant amount of our future revenues will be denominated in RMB, any existing and future restrictions on currency exchange may limit our ability to utilize revenues generated in RMB to fund our business activities outside China that are denominated in foreign currencies.

On August 29, 2008, the SAFE promulgated Circular 142, the Notice on Perfecting Practices Concerning Foreign Exchange Settlement Regarding the Capital Contribution by Foreign-invested Enterprises, to regulate the conversion by foreign-invested enterprises, or FIEs, of foreign currency into RMB by restricting how the converted RMB may be used. Circular 142 requires that RMB converted from the foreign currency-dominated capital of a FIE may only be used for purposes within the business scope approved by the applicable government authority and may not be used for equity investments within the PRC unless specifically provided for otherwise. In addition, the SAFE strengthened its oversight over the flow and use of RMB funds converted from the foreign currency-dominated capital of a FIE. The use of such RMB may not be changed without approval from the SAFE, and may not be used to repay RMB loans if the proceeds of such loans have not yet been used. These limitations could affect the ability of our subsidiaries in China to obtain foreign exchange through debt or equity financing.

If the China Securities Regulatory Commission, or CSRC, or another PRC regulatory agency determines that its approval is required in connection with our public offerings, we may become subject to penalties.

On August 8, 2006, six PRC regulatory agencies, including the CSRC, promulgated the Regulation on Mergers and Acquisitions of Domestic Companies by Foreign Investors, or the M&A Regulations, which became effective on

September 8, 2006. The M&A Regulations, among other things, have certain provisions that require offshore special purpose vehicles, or SPVs, formed for the purpose of acquiring PRC domestic companies and controlled by PRC individuals, to obtain the approval of the CSRC prior to listing their securities on an overseas stock exchange. We believe, based on the opinion of our PRC legal counsel, the Beijing Rondos Law Firm, that while the CSRC generally has jurisdiction over overseas listings of SPVs like us, CSRC's approval is not required for the offerings of our securities because our current corporate structure was established before the new regulation became effective. However, there remains some uncertainty as to how this regulation will be interpreted or implemented in the context of an overseas offering. If the CSRC or another PRC regulatory agency subsequently determines that its approval is required for our public offerings, we may face sanctions by the CSRC or another PRC regulatory agency. If this happens, these regulatory agencies may impose fines and penalties on our operations in the PRC, limit our operating privileges in the PRC, delay or restrict the repatriation of the proceeds from our public offerings into the PRC, restrict or prohibit payment or remittance of dividends by our PRC subsidiaries to us or take other actions that could have a material adverse effect on our business, financial condition, results of operations, reputation and prospects, as well as the trading price of our ordinary shares.

Table of Contents

We operate in the PRC through our operating entities whose foreign-investment status has been approved by the local offices of MOFCOM. If MOFCOM subsequently determines that such approval procedures have not been completely satisfied for our foreign-invested enterprises, we may lose the WFOE status of certain of our subsidiaries, which could negatively impact our business in China.

Our operating entities in the PRC have received approval from their respective local offices of MOFCOM as WFOEs and foreign-invested joint ventures. We believe we have satisfied all MOFCOM approval procedures for having obtained such status, but there may be conditions subsequent to complete and maintain such status. In particular, we believe that our acquisition of Taiyu, a privately held Sino-foreign joint venture company, in 2008 was not subject to the 2006 M&A Regulations but instead the 1997 Provisions on Changes in Equity Interest of Foreign Investment Enterprises, which do not require the approval of MOFCOM's central office in connection with the acquisition of interests in a foreign-invested entity operating in an industry not restricted or prohibited under PRC law. The meaning of many of the provisions of the M&A Regulations is still unclear, however, and PRC regulators have wide latitude in the enforcement of these and other relevant regulations. Consequently, the MOFCOM approval procedures or interpretations of its approval procedures may be different from our understanding or may change. If MOFCOM subsequently determines that we should have obtained the approval of MOFCOM's central office for our investments in any or all of our PRC foreign-invested subsidiaries, we may need to apply for a remedial approval or waiver of such approval requirements, and may be subject to certain administrative punishments or other sanctions from PRC regulatory agencies. As a result, if we lose the WFOE status of any of our PRC operating subsidiaries for any reason, there may be a material adverse effect on our business, financial condition, results of operations, reputation and prospects, as well as the trading price of our shares of common stock.

PRC regulations relating to the registration requirements for PRC resident shareholders owning shares in offshore companies may subject our PRC resident shareholders to personal liability and limit our ability to acquire companies in China or to inject capital into our operating subsidiaries in China, limit our subsidiaries' ability to distribute profits to us or otherwise materially and adversely affect our business.

The SAFE issued a public notice in October 2005, Relevant Issues Concerning Foreign Exchange Control on Domestic Residents' Corporate Financing and Roundtrip Investment through Offshore Special Purpose Vehicles, which we refer to as Circular 75, requiring PRC residents, including both legal persons and natural persons, to register with the competent local SAFE branch before establishing or controlling any company outside of China, referred to as an "offshore special purpose company," for the purpose of acquiring any assets of or equity interest in PRC companies and raising funds from overseas. In addition, any PRC resident who is the shareholder of an offshore special purpose company is required to amend his or her SAFE registration with the local SAFE branch, with respect to that offshore special purpose company in connection with any increase or decrease of capital, transfer of shares, merger, division, equity investment or creation of any security interest over any assets located in China. If any PRC resident who is the shareholder of an offshore special purpose company fails to comply with the SAFE registration requirements, the PRC subsidiaries of the offshore special purpose company may be prohibited from distributing their profits and proceeds from any reduction in capital, share transfer or liquidation to their offshore parent company and the offshore parent company may be restricted in its ability to contribute additional capital into its PRC subsidiaries. Moreover, failure to comply with the SAFE registration requirements could result in liabilities under PRC laws for evasion of foreign exchange restrictions. Although we believe that our PRC subsidiaries are in compliance with these regulations, should these regulations or the interpretation of them by course or regulatory agencies change, we may not be able to pay dividends outside of China. We do not believe that we have incurred a liability because of noncompliance with Circular 75 under SAFE registration procedures, however. Accordingly, we cannot predict fully how Circular 75 will affect our business operations or future strategies because of ongoing uncertainty over how Circular 75 is interpreted and implemented, and how or whether SAFE will apply it to us.

We have requested our PRC resident beneficial owners, including our former Chairman and Chief Executive Officer, to make the necessary applications, filings and amendments as required under SAFE regulations in connection with their equity interests in us and our acquisitions of equity interests in our PRC subsidiaries. We cannot provide any assurances that all of our present or prospective direct or indirect PRC resident beneficial owners have or will comply fully with all applicable registrations or required approvals. The failure or inability of our PRC resident beneficial owners to comply with the applicable SAFE registration requirements may subject these beneficial owners or us to fines, legal sanctions and restrictions described above.

On March 28, 2007, SAFE promulgated the Operating Procedures for Foreign Exchange Administration of Domestic Individuals Participating in Employee Stock Ownership Plans and Stock Option Plans of Offshore Listed Companies, or Circular 78. Under Circular 78, PRC citizens granted stock options by an offshore listed company are required, through an agent in China or a PRC subsidiary of the offshore listed company, to register with SAFE and complete certain other procedures, including applications for foreign exchange purchase quotas and opening special bank accounts. Failure to comply with these regulations may subject us or our PRC employees that receive stock option grants from us to fines and legal sanctions imposed by SAFE or other PRC government authorities and may prevent us from further granting stock options under our equity incentive plans to our PRC-citizen employees in China. Such events could adversely affect our business operations.

Table of Contents

PRC labor laws may adversely affect our results of operations.

On June 29, 2007, the PRC government promulgated the Labor Contract Law of the PRC, effective on January 1, 2008, to govern the establishment of employment relationships between employers and employees, and the conclusion, performance, termination of and the amendment to employment contracts. The Labor Contract Law imposes greater liabilities on employers and significantly affects the cost of an employer's decision to reduce its workforce. Further, it requires that certain terminations be based upon seniority and not merit. In the event our subsidiaries decide to significantly change or decrease their workforce in China, the Labor Contract Law could adversely affect their ability to effect such changes in a manner that is most advantageous to our business or in a timely and cost-effective manner, thus materially and adversely affecting our financial condition and results of operations.

Under the Enterprise Income Tax Law, we may be classified as a "resident enterprise" of China. Such classification will likely result in unfavorable tax consequences to us and our non-PRC resident shareholders.

China passed the Enterprise Income Tax Law, or the EIT Law, and its implementing rules, both of which became effective on January 1, 2008. Under the EIT Law, an enterprise established outside of China with "de facto management bodies" within China is considered a "resident enterprise," meaning that it must be treated as a PRC domestic enterprise for enterprise income tax purposes. The implementing rules of the EIT Law define de facto management as "substantial and overall management and control over the production and operations, personnel, accounting, and properties" of the enterprise.

On April 22, 2009, the PRC State Administration of Taxation, or the SAT, issued the Notice Concerning Relevant Issues Regarding Cognizance of Chinese Investment Controlled Enterprises Incorporated Offshore as Resident Enterprises pursuant to Criteria of de facto Management Bodies, or the Notice, further interpreting the application of the EIT Law and its implementation regarding non-PRC enterprise or group controlled offshore entities. Pursuant to the Notice, an enterprise incorporated in an off-shore jurisdiction and controlled by a PRC enterprise or group will be classified as a "non-domestically incorporated resident enterprise" if: (i) its senior management in charge of daily operations reside or perform their duties mainly in China; (ii) its financial or personnel decisions are made or approved by bodies or persons in China; (iii) its substantial assets and properties, accounting books, corporate chops, board and shareholder minutes are kept in China; and (iv) at least half of its directors with voting rights or senior management often reside in China. A "resident enterprise" would be subject to an enterprise income tax rate of 25% on its worldwide income and must pay a withholding tax at a rate of 10% when paying dividends to its non-PRC shareholders. However, detailed measures on imposition of tax from non-domestically incorporated resident enterprises are not yet available. Therefore, it is unclear how tax authorities will determine tax residency based on the facts of each case.

We may be deemed to be a "resident enterprise" by PRC tax authorities. If the PRC tax authorities determine that we are a "resident enterprise" for PRC enterprise income tax purposes, a number of unfavorable PRC tax consequences could follow. First, we may be subject to the enterprise income tax at a rate of 25% on our worldwide taxable income as well as PRC enterprise income tax reporting obligations. In our case, this would mean that income such as interest on financing proceeds and non-China source income would be subject to PRC enterprise income tax at a rate of 25%. Second, although under the EIT Law and its implementing rules dividends paid to us from our PRC subsidiaries would qualify as "tax-exempt income," we cannot guarantee that such dividends will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax, have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as "resident enterprises" for PRC enterprise income tax purposes. Finally, it is possible that future guidance issued with respect to the new "resident enterprise" classification could result in a situation in which a 10% withholding tax is imposed on dividends we pay to our non-PRC shareholders and with respect to gains derived by our non-PRC shareholders from transferring our shares. If we were treated as a "resident enterprise" by PRC tax authorities, we would be subject to taxation in both the U.S. and China, and our PRC tax may not be creditable against our U.S. tax.

Dividends distributed from our PRC subsidiaries to our non-PRC resident shareholders would be subject to U.S. and PRC withholding taxes.

We are a Nevada holding company and substantially all of our income is derived from dividends we receive from our subsidiaries, including those in China. Pretax earnings of a foreign subsidiary are subject to U.S. taxation when effectively repatriated. We currently consider the undistributed earnings of our PRC subsidiaries to be invested indefinitely and, accordingly, record no deferred U.S. tax expense on such earnings. If our PRC subsidiaries were to distribute dividends to us, the dividends would be subject to U.S. and PRC withholding taxes. Before the EIT Law came into effect on January 1, 2008, dividends paid to foreign investors by FIEs, such as dividends paid to us by our subsidiaries in China, were exempt from PRC withholding tax. Pursuant to the EIT Law, dividends generated after January 1, 2008, and distributed to us by our subsidiaries in China are subject to withholding tax at a rate of 5%, provided that we are determined by the relevant PRC tax authorities to be a "non-resident enterprise" under the EIT Law and hold at least 25% of the equity interest of our subsidiaries. If we are determined to be a "resident enterprise," we cannot guarantee that such dividends will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax, have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as "resident enterprises" for PRC enterprise income tax purposes.

Table of Contents

The SAT promulgated “Notice on How to Understand and Determine the Beneficial Owners in Tax Agreement” on October 27, 2009, or SAT Circular 601, which provides guidance for determining whether a resident of a contracting state is the “beneficial owner” of an item of income under China’s tax treaties and tax arrangements. According to SAT Circular 601, a beneficial owner generally must be engaged in substantive business activities. An agent or conduit company will not be regarded as a beneficial owner and, therefore, will not qualify for treaty benefits. The agent or conduit company normally refers to a company that is registered in a jurisdiction other than China and merely meets the minimum legal requirements on organizational form and is not engaged in substantive operational activities for manufacturing, distribution or management. It is still unclear how SAT Circular 601 is implemented by SAT or its local counterparts in practice and whether we could be recognized as a “beneficial owner.” If we are deemed a non-resident enterprise but not qualified as a beneficial owner, we will not be entitled to a reduced 5% withholding tax and the 10% withholding tax would be imposed on any dividend income received from our subsidiaries in China. As a result, our net income would be reduced and our operating results would be adversely affected.

Tax laws and regulations in China are subject to revision, some of which may adversely affect our profitability, and the termination of certain preferential tax treatment for which our subsidiaries are eligible in China may adversely affect our net income.

The PRC corporate tax regime continues to undergo revision. Tax benefits that our subsidiaries presently enjoy may not be available to us in the wake of these changes, and our subsidiaries could incur tax obligations to the PRC government that are significantly higher than currently anticipated. These increased tax obligations could negatively affect our financial condition and our revenues, gross margins, profitability and results of operations may be adversely affected as a result.

Furthermore, certain tax exemptions that certain of our subsidiaries presently enjoy in China are scheduled to expire after 2013. Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriate tax adjustments. Taiyu has been classified as a high-tech enterprise eligible for certain tax benefits, including a preferential enterprise income tax rate of 15% through 2013. SanDeKe was entitled to a 50% discount on its income tax rate from 2010 through 2012, resulting in an income tax rate of 13% and 12% for 2012 and 2011, respectively. SanDeKe’s income tax rate increased to 25% in 2013. We plan to apply for renewal of these preferential tax benefits for Taiyu after 2013 and will apply in 2014. If these tax benefits enjoyed by Taiyu expire without renewal, however, our income tax expenses will increase, which will reduce our net income.

Our compliance with the Foreign Corrupt Practices Act may put our subsidiaries at a competitive disadvantage, while our failure to comply with the Foreign Corrupt Practices Act may result in substantial penalties.

We are required to comply with the United States Foreign Corrupt Practices Act, or the FCPA, which prohibits U.S. companies from engaging in bribery or other prohibited payments to foreign officials for the purpose of obtaining or retaining business. Although we inform our subsidiaries’ personnel that such practices are illegal, we cannot assure you that our subsidiaries’ employees or other agents will not engage in such conduct for which we might be held responsible. If our subsidiaries’ employees or other agents are found to have engaged in such practices, we could suffer severe penalties. Non-U.S. companies, including some of our subsidiaries’ competitors, are not subject to the provisions of the FCPA. Corruption, extortion, bribery, pay-offs, theft and other fraudulent practices occur from time to time in mainland China. If our subsidiaries’ competitors engage in these practices, they may receive preferential treatment from personnel of some companies, giving our subsidiaries’ competitors an advantage in securing business or from government officials who might give them priority in obtaining new licenses, which would put our subsidiaries at a disadvantage.

Risks Related to Our Securities

The application of the “penny stock” rules could adversely affect the market price of our common stock and increase your transaction costs to sell those shares.

Our common stock may be subject to the “penny stock” rules adopted under Section 15(g) of the Exchange Act. The penny stock rules apply to issuers whose common stock does not trade on a national securities exchange and trades at less than $5.00 per share, or that have a tangible net worth of less than $5,000,000 ($2,000,000 if the company has been operating for three or more years). The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from those rules, to deliver a standardized risk disclosure document prepared by the SEC that contains the following information:

- a description of the nature and level of risk in the market for penny stocks in both public offerings and secondary trading;
- a description of the broker’s or dealer’s duties to the customer and of the rights and remedies available to the customer with respect to violation to such duties or other requirements of securities laws;

Table of Contents

- a brief, clear, narrative description of a dealer market, including “bid” and “ask” prices for penny stocks and the significance of the spread between the “bid” and “ask” prices;
- a toll-free telephone number for inquiries on disciplinary actions;
- definitions of any significant terms in the disclosure document or in the conduct of trading in penny stocks; and
- such other information and is in such form (including language, type, size and format), as the SEC shall require by rule or regulation.

Prior to effecting any transaction in a penny stock, the broker-dealer also must provide the customer with the following information:

- bid and offer quotations for the penny stock;
- compensation of the broker-dealer and our salesperson in the transaction;
- number of shares to which such bid and ask prices apply, or other comparable information relating to the depth and liquidity of the market for such stock; and
- monthly account statements showing the market value of each penny stock held in the customer’s account.

The penny stock rules further require that, prior to a transaction in a penny stock not otherwise exempt from those rules, the broker-dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser’s written acknowledgment of the receipt of a risk disclosure statement, a written agreement to transactions involving penny stocks and a signed and dated copy of a written suitability statement.

Due to the requirements of the penny stock rules, many broker-dealers have decided not to trade penny stocks. As a result, the number of broker-dealers willing to act as market makers in such securities is limited. If we remain subject to the penny stock rules for any significant period, it could have an adverse effect on the market, if any, for our securities. Moreover, if our securities are subject to the penny stock rules, investors will find it more difficult to dispose of our securities.

The market price for our common stock may be volatile, which could make it more difficult or impossible for you to sell our common stock for a positive return on your investment.

