SMARTHEAT INC.
Form 10-Q
August 15, 2013

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

FORM 10-Q

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

For the quarterly period ended March 31, 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 x

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 x 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 ¨ (do not check if a smaller reporting company)	Smaller reporting company x

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

As of August 15, 2013, there were 5,733,399 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

	March 31, 2013 (Unaudited)	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash & equivalents	$15,063,975	$18,336,163
Restricted cash	1,155,453	994,455
Accounts receivable, net	24,331,350	32,250,817
Retentions receivable	4,723,504	3,812,376
Advances to suppliers	2,850,471	3,279,007
Other receivables (net), prepayments and deposits	3,002,497	6,467,280
Inventories, net	60,621,832	58,297,562
Tax receivable	1,278,909	-
Notes receivable - bank acceptances	2,538,547	2,797,551
Total current assets	115,566,538	126,235,211
NONCURRENT ASSETS		
Long term investment	865,723	865,773
Restricted cash	125,859	36,592
Retentions receivable	-	421,731
Advance to supplier for equipment	-	1,744,056
Construction in progress	1,302,280	1,298,841
Property and equipment, net	10,841,903	10,947,480
Intangible assets, net	14,808,269	14,920,603
Total noncurrent assets	27,944,034	30,235,076
TOTAL ASSETS	$143,510,572	$156,470,287
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$9,155,631	$8,574,981
Advance from customers	6,375,063	5,481,960
Taxes payable	16,873	769,167
Accrued liabilities and other payables	5,676,362	5,089,664
Notes payable - bank acceptances	862,080	736,698
Loans payable	24,462,027	26,155,437

Total current liabilities	46,548,036	46,807,907
DEFERRED TAX LIABILITY	70,577	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 at March 31, 2013 and December 31, 2012	5,733	5,733
Paid-in capital	103,607,559	103,607,559
Statutory reserve	5,537,145	5,396,014
Accumulated other comprehensive income	11,462,014	11,273,497
Accumulated deficit	(24,736,354)	(11,771,349)
Total Company stockholders' equity	95,876,097	108,511,454
NONCONTROLLING INTEREST	1,015,862	1,057,872
TOTAL EQUITY	96,891,959	109,569,326
TOTAL LIABILITIES AND EQUITY	$143,510,572	$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)

	THREE MONTHS ENDED MARCH 31,	
	2013 (Unaudited)	2012
Net sales	$6,168,431	$6,746,398
Cost of goods sold	8,945,191	5,074,937
Gross profit (loss)	(2,776,760)	1,671,461
Operating expenses		
Selling	1,695,942	2,373,762
General and administrative	2,336,643	4,677,214
Provision for bad debts	4,763,074	2,495,891
Provision for advance to supplier	1,240,679	-
Total operating expenses	10,036,338	9,546,867
Loss from operations	(12,813,098)	(7,875,406)
Non-operating income (expenses)		
Investment income	561	-
Interest income	15,390	48,139
Interest expense	(343,811)	(282,580)
Financial expense	(62,899)	(51,131)
Foreign exchange transaction gain (loss)	2,499	(16,345)
Other income, net	310,298	1,162,964
Total non-operating income (expenses), net	(77,962)	861,047
Loss before income tax	(12,891,060)	(7,014,359)
Income tax benefit	(22,444)	(24,104)
Net loss before noncontrolling interest	(12,868,616)	(6,990,255)
Less: loss attributable to noncontrolling interest	(44,742)	(57,790)
Net loss to SmartHeat Inc.	(12,823,874)	(6,932,465)
Other comprehensive item		
Foreign currency translation gain attributable to SmartHeat Inc.	188,517	270,037
Foreign currency translation gain attributable to noncontrolling interest	2,732	1,017

Comprehensive loss attributable to SmartHeat Inc.	$(12,635,357)	$(6,662,428)
Comprehensive loss attributable to noncontrolling interest	$(42,010)	$(56,773)
Basic and diluted weighted average shares outstanding	5,733,399	3,955,774
Basic and diluted loss per share	$(2.24)	$(1.75)

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)

