SMARTHEAT INC.
Form 10-Q
April 30, 2018

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

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FORM 10-Q

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

For the quarterly period ended June 30, 2017

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 | 98-0514768 |
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |

| | |
|---|---|
| A-1, 10, Street 7<br>Shenyang Economic and Technological Development Zone<br>Shenyang, China | 110141 |
| (Address of principal executive offices) | (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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer, "accelerated

filer," "non-accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

| | |
|---|---|
| Large accelerated filer | Accelerated filer |
| Non-accelerated filer<br>Emerging Growth Company<br>(do not check if a smaller reporting company) | Smaller reporting company |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES NO
APPLICABLE ONLY TO CORPORATE ISSUERS

As of June 30, 2017 there were 8,683,399 shares of common stock outstanding.

SmartHeat Inc.

Table of Contents

Table of Contents

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;
- 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 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.

1

Table of Contents

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

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

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

Our functional currency is the US 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.

Table of Contents
Part I – Financial Information

Item 1. Financial Statements
SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| | JUNE 30, 2017 (UNAUDITED) | DECEMBER 31, 2016 |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and equivalents | $ 1,244,753 | $ 1,046,884 |
| Other receivables (net), prepayments and deposits | 1,353,466 | 1,412,357 |
| Inventories, net | 253,454 | 262,778 |
| Taxes receivable | 2,208 | 5,513 |
| Total current assets | 2,853,881 | 2,727,532 |
| NONCURRENT ASSETS | | |
| Long term investment | 367,529 | 367,529 |
| Property and equipment, net | 16,864 | 19,966 |
| Total noncurrent assets | 384,393 | 387,495 |
| TOTAL ASSETS | $ 3,238,274 | $ 3,115,027 |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| CURRENT LIABILITIES | | |
| Accounts payable | $ 702,563 | $ 657,354 |
| Advances from customers | 1,339,280 | 1,155,748 |
| Taxes payable | 8,503 | 15,844 |
| Accrued liabilities and other payables | 7,709,319 | 9,070,789 |
| Total current liabilities | 9,759,665 | 10,899,735 |
| CREDIT LINE PAYABLE | 2,875,335 | 2,875,335 |
| TOTAL LIABILITIES | 12,635,000 | 13,775,070 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Common stock, $0.001 par value; 75,000,000 shares authorized, 8,683,399 and 8,283,399 shares issued and outstanding as of June 30, 2017 and December 31, 2016, respectively | 8,683 | 8,283 |
| Paid-in capital | 86,004,457 | 85,924,857 |
| Statutory reserve | 780,682 | 780,682 |

| | | |
|---|---|---|
| Shares to be issued | - | 80,000 |
| Accumulated other comprehensive income | 15,360,565 | 13,772,395 |
| Accumulated deficit | (117,030,773 ) | (116,769,554 ) |
| Dividend | (150,000 ) | (100,000 ) |
| Total Company stockholders' deficit | (15,026,386 ) | (16,303,337 ) |
| NONCONTROLLING INTEREST | 5,629,660 | 5,643,294 |
| TOTAL EQUITY (DEFICIT) | (9,396,726 ) | (10,660,043 ) |
| TOTAL LIABILITIES AND EQUITY (DEFICIT) | $ 3,238,274 | $ 3,115,027 |

3

Table of Contents

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

| | SIX MONTHS ENDED JUNE 30, | | THREE MONTHS ENDED JUNE 30, | |
|---|---|---|---|---|
| | 2017 | 2016 | 2017 | 2016 |
| Net sales | $38,344 | $35,817 | $32,715 | $22,530 |
| Cost of sales | 28,886 | 332,579 | 24,538 | (2,233) |
| Gross income (loss) | 9,458 | (296,762) | 8,178 | 24,763 |
| Operating expenses | | | | |
| Selling | 53,944 | 103,339 | 24,462 | 51,166 |
| General and administrative | (6,711) | 450,407 | 21,529 | 104,323 |
| Total operating expenses | 47,233 | 553,746 | 45,991 | 155,489 |
| Loss from operations | (37,775) | (850,508) | (37,813) | (130,726) |
| Non-operating income (expenses) | | | | |
| Interest income | 1,621 | 1,924 | 844 | 1,023 |
| Interest expense | (198,323) | (169,450) | (100,386) | (88,732) |
| Financial expense | (6,921) | (85,961) | (3,541) | (41,984) |
| Other expenses, net | 32,866 | 2,484 | 32,866 | 304 |
| Total non-operating expenses, net | (170,757) | (251,003) | (70,216) | (129,389) |
| Loss before income tax (benefit) | (208,532) | (1,101,511) | (108,029) | (260,115) |
| Income tax expense (benefit) | (456) | (7,138) | 201 | (7,138) |
| Loss from continuing operations | (208,076) | (1,094,373) | (108,230) | (252,977) |
| Cumulative foreign currency translation gain / loss on disposed entities | - | 682,036 | - | - |
| Loss from operations of discontinued entities, net of tax | (69,352) | (1,755,548) | (8,557) | (1,416,946) |
| Loss on disposal of discontinued entities, net of tax | - | (2,764,701) | - | - |
| Net loss including noncontrolling interest | (277,428) | (4,932,586) | (116,787) | (1,669,923) |
| Less: loss attributable to noncontrolling interest from continuing operations | (15,377) | (783,081) | (2,357) | (300,654) |
| Less: loss attributable to noncontrolling interest from discontinued operations, net of tax | (832) | (1,002) | (102) | - |

| | | | | |
|---|---|---|---|---|
| Net loss to SmartHeat Inc. | (261,219 ) | (4,148,503) | (114,328 ) | (1,369,269) |
| Other comprehensive item | | | | |
| Foreign currency translation loss attributable to discontinued operations | (103,076 ) | (28,184 ) | (79,944 ) | (10,050 ) |
| Foreign currency translation gain (loss) attributable to SmartHeat Inc. | 1,691,245 | 2,639,856 | (3,917 ) | (60,097 ) |
| Foreign currency translation gain (loss) attributable to noncontrolling interest | 2,575 | (11,408 ) | 1,984 | (14,424 ) |
| Comprehensive income (loss) attributable to SmartHeat Inc. | $1,326,950 | $(1,536,831) | $(198,189 ) | $(1,439,416) |
| Comprehensive loss attributable to noncontrolling interest | $(13,634 ) | $(795,491 ) | $(475 ) | $(315,078 ) |
| Basic and diluted weighted average shares outstanding | $8,323,178 | 8,283,399 | 8,362,520 | 8,283,399 |
| Basic and diluted loss per share from continuing operations | $(0.02 ) | $(0.04 ) | $(0.01 ) | $0.01 |
| Basic and diluted loss per share from discontinued operations | $(0.01 ) | $(0.46 ) | $(0.00 ) | $(0.17 ) |
| Basic and diluted net loss per share | $(0.03 ) | $(0.50 ) | $(0.00 ) | $(0.16 ) |

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | SIX MONTHS ENDED JUNE 30, 2017 | 2016 |
|---|---|---|
| | (UNAUDITED) | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Loss including noncontrolling interest | $(277,428) | $(4,932,586) |
| Adjustments to reconcile loss including noncontrolling interest to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 10,269 | 186,606 |
| Reversal of provision for bad debts | (57,046) | (367,906) |
| Provision for inventory impairment | (16,603) | 319,424 |
| Loss on sale of equity interest of subsidiaries | - | 2,082,665 |
| Changes in deferred tax | - | (12,559) |
| (Increase) decrease in assets and liabilities: | | |
| Accounts receivable | 98,187 | 388,627 |
| Retentions receivable | 5,917 | 23,903 |
| Advances to suppliers | - | 2,163 |
| Other receivables, prepayments and deposits | 15,872 | (193,435) |
| Inventories | 32,018 | 101,270 |
| Taxes receivable | 5,393 | (6,428) |
| Accounts payable | 29,020 | (131,558) |
| Advances from customers | 153,631 | 82,252 |
| Tax payable | (9,299) | - |
| Accrued liabilities and other payables | 180,361 | 1,705,008 |
| Net cash provided by (used in) operating activities | 170,292 | (752,554) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Cash disposed from equity interest sale of subsidiaries | - | (132,631) |
| Acquisition of property and equipment | - | (347) |
| Notes receivable | - | 161,414 |
| Net cash used in investing activities | - | 28,436 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Change in credit line payable | - | 340,000 |
| Net cash provided by financing activities | - | 340,000 |
| EFFECT OF EXCHANGE RATE CHANGE ON CASH AND EQUIVALENTS | 27,577 | (30,298) |
| NET INCREASE (DECREASE) IN CASH AND EQUIVALENTS | 197,869 | (414,416) |
| CASH AND EQUIVALENTS, BEGINNING OF PERIOD | 1,046,884 | 1,736,971 |
| CASH AND EQUIVALENTS, END OF PERIOD | $1,244,753 | $1,322,555 |

| | | |
|---|---|---|
| Supplemental cash flow data: | | |
| Income tax paid | $- | $- |
| Interest paid | $358 | $- |