The trading price of our common stock may fluctuate widely in response to various factors, some of which are beyond our control. These factors include, but are not limited to, our quarterly operating results or the operating results of other companies in our industry, announcements by us or our competitors of acquisitions, new products, product improvements, commercial relationships, intellectual property, legal, regulatory or other business developments and changes in financial estimates or recommendations by stock market analysts regarding us or our competitors. In addition, the stock market in general, and in particular the market for companies with substantial operations based in China, that became public by means of a reverse acquisition with a public shell company or that recently effected a reverse stock split, has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market prices of securities issued by many companies for reasons unrelated or disproportionate to their operating performance. These broad market fluctuations may have a material adverse effect on our stock price, regardless of our operating results. Further, the market for our common stock is limited and we cannot assure you that a larger market will ever be developed or maintained. Market fluctuations and volatility, as well as general economic, market and political conditions, could reduce our market price. As a result, these factors may make it more difficult or impossible for you to sell our common stock for a positive return on your investment.

Our quarterly results may be volatile, which could materially affect the per share price of our common stock.

Our operating results have varied on a quarterly basis during our operating history and are likely to fluctuate significantly in the future. Many factors, including the risk factors incorporated by reference herein, could cause our revenues and operating results to vary significantly in the future. Many of these factors are outside of our control. Accordingly, we believe that quarter-to-quarter comparisons of our operating results are not necessarily meaningful. Investors should not rely on the results of one quarter as an indication of our future performance. If our results of operations in any quarter do not meet analysts' expectations, our stock price could materially decrease.

Table of Contents

Future sales of our stock could depress the market price of our common stock and cause our stock price to decline.

Future sales of shares of our common stock could adversely affect the prevailing market price of our stock. If our significant stockholders sell a large number of shares, or if we issue a large number of shares, the market price of our common stock could significantly decline. Moreover, the perception in the public market that our significant stockholders might sell shares of our common stock could depress the market for our shares. If such shareholders sell substantial amounts of our common stock in the public market, such sales could create a circumstance commonly referred to as an “overhang,” in anticipation of which the market price of our common stock could fall. The existence of an overhang, whether or not sales have occurred or are occurring, also could make it more difficult for us to raise additional financing through the sale of equity or equity-related securities in the future at a time and price we deem reasonable or appropriate.

We may issue additional shares of our capital stock or debt securities to raise capital or complete acquisitions, which would reduce the equity interest of our stockholders.

Our Articles of Incorporation authorize the issuance of up to 75,000,000 shares of common stock, par value $0.001 per share. As of April 4, 2014, there were 68,416,601 authorized and unissued shares of our common stock available for future issuance, based on 6,583,399 shares of our common stock outstanding and our reservation of 2,400 shares of our common stock issuable upon exercise of outstanding options. Although we have no commitments as of the date of this report to issue our securities, we may issue a substantial number of additional shares of our common stock to complete a business combination, to raise capital or to repay outstanding debt obligation, including amounts we may borrow under the Credit Agreement with Northtech. The issuance of additional shares of our common stock may significantly reduce the equity interest of our existing stockholders and may adversely affect prevailing market prices for our common stock.

We have not paid dividends in the past and do not expect to pay dividends in the future. Any return on investment may be limited to the value of our common stock.

We have never paid cash dividends on our common stock and do not anticipate doing so in the foreseeable future. The payment of dividends on our common stock will depend on earnings, financial condition and other business and economic factors affecting it at such time as the Board of Directors may consider relevant. Furthermore, China has currency and capital transfer regulations that require us to comply with complex regulations for the movement of capital. See “Risks Related to Our Business – We are a holding company that depends on cash flow from our wholly owned subsidiaries to meet our obligations.” Although our management believes that we are in compliance with these regulations, should these regulations or the interpretation of them by PRC courts or regulatory agencies change, we may not be able to pay dividends to our shareholders outside of China. Our management intends to follow a policy of retaining all of our earnings to finance the development and execution of our strategy and the expansion of our business. If we do not pay dividends, our common stock may be less valuable because a return on your investment will only occur if our stock price appreciates.

Provisions in the Nevada Revised Statutes and our Articles of Incorporation and Amended and Restated Bylaws could make it very difficult for you to bring any legal actions against our directors or officers for violations of their fiduciary duties or could require us to pay any amounts incurred by our directors or officers in any such actions.

Members of our Board of Directors and our officers will have no liability for breaches of their fiduciary duty of care as a director or officer, except in limited circumstances, pursuant to provisions in the Nevada Revised Statutes and our Articles of Incorporation and Amended and Restated Bylaws as authorized by the Nevada Revised Statutes. Specifically, Section 78.138 of the Nevada Revised Statutes provides that a director or officer is not individually liable to the company or its shareholders or creditors for any damages as a result of any act or failure to act in his or her capacity as a director or officer unless it is proven that (1) the director's or officer's act or failure to act constituted a breach of his or her fiduciary duties as a director or officer and (2) his or her breach of those duties involved intentional misconduct, fraud or a knowing violation of law. This provision is intended to afford directors and officers protection against and to limit their potential liability for monetary damages resulting from suits alleging a breach of the duty of care by a director or officer. Accordingly, you may be unable to prevail in a legal action against our directors or officers even if they have breached their fiduciary duty of care. In addition, our Amended and Restated Bylaws allow us to indemnify our directors and officers from and against any and all costs, charges and expenses resulting from their acting in such capacities with us. This means that if you were able to enforce an action against our directors or officers, in all likelihood, we would be required to pay any expenses they incurred in defending the lawsuit and any judgment or settlement they otherwise would be required to pay. Accordingly, our indemnification obligations could divert needed financial resources and may adversely affect our business, financial condition, results of operations and cash flows, and adversely affect prevailing market prices for our common stock.

Item 1B. Unresolved Staff Comments

Not required.

Table of Contents

Item 2. Properties

Our headquarters and principal manufacturing facilities are located in the Shenyang Economic and Technological Development Zone, Shenyang City, Liaoning Province, PRC. We acquired land use rights in Shenyang by the municipal administration of state-owned land through 2055, on which we own two buildings, including our office headquarters and principal manufacturing facilities. Siping Beifang owns its manufacturing facilities and land use rights for three parcels of land in Siping through 2052, 2056 and 2060, respectively. SmartHeat Energy acquired land use rights in Shenyang that are valid through 2060. We temporarily halted construction on a factory project for SmartHeat Energy because we believe that economic and market conditions in China at this time make it unlikely for the factory to operate profitably if completed in 2013 as originally scheduled. SanDeKe, Ruicheng and SmartHeat Pump lease space for their business offices and manufacturing facilities. SmartHeat Germany owns manufacturing facilities and land in Güstrow, Germany. We have leased offices for our sales representatives in multiple PRC cities under short-term, renewable leases.

Properties owned or acquired by SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd, SanDeKe Co., Ltd, SmartHeat (Shenyang) Energy Equipment Co., Ltd, SmartHeat Siping Beifang Energy Technology Co., Ltd and Hohhot Ruicheng Technology Co., Ltd are used for Heat PHE; while properties owned or acquired by SmartHeat (Shenyang) Heat Pump Technology Co., Ltd and SmartHeat Deutschland GmbH are used for Heat HP. In general, our properties are well maintained, considered adequate and being utilized for their intended purposes.

Item 3. Legal Proceedings

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. Aside from the proceeding described 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.

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 plaintiff once again filed a motion for class certification. On September 19, 2014, we filed an opposition to the lead plaintiff’s motion for class certification, to which plaintiff filed a response on October 20, 2014. By Opinion and Order dated January 21, 2015, the Court denied plaintiffs’ class certification motion, finding that it failed to satisfy the requirements of Fed. R. Civ. Pro. 23 for typicality, adequacy and predominance. Specifically, the Court found that plaintiffs’ theory of liability required a trade-by-trade inquiry as to whether the sale of the locked-up shares resulted in price inflation of the company’s stock, and that, as a result, the injury to all class members could not be established by common proof. In addition to finding a lack of predominance of common issues, the Court expressed substantial concerns about the adequacy of the class representative, and that his claims were typical of other class members. The Court also expressed doubts as to how plaintiffs would establish damages. The Court's denial of class certification was without prejudice, and the Court gave plaintiffs until February 17, 2015 to file a "far more rigorous, and a far more convincing submission…" The pleadings and court orders are publicly available. We intend to continue to vigorously defend this action, as we believe the allegations against us are without merit.

Item 4. Mine Safety Disclosures

Not applicable.

Table of Contents

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information

Our common stock has traded on the over the counter market since November 9, 2012. Previously, and prior to NASDAQ halting trading in our common stock, our common stock was listed on the NASDAQ Global Select Market under the symbol "HEAT" and had been trading on NASDAQ since January 29, 2009. The following table sets forth the range of the high and low sales prices of our common stock for each quarter in the years ended December 31, 2013 and 2012.

	2013		2012	
	High	Low	High	Low
First Quarter (through March 31)	$ 0.70	$ 0.30	$ 5.15	$ 0.32
Second Quarter (through June 30)	0.55	0.22	9.64	4.04
Third Quarter (through September 30)	0.60	0.21	4.04	4.04
Fourth Quarter (through December 31)	0.50	0.15	4.04	0.25

Holders of Record

On April 4, 2014, there were approximately 47 shareholders of record based on information provided by our transfer agent. Many of our shares of common stock are held in street or nominee name by brokers and other institutions on behalf of shareholders and we are unable to estimate the total number of shareholders represented by these record holders.

Dividend Policy

We have not paid and do not expect to declare or pay any cash dividends on our common stock in the foreseeable future, and we currently intend to retain future earnings, if any, to finance the expansion of our business. The decision whether to pay cash dividends on our common stock will be made by our Board of Directors, in their discretion, and will depend on our financial condition, operating results, capital requirements and other factors deemed relevant by our Board of Directors.

Our ability to pay dividends may be affected by the complex currency and capital transfer regulations in China that restrict the payment of dividends to us by our subsidiaries in China. PRC regulations currently permit payment of dividends only out of accumulated profits as determined in accordance with accounting standards and regulations in China. Our subsidiaries in China also are required to set aside at least 10% of net income after taxes based on PRC accounting standards each year to statutory surplus reserves until the cumulative amount of such reserves reaches 50% of registered capital. These reserves are not distributable as cash dividends. Our subsidiaries in China also may allocate a portion of their after-tax profits to their staff welfare and bonus funds, which may not be distributed to equity owners except in the event of liquidation. If any of our subsidiaries incur debt, the instruments governing the debt may restrict their ability to pay dividends or make other distributions to us.

In addition, Circular 75 requires PRC residents, including both legal persons and natural persons, to register with the competent local SAFE branch before establishing or controlling any company outside of China. If the PRC subsidiaries of an offshore parent company do not report the need for their PRC investors to register to the local SAFE authorities, they may be prohibited from distributing their profits and proceeds from any reduction in capital, share transfer or liquidation to their offshore parent company. Although we believe that our subsidiaries in China are in compliance with these regulations, should these regulations or the interpretation of them by PRC courts or regulatory agencies change, we may not be able to pay dividends outside of China.

Item 6. Selected Financial Data

Not required.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Safe Harbor Declaration

The comments made throughout this Annual 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.

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.

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.	SmartHeat (China) Investment Co., Ltd.
SanDeKe Co., Ltd.	SmartHeat (Shenyang) Heat Pump Technology Co., Ltd.
SmartHeat (Shenyang) Energy Equipment Co., Ltd.	SmartHeat Deutschland GmbH
SmartHeat Siping Beifang Energy Technology Co., Ltd.	SmartHeat (Shanghai) Trading Co., Ltd.
Hohhot Ruicheng Technology Co., Ltd.	Beijing SmartHeat Jinhui Energy Technology Co., Ltd.
SmartHeat Heat Exchange Equipment Co.	

30

Table of Contents

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 grew at its slowest pace in three years according to the National Bureau of Statistics of China. This slow growth continued into 2013. 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 2011 and 2012 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 2013. 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, 2012 and 2013. 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, 2012 and into 2013, a portion of the canceled PHE and PHE Unit orders were reinstated in 2012, and additional orders and contracts that were canceled or partially delayed are performed in 2013, 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, which normally account for approximately 69-72% of our cost of sales. 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 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.

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, which typically make up 69-72% of total cost. 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 2011, 2012, and 2013, 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 3, 2015 (see Note 15).

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. 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.We did not exercise the option to repurchase the equity interest of the Target Companies.

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.

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 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.

Table of Contents

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 $48.2 million and $28.2 million at December 31, 2013 and 2012, 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. The revenue earned from these services was not material during the years ended December 31, 2013 and 2012.

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.

Impairment of Long-Lived Assets

Long-lived assets, which include tangible assets, such as property, plant and equipment, goodwill and other intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable.

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value ("FV") of the assets. FV generally is determined using the asset's expected future discounted cash flows or market value, if readily determinable. We evaluate goodwill and intangible assets with indefinite lives for impairment annually using a two-step approach (codified in FASB ASC Topic 350). Based on this valuation approach, we concluded that the goodwill balance of $2.08 million for SmartHeat Germany was impaired as of December 31, 2012.

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 our equity interests in the following PHE segment subsidiaries ("Target Companies"): Taiyu, Siping, SmartHeat Energy, Ruicheng and XinRui for the purchase price of RMB 5,000,000 ($0.82 million).

The buyers had the option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000 which was exercised on March 27, 2014 subject to the approval of the Company's shareholders prior to completing the sale. Should 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.

According to ASC 360-10-35, long-lived assets (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. We believed the following events or changes in circumstances indicated the carrying amount of its long-lived assets (asset group) may not be recoverable: 1) a current expectation that, more likely than not, a long-lived assets (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life, and 2) A significant decrease in the market price of a long-lived asset (asset group). Since we have the option to sell 100% ownership in Target Companies for RMB 13.5 million ($2.21 million), a significant decrease in the market price, before the end of its previously estimated useful life for their long-lived assets, we therefore performed assets recoverability testing by comparing the assets estimated future undiscounted cash flows with their carrying values, and concluded the long-lived assets were not recoverable as a result of future cash flows are less than the carrying amount. We further calculated the impairment loss amount of Target Companies by determining the fair value for the long-lived assets group and recorded a write-down (loss) for the difference between their carrying value and their fair value. Fair value is an asset's purchase or sale price in a current transaction between willing parties. The best evidence of fair value is prices quoted in active markets, although we have the option to sell 100% ownership in Target Companies for RMB 13.5 million ($2.21 million), the market prices are not available for many long-lived assets such as equipment, we used discounted cash flow methods for estimating fair value of long-lived assets which are acceptable under ASC 360-10.

Based on our review, we believed that, as of December 31, 2013, our long-lived assets of Target Companies including construction in progress, property and equipment, and intangible assets were impaired for $13.73 million. In addition, our remaining 30.6% and 27.6% interest in Ruicheng and XinRui (after the 40% sale), respectively, at December 31, 2013, which was accounted for under the equity method of accounting, we recorded the long-term investment in Ruicheng and XinRui at fair value as provided in ASC 323-10-30-2. The fair value of the long-term investment was the prorated selling price for the remaining 60% equity interest that are allocated to Ruicheng and XinRui for approximately $26,720; accordingly, we recorded $0.91 million impairment loss of long-term investment in Ruicheng and XinRui for the excess of the carrying amount over the fair value.

Recent Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-2, Comprehensive Income (ASC Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, the new ASU requires entities to disclose in a single location (either on the face of the financial statement that reports net income or in the notes) the effects of reclassifications out of accumulated other comprehensive income (AOCI). For items reclassified out of AOCI and into net income in their entirety, entities must disclose the effect of the reclassification on each affected net income item. For AOCI reclassification items that are not reclassified in their entirety into net income, entities must provide a cross-reference to other required U.S. GAAP disclosures. There is no change in the requirement to present the components of net income and other comprehensive income in either a single continuous statement or two separate consecutive statements. The ASU does not change the items currently reported in other comprehensive income.

Table of Contents

For public entities, the new disclosure requirements are effective for annual reporting periods beginning after December 15, 2012, and interim periods within those years (i.e., the first quarter of 2013 for entities with calendar year-ends). The ASU applies prospectively, and early adoption is permitted. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

As of December 31, 2013, there is no recently issued accounting standards not yet adopted that would have a material effect on the Company's consolidated financial statements.

Results of Operations

Year ended December 31, 2013 Compared to the Year ended December 31, 2012

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.

	2013		2012	
	$	% of Sales	$	% of Sales
Sales	$ 44,709,526		$ 47,850,292	
Cost of sales	40,401,380	90%	32,481,271	68%
Gross profit	4,308,146	10%	15,369,021	32%
Operating expenses	58,550,416	131%	45,358,344	95%
Loss from operations	(54,242,270)	(121)%	(29,989,323)	(63)%
Non-operating income (expenses), net	(1,289,971)	(3)%	1,236,968	3%
Income tax expense (benefit)	(50,657)	(0.1)%	493,624	1%
Noncontrolling interest	(5,812,244)	(13)%	(28,897)	(0)%
Net Loss to SmartHeat Inc.	$ (49,669,341)	(111)%	$ (29,217,082)	(61)%

The following table sets forth the results of our operations for our PHE and heat meter segment (include inter-segment sales of $131,806) for the periods indicated as a percentage of net sales, certain columns may not add due to rounding.

	2013		2012	
	$	% of Sales	$	% of Sales
Sales	$ 38,882,321		$ 42,074,895	
Cost of sales	36,076,054	93%	27,412,639	65%
Gross profit	2,806,266	7%	14,662,255	35%
Operating expenses	51,723,608	133%	36,142,111	86%
Loss from operations	(48,917,342)	(126)%	(21,479,856)	(51)%
Non-operating expenses, net	(1,154,267)	(3)%	(339,647)	(1)%
Income tax expense	9,456	0.02%	561,218	1%
Noncontrolling interest	(5,798,050)	(15)%	(737)	(0)%
Net Loss to SmartHeat Inc.	$ (44,283,015)	(114)%	$ (22,379,983)	(53)%

Table of Contents

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.