	THREE MONTHS ENDED MARCH 31, 2013 (Unaudited)	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss including noncontrolling interest	$(12,868,616)	$(6,990,255)
Adjustments to reconcile loss including noncontrolling interest to net cash used in operating activities:		
Investment income	(561)	-
Depreciation and amortization	523,793	467,833
Provision for bad debts	4,763,074	2,449,552
Provision for inventory impairment	4,930,764	126,156
Provision for advance to suppliers	1,240,679	-
Reserve for warranty	10,627	-
Unearned interest on accounts receivable	-	(26,081)
Stock option expense	-	19,167
Changes in deferred tax	(22,689)	(24,760)
(Increase) decrease in assets and liabilities:		
Accounts receivable	6,921,548	4,966,662
Retentions receivable	(477,454)	542,728
Advances to suppliers	941,871	3,666,981
Other receivables, prepayments and deposits	(243,164)	98,927
Inventories	(7,127,116)	(778,158)
Tax receivable	(1,275,150)	(583,212)
Accounts payable	684,949	(3,039,905)
Advance from customers	877,244	89,621
Taxes payable	(756,162)	(1,155,066)
Accrued liabilities and other payables	335,237	(177,567)
Net cash used in operating activities	(1,541,126)	(347,377)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	(247,156)	(1,938,601)
Acquisition of property & equipment	(257,492)	(8,693)
Acquisition of intangible asset	-	(7,927)
Notes receivable	266,004	833,325
Advance for equipment purchase	-	(964,269)
Construction in progress	-	(812,935)
Net cash used in investing activities	(238,644)	(2,899,100)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from short-term loans	22,821,303	7,927,197
Repayment on short-term loans	(24,281,277)	-

Notes payable	-	(1,307,041)
Net cash provided by (used in) financing activities	(1,459,974)	6,620,156
EFFECT OF EXCHANGE RATE CHANGE ON CASH & EQUIVALENTS	(32,444)	59,948
NET INCREASE (DECREASE) IN CASH & EQUIVALENTS	(3,272,188)	3,433,627
CASH & EQUIVALENTS, BEGINNING OF PERIOD	18,336,163	12,419,922
CASH & EQUIVALENTS, END OF PERIOD	$15,063,975	$15,853,549
Supplemental cash flow data:		
Income tax paid	$589,065	$207,724
Interest paid	$340,139	$282,456

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
MARCH 31, 2013 and 2012 (UNAUDITED) AND DECEMBER 31, 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.

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 March 31, 2013, and for the three months ended March 31, 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 March 31, 2013, its consolidated results of operations and cash flows for the three months ended March 31, 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 Energy, SmartHeat Trading, Ruicheng, SmartHeat Germany and SmartHeat 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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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 March 31, 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	$ 0.72	$ 0.62
Support of bank acceptance	0.43	0.37
Support of letter of credit	0.005	-
Total restricted cash - current	1.16	0.99
Performance guarantee -- noncurrent	$ 0.12	$ 0.04

The following table presents in U.S. dollars ("USD") the amount of cash and equivalents held by the Company as of March 31, 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
March 31, 2013	$ 311,190	$ 12,559,603	$ 2,193,182	$ 15,063,975
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 $29.34 million and $28.20 million at March 31, 2013 and December 31, 2012, respectively.

At March 31, 2013 and December 31, 2012, the Company had retentions receivable from customers for product quality assurance of $4.72 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 $12,565 and $12,532 at March 31, 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.

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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 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 equipment	5 years
Production equipment	5-10 years

Land Use Rights

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

Warranties

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

Activity in the Company's warranty reserve from January 1, 2012 to March 31, 2013, is as follows:

	2013	2012
Beginning balance	$ 517,076	$ 515,812
Provisions	46,464	377,583
Actual costs incurred	(35,837)	(377,583)
Due to exchange rate	-	1,264
Ending balance in current liabilities (Note 13)	$ 527,703	$ 517,076

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SMARTHEAT INC. AND SUBSIDIARIES
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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 three months ended March 31, 2013 and 2012, were $122,437 and $50,934, 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 three months ended March 31, 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 three months ended March 31, 2013 and 2012, revenue from after-sales services after the expiration of the warranty period was $81,630 and $215,712, respectively, which was recorded in other income.

SMARTHEAT INC. AND SUBSIDIARIES
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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 with the customers.