5

Table of Contents

SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2017 (UNAUDITED) AND DECEMBER 31, 2016

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 and at that time had little or no operations. On April 14, 2008 we changed our name to SmartHeat Inc. and acquired all of the equity interests in Taiyu, at that time a leading developer of plate heat exchangers ("PHEs") and PHE Units in China. Taiyu was formed in July 2002 under the laws of China and is headquartered in Shenyang City, Liaoning Province, China. The Company, through its operating subsidiaries in China and Germany, formerly designed, manufactured, sold PHEs , PHE Units, temperature sensors, valves and automated control systems, heat meters and heat pumps for use in commercial and residential buildings until the sale of certain of its subsidiaries effective December 31, 2014.

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

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

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

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

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

On December 30, 2013, the Company, closed the transaction contemplated by the Equity Interest Purchase Agreement ("EIPA") dated October 10, 2013, whereby the buyers purchased 40% of the Company's equity interests in the following PHE segment subsidiaries: Taiyu; SmartHeat Siping; SmartHeat Energy; Ruicheng; and XinRui (collectively, the "Target Companies"). The purchase price was RMB 5 million ($0.82 million). XinRui was 46% owned by SmartHeat US parent prior to the 40% equity interest sale.

On November 28, 2014, the Company entered into an Amended and Restated EIPA, which amended and restated the EIPA dated October 10, 2013 between the Company and the buyers. Under the terms of the Amended EIPA, the buyers agreed to purchase the remaining 60% of the Company's equity interests in the Target Companies effective as of December 31, 2014 (the "Closing Date"). The purchase price for the remaining 60% consists of: (i) RMB 8.5 million ($1.4 million) and (ii) the forgiveness of all net indebtedness of $11.75 million owed to the Target Companies by SmartHeat and each of its other subsidiaries as of December 31, 2014 subject to termination provisions as set forth in EIPA.

The effectiveness of the transaction was subject to the following conditions: (i) approval of its shareholders and (ii) receipt by the Board of Directors ("BOD" or the "Board") of the Company of an opinion that the purchase and sale transaction was fair to the shareholders of SmartHeat from a financial point of view. The parties executed a mutual release to be delivered at the closing which provided, in part, for the target companies to forgive all net indebtedness of $11.75 million from SmartHeat and all of its other subsidiaries. In the event that the conditions were not met prior to December 31, 2014, the consideration and all documents were to be deposited into escrow and released when the conditions were satisfied; provided that if the conditions were not satisfied on or before March 31, 2015, either party was able to terminate the Amended EIPA and the funds and documents were to be returned to the depositing party. The termination deadline of the Amended EIPA was extended to May 15, 2015.

Table of Contents

On May 11, 2015, the Company’s stockholders approved the sale of all of the remaining interests, constituting 100% of its ownership interests, (the “Stock Sale”) of certain subsidiaries of the Company as described above, all of the conditions precedents to the Stock Sale were satisfied. The parties executed a mutual release which became effective and provided, in part, that the Target Companies forgave all net indebtedness from SmartHeat and all of its other subsidiaries owed to the Target Companies. The consideration and all documents relating to the transaction were released from escrow upon the satisfaction of the foregoing conditions.  The buyers consisted of 25 natural persons, all of whom are PRC citizens, including Wen Sha, Jun Wang and Xudong Wang, managers of the Company’s subsidiaries engaged in the PHE segment of its business, and Huajun Ai and Yingkai Wang, the Company’s Corporate Secretary and Acting Chief Accountant, respectively. Huajun Ai, Wen Sha, Jun Wang and Xudong Wang are also principals in Northtech.

On January 20, 2016, SmartHeat Pump entered and closed a Share Purchase Agreement with a series of buyers to sell 85% of the equity shares of SmartHeat Germany for Euro 170,000 ($185,400).  The purchasing price of Euro 170,000 was returned to the buyers and subsequently paid into SmartHeat Germany as reserve by the buyers. The buyers are not related parties of the Company. SmartHeat Germany had continuous losses and the management decided to sell at a minimal or no cost due to its higher operating cost.

During the year ended December 31, 2016, SmartHeat Pump decided to file for bankruptcy protection in China due to the slowdown of the business. SmartHeat Pump is preparing bankruptcy documents to be filed with the proper authorities in China, and expects the bankruptcy process to last for a few years before obtaining the final approval. Accordingly, the Company reclassified SmartHeat Pump business as discontinued operations and made an impairment reserve for its assets including accounts receivable, retentions receivable, other receivables, advance to suppliers, inventory, deferred tax assets, fixed assets and intangible assets (See note 19).

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

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

The consolidated financial statements include the financial statements of the Company and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation.

The interim condensed consolidated financial information as of June 30, 2017 and for the six and three-month periods ended June 30, 2017 and 2016 have been prepared without audit, pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures, which are normally included in consolidated financial statements prepared in accordance with U.S. GAAP have not been included. The interim consolidated financial information should be read in conjunction with the Financial Statements and the notes thereto, included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2016, previously filed with the SEC on August 29, 2017.

In the opinion of management, all adjustments (which include all significant normal and recurring adjustments) necessary to present a fair statement of the Company’s interim consolidated financial position as of June 30, 2017, its interim consolidated results of operations and cash flows for the six and three months ended June 30, 2017 and 2016, as applicable, have been 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

For the six and three months ended June 30, 2017 and 2016, the accompanying consolidated financial statements include the accounts of SmartHeat's US parent, its subsidiaries Heat HP and Heat PHE, and their subsidiaries SanDeKe, Jinhui, SmartHeat Investment, SmartHeat Trading, SmartHeat Germany (until January 20, 2016), SmartHeat Pump, and Heat Exchange, which are collectively referred to as the "Company." All significant intercompany accounts and transactions were eliminated in consolidation.

Going Concern

The Company has incurred significant recurring losses from operations in the past several years, including a loss from continuing operations of $0.21 million for the six months ended June 30, 2017; and an accumulated deficit of $117,030,773 as of June 30, 2017. These conditions raise a substantial doubt about the Company's ability to continue as a going concern.

The Company is currently seeking potential assets, property or businesses to acquire, in a business combination, by reorganization, merger or acquisition. The plan of operation for the next 12 months is to: (i) consider guidelines of industries in which the Company may have an interest; (ii) adopt a business plan regarding engaging in the business of any selected industry; and (iii) to commence operations through funding and/or the acquisition or business combination with a "going concern" engaged in any industry selected. The Company is unable to predict the time as to when and if it may actually participate in any specific business endeavor, and the Company will be unable to do so until it determines any particular industry in which the Company may conduct business operations.

Table of Contents

Noncontrolling Interest

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

On July 27, 2012, the Company entered into a secured, revolving credit facility under the terms of a Secured Credit Agreement with Northtech Holdings Inc., a British Virgin Islands business corporation ("Northtech") for the Company's working capital needs. On December 28, 2015, the Company entered into the Fourth Amendment to the Credit and Security Agreement dated July 27, 2012, as first amended on December 21, 2012 and subsequently amended on August 23, 2013, and July 14, 2014, between the Company and Northtech (see Note 12). Under the Fourth Amendment, SmartHeat paid loan repayment of $1,000,000, represented by such number of shares of Series A Preferred Stock of Heat HP convertible into 20% of the issued and outstanding Common Stock of Heat HP on fully diluted basis, with a conversion, redemption and liquidation value of $1,000,000, and a 10% cumulative dividend accruing and payable quarterly ($25,000 per quarter). Accordingly, Northtech became the 20% noncontrolling interest of Heat HP Inc.