	2013		2012	
	$	% of Sales	$	% of Sales
Sales (including intercompany)	$ 5,959,011		$ 5,797,898	
Cost of sales	4,457,132	75%	5,091,132	88%
Gross profit	1,501,879	25%	706,766	12%
Operating expenses	4,388,694	74%	7,142,687	123%
Loss from operations	(2,886,815)	(48)%	(6,435,921)	(111)%
Non-operating income, net	717,301	12%	624,958	11%
Income tax benefit	(60,113)	(1)%	(67,594)	(1)%
Noncontrolling interest	(14,194)	(0)%	(28,159)	(0)%
Net Loss to SmartHeat Inc.	$ (2,095,207)	(35)%	$ (5,715,209)	(99)%

Sales.Net sales in the year ended December 31, 2013, were $44.71 million, consisting of $27.39 million for PHEs, $10.49 million for PHE Units, $1.13 million for heat meters and $5.70 million (excluding intercompany sales) for HPs, while net sales in the year ended December 31, 2012, were $47.85 million, consisting of $22.29 million for PHEs, $18.55 million for PHE Units, $3.28 million for heat meters and $3.73 million for HPs, an overall decrease of $3.14 million or 7%. The 7% decrease in total revenue was due primarily to the decrease in sales of PHE unit in the year ended December 31, 2013, compared to 2012. However, sales of PHE, increased 23% in the year ended December 31, 2013 compared to 2012. The overall slow-down of the PRC economy and tight fiscal policy including restricted lending practice continues in 2013, 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 2013, we obtained less new sales contracts in 2013 for PHE unit which is more commonly used in real estate industry, and the real estate industry is very slow in PRC in recent years due to the reasons explained above; however, we got improved sales performance for industrial use of PHE in 2013, which has less impact from tight fiscal policy.

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 $40.40 million in the year ended December 31, 2013, compared to $32.48 million in 2012, an increase of $7.92 million or 24%. The increase in our COS is attributable to an increased inventory impairment provision. We reserved $6.34 million for inventory impairment provision for PHEs and PHE Units during the year ended December 31, 2013, compared with $1.59 million for 2012. COS mainly consisted of the cost of materials, factory overhead and labor. Materials cost was 69% of total cost, while factory overhead cost was 27% and labor was 4% during the year ended December 31, 2013, as compared to 65%, 31% and 4%, respectively, for 2012. Our materials cost as a percentage of total costs increased to 69% from the typical 65% as a result of increased raw material price. Combined with a significant increase in inventory impairment provision, the COS as a percentage of sales was 90% in the year ended December 31, 2013 compared with 68% for the same period of 2012.

We performed an inventory impairment assessment as of December 31, 2013 and 2012, 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 $12,067,544 and $5,433,879 as of December 31, 2013 and 2012, respectively.

Gross Profit. Gross profit (loss) was $4.31 million in the year ended December 31, 2013, compared to $15.37 million in 2012. Profit margin was 10% and 32% for the year ended December 31, 2013 and 2012 respectively. The decrease in profit margin in the year ended December 31, 2013 was primarily due to increased inventory impairment provision which was recorded in COS, and increased raw material cost as a percentage to total cost.

Table of Contents

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $58.55 million in year ended December 31, 2013, compared to $45.36 million in 2012, an increase of $13.19 million or 29.08%. Operating expenses as a percentage of sales were 131% in the year ended December 31, 2013, compared to 95% in 2012. The increase in operating expenses was mainly due to impairment loss on long-lived assets of $13.73 million and impairment loss on long-term investment of $0.91 million for the year ended December 31, 2013, compared with $0 for 2012.

We recorded a bad debt allowance of $18.81 million for accounts receivable (consisting of $18.64million for PHEs and related products and $0.17 million for HPs and related products), $8.43 million for bad debt allowance for other receivables (consisting of $8.41 million for PHEs and related products and $23,495 for HPs and related products), and $(0.59) million for allowance for advances to suppliers (consisting of $(0.68) million for PHEs related and $89,134 for HPs related), respectively, for the year ended December 31, 2013, compared with $17.52 million for bad debt allowance for accounts receivable, $1.27 million for bad debt allowance for other receivables, and $2.22 for allowance for advance to suppliers for 2012. The increased bad debt allowance for accounts and other receivables was primarily attributable to payment delays caused by the working capital difficulties of many of our state-owned customers. Due to the deflationary fiscal policy of the PRC government in 2012 that continued into 2013, some of our state-owned customers encountered difficulties in obtaining grants from the government and loans from state-owned banks, both of which typically are used to finance the purchase of our products, which resulted in unexpected delays in the payment of our accounts receivable in a timely manner. 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 income (expenses), net. Our net non-operating expenses for the year ended December 31, 2013 was $1.29 million compared to net non-operating income of $1.24 million for 2012, an increase of expenses of $2.53 million or 204%. The increase in non-operating expenses was due mainly to increased interest expense of $1,816,456 for the year ended December 31, 2013, compared with $1,548,937 for 2012, and decreased net other income of $1,314,945 for the year ended December 31,2013, compared with $2,643,786 for 2012. The net other income of $1,314,945 for the year ended December 31, 2013 mainly consisted of income (net), from selling of raw material of $810,653, government subsidy of $457,717 and other non-operating income of $245,119, but offset by loss (net) from after-sales services of $198,544. The net other income of $2,643,786 for the year ended December 31, 2012, mainly consisted of income (net), from selling of raw material of $582,200; income from providing technical service of $450,700; income (net) from after-sales services of $186,730, gain on settlement of debts of $813,245 through issuance of shares, and insurance compensation of $496,260 for the fire loss. In addition, we incurred $842,491 loss on sale of 40% equity interest on Taiyu, Siping, Shenyang Energy, Ruicheng and Xinrui in 2013.

Income tax expense (benefit). We had income tax benefit of $50,657 for the year ended December 31, 2013, compared to income tax expense of $493,624 for 2012. The effective income tax rate to taxable loss for the year ended December 31, 2013, was (0.1)% compared to 1.7% for 2012.

Net Loss. Our net loss for the year ended December 31, 2013, was $49.67 million compared to net loss of $29.22 million for 2012, an increase of $20.45 million or 70%. Net loss as a percentage of sales was 111% in the year ended December 31, 2013, and net loss as a percentage of sales was 61% in 2012. This increase in net loss was attributable to increased impairment loss on long-lived assets and long-term investment, increased inventory impairment provision, increased provision for bad debts, and increased non-operating expenses as described above.

Liquidity and Capital Resources

As of December 31, 2013, we had cash and equivalents of $13.60 million. Working capital was $47.96 million at December 31, 2013. The ratio of current assets to current liabilities was 1.89:1 at December 31, 2013.

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 $2.5million, to address the cash needs of the Company's U.S. parent. In 2013 and 2012, the Company issued 200,000 and 1,300,000 Restricted Shares of Common Stock, respectively, in cancellation of $100,000 and $1,301,300, respectively, of indebtedness under the Credit Facility. The remaining balance under the Credit Agreement as of December 31, 2013 was $1.40 million.

Table of Contents

The following is a summary of cash provided by or used in each of the indicated types of activities during the year ended December 31, 2013 and 2012:

		2013		2012
Cash provided by (used in):				
Operating activities	$	(4,545,268)	$	(5,443,788)
Investing activities	$	(1,621,293)	$	(2,030,407)
Financing activities	$	949,832	$	13,437,773

Net cash flow used in operating activities was $4.54 million in the year ended December 31, 2013, compared to net cash flow used in operating activities of $5.44 million in 2012. The decrease in net cash outflow in operating activities was due mainly to increased noncash charge of $33.58 million from provision for bad debts and inventory impairment in the year ended December 31, 2013, compared with $20.38 million in 2012; improved cash collected from accounts receivable, decreased cash outflow by $3.32 million for inventory, and cash inflow of $9.07 million resulted from accrued liabilities and other payables in the year ended December 31, 2013 compared with $2.34 cash outflow in 2012, despite we had increased net loss in 2013, and increased cash outflow on other receivables and prepayments by $7.80 million.

Net cash flow used in investing activities was $1.62 million in the year ended December 31, 2013, compared to net cash used in investing activities of $2.03 million in 2012. In the year ended December 31, 2013, we had $804,609 proceeds from sale of 40% equity interest on Taiyu, Siping, Shenyang Energy, Ruicheng and Xinrui, $122,483 cash inflow from note receivable, offset with $1.50 million cash outflows for restricted cash, and $0.57 million for purchase of fixed assets; while in 2012, we had $1.86 million cash inflow from changes in restricted cash, offset with $0.72 million investment into a new subsidiary, $0.83 million for purchase of fixed assets, $1.39 million for construction in progress and advance for construction and $0.8 million from increase in notes receivable.

Net cash flow provided by financing activities was $0.95 million in the year ended December 31, 2013, compared to net cash provided by financing activities of $13.43 million in 2012. The cash inflow in 2013 consisted primarily of proceeds from a credit line of $1.31 million and proceeds from short-term loans of $24.48 million, but offset by repayment on short-term loans of $24.85 million. In the year ended December 31, 2012, we had $1.28 million from a credit line and $23.70 million in proceeds from a short-term loan, partially offset by repayment on short-term loans of $9.03 million and repayment of notes payable of $2.54 million.

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 in 2013 and 2012 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 year ended December 31, 2013, was due primarily to the temporary financial difficulties of some of our state-owned customers that resulted in delays in payment. The low inventory turnover rate in the year ended December 31, 2013, was due to overall less purchase orders received from our state-owned customers in China who are having temporary financial difficulties.

As of December 31, 2013, we had gross accounts receivable of $65,623,090, of which $12,374,447 was with aging within 30 days, $6,604,855 with aging between 31 and 90 days, $6,821,354 with aging between 91and 180 days, $17,266,794 with aging between 181 and 360 days, and $22,555,640 with aging over 360 days. At December 31, 2013, net accounts receivable was $12,907,612, or gross accounts receivable of $65,623,090 less bad debt allowance of $48,248,832, unearned interest of $26,655, and total retention receivables of $4,439,991.

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 in 2013 and 2012 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.

Table of Contents

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 December 31, 2013, the Company collected 55% of the accounts receivable that were outstanding as of December 31, 2012.

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.

Table of Contents

Contractual Obligations

The Company was obligated for the following short-term loans as of December 31, 2013 and 2012:

	2013	2012	Subsidiary obligated
From a commercial bank in the PRC for RMB 50,000,000 entered into on February 17, 2012.The loan bore interest at 7.872% with maturity on January 16, 2013. The loan was repaid at maturity.	$ -	$ 7,954,817	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on July 12, 2012. The loan bore interest at 7.87% with maturity on July 11, 2013. The loan was repaid at maturity.	-	1,590,963	Siping
From a commercial bank in the PRC for RMB 10,000,000 entered into on August 23, 2012. The loan bore interest at 6.30% with maturity on August 22, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,590,963	Taiyu
From a commercial bank in the PRC for RMB 9,000,000 entered into on September 7, 2012. The loan bore interest at 6.3% with maturity on September 6, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,431,867	Taiyu
From a commercial bank in the PRC for RMB 8,000,000 entered into on September 13, 2012. The loan bore interest at 6.3% with maturity on September 12, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,272,771	Taiyu
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 21, 2012. The loan bore interest at 6.6% with maturity on August 20, 2013. The loan was repaid at maturity.	-	4,772,890	Taiyu
From a commercial bank in the PRC for RMB 9,600,000 entered into on September 13, 2012. The loan bore interest at 6.6% with maturity on March 3, 2013. This loan was guaranteed by accounts receivable. The loan was repaid at maturity.	-	1,527,325	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. This loan was repaid at maturity.	2,188,684	2,354,626	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.	1,640,178	1,590,963	Siping
From a commercial bank in the PRC for RMB 13,000,000 entered into on December 12, 2011. The loan bore interest at 6.65% with maturity on October 26, 2013. This loan was pledged with Taiyu's building and	-	2,068,252	Taiyu

land. This loan was repaid at maturity.			
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 8,550,000 entered into on January 9, 2013. The loan bore interest at 6.00% with maturity on December 10, 2013. This loan was repaid at maturity.	-	-	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.	1,640,178	-	Taiyu
From a commercial bank in the PRC for RMB 10,570,234 entered into on June 3, 2013. The loan bore interest at 6.16% with maturity on December 30, 2013. This loan was repaid at maturity.	-	-	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.	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.	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.	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.	1,623,776	-	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.	1,623,776	-	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
TOTAL	$ 24,462,299	$ 26,155,437	

40

Table of Contents

Of the loans listed above that are guaranteed by a third party, the guarantees were provided by Liaoning Wugang Metal Trading Co., Ltd. ("Liaoning Wugang"), with a maximum guarantee amount of RMB 46 million ($7.32 million). The guarantee is for the loans entered or will be 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 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.

The Company was obligated for the following long-term loan as of December 31, 2013:

The Company entered into a long-term loan of $2,132,231(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 for 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 on the grounds that, among other things, the plaintiffs did not, in fact, allege that a member of our senior management team had sold their shares. The motion to dismiss was subsequently denied and the court set a discovery and class briefing schedule.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Not required.

Item 8. Financial Statements and Supplementary Data

Our financial statements, together with the report thereon, appear in a separate section of this Annual Report beginning on page F-1.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our President and Acting Chief Accountant, our principal executive officer and acting 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 December 31, 2013, 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.

Table of Contents

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) of the Exchange Act. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Therefore, internal control over financial reporting determined to be effective provides only reasonable assurance regarding the reliability of financial reporting and the preparations of financial statements for external purposes in accordance with generally accepted accounting principles.

Our management carried out an evaluation of the effectiveness of our internal control over financial reporting based on the framework in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, our management concluded that our internal control over financial reporting was not effective as of December 31, 2013, because of a material weakness 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 Chief Financial Officer, 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.

In order to mitigate the foregoing material weakness, we engaged an outside accounting consultant to assist us in the preparation of our financial statements to ensure that these financial statements are prepared in conformity to U.S. GAAP. Our outside accounting consultant is a Certified Public Accountant in the U.S. and has significant experience in the preparation of financial statements in conformity with U.S. GAAP. Our Chief Financial Officer and internal accounting personnel consult with our outside accounting consultant on an ongoing basis with regards to our treatment and conversion of financials from PRC GAAP to U.S. GAAP. We believe that the engagement of this outside accounting consultant lessens the possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis, and we will continue to monitor the effectiveness of this action and make any changes that our management deems appropriate. We expect to continue to rely on this outside consulting arrangement to supplement our current internal accounting staff for the foreseeable future.

Our Board of Directors and management are evaluating remediation measures that we will undertake to address this material weakness and will continue this evaluation in order to implement a comprehensive remediation plan. We expect that this plan will include but not be limited to (a) appointing a principal accounting officer with extensive U.S. GAAP training and experience, (b) hiring accounting personnel with appropriate knowledge and experience in U.S. GAAP and (c) providing more training on U.S. GAAP to accounting and other relevant personnel responsible for the preparation of books, records and financial statements. In the interim, our Acting Chief Accountant has attended U.S. GAAP training courses conducted by our outside Sarbanes-Oxley consultant and intends to continue attending training courses in U.S. GAAP. Until such time as we hire qualified accounting staff and train our current accounting staff with the requisite U.S. GAAP experience, however, it is unlikely we will be able to remediate this material weakness in our internal control over financial reporting.

We believe that the foregoing steps will remediate the material weakness identified above, and we will continue to monitor the effectiveness of these steps and make any changes that our management deems appropriate.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the fiscal year ended December 31, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. Other Information

None.

Table of Contents

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The following table sets forth the names of our directors, executive officers and their ages, positions and biographical information as of the date of this report. Our executive officers are appointed by, and serve at the discretion of, our Board of Directors. Our directors hold office for one-year terms or until their successors have been elected and qualified. There are no family relationships between any of our directors, executive officers or other key personnel and any other of our directors, executive officers or key personnel. There are no arrangements or understandings between any of our directors or executive officers and any other persons pursuant to which such director or executive officer was selected in that capacity.

Name	Age	Position
Oliver Bialowons	45	President and Director
Yingkai Wang	41	Acting Chief Accountant
Huajun Ai	42	Corporate Secretary
Kenneth Scipta	72	Director
Weiguo Wang	48	Director
Xin Li	40	Director
Qingtai Kong	67	Director

Oliver Bialowons, President and Director

Oliver Bialowons was appointed as a Director and as President of the Company on May 25, 2012, to fill the roles formerly held by Jun Wang. Mr. Bialowons brings more than 20 years of experience as a turnaround executive to the Board of Directors and management of the Company. In 2009, Mr. Bialowons recently served as Chairman of Bowe Bell Howell Inc., a financially stressed U.S. based manufacturer of industrial logistics equipment with worldwide operations and distribution. Mr. Bialowons directed the restructuring of Boewe Bell Howell's business and eventual sale of the Bell Howell business to Bell and Howell, LLC, a portfolio company of Versa Capital Management, LLC. Mr. Bialowons continued to serve as Chairman of Bowe Bell Howell in the United States until March of 2012. Since March of 2012, Mr. Bialowons has also served as the Chief Executive Officer of IHR Platz in Germany. From 2008 to 2010, Mr. Bialowons was Chief Executive Officer of Boewe Systec AG and Wanderer Werke AG, and from 2007-2008 he was Chief Operating Officer of neckermann.de GmBH. Prior to 2007, Mr. Bialowons held various management positions at Mitsubishi Motors Corp. and DaimlerChrysler AG.