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 loss per share are the same for the three months ended March 31, 2013 and 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 March 31, 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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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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The RMB to USD exchange rates and EUR to USD exchange rates in effect as of March 31, 2013 and December 31, 2012, and the average exchange rates for the three months ended March 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 Three Months Ended		Balance Sheet Date Exchange Rate	
	03/31/13	03/31/12	03/31/13	12/31/12
RMB - USD	6.2785	6.3074	6.2689	6.2855
EUR - USD	0.7572	0.7777	0.7803	0.7777

Segment Reporting

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

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

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The Company evaluates performance based on several factors, of which the primary financial measure is business segment income before taxes. The following table shows the operations of the Company's reportable segments.

	Three Months Ended March 31,	
	2013	2012
Revenue from unaffiliated customers		
Plate heating, meters and related	$ 5,671,793	$ 5,738,643
Heat pumps and related	496,638	1,007,755
Consolidated	$ 6,168,431	$ 6,746,398
Operating loss:		
Plate heating, meters and related	$ (11,414,210)	$ (6,231,570)
Heat pumps and related	(1,225,694)	(1,366,426)
Corporation	(173,194)	(277,410)
Consolidated	$ (12,813,098)	$ (7,875,406)
Net loss from continuing operations:		
Plate heating, meters and related	$ (11,599,642)	$ (5,342,925)
Heat pumps and related	(1,054,244)	(1,369,312)
Corporation	(214,730)	(278,018)
Consolidated	$ (12,868,616)	$ (6,990,255)
Depreciation and amortization:		
Plate heating, meters and related	$ 382,667	$ 374,868
Heat pumps and related	122,981	92,965
Corporation	18,145	-
Consolidated	$ 523,793	$ 467,833
Total assets:		
Plate heating, meters and related	$ 140,760,531	$ 152,830,853
Heat pumps and related	13,499,478	14,340,054
Corporation	4,222,694	4,031,567
Inter-company elimination	(14,972,131)	(14,732,187)
Consolidated	$ 143,510,572	$ 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.

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As of March 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.

3. INVENTORIES

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

	2013	2012
Raw materials	$ 47,766,388	$ 38,829,405
Work in process	10,337,913	9,831,235
Finished goods	12,904,114	15,070,801
Total	71,008,415	63,731,441
Inventory allowance	(10,386,583)	(5,433,879)
Inventories, net	$ 60,621,832	$ 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.

5. PROPERTY AND EQUIPMENT, NET

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

	2013	2012
Buildings	$ 4,843,542	$ 4,830,751
Production equipment	8,380,464	8,160,111
Office equipment	1,120,751	1,120,799
Vehicles	934,176	937,364
Total	15,278,933	15,049,025
Less: accumulated depreciation	(4,437,030)	(4,101,545)
Property & equipment, net	$ 10,841,903	$ 10,947,480

Depreciation expense for the three months ended March 31, 2013 and 2012, was $354,421 and $302,815, respectively.

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

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

	2013	2012
Advance to third parties	$ 5,535,682	$ 4,813,659

Deposit for public bids of sales contracts	1,493,006	1,397,375
Prepayment for freight, related, insurance, advertisement and consulting expenses	163,797	332,415
Other deposits	94,285	93,816
Advance to employees	454,520	729,422
Others	245,240	376,738
Total	7,986,530	7,743,425
Less: bad debt allowance	(4,984,033)	(1,276,145)
Other receivables (net), prepayments & deposits	$ 3,002,497	$ 6,467,280

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Advance to third parties were short-term advances to unrelated parties with payment usually due within a year and includes an advance to Siping Beifang of RMB 22.13 million ($3.53 million) that is non-interest bearing and with due date extended to the end of August, 2013. Deposits for public bidding represented the deposits for bidding on expected contracts, which will be returned to the Company after the bidding process is completed, usually within three to four months from the payment date. Prepayment for freight, related insurance expenses and advertisement represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products and prepaid advertising expense. Other deposits mainly consisted of deposits for rents, payroll expense and utilities. Advance to employees represented short-term loans to employees and advances for business trips and related expenses. Other receivables (consisting of advance to third parties and employees, deposit for public bids and others), prepayments and deposits are reimbursed or settled within 12 months.