Use of Estimates

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

Cash and Equivalents

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

The following table presents in US dollars ("USD") the amount of cash and equivalents held by the Company as of June 30, 2017 and December 31, 2016, based on the jurisdiction of deposit. The Company's US parent holds cash and equivalents in US bank accounts denominated in USD.

| | United States | China | | Total |
|---|---|---|---|---|
| June 30, 2017 | $ - | $1,244,753 | $- | $1,244,753 |
| December 31, 2016 | $ | $1,046,884 | $ | $1,046,884 |

Accounts and Retentions Receivable, net

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 $1.83 million and $1.89 million at June 30, 2017 and December 31, 2016, respectively.

At June 30, 2017 and December 31, 2016, the Company had retentions receivable from customers for product quality assurance of $0.19 million and $0.19 million, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from three to 24 months depending on the shipping date, and for PHE Units, the customer acceptance date of the products and the number of heating seasons that the warranty period covers. The Company had allowances of $0.19 million and $0.19 million at June 30, 2017 and December 31, 2016, respectively.

Advances to Suppliers, net

The Company makes advances to certain vendors to purchase raw material and equipment for production. The advances are interest-free and unsecured. As of June 30,2017 and December 31, 2016, the Company had allowances for advances to suppliers of $2.19 million and $2.14 million, respectively.

Table of Contents
Inventories, net

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

As part of inventory impairment analysis, the Company performs an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory can be utilized and will be consumed within the next six months through new customer orders or substitute orders, no impairment is recorded. The Company collects information about delayed and canceled contracts and meets with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that the Company does not expect to be reinstated and contracts for which the Company has been unable to find substitute customers become impaired. Following the completion of the impairment analysis, the Company had inventory impairment allowance of $7.15 million and $7.00 million as of June 30, 2017 and December 31, 2016, respectively. The Company recorded reversal of inventory impairment provision of $0.02 million and inventory impairment provision of $0.32 million for the six months ended June 30, 2017 and 2016, respectively, which was included in the cost of sales. The Company recorded reversal of inventory impairment provision of $0.02 million and $5,300 for the three months ended June 30, 2017 and 2016, respectively.

Property and Equipment, net

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 |

Impairment of Long-Lived Assets

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

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value (“FV”) of the assets. FV generally is determined using the asset’s expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of June 30, 2017, there was no significant impairment of long-lived assets; and at December 31, 2016, impairment of long-lived assets was $508,744 due to discontinued operation of Heat Pump.

Warranties

The Company offers 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.

Research and Development Costs

Research and development (“R&D”) costs are expensed as incurred and included in general and administrative (“G&A”) 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 six and three months ended June 30, 2017 and 2016 were $0.

Table of Contents

Income Taxes

The Company utilizes FASB ASC Topic 740, “Income Taxes,” which requires recognition of deferred tax assets and liabilities for expected future tax consequences of events included in the financial statements or tax returns. Under this method, deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each period end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

When tax returns are filed, it is likely that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50% likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest associated with unrecognized tax benefits is classified as interest expense and penalties are classified as selling, general and administrative expense in the statements of operation. At June 30, 2017, the Company had not taken any significant uncertain tax position on its tax returns for 2016 or prior years, or in computing its tax provision for 2017.

Revenue Recognition

The Company’s revenue recognition policies comply with FASB ASC Topic 605, “Revenue Recognition.” 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.” For the six and three months ended June 30, 2017, the Company only sold PHEs. For the six and three months ended June 30, 2016, the Company only sold PHEs and heat pumps.

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 three to 24 months from the acceptance date.

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

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

Sales returns and allowances were $0 for the six and three months ended June 30, 2017 and 2016. The Company does not provide a right of return, price protection or any other concessions to its customers.

The Company provides a 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 product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the FASB ASC Subtopic 605-25 separation and allocation model for a multiple deliverable arrangement. FASB ASC Topic 450, "Contingencies," specifically addresses the accounting for standard warranties. The Company believes that accounting for its standard warranty pursuant to FASB ASC Topic 450 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. Such revenue was recorded in other income, net of cost for after-sales services.

Table of Contents

Cost of Sales

Cost of sales (“COS”) consists primarily of material costs and direct labor and manufacturing overhead directly attributable to the products. The Company also records reserve for inventories to COS.

Advances from Customers

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

Concentration of Credit Risk

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

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

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

Statement of Cash Flows

In accordance with FASB ASC Topic 230, “Statement of Cash Flows,” 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.

Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the US 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 FASB ASC Topic 830, “Foreign Currency Matters.” According to FASB ASC Topic 830, 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

FASB ASC Topic 220, “Comprehensive Income.”

The Company sold 85% equity interest of SmartHeat Germany on January 20, 2016. According to ASC 830-30-40-1, upon the sale of a subsidiary, accumulated foreign currency translation adjustment relating to the disposed entities as of January 20, 2016 amounting to $0.68 million was reported separately in the Consolidated Statements of Operations and Comprehensive Income (Loss) as cumulative foreign currency translation gain on disposed entities, and was part of the loss on sale.

Table of Contents

RMB to USD and EUR to USD (until January 20, 2016) exchange rates in effect as of June 30, 2017 and December 31, 2016, and the average exchange rates for six months ended June 30, 2017 and 2016 are as following. The exchange rates used in translation from RMB to USD were published by State Administration of Foreign Exchange ("SAFE") of the PRC.

| | Average Exchange Rate For the six months Ended | | Balance Sheet Date Exchange Rate | |
|---|---|---|---|---|
| | 6/30/17 | 6/30/16 | 6/30/17 | 12/31/16 |
| RMB - USD | 6.8697 | 6.5303 | 6.7744 | 6.9370 |
| EUR – USD (until disposal date of January 20, 2016) | - | 0.9209 | - | 0.9233 |

Segment Reporting

FASB ASC Topic 280, "Segment Reporting," 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 had one operating segment at June 30, 2017, which is PHE.

New Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is in the process of evaluating the impact of adoption of this ASU on the consolidated financial statements.

In May 2014, the FASB issued No. 2014-09, Revenue from Contracts with Customers, which supersedes the revenue recognition requirements in Accounting Standards Codification 605 - Revenue Recognition and most industry-specific guidance throughout the Codification. The standard requires that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In August 2015, the FASB approved a one-year deferral of the effective date of the new revenue recognition standard. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 31, 2016, including interim reporting periods within that reporting period. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue versus Net). In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606), Identifying Performance Obligations and Licensing. In May 2016, the FASB issued ASU 2016-11, Revenue from Contracts with Customers (Topic 606) and Derivatives and Hedging (Topic 815) - Rescission of SEC Guidance Because of ASU 2014-09 and 2014-16, and ASU 2016-12, Revenue from Contracts with Customers (Topic 606) - Narrow Scope Improvements and Practical Expedients. These ASUs clarify the implementation guidance on a few narrow areas and adds some practical expedients to the guidance

Topic 606. The Company is evaluating the effect that these ASUs will have on its consolidated financial statements and related disclosures.

On March 30, 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which includes amendments to accounting for income taxes at settlement, forfeitures, and net settlements to cover withholding taxes. The amendments in ASU 2016-09 are effective for public companies for fiscal years beginning after December 31, 2016, and interim periods within those annual periods. The Company adopted this new guidance on January 1, 2017 and this standard does not have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326), which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact that the standard will have on its consolidated financial statements and related disclosures.

Table of Contents

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 clarifies the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. This ASU is effective for public business entities for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted. The Company is currently assessing the potential impact of ASU 2016-15 on its financial statements and related disclosures.

In October 2016, the FASB issued ASU No. 2016-16—Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. This ASU improves the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. For public business entities, the amendments in this update are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. Early adoption is permitted. The Company does not anticipate that the adoption of this ASU will have a significant impact on its consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash. The guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2017, and interim period within those fiscal years. Early adoption is permitted, including adoption in an interim period. The standard should be applied using a retrospective transition method to each period presented. The Company does not anticipate that the adoption of this ASU will have a significant impact on its consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, which clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The standard should be applied prospectively on or after the effective date. The Company will evaluate the impact of adopting this standard prospectively upon any transactions of acquisitions or disposals of assets or businesses.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The guidance should be adopted on a prospective basis for the annual or any interim goodwill impairment tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

Reclassification

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period including discontinuing the operation of SmartHeat Pump. These reclassifications had no effect on the Company’s balance sheet, net loss or stockholders’ equity (deficit).