Yingkai Wang, Acting Chief Accountant

Yingkai Wang was appointed as our Acting Chief Accountant on June 7, 2013. Mr. Wang has served as our subsidiaries financial manager since 2007, and has been responsible for our internal financial reporting, establishing a budget and for analyzing our subsidiaries' overall financial position. Mr. Wang was previously the financial manager of Shengyang Zhong Zhijie Electric Equipment Co., Ltd. from 2004-2007, and Shenyang Materials Group from August 1996 – April 2004. Mr. Wang is acquainted with our subsidiaries' operations and was appointed to serve our Acting Chief Accountant by our Board of Directors as we continue to search for a new Chief Financial Officer.

Huajun Ai, Corporate Secretary

Ms. Ai was appointed our Corporate Secretary on April 14, 2008. Ms. Ai joined Taiyu in 2002 as its Corporate Secretary. From December 2000 to October 2002, she served as an accountant at Shenyang Dongyu International Trade Co., Ltd. From July 1994 to November 2000, Ms. Ai served as an accountant at Northeast Jin Cheng Industrial

Corp. Ms. Ai obtained her bachelor's degree in Foreign Trade Accounting from Shenyang North Eastern University in 1994.

Kenneth Scipta, Director

Kenneth Scipta was appointed to our Board of Directors and as Chairman of our Audit Committee on July 10, 2012. Mr. Scipta, a certified public accountant, has over 35 years of relevant accounting experience, and has served on several boards of directors. From 1993 to 1996, Mr. Scipta was the president and a board member of Mid-West Springs Manufacturing Company, a NASDAQ traded company, where he was responsible for day to day operations, planning, administration and financial reporting. Upon Mr. Scipta's resignation he assumed the duties of president of the special products division, which included catalog sales, die springs and the development of international sales. Previously, from 1979-1993, Mr. Scipta served in various positions such as president, vice president of finance and vice president of sales and marketing for Mid-West's primary subsidiary. From 1998 to 2006, Mr. Scipta was the chief executive officer and a board member of First National Entertainment Company, a multi-million dollar company traded on NASDAQ.

Table of Contents

Weiguo Wang, Director

Mr. Wang was appointed to our Board of Directors on June 19, 2008, and serves currently as the Chairman of our Compensation Committee and member of our Audit Committee and Nominating and Corporate Governance Committee. Mr. Wang brings over eight years of relevant industry oversight and extensive engineering experience to the Board. Mr. Wang has served as a Director of the China Special Equipment Inspection and Research Agency since 2006. Prior positions include serving as a supervisor of the Lanzhou Heat Transfer & Save Energy Engineering Center in 2006, Assistant Secretary General of the China Standardization Committee on Boilers and Pressure Vessels in 2005 and Deputy General Manager of Boilers Standard (Beijing) Technology Services Center Co., Ltd. in 2004. From July 2001 to December 2003, Mr. Wang was a teacher at Tianjin University, China. Mr. Wang holds a bachelor's degree in Mechanics, a master's degree in Fluid Mechanics and a PhD in Fluid Mechanics, all from Beijing University. His skills include business analysis, industry analysis, and long-range planning, especially as applied to manufacturing and standards implementation.

Xin Li, Director

Mr. Li was appointed to our Board of Directors on July 29, 2009, and serves as the Chairman of our Nominating and Corporate Governance Committee and member of our Audit Committee and Compensation Committee. Mr. Li brings more than a decade of corporate governance and industrial operations management experience to the Board. He is a renowned management consultant in China and currently serves as the general manager of Beijing ShengGao Consulting Co., Ltd., a strategic advisory firm founded by him more than 10 years ago that focuses on providing strategic guidance and management training to global companies, including the Sangoal Metal Manufacturing Company in China. He also serves as an independent director and chairs the audit and various governance committees at several large Chinese domestic companies not listed in the United States. Mr. Li is a prolific writer in strategies and management issues. He has authored several books in the areas of management science and strategic planning. Mr. Li is proficient in Mandarin Chinese and English. He has an MBA and is a Research Fellow at the Management Science Center of Beijing University.

Qingtai Kong, Director

Mr. Kong was appointed to our Board of Directors on September 22, 2011, and serves as a member of our Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee. Mr. Kong is a senior engineer bringing over 20 years of management experience in the gas supply and heating industry in China to the Board, and he currently serves as commissioner of China's Industrial Gas Committee. From 1995 to 2001, Mr. Kong served as Deputy Director overseeing district heating projects for the Qinhuangdao District Bureau of Municipal & Rural Construction in Hebei Province. From 1991 to 1995, Mr. Kong served as general manager of the state-owned utility Gas Supply Corporation of Qinhuangdao in Hebei Province. Mr. Kong's career in the gas industry began in 1988 with his position as chief engineer of a gas network project in the city of Qinhuangdao.

Legal Proceedings

Oliver Bialowons, our President, was an executive officer of Bowe Bell & Howell Company, a U.S. based manufacturer of industrial logistics equipment with worldwide operations and distribution, which filed for bankruptcy in April of 2011. Bowe Bell & Howell Company acted as debtor in possession and no external receiver was appointed in the bankruptcy proceeding. The bankruptcy proceeding was subsequently dismissed in March of 2012.

Mr. Bialowons also served as chief executive officer of Wanderer-Werke AG from December 2008 to March 2010, and Boewe Systec AG from December 2008 to November 2010. Wanderer-Werke AG and Boewe Systec AG filed for insolvency in Germany in May of 2010.

Other than as disclosed above during the past ten years, none of our directors or executive officers has been:

- the subject of any bankruptcy petition filed by or against any business of which such person was a general partner or executive officer either at the time of the bankruptcy or within two years prior to that time;
- convicted in a criminal proceeding or is subject to a pending criminal proceeding (excluding traffic violations and other minor offenses);
- subject to any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction, permanently or temporarily enjoining, barring, suspending or otherwise limiting his involvement in any type of business, securities or banking activities;
- found by a court of competent jurisdiction (in a civil action), the SEC or the Commodity Futures Trading Commission to have violated a federal or state securities or commodities law, that has not been reversed, suspended, or vacated;

Table of Contents

- subject of, or a party to, any order, judgment, decree or finding, not subsequently reversed, suspended or vacated, relating to an alleged violation of a federal or state securities or commodities law or regulation, law or regulation respecting financial institutions or insurance companies, law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; or

- subject of, or a party to, any sanction or order, not subsequently reversed, suspended or vacated, of any self-regulatory organization, any registered entity or any equivalent exchange, association, entity or organization that has disciplinary authority over its members or persons associated with a member.

None of our directors, officers or affiliates, or any beneficial owner of 5% or more of our common stock, or any associate of such persons, is an adverse party in any material proceeding to, or has a material interest adverse to, us or any of our subsidiaries.

Audit Committee and Audit Committee Financial Expert

We have established a separately-designated standing audit committee in accordance with Section 3(a)(58)(A) of the Exchange Act. Our Audit Committee consists of Messrs. Scipta, Wang, Li and Kong, each of whom is an independent director. Mr. Scipta, Chairman of the Audit Committee, is an “audit committee financial expert” as defined under Item 407(d) of Regulation S-K. The purpose of the Audit Committee is to represent and assist our Board of Directors in its general oversight of our accounting and financial reporting processes, audits of the financial statements and internal control and audit functions. As more fully described in its charter, a copy of which is available on our website at www.smartheatinc.com, the functions of the Audit Committee include the following:

- appointment of independent auditors, determination of their compensation and oversight of their work;

- review the arrangements for and scope of the audit by independent auditors;

- review the independence of the independent auditors;

- consider the adequacy and effectiveness of the internal controls over financial reporting;

- pre-approve audit and non-audit services;

- establish procedures regarding complaints relating to accounting, internal accounting controls, or auditing matters;

- review and approve any related party transactions;

- discuss with management our major financial risk exposures and our risk assessment and risk management policies; and

- discuss with management and the independent auditors our draft quarterly interim and annual financial statements and key accounting and reporting matters.

Procedures for Shareholder Recommendations of Nominees to the Board of Directors

During 2013, there were no material changes to the procedures described in our Proxy Statement relating to the 2012 Annual Meeting of Shareholders by which shareholders may recommend nominees to our Board of Directors.

Code of Ethics

Our Board of Directors has adopted a Code of Conduct, which applies to all of our directors, officers and employees, that constitutes our "code of ethics" within the meaning of Section 406 of the Sarbanes-Oxley Act. The purpose of the Code of Conduct is to promote honest and ethical conduct. The Code of Conduct is posted on our website located at www.smartheatinc.com and is available in print, without charge, upon written request to SmartHeat Inc. at A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110141, Attn: Corporate Secretary. We intend to disclose any future amendments to our Code of Conduct, and any waivers of provisions of the Code of Conduct required to be disclosed under the rules of the SEC, on our website.

Table of Contents

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires our executive officers and directors, and persons who own more than 10% of our common stock, to file reports regarding ownership of, and transactions in, our securities with the Commission and to provide us with copies of those filings. Based solely on our review of the copies received by us and on the written representations of certain reporting persons, we believe that all such Section 16(a) filing requirements were timely met during 2013.

Item 11. Executive Compensation

As a "smaller reporting company," we have elected to follow the scaled disclosure requirements for smaller reporting companies with respect to the disclosures required by Item 402 of Regulation S-K. Under such scaled disclosure, we are not required to provide a Compensation Discussion and Analysis, Compensation Committee Report and certain other tabular and narrative disclosures relating to executive compensation.

Executive Compensation

The following table sets forth information concerning the compensation for the years ended December 31, 2012 and 2013, of each of our named executive officers.

Summary Compensation Table

Name and Principal Position	Year	Salary ($)	Bonus ($)	Stock Awards ($)(1)	Option Awards ($)(1)	Nonequity Incentive Plan Compensation ($)	Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Oliver Bialowons	2013	100,000	0	0	0	0	0	0	100,000
President	2012	48,800	0	5,000	0	0	0	0	53,800
Michael Wilhelm	2013	-	-	-	-	-	-	-	-
Former Chief Financial Officer	2012	30,000	0	0	0	0	0	0	30,000
Jun Wang	2013	-	-	-	-	-	-	-	-
Former President and Chief Executive Officer	2012	150,000	0	0	0	0	0	0	150,000
Zhijuan Guo	2013	-	-	-	-	-	-	0	-
Former Chief Financial Officer	2012	12,000	0	0	0	0	0	0	12,000
Xudong Wang	2013	-	-	-	-	-	-	-	-
Former Vice President of Strategy and Development	2012	107,397	0	367,107	0	0	0	0	111,278
Yingkai Wang	2013	21,242	0	0	0	0	0	0	21,242
Acting Chief Accountant	2012	20,911	0	0	0	0	0	0	20,911

(1)

Amounts shown reflect aggregate grant date fair value of awards and do not reflect whether the recipient actually has realized a financial benefit from such grant, such as by selling the stock or exercising the options.

Table of Contents

The following table sets forth information concerning the outstanding equity awards held by each of our named executive officers at December 31, 2013.

Outstanding Equity Awards at Fiscal Year-End for 2013

	Option Awards			
	Number of Securities Underlying Unexercised Options		Option Exercise Price	Option Expiration
Name	(#) Exercisable	(#) Unexercisable	($)	Date
Jun Wang	-	-	-	-
Zhijuan Guo	-	-	-	-
Xudong Wang	2,500 (1)		118.50	06/30/2016

(1) Options granted on February 1, 2010, with a life of five years that vested on June 30, 2011 and June 29, 2012.

Agreements with Personnel

On January 1, 2008, Taiyu entered into a 3-year employment agreement with Jun Wang, which agreement was renewed on the same terms through December 31, 2013, upon mutual agreement between Mr. Wang and Taiyu. Pursuant to the terms of his employment agreement, Mr. Wang shall receive a salary in an amount that is not less than the lowest minimum wage per month paid in Shenyang and shall be based on the uniform wage and incentive system in Shenyang. Effective on February 1, 2010, the Compensation Committee approved an increase in the annual compensation of Mr. Wang to a base salary of $150,000 per year from $18,000 per year. The Compensation Committee believed it in the best interests of the company to approve the increase in salary for Mr. Wang because of his continued importance to our long-term strategy and success and increased responsibilities since 2008 when his prior base salary was established under his employment agreement. However, he resigned in 2012.

On January 1, 2008, Taiyu entered into a 3-year employment agreement with Zhijuan Guo, which agreement was renewed on the same terms through December 31, 2013, upon mutual agreement between Ms. Guo and Taiyu. Pursuant to the terms of her employment agreement, Ms. Guo received a salary in an amount that is not less than the lowest minimum wage per month paid. Ms. Guo’s employment agreement was terminated concurrently with her resignation.

On February 1, 2010, SmartHeat entered into an executive agreement with Xudong Wang for a term ending on June 30, 2013. But he resigned as a member of Board of Directors in 2012. Mr. Wang was compensated at $120,000 per year and eligible for annual cash bonuses at the sole discretion of the Board of Directors during the term before he resigned. The Company terminated this executive agreement and issued a promissory note in the amount of $77,625 in satisfaction of the Company’s remaining commitment under the executive Agreement. The promissory note was subsequently paid in full with 77,625 shares of the Company’s common stock.

On July 10, 2012, SmartHeat entered into an agreement with Mr. Oliver Bialowons, the Company’s President, effective as of May 25, 2012 for a one-year term. His employment agreement is automatically renewed for another one year from May 25, 2013. Mr. Bialowons is compensated at $100,000 per year.

Each of the above agreements contains provisions prohibiting competition by such officers following their services to us.

We currently do not have any defined pension plan for our named executive officers. Pursuant to their executive agreements, we shall provide to such officers all the necessary insurances and social welfares, including but not limited to medical, work injury, maternity, retirement and unemployment insurance and housing fund, according to our policies and the relevant laws and regulations of local governmental authorities and the PRC.

We currently do not have nonqualified defined contribution or other plans that provides for the deferral of compensation for our named executive officers nor do we currently intend to establish any such plan.

Grants of Plan-Based Awards

On May 25, 2010, our shareholders approved the 2010 Equity Incentive Plan authorizing the issuance of up to 100,000 shares of our common stock. The Compensation Committee administers the Plan and may grant awards, including restricted shares, incentive stock options and nonqualified stock options, under the Plan to our officers, directors and employees pursuant to the guidelines set forth in the Plan.

On November 28, 2011, Jun Wang and Xudong Wang each received a grant of 32,500 restricted shares of our common stock under the 2010 Equity Incentive Plan in recognition of their service and contributions to us. The restricted shares were fully vested on the grant date and issued pursuant to exemptions from registration under the Securities Act.

Table of Contents

On April 14, 2011, Xudong Wang received a grant of 5,000 restricted shares of our common stock under the 2010 Equity Incentive Plan with the intent of reflecting his expected future performance and to further align Mr. Wang's interests with those of our shareholders. The restricted shares were fully vested on the grant date and issued pursuant to exemptions from registration under the Securities Act.

On February 1, 2010, pursuant to his employment agreement, Xudong Wang received a grant of options to purchase 5,000 shares of our common stock at an exercise price per share of $118.50. The options have a life of 5 years and options to purchase 2,500 shares of our common stock vested on June 30, 2011, with the remaining options to purchase 2,500 shares of our common stock to vest on June 29, 2012, subject to Mr. Wang's continued employment.

Change-In-Control and Separation Agreements

Our employment agreements with Jun Wang specified the conditions under which the agreements may be terminated and set forth minimum severance payments according to the relevant laws and regulations of local governmental authorities and the PRC.

Our employment agreement with Xudong Wang specifies the conditions under which the agreement may be terminated and stipulated that Mr. Wang shall not be entitled to severance payments upon termination.

We do not have any other existing arrangements providing for payments or benefits in connection with the resignation, severance, retirement or other termination of any of our named executive officers, or a change in control of the company or a change in the named executive officer's responsibilities following a change in control.

Compensation of Directors

The following table sets forth information concerning the compensation of our directors for the year ended December 31, 2013.

Director Compensation Table for 2013

Name	Fees Earned or Paid in Cash ($)	Option Awards ($)	All Other Compensation ($)	Total ($)
Kenneth Scipta	25,000	-	-	25,000
Weiguo Wang	12,000	-	-	12,000
Xin Li	17,910	-	-	17,910
Qingtai Kong	3,750	-	-	3,750

Our independent directors receive cash compensation, paid in equal quarterly installments, for their service. In addition, at the discretion of the non-interested members of the Compensation Committee, independent directors are eligible to receive bonuses for service to our company outside the normal duties as a director and grants of options to purchase our common stock under the 2010 Equity Incentive Plan. Messrs. Li and Kong receive compensation of $17,910 and $3,750 per year, respectively, paid in equal quarterly installments. Mr. Scipta receives $25,000 per year, paid in equal quarterly installments. We do not compensate our non-independent directors for serving as our directors. All directors are eligible to receive reimbursement of expenses incurred with respect to attendance at board meetings and meetings of committees thereof, which is not included in the above table. We do not maintain a medical, dental or retirement benefits plan for the directors.

The directors may determine remuneration to be paid to the directors with interested members refraining from voting. The Compensation Committee will assist the directors in reviewing and approving the compensation structure for the directors.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following sets forth information as of April 4, 2014, regarding the number of shares of our common stock beneficially owned by (i) each person that we know beneficially owns more than 5% of our outstanding common stock, (ii) each of our named executive officers, (iii) each of our directors and (iv) all of our named executive officers and directors as a group.

The amounts and percentages of our common stock beneficially owned are reported on the basis of SEC rules governing the determination of beneficial ownership of securities. Under the SEC rules, a person is deemed to be a "beneficial owner" of a security if that person has or shares "voting power," which includes the power to vote or to direct the voting of such security, or "investment power," which includes the power to dispose of or to direct the disposition of such security. A person is also deemed to be a beneficial owner of any securities of which that person has the right to acquire beneficial ownership within 60 days through the exercise of any stock option, warrant or other right. Under these rules, more than one person may be deemed a beneficial owner of the same securities and a person may be deemed to be a beneficial owner of securities as to which such person has no economic interest.