7. INTANGIBLE ASSETS

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

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

	Estimated Useful Life (In years)	2013	2012
Land use rights	50	$ 14,751,400	$ 14,712,441
Know-how technology	5 – 10	886,417	884,076
Customer lists	5	208,946	208,395
Covenants not to compete	5	113,666	113,366
Software	5	588,594	590,344
Trademarks	7	290,358	289,591
Total		16,839,381	16,798,213
Less: accumulated amortization		(2,031,112)	(1,877,610)
Intangible assets, net		$ 14,808,269	$ 14,920,603

Amortization expense of intangible assets for the three months ended March 31, 2013 and 2012, was $151,227 and $165,018, respectively. Annual amortization expense for the next five years from March 31, 2013, is expected to be $526,840, $466,330, $438,010, $426,190 and $408,380, and $12,542,520 thereafter.

8. CONSTRUCTION IN PROGRESS

The Company had construction in progress of $1.30 million at March 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 March 31, 2013 and December 31, 2012. The Company temporarily halted construction on this factory because of the current economic and market conditions in China.

2) SmartHeat Siping has a construction project of $33,510 for the laying of a foundation for its machinery installation. This foundation project will be completed by the end of 2013.

3) Taiyu paid $.81 million for equipment and installation, this project was completed in July 2013 and is in the stage of final inspection by the authority.

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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 $561 during the three months ended March 31, 2013.

The unaudited condensed Statement of Income of XinRui for the three months ended March 31, 2013 is below:

Net Revenue	$ 40,119
Cost of Revenue	(2,370)
Gross Profit	37,749
Operating expenses	36,122
Income from operations	1,627
Non-operating income	-
Income tax expense	407
Net Income	$ 1,220

10. MAJOR CUSTOMERS AND VENDORS

Below is the table indicating the Company's major customers that account for over 10% of the Company's total sales. At March 31, 2013, the total accounts receivable balance due from these customers was $9,670,657. At December 31, 2012, the accounts receivable balance due from these customers was $5,957,687.

	Three months ended March 31,	
	2013	2012
China Precision Optical Machinery Imports & Exports Co., Ltd.	28%	22%
Hengli Petrifaction (Dalian) Co., Ltd.	15%	26%
Daerkai Heating Electricity Co., Ltd.	11%	-
Inner Mongolia Xingtai Real Estate Development Co., Ltd.	10%	-

For the three months ended March 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 March 31, 2013:

	2013
Income	$ 82,985
Value-added	1,192,572
Other	3,352
Total	$ 1,278,909

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12. TAXES PAYABLE

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

	2013	2012
Income	$ -	$ 505,643
Value-added	3,465	101,195
Other	13,408	162,329
Total	$ 16,873	$ 769,167

13. ACCRUED LIABILITIES AND OTHER PAYABLES

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

	2013	2012
Advance from third parties	$ 21,742	$ 68,068
Payable to Siping Beifang	1,998,854	1,947,808
Payable for equipment purchase	313,452	312,624
Payable to employees	-	219,977
Other payables	1,951,537	1,332,414
Warranty reserve (See Note 2)	527,703	517,076
Accrued expenses	863,074	691,697
Total	$ 5,676,362	$ 5,089,664

Advance from third parties were short-term, non-interest-bearing advances from third parties due on demand. Other payables consisted of payables for the Company's miscellaneous expenses including postage, business insurance, employee benefits, bidding fee, $100,000 payable to a consulting firm that was paid by a third party on behalf of the Company during 2012 (see "Note 15"), and payable for a credit line balance from Northtech (see "Note 15"). 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 March 31, 2013 and December 31, 2012, the Company deposited $0.43 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.

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15. LOANS PAYABLE

Short-Term Bank Loans

The Company was obligated for the following short-term loans as of March 31, 2013 and December 31, 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 bears interest at 7.87% with maturity on July 11, 2013. The loan was repaid at maturity.	1,595,176	1,590,963	Siping
From a commercial bank in the PRC for RMB 10,000,000 entered into on August 23, 2012. The loan bears interest at 6.30% with maturity on August 22, 2013. The loan was guaranteed by a third party.	1,595,176	1,590,963	Taiyu
From a commercial bank in the PRC for RMB 9,000,000 entered into on September 7, 2012. The loan bears interest at 6.3% with maturity on September 6, 2013. The loan was guaranteed by a third party.	1,435,659	1,431,867	Taiyu
From a commercial bank in the PRC for RMB 8,000,000 entered into on September 13, 2012. The loan bears interest at 6.3% with maturity on September 12, 2013. The loan was guaranteed by a third party.	1,276,140	1,272,771	Taiyu
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 21, 2012. The loan bears interest at 6.6% with maturity on August 20, 2013.	4,785,529	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 14,800,000 entered into on October 24, 2012. The loan bears interest at 6.6% with maturity on May 21, 2013. The loan was repaid at maturity.	2,360,861	2,354,626	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on November 30, 2012. The loan bears interest at 7.87% with maturity on November 29, 2013.	1,595,176	1,590,963	Siping
	2,073,729	2,068,252	Taiyu

