

SMARTHEAT INC.
Form 10-Q
October 07, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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

Commission file number: 001-34246

SMARTHEAT INC.
(Exact name of registrant as specified in its charter)

Nevada
(State or other jurisdiction of incorporation
or organization)

98-0514768
(IRS Employer Identification No.)

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

110141
(Zip Code)

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

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

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and

post such files).

YES NO

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

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

YES NO

As of October 4, 2013, there were 6,033,399 shares of common stock outstanding.

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SmartHeat Inc.

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NOTE ABOUT FORWARD-LOOKING STATEMENTS AND OTHER INFORMATION

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

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

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

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

Additional information on the various risks and uncertainties potentially affecting our operating results are discussed in this report and other documents we file with the Securities and Exchange Commission, or the SEC, or available

upon written request to our corporate secretary at: A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110141. We undertake no obligation to revise or update publicly any forward-looking statements for any reason, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on these forward-looking statements.

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

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

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

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash & equivalents	\$ 10,335,187	\$ 18,336,163
Restricted cash	1,300,548	994,455
Accounts receivable, net	24,028,734	32,250,817
Retentions receivable	4,213,405	3,812,376
Advances to suppliers, net	4,941,818	3,279,007
Other receivables (net), prepayments and deposits	1,634,051	6,467,280
Inventories, net	58,239,685	58,297,562
Taxes receivable	1,437,938	-
Notes receivable - bank acceptances	1,904,278	2,797,551
Total current assets	108,035,644	126,235,211
NONCURRENT ASSETS		
Long term investment	904,905	865,773
Restricted cash	139,402	36,592
Retentions receivable	-	421,731
Advance to supplier for equipment	-	1,744,056
Construction in progress	1,321,292	1,298,841
Property and equipment, net	10,886,627	10,947,480
Intangible assets, net	14,876,848	14,920,603
Total noncurrent assets	28,129,074	30,235,076
TOTAL ASSETS	\$ 136,164,718	\$ 156,470,287
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 6,346,296	\$ 8,574,981
Advance from customers	6,152,963	5,481,960
Taxes payable	91,305	769,167
Accrued liabilities and other payables	5,822,878	5,089,664
Notes payable - bank acceptances	974,888	736,698
Loans payable	27,912,736	26,155,437
Total current liabilities	47,301,066	46,807,907

DEFERRED TAX LIABILITY	50,771	93,054
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, \$0.001 par value; 75,000,000 shares authorized, 5,733,399 shares issued and outstanding	5,733	5,733
Paid-in capital	103,607,559	103,607,559
Statutory reserve	5,537,986	5,396,014
Accumulated other comprehensive income	12,823,644	11,273,497
Accumulated deficit	(34,190,422)	(11,771,349)
Total Company stockholders' equity	87,784,500	108,511,454
NONCONTROLLING INTEREST	1,028,381	1,057,872
TOTAL EQUITY	88,812,881	109,569,326
TOTAL LIABILITIES AND EQUITY	\$ 136,164,718	\$ 156,470,287

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

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(UNAUDITED)

	SIX MONTHS ENDED JUNE		THREE MONTHS ENDED	
	2013	30, 2012	JUNE 30, 2013	2012
Net sales	\$13,891,423	\$11,728,846	\$7,722,992	\$4,982,448
Cost of goods sold	14,265,228	9,736,416	5,320,037	4,535,323
Gross profit (loss)	(373,805)	1,992,430	2,402,955	447,125
Operating expenses				
Selling	3,242,531	7,368,865	1,546,589	4,995,103
General and administrative	4,818,674	5,127,815	2,482,031	576,757
Provision for bad debts	12,287,944	6,233,423	7,524,870	3,737,532
Provision for advance to supplier	1,529,595	-	288,916	-
Total operating expenses	21,878,744	18,730,103	11,842,406	9,309,392
Loss from operations	(22,252,549)	(16,737,673)	(9,439,451)	(8,862,267)
Non-operating income (expenses)				
Investment income	39,345	-	38,784	-
Interest income	28,975	110,611	13,585	62,472
Interest expense	(772,242)	(628,049)	(428,431)	(345,469)
Financial expense	(150,341)	(83,015)	(87,442)	(31,884)
Foreign exchange transaction gain	3,339	20,322	840	36,667
Other income, net	734,075	973,212	423,777	(189,752)
Total non-operating income (expenses), net	(116,849)	393,081	(38,887)	(467,966)
Loss before income tax	(22,369,398)	(16,344,592)	(9,478,338)	(9,330,233)
Income tax benefit	(45,000)	(44,494)	(22,556)	(20,390)
Net loss before noncontrolling interest	(22,324,398)	(16,300,098)	(9,455,782)	(9,309,843)
Less: loss attributable to noncontrolling interest	(47,297)	(114,935)	(2,555)	(57,145)
Net loss to SmartHeat Inc.	(22,277,101)	(16,185,163)	(9,453,227)	(9,252,698)
Other comprehensive item				
Foreign currency translation gain (loss) attributable to SmartHeat Inc.	1,550,147	(624,625)	1,361,630	(894,662)
Foreign currency translation gain (loss) attributable to noncontrolling interest	17,806	(3,796)	15,074	(4,813)
Comprehensive loss attributable to SmartHeat Inc.	\$(20,726,954)	\$(16,809,788)	\$(8,091,597)	\$(10,147,360)