Table of Contents

Unless otherwise indicated, each of the shareholders named in the table below, or his or her family members, has sole voting and investment power with respect to such shares of our common stock. Except as otherwise indicated, the address of each of the shareholders listed below is: c/o SmartHeat Inc., A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110141.

As of April 4, 2014, there were 6,583,399 shares of our common stock issued and outstanding.

Name of beneficial owner	Number of shares		Percent of class	
5% Shareholders				
Northtech Holdings Inc. Mill Mall 5, Wickhams Cay 1 P.O. Box 3085 Road Town, Tortola British Virgin Islands	1,900,000	(5)	28.86	%
Beijing YSKN Machinery & Electronic Equipment Co., Ltd. Rm 1106, Huapu International Plaza No.19, Chaowai Street, Chaoyang District Beijing, China	680,800	(1)	10.34	%
Yang In Cheol #630-5, Namchon-Dong Namdong-Yu Incheon, South Korea 302-405	384,800	(2)	5.85	%
William J & Mary Ann P McGrath Foundation 943 Edgemere Court Evanston, IL 60202	300,000	(3)	4.56	%
ShenYang ZhiCe Investment Co., Ltd No. 1 Yuebin Street Shenhe District Shenyang, China 110027	296,000	(4)	4.50	%
Directors and Named Executive Officers				
Oliver Bialowons	200,000		3.04	%
Kenneth Scipta	50,000		0.76	%
All Directors and Named Executive Officers as a Group (7 Persons)	250,000		3.80	%

* Represents less than 1% of shares outstanding.

(1) Disclosed on Amendment No. 1 to the Schedule 13D for Beijing YSKN Machinery & Electronic Equipment Co., Ltd ("Beijing YSKN") filed on June 30, 2008, for beneficial ownership as of May 7, 2008. Beijing YSKN has sole power to vote and dispose of the shares owned by it. Jun Wang and Fang Li each hold 50% of the equitable and legal rights, title and interests in and to the share capital of Beijing YSKN and, as a result of such ownership, each of Messrs. Wang and Li has the shared power to vote and dispose of the shares held by Beijing YSKN.

(2) Disclosed on the Schedule 13G for Yang In Cheol filed on April 25, 2008, for beneficial ownership as of April 14, 2008.

(3) Disclosed on the Schedule 13D for William J & Mary Ann P McGrath Foundation filed on November 7, 2013.

(4) Disclosed on the Schedule 13G for ShenYang ZhiCe Investment Co., Ltd ("ShenYang ZhiCe") filed on April 25, 2008, for beneficial ownership as of April 14, 2008. ShenYang ZhiCe has sole power to vote and dispose of the shares owned by it.

(5) Disclosed on the Schedule 13D for Northtech Holdings filed on March 7, 2013, as amended on August 29, 2013.

Table of Contents

Securities Authorized for Issuance under Equity Compensation Plans

The following table sets forth information regarding all equity compensation plans, including individual compensation arrangements, under which our common stock is authorized for issuance as of December 31, 2013.

Equity Compensation Plan Information

Plan Category	(a) Number of Securities to be Issued Upon Exercise of Outstanding Options		(b) Weighted-Average Exercise Price of Outstanding Options	(c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders				
2010 Equity Incentive Plan	-		-	0
Equity compensation plans not approved by security holders	1,000(1)	$	46.00	-
	5,000(2)		118.50	-
Total	6,000	$	106.40	0

(1) Consists of options granted to Arnold Staloff on July 17, 2008, to purchase 1,000 shares of our common stock at an exercise price per share of $46.00. The options vested in full over a three-year period and expired after five years.

(2) Consists of options granted to Xudong Wang on February 1, 2010, to purchase 5,000 shares of our common stock at an exercise price per share of $118.50. The options have a life of 5 years and options to purchase 2,500 shares of our common stock vested on June 30, 2011, with the remaining options to purchase 2,500 shares of our common stock to vest on June 29, 2012, subject to Mr. Wang's continued employment.

Item 13. Certain Relationships and Related Transactions, and Director Independence

Certain Relationships and Related Transactions

On July 27, 2012, we entered into a secured revolving credit facility under the terms of a Secured Credit Agreement with Northtech Holdings, Inc., an entity owned by certain members of the Company's former management, Jun Wang, our former Chief Executive Officer, Xudong Wang, our former Vice President of Strategy and Development, and Wen Sha, our former Vice President of Marketing. Huajun Ai, our current 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 elected to repay $1,301,300 of the $1,384,455 outstanding under the

Credit Agreement with 1,300,000 restricted shares of our common stock, 22.67% of our total issued and outstanding shares of Common Stock, as authorized by the Credit Agreement and approved by our shareholders.

On December 30, 2013, the Company closed the transactions contemplated by the Equity Interest Purchase Agreement discussed above (See Sale of Equity Interests). 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.

Except as disclosed above, there were no transactions with any related persons (as that term is defined in Item 404 in Regulation S-K) during 2013 or 2012, or any currently proposed transaction, in which we were or are to be a participant and the amount involved was in excess of $120,000 and in which any related person had a direct or indirect material interest.

Table of Contents

Our written policy for related party transactions provides that we will enter into or ratify a transaction with a related party only when our Board of Directors, acting through the Audit Committee, determines that the transaction is in the best interests of the company and our shareholders. The policy requires the review and approval by our Audit Committee for any transaction in which (i) the aggregate amount involved will or may be expected to exceed $120,000 in any fiscal year, (ii) we are a participant and (iii) any related person has or will have a direct or indirect interest. Related persons include our executive officers, directors, director nominees, persons known to be the beneficial owner of more than 5% of our outstanding common stock or immediate family members of any of the foregoing persons. In determining whether to approve or ratify a transaction with a related party, the Audit Committee will take into account, among other relevant factors, whether the transaction is on terms no less favorable than terms generally available to an unaffiliated third party under the same or similar circumstances. If advance approval of a transaction is not feasible, the Audit Committee may approve and ratify the transaction in accordance with the policy. Any member of the Audit Committee who is a related party with respect to a transaction under review may not participate in the deliberations or vote on the approval of the transaction.

Director Independence

Our Board of Directors has determined that each of Kenneth Scipta, Weiguo Wang, Xin Li and Qingtai Kong is an independent director as defined by the listing standards of NASDAQ currently in effect and all applicable rules and regulations of the SEC. We have established the following standing committees of the Board of Directors: Audit, Compensation and Nominating and Corporate Governance. All members of the Audit, Compensation and Nominating and Corporate Governance Committees satisfy the independence standards applicable to members of each such committee. The Board of Directors made this affirmative determination regarding these directors' independence based on discussions with the directors and on its review of the directors' responses to a standard questionnaire regarding employment and compensation history; affiliations, family and other relationships; and transactions between us and the directors, if any. The Board of Directors considered relationships and transactions between each director, or any member of his immediate family, and our company, our subsidiaries and our affiliates. The purpose of the Board of Director's review with respect to each director was to determine whether any such relationships or transactions were inconsistent with a determination that the director is independent under NASDAQ rules.

Item 14. Principal Accounting Fees and Services

Our Audit Committee selected GKM as the independent registered certified public accounting firm to audit the books and accounts of our company and subsidiaries for the fiscal year ending December 31, 2013. GKM has served as our independent accountant since April 14, 2008. The following table presents the aggregate fees billed for professional services rendered by GKM for the years ended December 31, 2012 and 2013.

	2012	2013
Audit fees	$ 159,500	$ 175,500
Audit-related fees	1,300	10,000
Tax fees	-	-
All other fees	1,300	-

In the above table, "audit fees" are fees billed for services provided related to the audit of our annual financial statements, quarterly reviews of our interim financial statements and services normally provided by the independent accountant in connection with statutory and regulatory filings or engagements for those fiscal periods. "Audit-related fees" are fees not included in audit fees that are billed by the independent accountant for assurance and related services that are reasonably related to the performance of the audit or review of our financial statements. "Tax fees" are fees billed by the independent accountant for professional services rendered for tax compliance, tax advice and tax planning. "All other fees" are fees billed by the independent accountant for products and services not included in the foregoing categories.

Audit Committee's Pre-Approval Policy

The Audit Committee pre-approves all audit and permissible non-audit services provided by the independent accountants. These services may include audit services, audit-related services, tax services and other services. The Audit Committee has adopted a written policy for the pre-approval of services provided by the independent accountants, under which policy the Audit Committee generally pre-approves services for up to one year and any pre-approval is detailed as to the particular service or category of services and is subject to a specific budget. In addition, the Audit Committee may also pre-approve particular services on a case-by-case basis. For each proposed service, the independent accountant is required to provide detailed back-up documentation at the time of approval. The Audit Committee may delegate pre-approval authority to one or more of its members. Such a member must report any decisions to the Audit Committee at the next scheduled meeting.

Table of Contents

PART IV

Item 15. Exhibits, Financial Statement Schedules

The following documents are filed as part of or are included in this Annual Report:

1. Financial statements listed in the Index to Financial Statements, filed as part of this Annual Report beginning on page F-1; and
2. Exhibits listed in the Exhibit Index filed as part of this Annual Report.

Table of Contents

SMARTHEAT INC.

Consolidated Financial Statements
Years Ended December 31, 2013 and 2012

Index to Financial Statements

Table of Contents

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders of
SmartHeat Inc.

We have audited the accompanying consolidated balance sheets of SmartHeat, Inc. (the “Company”) as of December 31, 2013 and 2012, and the related consolidated statements of operations, stockholders’ equity and comprehensive loss, and cash flows for the years ended December 31, 2013 and 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2013 and 2012, and the consolidated results of their operations and their cash flows for the years ended December 31, 2013 and 2012, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 24 to the consolidated financial statements, the financial statements for the year ended December 31, 2013, have been restated to correct a misstatement.

/s/ Goldman Kurland and Mohidin, LLP
Goldman Kurland and Mohidin, LLP
Encino, California
April 11, 2014 except for note s 2, 5, 7, 16, 23 & 24 are as of October 21, 2014

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2013 (Restated)	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash & equivalents	$13,602,399	$18,336,163
Restricted cash	2,458,758	994,455
Accounts receivable, net	12,167,565	32,250,817
Retentions receivable	4,202,109	3,812,376
Advances to suppliers, net	6,584,832	3,279,007
Other receivables (net), prepayments and deposits	2,644,522	6,467,280
Inventories, net	56,324,363	58,297,562
Taxes receivable	989,635	-
Notes receivable - bank acceptances	2,759,251	2,797,551
Total current assets	101,733,433	126,235,211
NONCURRENT ASSETS		
Long term investment	26,721	865,773
Restricted cash	135,926	36,592
Retentions receivable	237,882	421,731
Advance to supplier for equipment	-	1,744,056
Construction in progress	-	1,298,841
Property and equipment, net	1,638,120	10,947,480
Intangible assets, net	11,042,719	14,920,603
Total noncurrent assets	13,081,369	30,235,076
TOTAL ASSETS	$114,814,802	$156,470,287
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$6,683,860	$8,574,981
Advance from customers	5,618,301	5,481,960
Taxes payable	197,078	769,167
Accrued liabilities and other payables	14,226,766	5,006,127
Notes payable - bank acceptances	2,590,025	736,698
Loans payable	24,462,299	26,155,437
Total current liabilities	53,778,329	46,724,370
CREDIT LINE PAYABLE	1,396,378	83,537

LONG-TERM LOAN	2,132,231	-
DEFERRED TAX LIABILITY	17,177	93,054
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, $0.001 par value; 75,000,000 shares authorized, 6,133,399 and 5,733,399 shares issued and outstanding as of December 31, 2013 and 2012, respectively	6,133	5,733
Paid-in capital	87,393,606	103,607,559
Statutory reserve	5,389,057	5,396,014
Accumulated other comprehensive income	8,991,269	11,273,497
Accumulated deficit	(66,630,772)	(11,771,349)
Total Company stockholders' equity	35,149,293	108,511,454
NONCONTROLLING INTEREST	22,341,394	1,057,872
TOTAL EQUITY	57,490,687	109,569,326
TOTAL LIABILITIES AND EQUITY	$114,814,802	$156,470,287

Table of Contents

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

	YEARS ENDED DECEMBER 31, 2013 (Restated)	2012
Net sales	$44,709,526	$47,850,292
Cost of goods sold	40,401,380	32,481,271
Gross profit	4,308,146	15,369,021
Operating expenses		
Selling	6,864,059	9,922,607
General and administrative	10,400,323	12,345,739
Goodwill impairment	-	2,083,586
Long-lived assets impairment	13,730,849	-
Impairment of long-term investment	908,084	-
Provision for bad debts	27,240,939	18,790,256
Provision for advance to supplier	(593,838)	2,216,156
Total operating expenses	58,550,416	45,358,344
Loss from operations	(54,242,270)	(29,989,323)
Non-operating income (expenses)		
Investment income	153,237	142,411
Interest income	159,972	164,454
Interest expense	(1,816,456)	(1,548,937)
Financial expense	(249,681)	(170,220)
Foreign exchange transaction gain (loss)	(9,495)	5,474
Loss on sale of equity interest	(842,491)	-
Other income, net	1,314,945	2,643,786
Total non-operating income (expenses), net	(1,289,971)	1,236,968
Loss before income tax	(55,532,241)	(28,752,355)
Income tax (benefit) expense	(50,657)	493,624
Net loss before noncontrolling interest	(55,481,585)	(29,245,979)
Less: loss attributable to noncontrolling interest	(5,812,244)	(28,897)
Net loss to SmartHeat Inc.	(49,669,341)	(29,217,082)
Other comprehensive item		
Foreign currency translation gain (loss) attributable to SmartHeat Inc.	(2,282,228)	153,610

Foreign currency translation gain (loss) attributable to noncontrolling interest	(31,371)	2,532
Comprehensive loss attributable to SmartHeat Inc.	$(51,951,569)	$(29,063,472)
Comprehensive loss attributable to noncontrolling interest	$(5,843,614)	$(26,365)
Basic and diluted weighted average shares outstanding	5,870,111	4,129,400
Basic and diluted loss per share	$(8.46)	$(7.08)

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2013 and 2012

	Common stock				Accumulated other comprehensive	Retained earnings		Noncontr
	Shares	Amount	Paid in capital	Statutory reserves	income (loss)	(accumulated deficit)	Total	interes
Balance at January 1, 2012	3,955,774	$3,956	$102,985,737	$5,396,014	$11,119,887	$17,445,733	$136,951,327	$1,084,2
Shares issued for debt repayment	1,300,000	1,300	531,700	-	-	-	533,000	-
Shares issued in connection with executives compensation	177,625	178	37,503	-	-	-	37,680	-
Compensation expense of stock options	-	-	37,919	-	-	-	37,919	-
Shares issued in connection with consulting service	300,000	300	14,700	-	-	-	15,000	-
Net loss for year	-	-	-	-	-	(29,217,082)	(29,217,082)	(28,897
Foreign currency translation gain	-	-	-	-	153,610	-	153,610	2,532
Balance at December 31, 2012	5,733,399	5,733	103,607,559	5,396,014	11,273,497	(11,771,349)	108,511,454	1,057,8
Shares issued for debt repayment	200,000	200	119,800	-	-	-	120,000	-
Shares issued for loan amendment fee	100,000	100	59,900	-	-	-	60,000	-
Shares issued for equity interest sale consent	100,000	100	29,900	-	-	-	30,000	-

Sale of equity interest and deconsolidation	-	-	(16,423,553)	(9,537)	(4,924,845)	(5,187,502)	(26,545,437)	27,127,
Net loss for year	-	-	-	-	-	(49,669,341)	(49,669,341)	(5,812,2
Transfer to statutory reserves	-	-	-	2,580	-	(2,580)	-	-
Foreign currency translation gain (loss)	-	-	-	-	2,642,617	-	2,642,617	(31,371
Balance at December 31, 2013 (Restated)	6,133,399	$6,133	$87,393,605	$5,389,057	$8,991,269	$(66,630,772)	$35,149,293	$22,341,

F-5

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEARS ENDED DECEMBER 31, 2013 (Restated)	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss including noncontrolling interest	$(55,481,585)	$(29,245,979)
Adjustments to reconcile loss including noncontrolling interest to net cash used in operating activities:		
Investment income	(153,237)	(142,411)
Depreciation and amortization	2,151,325	1,892,084
Long-lived assets impairment	13,730,849	-
Impairment of long-term investment	908,084	-
Provision for bad debts	27,240,939	18,790,256
Provision for inventory impairment	6,343,530	1,590,721
Provision for advance to suppliers	(593,838)	2,216,156
Changes in warranty reserves	(44,518)	-
Loss on disposal of fixed asset	19,133	-
Loss on sale of equity interest	842,491	-
Unearned interest on accounts receivable	13,476	(45,244)
Stock option expense	-	37,919
Stock compensation expense in connection with shares issued to executives	-	75,000
Amortization of loan amendment fee paid by shares	31,315	-
Shares issued for equity interest sale consent	30,000	-
Gain (Loss) on settlement of debts by shares	20,000	(813,245)
Goodwill impairment	-	2,083,586
Changes in deferred tax	(77,269)	(96,512)
(Increase) decrease in assets and liabilities:		
Accounts receivable	1,134,956	(2,607,336)
Retentions receivable	(73,493)	30,374
Advances to suppliers	1,461,069	12,153,058
Other receivables, prepayments and deposits	(6,846,995)	951,546
Inventories	(2,746,109)	(6,070,050)
Taxes receivable	(827,925)	-
Accounts payable	3,967	(4,099,812)
Advance from customers	(32,609)	602,864
Taxes payable	(676,552)	(408,863)
Accrued liabilities and other payables	9,077,728	(2,337,900)
Net cash used in operating activities	(4,545,268)	(5,443,788)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(1,502,829)	1,861,726
Equity method investment	-	(722,750)
Cash disposed on equity interest sale	(399,241)	-
Acquisition of property & equipment	(565,295)	(827,626)

Acquisition of intangible asset	(79,169)	(81,854)
Sale of equity interest	804,609	-
Notes receivable	122,483	(872,787)
Advance for construction and equipment	-	(615,746)
Construction in progress	(1,851)	(771,370)
Net cash used in investing activities	(1,621,293)	(2,030,407)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term loans	24,483,311	23,701,300
Repayment on short-term loans	(24,846,320)	(9,029,703)
Payment on notes payable	-	(2,538,661)
Credit line payable	1,312,841	1,284,837
Stock issued relating to executive compensation	-	5,000
Stock issued relating to consulting services	-	15,000
Net cash provided by financing activities	949,832	13,437,773
EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS	482,965	(47,337)
NET (DECREASE) INCREASE IN CASH & EQUIVALENTS	(4,733,764)	5,916,241
CASH & EQUIVALENTS, BEGINNING OF PERIOD	18,336,163	12,419,922
CASH & EQUIVALENTS, END OF PERIOD	$13,602,399	$18,336,163
Supplemental cash flow data:		
Income tax paid	$720,001	$392,346
Interest paid	$1,663,459	$1,644,001
Supplemental disclosure of non-cash financing activities:		
Shares issued for debts repayment	$100,000	$1,378,925

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2013 (RESTATED) AND 2012

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 April 14, 2008, the Company entered into a Share Exchange Agreement (the "Share Exchange Agreement") to acquire Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd., subsequently renamed SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd. ("Taiyu"), a privately held Sino-foreign joint venture company formed under the laws of the People's Republic of China ("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. Pursuant to the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu's share capital of RMB 25,000,000 ($3.95 million) were exchanged for 1,850,000 shares of SmartHeat's common stock (the "Share Exchange"). SmartHeat received PRC government approval on May 28, 2008, of its 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 joint venture shareholders who had received shares of SmartHeat common stock in the Share Exchange. Concurrent with the Share Exchange, one of SmartHeat's shareholders cancelled 250,000 issued and outstanding shares of SmartHeat common stock pursuant to a split-off agreement dated April 14, 2008. As a result of the Share Exchange, Taiyu became a wholly foreign-owned enterprise of SmartHeat.