3. INVENTORIES, NET

Inventories at June 30, 2017 and December 31, 2016,, respectively, were as follows:

| | 2017 | 2016 |
|---|---|---|

| | | |
|---|---|---|
| Raw materials | $6,142,656 | $5,971,570 |
| Work in process | 488,123 | 476,682 |
| Finished goods | 771,653 | 812,378 |
| Total | 7,402,432 | 7,260,630 |
| Inventory allowance | (7,148,978) | (6,997,852) |
| Inventories, net | $253,454 | $262,778 |

As of June 30, 2017 and December 31, 2016, SmartHeat Pump's inventory was fully reserved as a result of its discontinued operation.

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received commercial notes (bank acceptances) from them in lieu of payments. The Company discounted the commercial notes with the banks 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 nine months. As of June 30, 2017 and December 31, 2016, the Company was contingently liable for the notes endorsed to vendors of $0, respectively.

Table of Contents

5. OTHER RECEIVABLES (NET), PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | 2017 | 2016 |
|---|---|---|
| Advances to unrelated third party companies | $ 1,346,366 | $ 1,314,808 |
| Prepayment for freight, related insurance, advertisement and consulting expenses | 4,641 | 34,755 |
| Advances to employees | 412,882 | 337,380 |
| Other | 396,805 | 447,898 |
| Total | 2,160,694 | 2,134,841 |
| Less: bad debt allowance | (807,228) | (722,484) |
| Other receivables (net), prepayments and deposits | $ 1,353,466 | $ 1,412,357 |

Advances to unrelated third party companies were short-term unsecured advances.

Prepayment for freight and related insurance expenses represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products.
Advances to employees represented short-term loans to employees and advances for business trips and related expenses. As of December 31, 2016, as a result of discontinued operation for SmartHeat Pump, other receivables including advance to employees was fully reserved as bad debt allowance.

6. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | 2017 | 2016 |
|---|---|---|
| Production equipment | $891,003 | $870,119 |
| Office equipment | 189,628 | 185,183 |
| Vehicles | 169,121 | 182,753 |
| Total | 1,249,752 | 1,238,055 |
| Less: impairment of fixed asset | (191,894) | (187,397) |
| Less: accumulated depreciation | (1,040,994) | (1,030,692) |
| Property and equipment, net | $16,864 | $19,966 |

Depreciation expense including SmartHeat Germany (prior to disposition on January 20, 2016) and SmartHeat Pump prior to their discontinued operation in 2016 for the six months ended June 30, 2017 and 2016 was $3,531 and $37,904, respectively. Depreciation for the three months ended June 30, 2017 and 2016 was $ 2,656 and $ 5,604, respectively.

7. INTANGIBLE ASSETS, NET

Intangible assets consisted mainly of trademarks, computer software and know-how technology. Intangible assets consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | Estimated Useful Life (In years) | 2017 | 2016 |
|---|---|---|---|
| Know-how technology | 5–10 | $551,094 | $538,177 |
| Software | 5 | 137,689 | 134,462 |
| Trademarks | 7 | 268,692 | 262,393 |
| Total | | 957,475 | 935,032 |
| Less: impairment of intangible asset | | (306,929) | (299,735) |
| Less: accumulated amortization | | (650,546) | (635,297) |
| Intangible assets, net | | $- | $- |

Amortization of intangible assets including that of SmartHeat Germany (prior to disposition on January 20, 2016) and SmartHeat Pump (prior to discontinued operation in 2016) for the six months ended June 30, 2017 and 2016 was $ 0 and $ 62,988, respectively. Amortization of intangible assets for the three months ended June 30, 2017 and 2016 was $0 and $31,313, respectively.

14

Table of Contents

8. TAXES RECEIVABLE

Taxes receivable consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | 2017 | 2016 |
|---|---|---|
| Value-added | $2,208 | $5,485 |
| Other | - | 28 |
| Taxes receivable | $2,208 | $5,513 |

9. TAXES PAYABLE

Taxes payable consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | 2017 | 2016 |
|---|---|---|
| Income | $7,831 | $13,784 |
| Value-added | | 1,442 |
| Other | 672 | 618 |
| Taxes payable | $8,503 | $15,844 |

10. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at June 30, 2017 and December 31, 2016, respectively:

| | 2016 | 2016 |
|---|---|---|
| Advances from third parties | $3,099,035 | $4,733,428 |
| Other | 1,552,239 | 1,334,315 |
| Accrued expenses | 3,058,044 | 3,003,046 |
| Total accrued liabilities and other payables | $7,709,318 | $9,070,789 |

Advances from third parties were short term, non-interest-bearing and due on demand.

At June 30, 2017, other mainly represented payables for the Company's interest payable of $1,240,482 to Northtech and dividend payable of $150,000 to Northtech. At December 31, 2016, other mainly consisted of interest payable of $1,042,159 to Northtech and dividend payable of $100,000 to Northtech.

As of June 30, 2017, accrued expenses mainly consisted of accrued property and land rental fee of $2.72 million and accrued payroll of $0.34 million. As of December 31, 2016, accrued expenses mainly consisted of accrued property and land rental fee of $2.65 million, and accrued payroll of $0.35 million.

11. CREDIT LINE PAYABLE (RELATED PARTY TRANSACTION)

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

An origination fee of 4% of the Committed Amount was accrued to Northtech upon the signing of the Credit Agreement. As amended, Borrowings bear interest of 10%, payable quarterly, and the Credit Facility matured on

April 30, 2013, and extended to April 30, 2014 with an extension fee of 4% of the Committed Amount. Generally, borrowings may be prepaid at any time without premium or penalty, provided however that if the Company prepays any amount due under the Credit Facility from the proceeds of another instrument or agreement of indebtedness, the Company shall pay a 10% prepayment fee. All amounts due under the Credit Facility may, at the Company's option, be paid in either cash or restricted shares of the Company's common stock.

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

Table of Contents

On March 26, 2014, the Company gave notice to Northtech pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 3, 2015. The Company elected to pay the extension fee of 4% of the credit line amount of $2.5 million by issuing 200,000 shares of its common stock to Northtech at $0.50 per share (equal to $100,000). The BOD approved such extension on March 27, 2014. The FV of 200,000 shares on March 27, 2014 was $30,000. The Company recorded $70,000 gain from issuance of 200,000 shares.

On July 14, 2014, the BOD approved and the Company entered the third amendment to the Credit Agreement with Northtech, the Amendment modified the definition of "Average Share Price" in the Credit Agreement to decrease the minimum and maximum values for the "Average Share Price," by 20% each from $0.50 to $0.40 and from $3.50 to $2.80, respectively. The Amendment also increased the maximum line, which may be borrowed under the Credit Agreement from $2,500,000 to $3,250,000 and extended the maturity date for amounts borrowed from April 30, 2014 to October 31, 2015. Pursuant to the terms of the Amendment, the Company extended the Initial Maturity Date by a payment to Northtech of an extension fee of 4% of the Maximum Line under the Credit Agreement. Northtech agreed to the extension of the maturity in consideration of an extension fee of 200,000 Restricted Shares of the Company's Common Stock at $0.50 per share issued on July 22, 2014. The FV of 200,000 shares on July 22, 2014 was $40,000. The Company recorded $60,000 gain from issuance of the 200,000 shares.

On December 28, 2015, the Company entered into the Fourth Amendment to the Credit and Security Agreement dated July 27, 2012, as first amended on December 21, 2012 and subsequently amended on August 23, 2013, and July 14, 2014, between the Company and Northtech. The Amendment provides that SmartHeat to pay 1) an extension fee of $100,000 for Northtech extending the maturity date to July 31, 2016 and a loan re-payment of $500,000 of outstanding principal (for a total payment of $600,000), represented by the delivery by the Company of 1,500,000 restricted shares of Common Stock at a price of $0.40 per share; 2) loan repayment of $1,000,000, represented by such number of shares of Series A Preferred Stock of Heat HP convertible into 20% of the issued and outstanding Common Stock of Heat HP on fully diluted basis, with a conversion, redemption and liquidation value of $1,000,000, and a 10% cumulative dividend accruing and payable quarterly ($25,000 per quarter). In addition, the parties agreed to adjust the minimum conversion/exchange price in the Amendment from $0.40 to $0.20 per share and the maximum conversion/exchange price from $2.80 to $1.40 to reflect the current market conditions of the stock. The new maximum credit line was reduced to $2,500,000.