From a commercial bank in the PRC for RMB 13,000,000 entered into on December 12, 2011. The loan bears interest at 6.65% with maturity on October 26, 2013. This loan was pledged with Taiyu's building and land.			
From a commercial bank in the PRC for RMB 40,000,000 entered into on March 11, 2013. The loan bears interest at 6.60% with maturity on March 10, 2014.	6,380,705	-	Taiyu
From a commercial bank in the PRC for RMB 8,550,000 entered into on January 9, 2013. The loan bears interest at 6.00% with maturity on December 10, 2013.	1,363,876	-	Taiyu
	$ 24,462,027	$ 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 or will be entered from February 20, 2012 to August 16, 2013 with the guarantee length equal to the loan term, 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 Lianoning 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.

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Holding Company Credit Agreement

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. The Credit Facility provides for borrowings of up to $2.0 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 35% 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. Borrowings bear interest of 1.25% per month, payable monthly, 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 shares price” average of the opening and closing price for each share of Borrower’s common stock (HEAT) on a trading day, or the average of the bid and ask prices if no share of the Borrower’s common stock is traded on such a trading day; provided that in no event shall the Average Share Price be lower than $0.50 or higher than $3.50; (2) raised the maximum credit line was up 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 35% to 55% of its equity interests 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 March 31, 2013 and December 31, 2012 was $387,209 and $83,537, respectively, and was recorded as other payable. The Company amortized $18,145 of the $100,000 extension fee during the three months ended March 31, 2013, $73,589 will be amortized in one year and $6,048 will be amortized after one year, the unamortized extension fee was recorded as prepaid expense. On June 25, 2013, the Board approved an amendment to the Credit Agreement, which provides, among other matters, for the reduction of the interest rate to 10% per year, compounded quarterly, effective as of January 1, 2013.

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

	2013	2012
Deferred tax asset - current (bad debt allowance)	$ 4,765,184	$ 5,147,303

Deferred tax asset - current (inventory allowance)		2,251,027		959,388
Deferred tax asset – current (allowance to other receivable)		1,143,339		-
Deferred tax asset – current (allowance for advance to supplier)		857,041		-
Deferred tax asset – current (reserve for warranty)		101,934		-
Less: valuation allowance		(9,118,525)		(6,106,691)
Deferred tax liability - noncurrent (depreciation of fixed assets)	$	(70,577)	$	(93,054)

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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.

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 $4.92 million at March 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 has been 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 $12.68 million and $6.74 million for the three months ended March 31, 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 March 31, 2013, approximately $14.97 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 $2.68 million 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 three months ended March 31, 2013 and 2012:

	2013	2012
U.S. statutory tax (benefit) rates	(34.0)%	(34.0)%
Tax rate difference	9.0%	8.8%
Effect of tax holiday	(0.9)%	6.0%
Permanent difference - goodwill impairment	-%	- %
Other	-%	-%
Valuation allowance	25.7%	18.9%
Tax benefit per financial statements	(0.2)%	(0.3)%

The income tax (benefit) for the three months ended March 31, 2013 and 2012, consisted of the following:

	2013	2012
Income tax expense - current	$ 245	$ 656
Income tax benefit - deferred	(22,689)	(24,760)
Total income tax benefit, net	$ (22,444)	$ (24,104)

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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 March 31, 2013, the Company has met all registered capital requirements for its FIEs except for SmartHeat Investment, for which the Company is committed to contribute an additional $40.00 million in registered capital by April 2015 (see Note 21).

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 February 1, 2010, the Company issued stock options to an officer. The terms of the options are 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 the severance agreement and mutual release.

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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 December 31, 2011	6,000		106.40	2.83
Exercisable at December 31, 2011	3,500		97.80	2.65
Granted	-		-	-
Exercised	-		-	-
Forfeited	2,500		118.50	-
Outstanding at December 31, 2012	3,500	$	97.80	1.65
Exercisable at December 31, 2012	3,500	$	97.80	1.65
Granted	-		-	-
Exercised	-		-	-
Forfeited	-		-	-
Outstanding at March 31, 2013	3,500	$	97.80	1.40
Exercisable at March 31, 2013	3,500	$	97.80	1.40

There were no options exercised during the three months ended March 31, 2013 and 2012. The Company recorded $0 and $19,167 as compensation expense for stock options during the three months ended March 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.