On September 25, 2008, the Company entered into a Share Exchange Agreement with Asialink (Far East) Limited to acquire all of the outstanding capital stock of SanDeKe Co., Ltd., a Shanghai-based manufacturer of PHEs ("SanDeKe") for $741,500. In June 2013, SanDeKe temporary halted its factory operation as a result of cost control; Taiyu temporarily took over SanDeKe's business including existing sales orders and manufacturing task fulfillment, and consumption of inventory in stock. The management will resume the operation of SanDeKe's factory in Shanghai depending on future operating and production needs.

On June 12, 2009, the Company incorporated a new subsidiary, SmartHeat Siping Beifang Energy Technology Co., Ltd. ("SmartHeat Siping"), to manufacture PHEs.

On June 16, 2009, Taiyu closed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd. ("SipingBeifang"), a company organized under the laws of the PRC, to purchase certain assets consisting of the plant, equipment and certain land use rights for RMB 54,000,000 ($7.91 million). Taiyu then transferred all the acquired assets to SmartHeat Siping, the newly incorporated subsidiary. The Company paid RMB 7,250,000 ($1.06 million) on completion of inventory inspection, with the remaining consideration paid as of June 30, 2011.

On August 14, 2009, the Company formed Beijing SmartHeat Jinhui Energy Technology Co., Ltd. ("Jinhui"), a joint venture in Beijing with registered capital of RMB 10 million ($1.46 million), to provide consulting services and expand the Company's sales of PHEs into new industries and regions of China. SmartHeat owns 52% of Jinhui and invested $765,000.

On April 7, 2010, the Company formed SmartHeat (China) Investment Co., Ltd. ("SmartHeat Investment"), an investment holding company and wholly owned subsidiary in Shenyang with registered capital of $70 million.

Table of Contents

On April 12, 2010, SmartHeat Investment formed SmartHeat (Shenyang) Energy Equipment Co., Ltd. (“SmartHeat Energy”), a wholly owned subsidiary in Shenyang with registered capital of $30 million, for the research, development, manufacturing and sales of energy products.

On May 6, 2010, the Company formed SmartHeat (Shanghai) Trading Co., Ltd. (“SmartHeat Trading”) through a nominee to market and to expand sales of the Company’s Taiyu-branded products. The Company made a capital contribution of $1.5 million and, from inception until November 9, 2011, controlled and was entitled to 100% of the profit or loss of SmartHeat Trading pursuant to an investment agreement dated February 1, 2010.Effective November 9, 2011, the Company terminated the nominee-owner relationship and acquired direct control over SmartHeat Trading.

On January 7, 2011, the Company invested $771,600 for 51% of the equity in Hohhot Ruicheng Technology Co., Ltd. (“Ruicheng”), a joint venture (“JV”) formed on December 2, 2010, in Hohhot City, China, for the design and manufacture of heat meters.

On March 1, 2011, the Company entered into a purchase agreement with Shenyang Bingchuan Refrigerating Machine Limited Company, a Shenyang-based state-owned heat pump manufacturer and designer, which was renamed SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. (“SmartHeat Pump”). The Company paid RMB 50 million ($7.6 million) to acquire 95% of the equity in SmartHeat Pump, with a local government entity retaining the remaining 5%. The Company increased its ownership in SmartHeat Pump to 98.8% in late 2011.

On March 3, 2011, the Company completed the acquisition of GustrowerWarmepumpen GmbH, a designer and manufacturer of high efficiency heat pumps in Germany subsequently renamed SmartHeat Deutschland GmbH (“SmartHeat Germany”), from Conergy AG for EUR 4.25 million ($5.90 million) paid at closing. This acquisition extended the Company’s clean technology heating solutions into the rapidly growing heat pump markets in Europe and China, enabling its customers to purchase technologically advanced heat pumps at competitive prices.

In April 2012, the Company invested RMB 4,600,000 ($0.72 million) to establish a new JV named Urumchi XinRui Technology Limited Liability Company (“XinRui”). The Company owns 46% of XinRui. During 2012, XinRui commenced operations. Xinrui mainly conducts research and development, production and selling of heat meters and automatic control of heat supply network, Urumchi Annai energy Conservation Company Ltd. (“Annai”) owns 30% of Xinrui’s registered capital and Beijing Taiyu Huineng Company Ltd. (“Huineng”) owns 24% of Xinrui’s registered capital.

Effective February 7, 2012, the Company implemented a one-for-ten reverse split of its common stock as approved by the Board of Directors on January 19, 2012. All share amounts and per share prices were retroactively adjusted to reflect the effect of this reverse split.

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 Investment, SmartHeat Trading, SmartHeat Jinhui, SmartHeat Germany and 98.8% of SmartHeat (Shenyang) Heat Pump.

After the assignment, Heat PHE Inc. owned 100% of Taiyu, SanDeKe, SmartHeat Siping, SmartHeat Shenyang Energy and 51% of Hohot Ruicheng.

On August 23, 2013, the Company entered into a Stock Pledge Agreement with Northtech Holdings Inc. 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.; 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.

The 40% equity interest sale of Taiyu, Siping, Shenyang Energy Equipment changes the parent company's ownership interest while it retains controlling financial interest in the subsidiaries and is accounted for as an equity transaction (investments by owners and distributions to owners acting in their capacity as owners). No gain or loss was recognized in consolidated net income or comprehensive income. The carrying amount of the non-controlling interest was adjusted to reflect the change in the parent's ownership interest in the subsidiaries. Any difference between the fair value of the consideration received or paid and the amount by which the non-controlling interest is adjusted is recognized in equity attributable to the parent. The amount of difference recognized and allocated to non-controlling interest was $22.09 million including $4.86 million the carrying amount of accumulated other comprehensive income (ASC Topic 810-10-45-23 & 24). The 40% equity interest sale of Ruicheng and Xinrui changes the parent's ownership interest and the parent lost controlling interest; accordingly, an $842,491 loss was recognized from the sale.

The Company retains 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 unexercised. If the Company does not exercise its option to repurchase the equity interest, the buyers shallhave the option to purchase an additional 40% equity interest in the TargetCompanies for an additional purchase price of RMB 6,000,000, which was exercised on March 27, 2014 subject to satisfaction of the terms set forth in the Equity Interest Purchase Agreement including, without limitation, requisite approval of the Company's 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 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.

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").

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 and SmartHeat Shenyang Heat Pump, 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, Shengyang 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 will be accounted for by equity method accounting.

Equity Method Investee

In April 2012, the Company invested $722,700 to establish XinRui. The Company owns 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 will increase with income and decrease for dividends and losses that accrue 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. For accounting purposes, Ruicheng assets and liabilities were not consolidated as at December 31, 2013 while its income and expenses remain part of the consolidated financial statements as the change in ownership interest may not change financials results substantially between December 30, 2013 and December 31, 2013. Similarly for XinRui, the equity method investment income was recorded using 46% ownership interest for the year ended December 31, 2013, as the change in ownership interest may not change financials results substantially between December 30, 2013 and December 31, 2013 (See Note 9). The Company recorded $400,941 and $441,550 loss on sale of 40% equity interest of Xinrui and Ruicheng, respectively and long term investment impairment of $0.91 million.

Noncontrolling Interest

The Company follows Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") Topic 810, "Consolidation," which established new standards governing the accounting for and reporting of noncontrolling interests ("NCIs") in partially owned consolidated subsidiaries and the loss of control of subsidiaries. Certain provisions of this standard indicate, among other things, that NCIs, previously referred to as minority interests, be treated as a separate component of equity, not as a liability, as was previously the case, that increases and decreases in the parent's ownership interest that leave control intact be treated as equity transactions rather than as step acquisitions or dilution gains or losses and that losses of a partially owned consolidated subsidiary be allocated to the NCI even when such allocation might result in a deficit balance. This standard also required changes to certain presentation and disclosure requirements. Losses attributable to the NCI in a subsidiary may exceed the NCI's interests in the subsidiary's equity. The excess attributable to the NCI is attributed to those interests. The NCI shall continue to be attributed its share of losses even if that attribution results in a deficit NCI balance.

After the sale of 40% equity interest of Taiyu, Siping, Shengyang 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 and 27.6% of Xinrui. For accounting purposes, the 40% net loss of Taiyu, Siping, Shenyang Energy were not allocated to noncontrolling interest between December 30, 2013 and December 31, 2013, as the change in ownership interest may not change financial results substantially between December 30, 2013 and December 31, 2013. However, the Company performed long-lived assets impairment test for Taiyu, Siping, Shengyang Energy on December 31, 2013, and recognized $13.73 million impairment loss with $5.49 million allocated to noncontrolling interest on December 31, 2013.

F-10

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

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 December 31, 2013 and 2012, the Company maintained restricted cash deposit in several bank accounts for the purposes described below.

		2013		2012
		(In millions)		
Support of performance guarantee	$	1.16	$	0.62
Support of bank acceptance		1.29		0.37
Support of letter of credit		0.008		-
Total restricted cash - current	$	2.46	$	0.99
Performance guarantee -- noncurrent	$	0.14	$	0.04

The following table presents in U.S. dollars ("USD") the amount of cash and equivalents held by the Company as of December 31, 2013 and 2012, 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
December 31, 2013	$	251,461	$	11,326,282	$	2,024,656	$	13,602,399
December 31, 2012	$	82,479	$	15,311,830	$	2,941,854	$	18,336,163

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 $48.25 million and $28.2 million at December 31, 2013 and 2012, respectively.

At December 31, 2013, and 2012, the Company had retentions receivable from customers for product quality assurance of $4.44 and $4.23 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.

Accounts receivable is net of unearned interest of $26,655 and $12,532 at December 31, 2013 and 2012, 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 during 2013 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.

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.

Impairment of Long-Lived Assets

Long-lived assets, which include tangible assets, such as property, plant and equipment, goodwill and other intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable.

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value ("FV") of the assets. FV generally is determined using the asset's expected future discounted cash flows or market value, if readily determinable. The Company evaluates goodwill and intangible assets with indefinite lives for impairment annually using a two-step approach (codified in FASB ASC Topic 350). Based on this valuation approach, the Company concluded that the goodwill balance of $2.08 million for SmartHeat Germany was impaired as of December 31, 2012, as discussed under Goodwill below.

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 ("Target Companies"): Taiyu, Siping, SmartHeat Energy, Ruicheng and XinRui for the purchase price of RMB 5,000,000 ($0.82 million) (See Note 1). The buyers had the option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000 which was exercised on March 27, 2014 subject to the approval of the Company's shareholders prior to completing the sale. Should 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.

According to ASC 360-10-35, a long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The Company believed the following events or changes in circumstances indicated the carrying amount of its long-lived assets (asset group) may not be recoverable: 1) a current expectation that, more likely than not, a long-lived assets (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life, and 2) A significant decrease in the market price of a long-lived asset (asset group). Since the Company has the option to sell 100% ownership in Target Companies for RMB 13.5 million ($2.21 million), a significant decrease in the market price, before the end of its previously estimated useful life for their long-lived assets, the Company therefore performed assets recoverability testing by comparing the assets estimated future undiscounted cash flows with their carrying value, and concluded the long-lived assets were not recoverable as a result of future cash flows are less than the carrying amount. The Company further calculated the impairment loss amount of Target Companies by determining the fair value for the long-lived asset group and recorded a write-down (loss) for the difference between their carrying value and their fair value. Fair value is an asset's purchase or sale price in a current transaction between willing parties. The best evidence of fair value is prices quoted in active markets, although the Company has the option to sell 100% ownership in Target Companies for RMB 13.5 million ($2.21 million), the market prices are not available for many long-lived assets such as equipment, the Company used discounted cash flow method for estimating fair value of long-lived assets which are acceptable under ASC 360-10.

Based on its evaluation, the Company believed, as of December 31, 2013, the long-lived assets of Target Companies including construction in progress, property and equipment, and intangible assets were impaired for $13.73 million. In addition, the Company retained remaining 30.6% and 27.6% interest in Ruicheng and XinRui (after the 40% sale), respectively, at December 31, 2013, that was accounted for under the equity method of accounting, the Company recorded the long-term investment in Ruicheng and XinRui at fair value as provided in ASC 323-10-30-2. The fair value of the long-term investment was the prorated selling price for the remaining 60% equity interest that are allocated to Ruicheng and XinRui for approximately $26,720; accordingly, the Company recorded

$0.91 million impairment loss of long-term investment in Ruicheng and XinRui for the excess of the carrying amount over the fair value.

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, 2012, to December 31, 2013, is as follows:

	2013	2012
Beginning balance	$ 517,076	$ 515,812
Provisions	331,989	377,583
Actual costs incurred	(376,507)	(377,583)
Exchange rate	-	1,264
Ending balance in current liabilities (Note 13)	$ 472,558	$ 517,076

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 years ended December 31, 2013 and 2012, were $1,424,400 and $1,530,000, respectively.

Income Taxes

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes" (codified in FASB ASC Topic 740), which requires recognition of deferred tax assets and liabilities for expected future tax consequences of events included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

The Company follows FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (codified in FASB ASC Topic 740). When tax returns are filed, it is likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50% likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest associated with unrecognized tax benefits is classified as interest expense and penalties are classified as selling, general and administrative expense in the statements of operation. At December 31, 2013, the Company had not taken any significant uncertain tax position on its tax returns for 2012 or prior years, or in computing its tax provision for 2013.

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.

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 2013 and 2012. 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 2013 and 2012, revenue from after-sales services after the expiration of the warranty period was $24,732 and $346,653, 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.

Concentration of Credit Risk

Cash includes cash on hand and demand deposits in accounts maintained within China. Balances at financial institutions within China are not covered by insurance. The Company has not experienced any losses in such accounts.

Certain other financial instruments, which subject the Company to concentration of credit risk, consist of accounts and other receivables. The Company does not require collateral or other security to support these receivables. The Company conducts periodic reviews of its customers' financial condition and customer payment practices to minimize collection risk on accounts receivable.

The operations of the Company are located primarily in China. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in China, as well as by the general state of the PRC economy.

Goodwill

Goodwill is the excess of purchase price and related costs over the value assigned to the net tangible and identifiable intangible assets of businesses acquired. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets" ("Statement No. 142"), codified in ASC Topic 350, goodwill is not amortized but is tested for impairment, annually or when circumstances indicate a possible impairment may exist. Impairment testing is performed at a reporting unit level. An impairment loss generally would be recognized when the carrying amount of the reporting unit exceeds its FV with the FV of the reporting unit determined using discounted cash flow ("DCF") analysis. A number of significant assumptions and estimates are involved in the application of the DCF analysis to forecast operating cash flows, including the discount rate, the internal rate of return and projections of realizations and costs to produce. Management considers historical experience and all available information at the time the FVs of its reporting units are estimated.

The excess of the purchase price for SmartHeat Germany over the FV of the net assets acquired of $5.1 million (EUR 3.69 million at acquisition date) was recorded as goodwill.

The Company performed an annual goodwill impairment assessment for SmartHeat Germany as of December 31, 2012. Based on this analysis, the Company concluded that the remaining goodwill balance of $2.08 million ($3.00 million was impaired in 2011) for SmartHeat Germany was impaired as of December 31, 2012. The goodwill impairment charge is non-cash. The goodwill impairment charge is not deductible for income tax purposes and, therefore, the Company has not recorded a corresponding tax benefit in 2012.

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 2013 and for 2012, 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 December 31, 2013 and 2012, options to purchase 2,500 and 3,500 shares of common stock were outstanding and exercisable, respectively.