On July 31, 2016, the Company entered into the Fifth Amendment to the Credit and Security Agreement between the Company and Northtech. The Amendment increased the maximum credit line of the Credit Agreement to $3,500,000 and extended the maturity dated to October 31, 2017. The Company agreed to pay to Northtech an amendment fee of $80,000 payable in 400,000 restricted shares of the Company's Common Stock valued at $0.20 per share. The Amendment received the approval of a majority of shareholders of the Company in a vote held at the meeting of the stockholders on September 10, 2016.

As of June 30, 2017, Northtech owns 43.5% of the Company as a result of shares received from the Company for loan repayment and extension fee. In addition, Northtech became the 20% noncontrolling interest of Heat HP as a result of $1,000,000 loan repayment by issuing Series A Preferred Stock of Heat HP which can be convertible into 20% of the issued and outstanding Common Stock of Heat HP on fully diluted basis, as described above.

## 12. DEFERRED TAX ASSET (LIABILITY)

As of June 30, 2017 and December 31, 2016, deferred tax asset (liability) consisted of the following:

| | 2017 | 2016 |
|---|---|---|
| Deferred tax asset - current (bad debt allowance for accounts receivable) | $668,923 | $682,358 |
| Deferred tax asset - current (bad debt allowance for retention receivable) | 47,471 | 35,142 |

| | | |
|---|---|---|
| Deferred tax asset - current (inventory impairment provision) | 1,787,244 | 1,749,463 |
| Deferred tax asset – current (bad debt allowance for other receivables) | 201,807 | 180,621 |
| Deferred tax asset – current (allowance for advance to supplier) | 548,288 | 535,436 |
| Deferred tax asset – noncurrent (NOL of US parent company) | 3,431,884 | 3,362,162 |
| Deferred tax asset – noncurrent (NOL of PRC subsidiaries) | 4,516,216 | 4,403,714 |
| Less: valuation allowance | (11,201,883) | (10,948,896) |
| Deferred tax assets, net | $- | $- |
| Deferred tax liability - noncurrent (depreciation of fixed assets) | $- | $- |

The Company recorded a 100% valuation allowance for all deferred tax assets due to the uncertainty of its realization.

16

Table of Contents

## 13. INCOME TAXES

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

SmartHeat, the parent company, was incorporated in the US 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 $10.10 million at June 30, 2017, which may be available to reduce future years' taxable income. Management believes the realization of benefits from these losses remains uncertain due to SmartHeat's limited operating history and continuing losses. Accordingly, a 100% deferred tax asset valuation allowance was provided.

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

The following table reconciles the US statutory rates to the Company's effective tax (benefit) rate for the six months ended June 30, 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| US statutory benefit rates | (34.21)% | (33.35)% |
| Tax rate difference | 0.15 % | 4.84 % |
| Valuation allowance | 33.84 % | 27.86 % |
| Tax expense (benefit) per financial statements | (0.22 )% | (0.65 )% |

The following table reconciles the US statutory rates to the Company's effective tax (benefit) rate for the three months ended June 30, 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| US statutory benefit rates | (33.60)% | (31.26)% |
| Tax rate difference | 0.30 % | 6.20 % |
| Other | - % | - % |
| Valuation allowance | 33.49 % | 22.32 % |
| Tax expense (benefit) per financial statements | 0.19 % | (2.74) % |

The income tax expense (benefit) for the six months ended June 30, 2017 and 2016, consisted of the following:

| | 2017 | 2016 |
|---|---|---|
| Income tax expense (benefit) - current | $(456) | $(7,138) |
| Income tax benefit - deferred | - | - |
| Total income tax expense (benefit), net | $(456) | $(7,138) |

The income tax expense (benefit) for the three months ended June 30, 2017 and 2016, consisted of the following:

| | 2017 | 2016 |
|---|---|---|
| Income tax expense (benefit) - current | $201 | $(7,138) |
| Income tax benefit - deferred | - | |
| Total income tax expense (benefit), net | $201 | $(7,138) |

## 14. 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 US GAAP differ from those reflected in the statutory financial statements of the Company’s PRC subsidiaries.

Table of Contents

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 BOD 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. SanDeKe, Jinhui, and SmartHeat Investment were established as FIEs and therefore are subject to the above-mandated restrictions on distributable profits. The Company met all registered capital requirements for its FIEs except for SmartHeat Investment, for which the Company is committed to contribute an additional $40 million in registered capital by the end of 2017 (See note 17).

Additionally, in accordance with the Company Laws 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 BOD, 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 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.

15. STOCKHOLDERS' EQUITY

On July 31, 2016, the Company entered into the Fifth Amendment to the Credit and Security Agreement between the Company and Northtech. The Amendment increased the maximum credit line of the Credit Agreement to $3,500,000 and extended the maturity dated to October 31, 2017. The Company agreed to pay to Northtech an amendment fee of $80,000 payable in 400,000 restricted shares of the Company's Common Stock valued at $0.20 per share. The Amendment received the approval of a majority of shareholders of the Company in a vote held at the meeting of the stockholders on September 10, 2016.

16. COMMITMENTS

Lease Agreements

The Company leased offices for its sales representatives in several different cities under various one-year, non-cancellable and renewable operating lease agreements. Rental expense for the six months ended June 30, 2017 and 2016 was $ 54,615 and $ 921,041, respectively. Rental expense for the three months ended June 30, 2017 and 2016 was $30,392 and $854,945, respectively.

Capital Contribution

The Company formed SmartHeat Investment on April 7, 2010, as an investment holding company with registered capital of $70 million to enable its establishment and investment in new businesses in China. Under PRC company law, registered capital must be used in the operations of the domestic company within its approved business scope. SmartHeat Investment was established as a separate subsidiary of the Company to allow allocation of capital to new businesses in China separate from its existing subsidiaries and operations. As a PRC investment holding company, the $70 million in approved registered capital of SmartHeat Investment is deemed a planned investment amount for the entity, not a traditional registered capital requirement under PRC corporate law. The Company contributed $30 million in capital to SmartHeat Investment on April 15, 2010, from proceeds of its public offering that closed on September 22, 2009. As of June 30, 2017, the Company is committed to contributing the remaining $40 million in registered capital to SmartHeat Investment by the end of 2017. 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.

## 17. CONTINGENCIES

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

Table of Contents

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.

## 18. DISCONTINUED OPERATION OF SMARTHEAT PUMP

During the year ended December 31, 2016, SmartHeat Pump decided to file bankruptcy due to the slowdown of the business, SmartHeat Pump is currently preparing the bankruptcy documents to be filed with the authority, and is expecting the bankruptcy process to last for a few years before obtaining the final approval; accordingly, the Company reclassified SmartHeat Pump business as discontinued operations and made impairment reserve for its assets including accounts receivable, retentions receivable, other receivables, advance to suppliers, inventory, deferred tax assets, fixed assets and intangible assets.

The following table summarizes the carrying value of the assets and liabilities of SmartHeat Pump at December 31, 2016.

| | |
|---|---|
| Cash and equivalents | $205,104 |
| Prepaid expenses | 23,376 |
| Tax receivable | 143 |
| Noncurrent assets, net | 367,529 |
| Accounts payable | (617,751) |
| Unearned revenue | (869,650) |
| Other payable | (995,924) |
| Accrued expenses | (2,988,232) |

## 19. DISPOSAL OF SUBSIDIARIES

On January 20, 2016, SmartHeat Pump entered and closed a Share Purchase Agreement with a series of buyers to sell 85% of the equity shares of SmartHeat Germany for Euro 170,000 ($185,400). The purchasing price of Euro 170,000 was returned to the buyers and subsequently paid into SmartHeat Germany as reserve by the buyers.