Comprehensive (loss) gain attributable to noncontrolling interest	\$(29,491)	\$(118,731)	\$12,519	\$(61,958)
Basic and diluted weighted average shares outstanding	5,733,399	3,955,774	5,733,399	3,955,774
Basic and diluted loss per share	\$(3.89)	\$(4.09)	\$(1.65)	\$(2.34)

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

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	SIX MONTHS ENDED JUNE	
	30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss including noncontrolling interest	\$(22,324,398)	\$(16,300,098)
Adjustments to reconcile loss including noncontrolling interest to net cash (used in) provided by operating activities:		
Investment income	(39,345)	-
Depreciation and amortization	1,071,447	942,269
Provision for bad debts	12,287,944	6,233,423
Provision for inventory impairment	4,188,169	670,887
Provision for advance to suppliers	1,529,595	-
Reserve for warranty	7,945	-
Loss on disposal Fixed asset	18,829	-
Unearned interest on accounts receivable	-	(54,553)
Stock option expense	-	37,919
Changes in deferred tax	(43,451)	(49,504)
(Increase) decrease in assets and liabilities:		
Accounts receivable	2,240,647	6,414,799
Retentions receivable	92,947	75,783
Advances to suppliers	(1,363,211)	9,890,950
Other receivables, prepayments and deposits	(897,047)	(682,631)
Inventories	(3,274,909)	(519,271)
Tax receivable	(1,421,702)	(1,491,007)
Accounts payable	(2,126,638)	(3,997,057)
Advance from customers	570,467	748,702
Taxes payable	(687,227)	(1,169,319)
Accrued liabilities and other payables	144,611	822,137
Net cash (used in) provided by operating activities	(10,025,327)	1,573,429
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(387,158)	502,180
Acquisition of property & equipment	(516,140)	(533,098)
Acquisition of intangible asset	-	(32,124)
Notes receivable	932,185	1,197,726
Advance for equipment purchase	-	(5,608,880)
Construction in progress	-	(788,427)
Equity method investee	-	(721,439)
Net cash provided by (used in) investing activities	28,887	(5,984,062)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term loans	13,767,295	5,866,126

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Repayment on short-term loans	(11,920,593)	-
Notes payable	-	(3,227,291)
Net cash provided by financing activities	1,846,702	2,638,835
EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS	148,762	(123,649)
NET DECREASE IN CASH & EQUIVALENTS	(8,000,976)	(1,895,447)
CASH & EQUIVALENTS, BEGINNING OF PERIOD	18,336,163	12,419,922
CASH & EQUIVALENTS, END OF PERIOD	\$10,335,187	\$10,524,475
Supplemental cash flow data:		
Income tax paid	\$703,889	\$207,724
Interest paid	\$878,062	\$723,113

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

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

Effective February 7, 2012, the Company implemented a one-for-ten reverse stock 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 stock split.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

The consolidated interim financial information as of June 30, 2013, and for the six and three months ended June 30, 2013 and 2012, were prepared without audit, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with U.S. GAAP are not included. The interim consolidated financial information should be read in conjunction with the financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012, previously filed with the SEC.

In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present a fair statement of the Company’s consolidated financial position as of June 30, 2013, its consolidated results of operations and cash flows for the six and three months ended June 30, 2013 and 2012, as applicable, were made. The interim results of operations are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat’s U.S. parent, 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.

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.

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.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 June 30, 2013, and December 31, 2012, the Company maintained restricted cash deposit in several bank accounts for the purpose described below.

	2013		2012
	(In millions)		
Support of performance guarantee	\$ 0.81		\$ 0.62
Support of bank acceptance	0.49		0.37
Total restricted cash - current	1.30		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 June 30, 2013 and December 31, 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	
June 30, 2013	\$ 265,567		\$ 7,924,932		\$ 2,144,688		\$ 10,335,187	
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 \$35.2 million and \$28.20 million at June 30, 2013 and December 31, 2012, respectively.