Fair Value of Financial Instruments

For certain of the Company's financial instruments, including cash and equivalents, restricted cash, accounts and other receivables, advance to suppliers, accounts payable, advance from customers, accrued liabilities and short-term debts, the carrying amounts approximate their fair values due to their short maturities. ASC Topic 820, "Fair Value Measurements and Disclosures," requires disclosure of the FV of financial instruments held by the Company. ASC Topic 825, "Financial Instruments," defines FV, and establishes a three-level valuation hierarchy for disclosures of FV measurement that enhances disclosure requirements for FV measures. The carrying amounts reported in the consolidated balance sheets for receivables and current liabilities each qualify as financial instruments and are a reasonable estimate of their fair values because of the short period of time between the origination of such instruments and their expected realization and their current market rate of interest. The three levels of valuation hierarchy are defined as follows:

- Level 1 inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets.

- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

- Level 3 inputs to the valuation methodology are unobservable and significant to the FV measurement.

The Company analyzes all financial instruments with features of both liabilities and equity under ASC 480, "Distinguishing Liabilities from Equity," and ASC 815.

As of December 31, 2013 and 2012, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at FV.

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 December 31, 2013 and 2012, and the average exchange rates for the years ended December 31, 2013 and 2012 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 Years Ended		Balance Sheet Date Exchange Rate	
	12/31/13	12/31/12	12/31/13	12/31/12
RMB - USD	6.2142	6.3125	6.0969	6.2855
EUR - USD	0.7530	0.7777	0.7263	0.7777

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with SFAS No. 123R, "Share-Based Payment, an Amendment of FASB Statement No. 123" (codified in FASB ASC Topics 718 and 505). The Company recognizes in the income statement the grant date FV of stock options and other equity-based compensation issued to employees and non-employees.

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.

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 years ended December 31, 2013 and 2012, and as of December 31, 2013 and 2012, respectively.

	Years Ended December 31,	
	2013 (Restated)	2012
Revenue from unaffiliated customers:		
Plate heating, meters and related	$ 38,882,321	$ 42,074,895
Heat pumps and related	5,959,011	5,797,898
Inter-segment elimination	(131,806)	(22,501)
Consolidated	$ 44,709,526	$ 47,850,292
Operating loss:		
Plate heating, meters and related	$ (48,917,342)	$ (21,479,856)
Heat pumps and related	(2,886,815)	(6,435,921)
Corporation	(2,439,168)	(2,073,546)
Inter-segment elimination	1,055	-
Consolidated	$ (54,242,270)	$ (29,989,322)
Net loss:		
Plate heating, meters and related	$ (44,283,015)	$ (22,379,983)
Heat pumps and related	(2,095,207)	(5,715,209)
Corporation	(3,292,174)	(1,121,889)
Inter-segment elimination	1,055	-
Consolidated	$ (49,669,341)	$ (29,217,082)
Depreciation and amortization:		
Plate heating, meters and related	$ 1,537,002	$ 1,591,210
Heat pumps and related	511,846	300,875
Corporation	133,792	-
Consolidated	$ 2,182,640	$ 1,892,084
Total assets:		
Plate heating, meters and related	$ 113,919,061	$ 152,830,853
Heat pumps and related	13,674,622	14,340,054
Corporation	3,374,858	4,031,567
Inter-segment elimination	(16,153,739)	(14,732,187)
Consolidated	$ 114,814,802	$ 156,470,287

New Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-2, Comprehensive Income (ASC Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income, the new ASU requires entities to disclose in a single location (either on the face of the financial statement that reports net income or in the notes) the effects of reclassifications out of accumulated other comprehensive income (AOCI). For items reclassified out of AOCI and into net income in their entirety, entities must disclose the effect of the reclassification on each affected net income item. For AOCI reclassification items that are not reclassified in their entirety into net income, entities must provide a cross-reference to other required U.S. GAAP disclosures. There is no change in the requirement to present the components of net income and other comprehensive income in either a single continuous statement or two separate consecutive statements. The ASU does not change the items currently reported in other comprehensive income.

For public entities, the new disclosure requirements are effective for annual reporting periods beginning after December 15, 2012, and interim periods within those years (i.e., the first quarter of 2013 for entities with calendar year-ends). The ASU applies prospectively, and early adoption is permitted. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

As of December 31, 2013, 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, including the reclassification of credit line payable of $83,537 from other payables in the balance sheet, and reclassification of proceeds from credit line payable of $1,284,837 to financing activities from operating activities in the cash flow statement.

3. INVENTORIES

Inventories at December 31, 2013 and 2012, were as follows:

	2013	2012
Raw materials	$ 48,258,773	$ 38,829,405
Work in process	6,822,102	9,831,235
Finished goods	12,639,202	15,070,801
Total	67,720,077	63,731,441
Inventory allowance	(11,395,714)	(5,433,879)
Inventories, net	$ 56,324,363	$ 58,297,562

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 December 31, 2013, the Company was contingently liable for the notes endorsed to vendors of $1.37 million.

5. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at December 31, 2013 and 2012:

		2013 (Restated)		2012
Buildings	$	4,980,184	$	4,830,751
Production equipment		8,599,701		8,160,111
Office equipment		1,124,176		1,120,799
Vehicles		940,624		937,364
Total		15,644,685		15,049,025
Less: accumulated depreciation		(5,459,525)		(4,101,545)
Less: impairment		(8,547,040)		-
Property & equipment, net	$	1,638,120	$	10,947,480

Depreciation for 2013 and 2012, was $1,482,500 and $1,275,000, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at December 31, 2013 and 2012, respectively:

		2013		2012
Advance to third parties	$	10,059,572	$	4,813,659
Deposit for public bids of sales contracts		758,465		1,397,375
Prepayment for freight, related, insurance, advertisement and consulting expenses		73,773		332,415
Other deposits		53,863		93,816
Advance to employees		926,441		729,422
Others		680,588		376,738
Total		12,552,702		7,743,425
Less: bad debt allowance		(9,908,180)		(1,276,145)
Other receivables (net), prepayments & deposits	$	2,644,522	$	6,467,280

Advance to third parties were short-term unsecured advances to unrelated parties with payment usually due within a year and includes an advance to SipingBeifang of RMB 22.13 million ($3.63 million) that is non-interest bearing and with due date extended to September 2014, and an advance to unrelated company of RMB 39.20 million ($6.43 million) that is non-interest bearing and will be collected by the end of June 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 SipingBeifang. 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 by 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 total 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.

Intangible assets consisted of the following at December 31, 2013 and 2012, respectively:

	Estimated Useful Life (In years)	2013 (Restated)	2012
Land use rights	50	$ 15,167,552	$ 14,712,441
Know-how technology	5 – 10	911,423	884,076
Customer lists	5	214841	208,395
Covenants not to compete	5	116,873	113,366
Software	5	680,049	590,344
Trademarks	7	298,549	289,591
Total		17,389,287	16,798,213
Less: accumulated amortization		(2,503,664)	(1,877,610)
Less: impairment		(3,842,904)	-
Intangible assets, net		$ 11,042,719	$ 14,920,603

Amortization of intangible assets for the years ended December 31, 2013 and 2012, was $566,300 and $452,300, respectively. Annual amortization for the next five years from December 31, 2013, is expected to be $251,820, $135,070, $131,650, $127,030 and $74,880, and $96,550 thereafter.

8. CONSTRUCTION IN PROGRESS

The Company had construction in progress of $1.34 million at December 31, 2013, consisting of three ongoing projects.

1) SmartHeat Energy is building a factory for a total estimated cost of $9.00 million, of which the Company paid $0.46 million as of December 31, 2013 and 2012. The Company temporarily halted construction on this factory because of the return of the land use right to the local authority with full refund of the purchase price received.

2) SmartHeat Siping has a construction project of $36,000 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 stage of final inspection by the authority. The Company expects to complete the inspection in the third quarter of 2014.

The construction in progress at December 31, 2013 was fully impaired as described in Note 2 “Impairment of Long-Lived Assets”.

9. LONG TERM INVESTMENT

In April 2012, the Company invested $722,700 to establish XinRui. The Company owns 46% of XinRui and accounted for this investment under the equity method. The investment income from XinRui was $153,237 during the year ended December 31, 2013.

The unaudited condensed Statement of Income of XinRui for the year ended December 31, 2013 is below:

Net Revenue	$ 1,216,983
Cost of Revenue	(593,476)
Gross Profit	623,507
Operating expenses	149,276
Income from operations	474,231
Non-operating income	(22,549)
Income tax expense	(118,559)
Net Income	$ 333,123

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 carrying amount of investment of Xinrui after the sale was $612,808.

On January 7, 2011, the Company invested $771,600 for 51% of the equity in Ruicheng and sold 40% equity interest of Ruicheng on December 30, 2013, and owns 30.6% of Ruicheng after the sale (See Note 2). The carrying amount of investment of Ruicheng after the sale was $321,997.

The long-term investment was accounted for under the equity method of accounting, the Company recorded the long-term investment in Ruicheng and XinRui at fair value as provided in ASC 323-10-30-2. The fair value of the long-term investment was the prorated selling price for the remaining 60% equity interest that are allocated to Ruicheng and XinRui for approximately $26,720; accordingly, the Company recorded $0.91 million impairment loss of long-term investment in Ruicheng and XinRui for the excess of the carrying amount over the fair value.

10. MAJOR CUSTOMERS AND VENDORS

One customer accounted for 10% of total sales for the year ended December 31, 2013. At December 31, 2013, total receivable from this customer was $1,286,257.

For the year ended December 31, 2012, no customer accounted for over 10% of the Company’s total sales.

For the years ended December 31, 2013 and 2012, no vendors accounted for over 10% of the Company’s total purchases.

11. TAXES RECEIVABLE

Taxes receivable consisted of the following at December 31, 2013:

	2013
Income	$ 180,764
Value-added	787,293
Other	21,578
Total	$ 989,635

12. TAXES PAYABLE

Taxes payable consisted of the following at December 31, 2013 and 2012:

	2013	2012
Income	$ 516	$ 505,643
Value-added	160,118	101,195
Other	36,444	162,329
Total	$ 197,078	$ 769,167

13. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at December 31, 2013 and 2012:

	2013	2012
Advance from third parties	$ 3,378,167	$ 68,068
Payable to Siping Beifang	2,306,184	1,947,808
Payable for equipment purchase	322,295	312,624
Payable to employees	-	219,977
Refund of land use right purchased	4,627,270	-
Others	1,738,241	1,248,877
Warranty reserve (See Note 2)	472,558	517,076
Accrued expenses	1,382,051	691,697
Total	$ 14,226,766	$ 5,006,127

Advances from third parties were short-term, non-interest-bearing advances from third parties due on demand. Payable to Siping Beifang represents loans to them without interest and payable upon demand.

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 $4.63 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 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 SmartHeat Energy receives further information, the excess amount 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, $213,149 for to-be-reimbursed expenses, and $25,000 to the Company's audit committee chairman for performing market research for the HP products in North America. Accrued expenses mainly consisted of accrued payroll, interest and utility.

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 December 31, 2013 and 2012, the Company deposited $1.30 million and $0.37 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.

15. LOANS PAYABLE

Short-Term Bank Loans

The Company was obligated for the following short-term loans as of December 31, 2013 and 2012:

	2013	2012	Subsidiary obligated
From a commercial bank in the PRC for RMB 50,000,000 entered into on February 17, 2012.The loan bore interest at 7.872% with maturity on January 16, 2013. The loan was repaid at maturity.	$ -	$ 7,954,817	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on July 12, 2012. The loan bore interest at 7.87% with maturity on July 11, 2013. The loan was repaid at maturity.	-	1,590,963	Siping
From a commercial bank in the PRC for RMB 10,000,000 entered into on August 23, 2012. The loan bore interest at 6.30% with maturity on August 22, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,590,963	Taiyu
From a commercial bank in the PRC for RMB 9,000,000 entered into on September 7, 2012. The loan bore interest at 6.3% with maturity on September 6, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,431,867	Taiyu
From a commercial bank in the PRC for RMB 8,000,000 entered into on September 13, 2012. The loan bore interest at 6.3% with maturity on September 12, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,272,771	Taiyu
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 21, 2012. The loan bore interest at 6.6% with maturity on August 20, 2013. The loan was repaid at maturity.	-	4,772,890	Taiyu
From a commercial bank in the PRC for RMB 9,600,000 entered into on September 13, 2012. The loan bore interest at 6.6% with maturity on March 3, 2013. This loan was guaranteed by accounts receivable. The loan was repaid at maturity.	-	1,527,325	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	2,354,626	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.	1,640,178	1,590,963	Siping
From a commercial bank in the PRC for RMB 13,000,000 entered into on December 12, 2011. The	-	2,068,252	Taiyu

loan bore interest at 6.65% with maturity on October 26, 2013. This loan was pledged with Taiyu's building and land. This loan was repaid at maturity.			
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 8,550,000 entered into on January 9, 2013. The loan bore interest at 6.00% with maturity on December 10, 2013. This loan was repaid at maturity.	-	-	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.	1,640,178	-	Taiyu
From a commercial bank in the PRC for RMB 10,570,234 entered into on June 3, 2013. The loan bore interest at 6.16% with maturity on December 30, 2013. This loan was repaid at maturity.	-	-	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.	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.	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.	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.	1,623,776	-	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.	1,623,776	-	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
TOTAL	$ 24,462,299	$ 26,155,437	

Of the loans listed above that are guaranteed by a third party, the guarantees were provided by 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.

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, 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. At the Company's option, the maturity date of the Credit Facility may be extended for up to four successive 9-month periods for an extension fee of 4% of the Committed Amount for each extension. 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 December 21, 2012, the Company entered into an amendment to the credit and security agreement, which (1) redefined the "average share price" to state that in no event would the average share price be lower than $0.50 or higher than $3.50; (2) raised the maximum credit line to $2.5 million; (3) changed the initial maturity date to April 30, 2014; (4) redefined the calculation of the Restricted Shares of common stock if repaid by Restricted Shares; (5) redefined the purpose of the proceeds of the credit line; (6) raised the security interest from 35% to 55% of the Company's equity interests in each of its wholly, directly owned subsidiaries.

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, and pledged shares representing 55% security interest in each of its wholly-, directly-owned subsidiaries.

On December 21, 2012, the Company's Board of Director ("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 December 31, 2013 and 2012 was $1,396,378 and

$83,537, 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 amortized $73,589 of the $100,000 extension fee during the year ended December 31, 2013, $24,194 will be amortized in one year, the unamortized extension fee was recorded as prepaid expense. The Company amortized $31,315 of the $60,000 amendment fee during the year ended December 31, 2013, $28,685 will be amortized in one year, the unamortized amendment fee was recorded as prepaid expense.

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 Board of Directors approved the extension on March 27, 2014.

Long-Term Bank Loan

The Company entered into a long-term loan of $2,132,231(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.

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 December 31, 2013 and 2012, deferred tax asset (liability) consisted of the following:

		2013 (Restated)		2012
Deferred tax asset - current (bad debt allowance)	$	7,715,041	$	5,147,303
Deferred tax asset - current (inventory allowance)		2,321,878		959,388
Deferred tax asset – current (allowance to other receivable)		2,099,125		-
Deferred tax asset – current (allowance for advance to supplier)		398,224		-
Deferred tax asset – current (reserve for warranty)		75,808		-
Deferred tax asset – noncurrent (impairment loss on long-lived assets)		3,334,594		-
Less: valuation allowance		(15,944,670)		(6,106,691)
Deferred tax assets, net	$	-	$	-
Deferred tax liability - noncurrent (depreciation of fixed assets)	$	(17,177)	$	(93,054)

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 $7.25 million at December 31, 2013, 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 2013. The local PRC government reviews the high-tech status of such enterprises annually. The income tax rate for SanDeKe is 13% for 2012, because of its foreign-invested enterprise status, and its income tax rate increased to 24% in 2013.

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

Consolidated foreign pretax loss approximated $52.09 million and $27.95 million for 2013 and 2012, respectively. Pretax earnings of a foreign subsidiary are subject to U.S. taxation when effectively repatriated. The Company provides income taxes on the undistributed earnings of non-U.S. subsidiaries except to the extent those earnings are invested indefinitely outside the United States. At December 31, 2013, approximately 0.94 million of accumulated undistributed earnings of non-U.S. subsidiaries was invested indefinitely. At the existing U.S. federal income tax rate, additional taxes of $94,500 would have to be provided if such earnings were remitted currently.

The following table reconciles the U.S. statutory rates to the Company's effective tax (benefit) rate for the years ended December 31, 2013 and 2012:

	2013	2012
U.S. statutory tax (benefit) rates	(34.0)%	(34.0)%
Tax rate difference	8.4%	8.6%
Effect of tax holiday	5.2%	6.5%
Permanent difference – goodwill impairment	-%	1.1%
Valuation allowance	20.3%	19.5%
Tax benefit per financial statements	(0.1)%	1.7%

The income tax (benefit) for the years ended December 31, 2013 and 2012, consisted of the following:

		2013		2012
Income tax expense - current	$	26,612	$	590,136
Income tax benefit - deferred		(77,269)		(96,512)
Total income tax (benefit) expense	$	(50,657)	$	493,624

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 December 31, 2013, 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.

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.

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 July 17, 2008, the Company granted non-statutory stock options to each of its two independent U.S. directors. The terms of each option are 1,000 shares at an exercise price per share of $46.00, with a life of five years and vesting over three years as follows: 333 shares vested on July 17, 2009; 333 shares vested on July 17, 2010; and 334 shares vested on July 17, 2011, subject in each case to the director continuing to be associated with the Company as a director. The options were valued using a volatility of 15%, risk-free interest rate of 2.76%, and dividend yield of 0%. No estimate of forfeitures was made as the Company has a short history of granting options. On July 31, 2009, one of the Company's independent U.S. directors voluntarily retired. As such, he forfeited his right to his unvested options to purchase 667 shares. Upon his retirement as director, any vested portion of the grant remained exercisable for 90 days following retirement under the terms of the option grant. Accordingly, the 333 vested options expired unexercised as of October 29, 2009. The remaining 1,000 options were expired unexercised on July 16, 2013.

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.