The following table summarizes the 85% of the carrying value of the assets and liabilities disposed of in SmartHeat Germany at the closing date of disposal. The excess of the carrying value of the net assets disposed over the selling price of $2,082,665 was recorded as disposal loss.

| | |
|---|---|
| Cash and equivalents | $112,737 |
| Accounts receivable, net | 91,919 |
| Other receivable | 9,813 |
| Tax receivable | 4,173 |
| Inventories | 460,878 |
| Receivable from Parent | 1,385,561 |
| Noncurrent assets, net | 555,456 |
| Accounts payable | (66,540) |
| Other payable | (447,740) |
| Other current payable | (23,592) |
| Disposal loss | (2,082,665) |
| Selling price | $- |

19

Table of Contents

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

Safe Harbor Declaration

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

Overview

On May 11, 2015 the holders of 62.3% of the outstanding common stock, par value $.0001 per share, of SmartHeat Inc., authorized the sale of all of the remaining interests, constituting 100% of its ownership interests, (the "Stock Sale") of certain subsidiaries of the Company pursuant to the terms of an Equity Interest Purchase Agreement (the "EIPA") dated October 10, 2013, as amended and restated on November 28, 2014 and amended on March 19, 2015 (the "Amended EIPA"), by and among Heat PHE, Inc. ("Heat PHE"), as Seller, and Hongjun Zhang, on behalf of all of several individuals ( "Buyers") identified in Buyers' Response to RFP submitted to the Company on September 10, 2013 and as revised and accepted by Company on September 23, 2013. The subsidiaries of the Company which were sold to the Buyers were:

SmartHeat Taiyu (Shenyang) Energy

SmartHeat Siping Beifang Energy Technology Co., Ltd.

SmartHeat (Shenyang Energy Equipment) Co., Ltd.

Hohhot Ruicheng Technology Co., Ltd.

Urumchi XinRui Technology Limited Liability Company

Upon approval by the Company's stockholders on May 11, 2015, all of the conditions precedents in the Amended EIPA were satisfied which consisted of: (i) approval of its stockholders and (ii) receipt by the Board of Directors ("BOD") of the Company of an opinion that the Stock Sale was fair to the stockholders of SmartHeat from a financial point of view. The parties executed a mutual release which became effective and provided, in part, that the Target Companies forgave all net indebtedness of $8.79 million owing to the Target Companies by SmartHeat and all of its other subsidiaries. The consideration and all documents relating to the transaction were released from escrow upon the satisfaction of the foregoing conditions.

The Buyers purchased 40% of Heat PHE's equity interests in the Target Companies for a purchase price of RMB 5 million ($0.82 million) paid on December 30, 2013. The Buyers purchased the remaining 60% of Target Companies (constituting all of the remaining equity interests in the Target Companies) for purchase price of: (i) RMB 8.5 million ($1.39 million) and (ii) the forgiveness of $8.79 million in net indebtedness owing to Target Companies by SmartHeat and each of its other subsidiaries as of December 31, 2014, the date on which the sale occurred.

As a result of the Stock Sale our business has changed significantly as the significant operations of our Plated Heat Exchanges operating segment have been sold.  We currently operate the Heat Pump (“HP”) operating segment which has limited continuing operations in its operating subsidiaries and its business primarily consists of winding down existing businesses, selling inventory, collecting receivables and making arrangements for final payments to our former employees. As a result of the decision to seek bankruptcy protection for SmartHeat Pump, as discussed in more depth below, we are examining strategic alternatives for our business, which includes seeking another operating company to merge its operations with us.

Prior to the Stock Sale, we designed, manufactured and sold clean technology plate heat exchangers (“PHE”) through our PHE operating segment and related systems marketed principally in the People’s Republic of China (“PRC”). Our former subsidiaries in the PHE operating segments designed, manufactured, sold and serviced 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.

Table of Contents

On January 20, 2016, SmartHeat Pump entered and closed a Share Purchase Agreement with a series of buyers to sell 85% of the equity shares of SmartHeat Germany for Euro 170,000 ($185,400). The purchasing price of Euro 170,000 was returned to the buyers and subsequently paid into SmartHeat Germany as reserve by the buyers. The buyers are not related parties of the Company. SmartHeat Germany had continuous losses and the management decided to sell at a minimal or no cost due to its higher operating cost.

The following chart displays our subsidiaries according to which operating segment they operated in after the Stock Sale:

| Plate Heat Exchangers (PHE) | Heat Pumps (HP) |
|---|---|
| SanDeKe Co., Ltd. | SmartHeat (China) Investment Co., Ltd. |
| SmartHeat Heat Exchange Equipment Co. | SmartHeat (Shenyang) Heat Pump Technology Co., Ltd. |
| | SmartHeat Deutschland GmbH (sold 85% equity interest on January 20, 2016) |
| | SmartHeat (Shanghai) Trading Co., Ltd. |
| | Beijing SmartHeat Jinhui Energy Technology Co., Ltd. |

During the year ended December 31, 2016, the management of SmartHeat Pump decided that it would be necessary to seek bankruptcy protection in China due to the slowdown of the business and liabilities exceeding assets. Management made the determination that the business could not be operated profitably in the future. SmartHeat Pump is preparing for the filing by negotiating with employees and the government entities that represents them and is preparing various bankruptcy documents to be filed with the proper authorities in China as resolution to the negotiations are reached. Management expects the bankruptcy process to last between one to two years before obtaining the final approval is obtained from the court. Accordingly, the Company reclassified SmartHeat Pump business as discontinued operations and made an impairment reserve for its assets including accounts receivable, other receivables, advance to suppliers, inventory, deferred tax assets, fixed assets and intangible assets.

Principal Factors Affecting Our Financial Performance

Our historical revenues also fluctuated significantly due to material costs; we experienced fluctuation in raw material costs as a result of world economic conditions, such as the price of stainless steel used to produce plates, our PHEs and PHE Units.

The economic conditions our subsidiaries faced in recent years, made it impossible for our subsidiaries to pay dividends to our US parent company, which is dependent upon such dividends to meet its financial obligations. Relevant PRC statutory laws and regulations permit payments of dividends by the Company's PRC subsidiaries only out of the subsidiary's retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. Further, the Company's PRC subsidiaries are required to take certain reserves as detailed in Note 15 to our financial statements. As a result, we sought alternative sources of capital for our US parent company. On July 27, 2012, we entered into a secured, revolving credit facility with Northtech Holdings Inc., a British Virgin Islands business corporation owned by certain members of our former management, James Wang, Rhett Wang and Wen Sha. Jane Ai, our Corporate Secretary, is also a part owner of Northtech. As amended on December 21, 2012, the Credit Agreement provides for borrowings of up to $2,500,000 with any amounts borrowed due on April 30, 2014. Borrowings under the Credit Agreement are secured by 55% of the equity interest in each of our wholly, directly-owned subsidiaries and are repayable, at our option, in shares of our common stock. On December 21, 2012, we repaid $1,300,000 of the $1,384,455 outstanding under the Credit Agreement with 1,300,000 restricted shares of our common stock, approximately 22.67% of our total issued and outstanding shares of Common Stock, as authorized by the Credit Agreement and approved by our shareholders. On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, we entered into second amendment to the credit and security agreement with Northtech, which redefined the “base rate”, and adjusted the base rate to 10%, compounded quarterly, effective January 1, 2013. On March 26, 2014, we gave notice to Northtech pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 31, 2015. On July 14, 2014, we entered the third amendment to the Credit Agreement with Northtech; the Amendment modifies the definition of “Average Share Price” in the Credit Agreement to decrease the minimum and maximum values for the “Average Share Price,” by 20% each from $0.50 to $0.40 and from $3.50 to $2.80, respectively. The Amendment also increases the maximum line which may be borrowed under the Credit Agreement from $2,500,000 to $3,250,000 and extends the maturity date for amounts borrowed from April 30, 2014 to October 31, 2015. On December 28, 2015, we entered into the Fourth Amendment to the Credit and Security Agreement dated July 27, 2012, (as first amended on December 21, 2012 and subsequently amended on August 23, 2013, and July 14, 2014, between the Company and Northtech). The Amendment provides that we will repay $1,600,000 of the outstanding principal and Northtech will extend the maturity date to July 31, 2016 in exchange for an extension fee of $100,000, 1,500,000 shares of common stock of SmartHeat, par value $.001 per share, which shall be restricted stock and a 10% Convertible Preferred Stock of its wholly owned subsidiary Heat HP, Inc. (“Heat HP”) representing 20% of the voting power of Heat HP, having a conversion, redemption and liquidation value of $1,000,000 and a 10% cumulative dividend accruing and payable quarterly ($25,000 per quarter). In addition, the parties agreed to adjust the minimum conversion/exchange price in the Amendment from $.40 to $.20 per share and the maximum conversion/exchange price from $2.80 to $1.40 to reflect the current market conditions of the stock. The new maximum credit line was reduced to $2,500,000. On July 31, 2016, the Company entered into the Fifth Amendment to the Credit and Security Agreement between the Company and Northtech. The Amendment increased the maximum credit line of the Credit Agreement to $3,500,000 and extended the maturity dated to October 31, 2017. The Company agreed to pay to Northtech an amendment fee of $80,000 payable in 400,000 restricted shares of the Company’s Common Stock valued at $0.20 per share. The Amendment received the approval of a majority of shareholders of the Company in a vote held at the meeting of the stockholders on September 10, 2016.