At June 30, 2013, and December 31, 2012, the Company had retentions receivable from customers for product quality assurance of \$4.21 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 \$12,748 and \$12,532 at June 30, 2013, and December 31, 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.

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.

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SMARTHEAT INC. AND SUBSIDIARIES
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 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.

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	5
equipment	years
Production	5-10
equipment	years

Land Use Rights

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

Warranties

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

Activity in the Company’s warranty reserve from January 1, 2012, to June 30, 2013, is as follows:

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	2013	2012
Beginning balance	\$ 517,076	\$ 515,812
Provisions	102,030	377,583
Actual costs incurred	(94,086)	(377,583)
Due to exchange rate	-	1,264
Ending balance in current liabilities (Note 13)	\$ 525,020	\$ 517,076

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Research and Development Costs

Research and development (“R&D”) costs are expensed as incurred and included in general and administrative expenses. These costs primarily consist of cost of materials used, salaries paid for the Company’s development department and fees paid to third parties. R&D costs for the six months ended June 30, 2013 and 2012, were \$238,053 and \$114,890, respectively. R&D costs for the three months ended June 30, 2013 and 2012, were \$115,616 and \$63,956, respectively.

Revenue Recognition

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

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

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

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 VAT tax return is filed offsetting 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 six and three months ended June 30, 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 the six months ended June 30, 2013 and 2012, revenue from after-sales services after the expiration of the warranty period was \$129,406 and \$110,672, respectively. For the three months ended June 30, 2013 and 2012, revenue from after-sales services after the expiration of the warranty period was \$47,776 and \$(65,228), respectively, which was recorded in other income.

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Cost of Goods Sold

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

Advance from Customers

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

Statement of Cash Flows

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

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

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

Basic and diluted shares outstanding are the same for the six and three months ended June 30, 2013, and same for the six and three months ended June 30, 2012, because the common stock equivalent of the convertible securities outstanding, consisting of unexercised warrants issued to investors and options issued to the Company’s directors and an officer, are anti-dilutive and, accordingly, were excluded from the computation of diluted earnings (loss) per share. At June 30, 2013 and December 31, 2012, options to purchase 3,500 shares of common stock were outstanding, 3,500 shares of common stock were exercisable.

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).

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The RMB to USD exchange rates and EUR to USD exchange rates in effect as of June 30, 2013 and December 31, 2012, and the average exchange rates for the six months ended June 30, 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 Six Months Ended		Balance Sheet Date Exchange Rate	
	06/30/13	06/30/12	06/30/13	12/31/12
RMB - USD	6.2413	6.3074	6.1787	6.2855
EUR - USD	0.7616	0.7706	0.7688	0.7777

Segment Reporting pending

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

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

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The Company evaluates performance based on several factors, of which the primary financial measure is business segment income before taxes. The following table shows the operations of the Company's reportable segments for the six months ended June 30, 2013 and 2012, and as of June 30, 2013 and December 31, 2012, respectively.

	Six Months Ended June 30,	
	2013	2012
Revenue from unaffiliated customers		
Plate heating, meters and related	\$11,808,874	\$9,798,089
Heat pumps and related	2,082,549	1,930,757
Consolidated	\$13,891,423	\$11,728,846
Operating loss:		
Plate heating, meters and related	\$(19,942,874)	\$(13,757,961)
Heat pumps and related	(1,866,988)	(2,524,301)
Corporation	(442,683)	(455,411)
Consolidated	\$(22,252,549)	\$(16,737,673)
Net loss from continuing operations before non-controlling interest:		
Plate heating, meters and related	\$(20,406,465)	\$(13,325,346)
Heat pumps and related	(1,433,574)	(2,465,514)
Corporation	(484,359)	(509,238)
Consolidated	\$(22,324,398)	\$(16,300,098)
Depreciation and amortization:		
Plate heating, meters and related	\$771,634	\$761,402
Heat pumps and related	234,432	180,867
Corporation	65,381	-
Consolidated	\$1,071,447	\$942,269
Total assets:		
Plate heating, meters and related	\$133,384,759	\$152,830,853
Heat pumps and related	14,480,873	14,340,054
Corporation	4,189,018	4,031,567
Inter-company elimination	(15,889,932)	(14,732,187)
Consolidated	\$136,164,718	\$156,470,287

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The following table shows the operations of the Company's reportable segments for the three months ended June 30, 2013 and 2012, respectively.

	Three Months Ended June 30,	
2013		2012