F-29

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, 2012	6,000	106.40	2.83
Exercisable at January 1, 2012	3,500	97.80	2.65
Granted	-	-	-
Exercised	-	-	-
Forfeited	2,500	118.50	-
Outstanding at December31, 2012	3,500	$ 97.80	1.65
Exercisable at December31, 2012	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

There were no options exercised during the years ended December 31, 2013 and 2012. The Company recorded $0 and $37,919 as compensation expense for stock options during the years ended December 31, 2013 and 2012, respectively.

Common Stock Issued

On October 10, 2012, the BOD approved the issuance of 300,000 shares of stock to a consulting firm at $0.05 per share in accordance with the restructuring agreement with the consulting firm (see "Restructuring Agreement with a Consulting Firm" below). The FV of the shares issued was $15,000 at the issuance date. The Company and the consulting firm mutually agreed in good faith that $0.05 per share was the FV of such restricted stock. The determination of FV was based on the market price of the Company's common stock, the volatility of the market price, the irregularity of trading in the Company's common stock, the absence of a stable trading market, the market's concern of NASDAQ and SEC view toward "reverse merger companies," the Company's financial condition, the Company's negative cash flow, the Company's limited control over the management or operations of its subsidiaries, the Company's commitment to fund substantial registered capital commitments to its subsidiaries, the transfer and sale restrictions applicable to the restricted stock, the restrictions on voting rights of such restricted stock, and limitations on the right to distributions on, and capital appreciation of, the restricted stock as the share could be bought back by the Company.

On December 11, 2012, at the Company's shareholders' annual meeting, the Company's shareholders approved the issuance of 100,000 restricted shares of common stock to the Executive Olive Bialowons for $5,000 in accordance with the Executive Agreement. The FV of the shares issued was $5,000 at the issuance date. The FV of $0.05 per share was determined in accordance with the factors referenced above.

On December 18, 2012, the Company issued 77,625 restricted shares of common stock at $1.00 per share to subsidiary executive Xudong Wang to repay the outstanding principal and interest on promissory note of $77,625 (principal of $75,000 and accrued interest of $2,625), as approved by the BOD on December 14, 2012. The Company recorded $44,945 gain on settlement of debt and was included in other income. The stock price at the stock issuance date was $0.42; accordingly, the FV of the shares issued was $32,603 on such date.

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).

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 is $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: 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 is RMB 5,000,000 ($801,000), was paid by the buyers on December 30, 2013.

20. OTHER INCOME

The Company had net other income, of $1,314,945 and $2,643,786 for the years ended December 31, 2013 and 2012, respectively. The net other income for the year ended December 31, 2013 consisted of income (net) from sales of raw material of $810,653, government subsidy of $457,717 and other non-operating income of $245,119, but offset by loss (net) from after-sales services of $198,544. The other income of $2,643,786 for 2012 mainly consisted of income (net), from selling of raw material of $582,200; income from providing technical service of $450,700; income (net) from after-sales services of $186,730, gain on settlement of debts of $813,245 through issuance of shares, and insurance compensation of $496,260 for the fire loss.

21. COMMITMENTS

Executive Agreements

On July 10, 2012, SmartHeat entered into an agreement with Mr. Oliver Bialowons, the Company's President, effective as of May 25, 2012 for a one-year term, and continued on a month-to-month basis thereafter, subject to termination by either party at any time. Mr. Bialowons was compensated at $20,000 per quarter during 2012 and $25,000 per quarter during 2013 and 2014. On December 11, 2012, the Company issued 100,000 restricted shares of common stock at $0.05 per share to the Oliver Bialowons in accordance with the Executive Agreement after the issuance was approved by the Company's stockholders and Mr. Bilaowons paid consideration of $0.05 per share.

F-31

The shares are restricted from being sold or transferred to more than 10 persons or entities, until June 30, 2017. The Company has the option to repurchase the 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, and $0.80 per share until January 31, 2016.

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 years ended December 31, 2013 and 2012, was $425,400 and $766,000, 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 December 31, 2013, 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. The agreement ran to January 23, 2013.

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.

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 until 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.

22. CONTINGENCIES

Certain of the Company's bank loans were guaranteed for repayment by a third party. The guarantee term is same as the loan term and the Company is not required to pay for this guarantee service as the Company provides the same guarantee service to loans of the third party. As of December 31, 2013 and 2012, the Company has signed a contract to provide guarantees of up to RMB 0 and RMB 20 million ($3.18 million) in loans for the third party, respectively (See Note 15 – Loans Payable).

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, DharanendraRai 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 for 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 on the grounds that, among other things, the plaintiffs did not, in fact, allege that a member of our senior management team had sold their shares. The motion to dismiss was subsequently denied and the court set a discovery and class briefing schedule. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice to move again for such certification pending (1) the resolution of Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. 2014) by the Supreme Court of the United States regarding the viability of the efficient market theory andthe plaintiffs’ claim that reliance, and therefore injury, can be determined on a classwide basis and(2) defendants' compliance with their discovery obligations.

23. CONDENSED FINANCIAL INFORMATION OF U.S. PARENT

SmartHeat Inc. is a holding company and owns no operating assets and has no significant operations independent of its subsidiaries. Set forth below are condensed financial statements of SmartHeat Inc. (U.S. Parent) on a stand-alone, unconsolidated basis as of December 31, 2013 and 2012.

CONDENSED BALANCE SHEETS

	2013 (Restated)	2012
ASSETS		
Cash and equivalents	$ 251,461	$ 82,479
Investment in subsidiaries	34,630,504	107,327,917
Other current assets	3,830,224	3,083,928
TOTAL ASSETS	$ 38,712,189	$ 110,494,324
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accrued liabilities and other payables	$ 3,562,896	$ 1,982,870
STOCKHOLDERS' EQUITY:		
Common stock	$ 6,133	$ 5,733
Additional paid-in capital	87,393,606	103,607,559
Statutory reserve	5,389,056	5,396,014
Other comprehensive income	8,991,270	11,273,497
Accumulated deficit	(66,630,772)	(11,771,349)
Total stockholders' equity	35,149,293	108,511,454
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 38,712,189	$ 110,494,324

CONDENSED STATEMENTS OF OPERATIONS

	2013 (Restated)	2012
Operating expenses		
General and administrative expenses	$ 1,531,085	$ 2,073,546
Impairment of long-term investment	908,084	
Loss from operations	(2,439,169)	(2,073,546)
Non-operating income (expenses)	(1,006,242)	809,246
Equity loss in subsidiaries	(46,223,930)	(27,952,782)
Total non-operating loss	(47,230,172)	(27,143,536)
Loss before income tax	(49,669,341)	(29,217,082)
Income tax	-	-
Net loss	$ (49,669,341)	$ (29,217,082)

F-35

CONDENSED STATEMENTS OF CASH FLOWS

	2013 (Restated)	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (49,669,341)	$ (29,217,082)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	-	37,919
Stock issued for consulting service	-	75,000
Shares issued for loan consenting fee	30,000	-
Loss (Gain) on settlement of debt	20,000	(813,245)
Amortization of loan origination and extension fee	102,477	-
Amortization of loan amendment fee paid by shares	31,315	-
Equity loss in subsidiaries	46,223,930	27,952,782
Loss on sale of equity interest	842,491	-
Impairment of long-term investment	908,084	
Increase in current assets	-	880,750
Increase in current liabilities	367,185	2,001,959
Net cash (used in) provided by operating activities	(1,143,859)	918,083
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in subsidiaries	-	(2,422,800)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Credit line payable	1,312,841	1,284,837
Proceeds from issuance of common stock	-	20,000
Net cash provided by financing activities	1,312,841	1,304,837
NET INCREASE (DECREASE) IN CASH & EQUIVALENTS	168,982	(199,880)
CASH & EQUIVALENTS, BEGINNING OF PERIOD	82,479	282,359
CASH & EQUIVALENTS, END OF PERIOD	$ 251,461	$ 82,479

24. RESTATEMENT OF FINANCIAL STATEMENT

The consolidated financial statements for the year ended December 31, 2013 were restated to reflect the following:

1) Impairment of long-lived assets of $13,730,849, long-lived assets including construction in progress of $1,340,904, property and equipment of $8,547,040, and intangible assets of $3,842,904.
2) Impairment of long-term investment in Ruicheng and XinRui of $908,084.

The following table presents the effects of the restatement adjustment on the accompanying consolidated balance sheet at December 31, 2013:

Consolidated Balance Sheet	As Previously Reported	Restated	Net Adjustment
Long term investment	$ 934,805	$ 26,721	$ (908,084)
Construction in progress	1,340,904	-	(1,340,904)
Property and equipment, net	10,185,160	1,638,120	(8,547,040)
Intangible assets, net	14,885,623	11,042,719	(3,842,904)
Total assets	129,453,735	114,814,802	(14,638,933)
Accumulated deficit	(51,991,839)	(66,630,772)	(14,638,933)
Total Company stockholders’ equity	44,295,886	35,149,293	(9,146,593)
Noncontrolling interest	27,833,735	22,341,394	(5,492,341)
Total equity	$ 72,129,620	$ 57,490,687	$ (14,638,933)

The following table presents the effects of the restatement adjustment on the accompanying consolidated statement of operations and comprehensive income for the year ended December 31, 2013:

Consolidated Statement of Operations and Comprehensive Income	As Previously Reported	Restated	Net Adjustment
Long-lived assets impairment	$ -	$ 13,730,849	$ 13,730,849
Impairment of long-term investment		908,084	908,084
Total operating expenses	43,911,483	58,550,416	14,638,933
Loss before income taxes	(40,893,308)	(55,532,241)	(14,638,933)
Net loss before noncontrolling interest	(40,842,652)	(55,481,585)	(14,638,933)
Less: loss attributable to noncontrolling interest	(319,904)	(5,812,244)	(5,492,340)
Net loss to SmartHeat Inc.	(40,522,748)	(49,669,341)	(9,146,593)
Basic and diluted EPS	$ (6.90)	$ (8.46)	$ (1.56)

25. SUBSEQUENT EVENTS

On March 27, 2014, SmartHeat Inc. received notice pursuant to the Equity Interest Purchase Agreement, dated October 10, 2013, whereby the buyers thereunder exercised their option to purchase an additional 40% of the equity interests in the following PHE segment subsidiaries from the Company: 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 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.

On March 26, 2014, the Company gave notice to Northtech Holdings, Inc. 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

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 Bialowons, 50,000 shares to Jane Ai, 50,000 shares to Rhett Wang and 50,000 shares to Ken Scipta. The stock price is $0.15 on grant date, and the FV of the shares granted at the grant date is $37,500.

On July 14, 2014, the Company 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 October 31, 2015.

Pursuant to the terms of the Amendment, the Company extended the Initial Maturity Date by a payment to Northtech of an extension fee of 4% of the Maximum Line under the Credit Agreement. Northtech agreed to the extension of the maturity in consideration of an extension fee of 200,000 Restricted Shares of the Company's Common Stock at $0.50 per share issued on July 22, 2014. The fair value of 200,000 shares on July 22, 2014 was $40,000.

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 plaintiff once again filed a motion for class certification. On September 19, 2014, we filed an opposition to the lead plaintiff's motion for class certification, to which plaintiff filed a response on October 20, 2014. By Opinion and Order dated January 21, 2015, the Court denied plaintiffs' class certification motion, finding that it failed to satisfy the requirements of Fed. R. Civ. Pro. 23 for typicality, adequacy and predominance. Specifically, the Court found that plaintiffs' theory of liability required a trade-by-trade inquiry as to whether the sale of the locked-up shares resulted in price inflation of the company's stock, and that, as a result, the injury to all class members could not be established by common proof. In addition to finding a lack of predominance of common issues, the Court expressed substantial concerns about the adequacy of the class representative, and that his claims were typical of other class members. The Court also expressed doubts as to how plaintiffs would establish damages. The Court's denial of class certification was without prejudice, and the Court gave plaintiffs until February 17, 2015 to file a "far more rigorous, and a far more convincing submission…" The pleadings and court orders are publicly available. We intend to continue to vigorously defend this action, as we believe the allegations against us are without merit.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: February 10, 2015

By: /s/ Oliver Bialowons
Oliver Bialowons
President
(Principal Executive Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
2.1	Share Exchange Agreement and Plan of Reorganization by and among SmartHeat Inc., Shenyang Taiyu Electronic & Machinery Co., Ltd. and the Shareholders of Shenyang Taiyu Electronic & Machinery Co., Ltd., dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on April 18, 2008)
2.2	Articles of Exchange between Shenyang Taiyu Electronic & Machinery Co., Ltd. and SmartHeat Inc., dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.2 to the Company's Current Report on Form 8-K filed on April 18, 2008)
2.3	Articles of Merger between Pacific Goldrim Resources, Inc. and SmartHeat Inc., dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.3 to the Company's Current Report on Form 8-K filed on April 18, 2008)
3.1	Articles of Incorporation (Incorporated herein by reference to Exhibit 3.1 to the Company's Form SB-2 filed on December 22, 2006)
3.2	Amended and Restated By-Laws adopted April 15, 2008 (Incorporated herein by reference to Exhibit 3(ii) to the Company's Current Report on Form 8-K filed on October 16, 2008)
3(ii).2	Amended and Restated Bylaws of the Company, effective November 23, 2012
3.3	Certificate of Amendment to Articles of Incorporation, filed January 19, 2012, effective February 6, 2012 (Incorporated herein by reference to Exhibit 3.3 to the Company's Current Report on Form 8-K filed on January 20, 2012)
4.1	Specimen Stock Certificate (Incorporated herein by reference to Exhibit 4.1 of Amendment No. 2 to the Company's Registration Statement on Form S-1/A filed on February 4, 2009)
10.1#	English Translation of Employment Agreement between Shenyang Taiyu Machinery & Electronic Co., Ltd. and Jun Wang, dated January 1, 2008 (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 18, 2008)
10.2#	English Translation of Employment Agreement between Shenyang Taiyu Machinery & Electronic Co., Ltd. and Zhijuan Guo, dated January 1, 2008 (Incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on April 18, 2008)
10.3	Certificate of Appointment by Sondex A/S of Shenyang Taiyu Machinery & Electronic Co., Ltd. as Authorized Dealer in China, dated March 2006 and letter naming Shenyang Taiyu Machinery & Electronic Co., Ltd. as Dealer of North China, dated May 5, 2006 (Incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on April 18, 2008)
10.4	Agreement of Conveyance, Transfer and Assignment of Assets and Assumption of Obligations between SmartHeat Inc. and PGR Holdings, Inc., dated April 14, 2008 (Incorporated herein by reference to Exhibit 10.11 to the Company's Current Report on Form 8-K filed on April 18, 2008)
10.5	Stock Purchase Agreement between Jason Schlombs and SmartHeat Inc., dated April 14, 2008 (Incorporated herein by reference to Exhibit 10.12 to the Company's Current Report on Form 8-K filed on April 18, 2008)
10.6	Form of Registration Rights Agreement (Incorporated herein by reference to Exhibit 10.14 to the Company's Current Report on Form 8-K filed on July 11, 2008)
10.7	

	English Translation of Share Exchange Agreement dated September 25, 2008, between SmartHeat Inc. and Asialink (Far East) Limited (Incorporated by reference to Exhibit 10.13 of Amendment No. 1 to the Company's Registration Statement on Form S-1/A filed on December 12, 2008)
10.8	English Translation of the Asset Acquisition Agreement, dated May 27, 2009, by and between Shenyang Taiyu Machinery & Electronic Co., Ltd. and Siping Beifang Heat Exchanger Manufacture Co., Ltd. (Incorporated herein by reference to Exhibit 10.14 to the Company's Current Report on Form 8-K filed on May 29, 2009)
10.9	English Translation of the Amended and Restated Asset Purchase Agreement, dated June 16, 2009, by and between Shenyang Taiyu Machinery & Electronic Co., Ltd. and Siping Beifang Heat Exchanger Manufacture Co., Ltd. (Incorporated herein by reference to Exhibit 10.15 to the Company's Current Report on Form 8-K/A filed on June 16, 2009)
10.10#	Employment Agreement, dated February 1, 2010, between SmartHeat Inc. and Xudong Wang (Incorporated herein by reference to Exhibit 10.18 to the Company's Current Report on Form 8-K filed on February 3, 2010)
10.11	SmartHeat, Inc. 2010 Equity Incentive Plan (Incorporated herein by reference to the Company's Definitive Proxy Statement on Schedule 14A filed on April 16, 2010)
10.12	Credit and Security Agreement by and between SmartHeat Inc. and Northtech Holdings, dated July 27, 2012

Table of Contents

10.13	December 2012 Amendment to the Credit and Security Agreement between SmartHeat Inc., and Northtech Holdings, Inc., dated December 21, 201
10.14	August 2013 Amendment to the Credit and Security Agreement between SmartHeat Inc. and Northtech Holdings Inc., dated August 23, 2013 (Incorporated herein by reference to Exhibit 10.14 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.15	Assignment and Assumption Agreement between SmartHeat Inc., and Northtech Holdings Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.15 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.16	Assignment Agreement between SmartHeat Inc. and Heat HP, Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.16 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.17	Assignment Agreement between SmartHeat Inc. and Heat PHE, Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.17 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.18	Equity Interest Purchase Agreement by and between SmartHeat Inc. and the Buyers, dated October 10, 2013 (Incorporated herein by reference to Exhibit 10.18 to the Company's Current Report on Form 8-K filed on October 10, 2010)
21.1†	Subsidiaries of the Registrant
24.1†	Power of Attorney (Included on the Signature Page of the Annual Report on Form 10-K filed on April 14, 2014)
31.1†	Certification of Principal Executive Officer 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
31.2†	Certification of Principal Financial Officer 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
32.1‡	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Executive Officer
32.2‡	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Financial Officer
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

# Indicates management contract or compensatory plan, contract or arrangement.
† Filed herewith.
‡ Furnished herewith.