Table of Contents

As of June 30,2017 and 2016, the outstanding credit line payable to Northtech was $2,875,335.  As of June 30, 2017, Northtech owns 46.06% of the Company as a result of shares received from the Company for loan repayment and extension fee.  In addition, Northtech became the 20% noncontrolling interest of Heat HP as a result of $1,000,000 loan repayment by issuing Series A Preferred Stock of Heat HP which can be convertible into 20% of the issued and outstanding Common Stock of Heat HP on fully diluted basis.

On December 30, 2013, we closed the transaction contemplated by the EIPA dated October 10, 2013, whereby the buyers purchased 40% of the Company's equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohhot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the "Target Companies"). The purchase price was RMB 5 million ($0.82 million). Urumchi XinRui was 46% owned by SmartHeat US parent company.

On November 28, 2014, we entered into the Amended and Restated EIPA, which amended and restated the EIPA dated October 10, 2013 between the Company and the buyers. Under the terms of the Amended EIPA, the buyers had agreed to purchase the remaining 60% of the Company's equity interests in the Target Companies effective as of December 31, 2014 (the "Closing Date"). The purchase price for the remaining 60% consisted of: (i) consideration of RMB 8.5 million ($1.39 million) and (ii) the forgiveness of all net indebtedness owed to the Target Companies by SmartHeat and each of its subsidiaries as of December 31, 2014. The effectiveness of the transaction was subject to the following conditions: (i) approval of its shareholders and (ii) receipt by the Board of Directors of the Company of an opinion that the purchase and sale transaction was fair to the shareholders of SmartHeat from a financial point of view. The parties executed a mutual release to be delivered at the closing which provide, in part, for the Target Companies to forgive all net indebtedness from SmartHeat and all of its other subsidiaries. In the event that the conditions were not met prior to December 31, 2014, the consideration and all documents were to be deposited into escrow and released when the conditions were satisfied; provided that if the conditions were not satisfied on or before March 31, 2015, either party may terminate the Amended EIPA and the funds and documents be returned to the depositing party. The termination deadline of the Amended EIPA was extended to May 15, 2015.

On May 11, 2015, the Company's stockholders approved the sale of all of the remaining interests, constituting 100% of its ownership interests, of certain subsidiaries of the Company as described above, all of the conditions precedents to the Stock Sale were satisfied which consisted of: (i) approval of its stockholders and (ii) receipt by the Board of Directors of the Company of an opinion that the Stock Sale was fair to the stockholders of SmartHeat from a financial point of view. The parties executed a mutual release which became effective and provided, in part, that the Target Companies forgave all net indebtedness from SmartHeat and all of its other subsidiaries owing to the Target Companies. The consideration and all documents relating to the transaction were released from escrow upon the satisfaction of the foregoing conditions. The Stock Sale was effective December 31, 2014.
Since we have decided to seek bankruptcy protection for our primary operating subsidiary, SmartHeat Pump, we have little if any operations and management is attempting to identify other options for the company, including a merger with another operating company.

Significant Accounting Policies

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

Basis of Presentation

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or US GAAP.

Principles of Consolidation

For the six and three months ended June 30, 2017, the accompanying consolidated financial statements include SmartHeat's US parent, its subsidiaries Heat HP and Heat PHE, and their subsidiaries SanDeKe, Jinhui, SmartHeat Investment, SmartHeat Trading, SmartHeat Germany (until January 20, 2016), SmartHeat Pump, and Heat Exchange, which are collectively referred to as the "Company."

Use of Estimates

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

Table of Contents

Accounts Receivable

We maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year. Based on historical collection activity, we had bad debt allowances of $1.83 million and $1.89 million at June 30, 2017 and December 31, 2016, respectively.

Revenue Recognition

Our revenue recognition policies are in compliance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605, "Revenue Recognition." Sales revenue is recognized when PHEs, heat meters and HPs are delivered, and for PHE Units when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of ours exist and collectability is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue under "Advance from customers." As a result of 100% Stock Sale of certain subsidiaries effective December 31, 2014, the Company only sold few PHEs for the six and three months ended June 30, 2017, and the Company only sold few PHES and heat pumps for the six and three months ended June 30, 2016.

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

Our warranty is provided to all customers and is not considered an additional service; rather, it is an integral part of the product sale. We believe the existence of our product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply FASB ASC subtopic 605-25, separation and allocation model for a multiple deliverable arrangement. FASB ASC Topic 450, "Contingencies," specifically addresses the accounting for standard warranties FASB ASC Topic 605 does not supersede FASB ASC Topic 450. We believe that accounting for its standard warranty pursuant to FASB ASC Topic 450 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

We charge for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. We recognize such revenue when service is provided. Such revenue was recorded in other income, net of cost for after-sales services.

Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the US 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 FASB ASC Topic 830, "Foreign Currency Matters." According to FASB ASC Topic 830, 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

FASB ASC Topic 220, “Comprehensive Income).”

Impairment of Long-Lived Assets

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

Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value (“FV”) of the assets. FV generally is determined using the asset’s expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of June 30, 2017, there was no significant impairment of long-lived assets; and at December 31, 2016, impairment of long-lived assets was $508,744 due to discontinued operation of SmartHeat Pump.

Table of Contents

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is in the process of evaluating the impact of adoption of this ASU on the consolidated financial statements.

In May 2014, the FASB issued No. 2014-09, Revenue from Contracts with Customers, which supersedes the revenue recognition requirements in Accounting Standards Codification 605 - Revenue Recognition and most industry-specific guidance throughout the Codification. The standard requires that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In August 2015, the FASB approved a one-year deferral of the effective date of the new revenue recognition standard. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 31, 2016, including interim reporting periods within that reporting period. In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606), Principal versus Agent Considerations (Reporting Revenue versus Net). In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606), Identifying Performance Obligations and Licensing. In May 2016, the FASB issued ASU 2016-11, Revenue from Contracts with Customers (Topic 606) and Derivatives and Hedging (Topic 815) - Rescission of SEC Guidance Because of ASU 2014-09 and 2014-16, and ASU 2016-12, Revenue from Contracts with Customers (Topic 606) - Narrow Scope Improvements and Practical Expedients. These ASUs clarify the implementation guidance on a few narrow areas and adds some practical expedients to the guidance Topic 606. The Company is evaluating the effect that these ASUs will have on its consolidated financial statements and related disclosures.

On March 30, 2016, the FASB issued ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which includes amendments to accounting for income taxes at settlement, forfeitures, and net settlements to cover withholding taxes. The amendments in ASU 2016-09 are effective for public companies for fiscal years beginning after December 31, 2016, and interim periods within those annual periods. The Company adopted this new guidance on January 1, 2017 and this standard does not have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments-Credit Losses (Topic 326), which requires entities to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact that the standard will have on its consolidated financial statements and related disclosures.

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 clarifies the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. This ASU is effective for public business entities for fiscal years, and interim periods within those years, beginning after December 15, 2017. Early adoption is permitted. The Company is currently assessing the potential impact of ASU 2016-15 on its financial statements and related disclosures.