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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.

20. OTHER INCOME

The Company had net other income, of $310,298 and $1,162,964 for the three months ended March 31, 2013 and 2012, respectively. The other income for the three months ended March 31, 2013 consisted of income (net), from selling of raw material of $133,456; income (net) from after-sales services of $33,243, government subsidy of $39,818 and other non-operating income of $103,781. The other income for the three months ended March 31, 2012 consisted of income (net), from selling of raw material of $129,200; income from providing technical service of $451,054; income (net) from after-sales service of $201,370 and other income of $381,340.

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. 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.

The shares are restricted from being sold or transferred to more than aggregate of 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 three months ended March 31, 2013 and 2012, was $132,359 and $93,500, 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 for the 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 March 31, 2013, the Company is committed to contribute 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. The Company has no present plans to sell any of its assets or to pursue any of the options mentioned above. If the Company is unable to make the required capital contribution to registered capital, the Company may apply to extend the payment period, typically granted for six months or more, or otherwise reduce the amount of registered capital to the amount already contributed.

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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. The Company has paid four such monthly payments as of May 21, 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.

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 March 31, 2013 and December 31, 2012, the Company has signed a contract to provide guarantees of up to 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, 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.

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CAUTIONARY STATEMENT FOR FORWARD-LOOKING STATEMENTS

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

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

Overview

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

In addition, we offer HPs in China and in Germany under the Gustrower brand name. Our subsidiaries design and build HPs specific to customer specifications and particular operating conditions and are known for their high quality and efficiency. Our subsidiaries produce HPs in a range of 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 had 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.

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As an expansion of our business following our acquisition of Taiyu, we acquired and established subsidiaries in China and Germany. On September 25, 2008, we acquired SanDeKe Co., Ltd., or SanDeKe, a Shanghai-based manufacturer of PHEs. On June 16, 2009, we completed an asset purchase transaction with Siping Beifang Heat Exchanger Manufacture Co., Ltd., or Siping Beifang, to set up a new manufacturing facility under our newly incorporated subsidiary, SmartHeat Siping Beifang Energy Technology Co., Ltd., or SmartHeat Siping. On August 14, 2009, we formed Beijing SmartHeat Jinhui Energy Technology Co., Ltd., or Jinhui, a JV in Beijing of which we own 52%, to provide consulting services and expand our sales of PHEs into new industries and regions of China. On April 7, 2010, we formed SmartHeat (China) Investment Co., Ltd., or SmartHeat Investment, as an investment holding company in Shenyang for our investment in and establishment of new companies and businesses in China. On April 12, 2010, SmartHeat Investment formed SmartHeat Energy (Shenyang) Energy Equipment Co., Ltd., or SmartHeat Energy, as its wholly owned subsidiary for the research, development, manufacturing and sales of energy products. On May 6, 2010, we formed SmartHeat (Shanghai) Trading Co., Ltd., or SmartHeat Trading, through a nominee, Cleantech Holdings Inc., a British Virgin Islands company, or Cleantech Holdings, to market and expand sales of our branded products in China. Prior to November 9, 2011, we had no direct ownership interest in SmartHeat Trading; instead, we controlled and were entitled to 100% of the profit or loss of SmartHeat Trading under contractual arrangements. Effective as of November 9, 2011, we terminated the nominee-owner relationship and acquired direct control over SmartHeat Trading. On December 2, 2010, we formed Hohhot Ruicheng Technology Co., Ltd., or Ruicheng, a joint venture in Hohhot City, China, for the design and manufacture of heat meters, of which we acquired 51% of the equity on January 7, 2011.

On March 1, 2011, we entered into a purchase agreement to acquire 95% of the equity in Shenyang Bingchuan Refrigerating Machine Limited Company, a Shenyang-based state-owned heat pump manufacturer and designer subsequently renamed SmartHeat (Shenyang) Heat Pump Technology Co., Ltd., or SmartHeat Pump. In late 2011, we increased our ownership percentage of SmartHeat Pump to 98.8%. On March 3, 2011, we completed the acquisition o