In October 2016, the FASB issued ASU No. 2016-16—Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. This ASU improves the accounting for the income tax consequences of intra-entity transfers of assets other than inventory. For public business entities, the amendments in this update are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. Early adoption is permitted. The Company does not anticipate that the adoption of this ASU will have a significant impact on its consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash. The guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The standard is effective for fiscal years beginning after December 15, 2017, and interim period within those fiscal years. Early adoption is permitted, including adoption in an interim period. The standard should be applied using a retrospective transition method to each period presented. The Company does not anticipate that the adoption of this ASU will have a significant impact on its consolidated financial statements.

Table of Contents

In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business, which clarifies the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions or disposals of assets or businesses. The standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The standard should be applied prospectively on or after the effective date. The Company will evaluate the impact of adopting this standard prospectively upon any transactions of acquisitions or disposals of assets or businesses.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment. The guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The guidance should be adopted on a prospective basis for the annual or any interim goodwill impairment tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

Results of Operations

Six months ended June 30, 2017 Compared to six months ended, 2016

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

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | $ | % of Sales | $ | % of Sales |
| Sales | $38,344 | | $35,817 | |
| Cost of sales | 28,886 | 75 % | 332,579 | 929 % |
| Gross income (loss) | 9,458 | 25 % | (296,762) | (829)% |
| Operating expenses | 47,233 | 123 % | 553,746 | 1546 % |
| Loss from operations | (37,775) | (99)% | (850,508) | (2375)% |
| Non-operating expenses, net | (170,757) | (445)% | (251,003) | (701)% |
| Income tax expense (benefit) | (456) | (1)% | (7,138) | (20)% |
| Loss from continuing operations | (208,076) | (543)% | (1,094,373) | (3055)% |
| Foreign currency translation gain on sold entities | | - % | 682,036 | 1904 % |
| Loss from operations of discontinued entities, net of tax | (69,352) | (181)% | (1,755,548) | (4901)% |
| Loss on disposal of discontinued entities, net of tax | (-) | (-)% | (2,764,701) | (7719)% |
| Less: loss attributable to noncontrolling interest from continuing operations | (15,377) | (40)% | (783,081) | (2186)% |
| Less: loss attributable to noncontrolling interest from discontinued operations, net of tax | (832) | (2)% | (1,002) | (3)% |
| Net Loss to SmartHeat Inc. | $(261,219) | (681)% | $(4,148,503) | (11582)% |

Sales. Net sales in the six months ended June 30, 2017, were $38,344, while net sales in the six months ended June 30, 2016, were $35,817, an overall decrease of $2,527 or 7.06%. The 7.06% decrease in total revenue was due primarily to the decrease in sales of PHEs in the six months ended June 30, 2017, compared to the same period of 2016.

Cost of Sales. Cost of sales ("COS") was $28,886 in the six months ended June 30, 2017, compared to $332,579 in the comparable period of 2016, a decrease of $303,693 or 91.31%. The decrease in our COS is attributable to decreased provision for inventory impairment for Sandeke as well as our decreased sales. The COS as a percentage of sales was

75% in the six months ended June 30, 2017 compared with 929% for the same period of 2016.

We performed an inventory impairment assessment as of June 30, 2017 and December 31, 2016, for the write-down of raw materials and finished goods in inventory. We stock inventory, consisting of raw materials and finished goods, according to projected sales and customer orders, with steel plates and components for our products generally ordered two to three months in advance of anticipated production needs. As part of our impairment analysis, we performed an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory can be utilized and will be consumed within the next few months through new customer orders or substitute orders, no impairment is recorded. We collected information about delayed and canceled contracts and met with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that we do not expect to be reinstated and contracts for which we have been unable to find substitute customers become impaired. We performed an evaluation of these finished goods stored over one year and recorded an impairment accordingly. We also analyzed whether to take a reserve for conversion costs of finished goods in inventory for resale to substitute customers. Following the completion of our impairment analysis, we had inventory impairment allowance of $7.15 million and $7.00 million as of June 30, 2017 and December 31, 2016, respectively.

Table of Contents

Gross Income (Loss). Gross income was $9,458 in the six months ended June 30, 2017, compared to gross loss of $0.30 million in the comparable period of 2016. Gross (loss) margin was 25% and (829)% for the six months ended March 31, 2017 and 2016, respectively.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $47,233 in the six months ended June 30, 2017, compared to $0.55 million selling, general and administrative expenses in the comparable period of 2016, a decrease of $0.51 million or 91.47%. The decrease in operating expenses is mainly attributable to decreased general and administrative expenses of $(6,711) in the six months ended June 30, 2017, compared to $0.45 million general and administrative expenses in the comparable period of 2016. Operating expenses as a percentage of sales were 123% in the six months ended June 30, 2017, compared to 1546% in the comparable period of 2016, the decreased operating expenses as percentage of sales resulted from decreased general and administrative expenses.

Generally, we reserve for 50% of accounts receivable with aging over 180 days and 100% of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and continue to work to collect all amounts due.

Non-Operating Expenses, net. Our net non-operating expenses for the six months ended June 30, 2017 was $0.17 million compared to net non-operating expense of $0.25 million for the comparable period of 2016, a decrease of expenses of $0.08 million or 31.97%. The decrease in non-operating expenses is mainly attributable to decreased financial expense of $6,921 in the six months ended June 30, 2017 compared to $85,961 in the comparable period of 2016, which was partially offset by other expense of 32,866 in the six months ended June 30, 2017 compare to 2,484 in the six months ended June 30, 2016

Loss from Discontinued Operations. We had loss from operation of discontinued entity of $69,352 from SmartHeat Pump in the six months ended June 30, 2017, compared to loss from operation of discontinued entities of $1.75 million for the six months ended June 30, 2016; in addition, we had loss on disposal of 85% equity interest of SmartHeat Germany of $2.08 million (after net with cumulative foreign currency translation gain of $0.68 million) for the comparable period of 2016.

Net Loss. Our net loss to SmartHeat Inc. for the six months ended June 30, 2017 was $0.27 million compared to net loss of $4.1 million for the comparable period of 2016 a decrease of $3.9 million or 93.7%. Net loss as a percentage of sales was 681% in the six months ended June 30, 2017, and net loss as a percentage of sales was 11,582% in the comparable period of 2016.

Three months ended June 30, 2017 Compared to three months ended June 30, 2016

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

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | $ | % of Sales | $ | % of Sales |
| Sales | $32,715 | | $22,530 | |
| Cost of sales | 24,538 | 75 % | (2,233) | (10)% |
| Gross loss | 8,178 | 25 % | 24,763 | 110 % |
| Operating expenses | 45,991 | 141 % | 155,489 | 690 % |
| Loss from operations | (37,813) | (116)% | (130,726) | (580)% |
| Non-operating expenses, net | (70,216) | (215)% | (129,389) | (574)% |
| Income tax benefit | 201 | 0.61 % | (7,138) | (32)% |

| | | | | |
|---|---|---|---|---|
| Loss from continuing operations | (108,230) | (331)% | (252,977) | (1123)% |
| Loss from operations of discontinued entities, net of tax | (8,557) | (26)% | (1,416,946) | (6289)% |
| Less: loss attributable to noncontrolling interest from continuing operations | (2,357) | (7)% | (300,654) | (1334)% |
| Less: loss attributable to noncontrolling interest from discontinued operations, net of tax | (102) | (0.3)% | - | - % |
| Net Loss to SmartHeat Inc. | $(114,328) | (349)% | $(1,369,269) | (6078)% |

Sales. Net sales in the three months ended June 30, 2017, were $32,715, while net sales in the three months ended June 30, 2016, were $22,530, an overall increase of $10,185 or 45%, mainly for the sale of PHEs.

Table of Contents

Cost of Sales. Cost of sales ("COS") was $24,538 in the three months ended June 30, 2017, compared to $(2,233) in the comparable period of 2016, an increase of $26,771 or 1199%. The increase in our COS is attributable to increased provision for inventory impairment for Sandeke as well as our increased sales. The COS as a percentage of sales was 75% in the three months ended June 30, 2017 compared with (10)% for the same period of 2016.

Gross Income (Loss). Gross income was $8,178 in the three months ended June 30, 2017, compared to gross income of $24,763 in the comparable period of 2016. Gross (loss) margin was 25% and 110% for the three months ended June 30, 2017 and 2016, respectively.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $45,991 in the six months ended June 30, 2017, compared to $0.16 million selling, general and administrative expenses in the comparable period of 2016, a decrease of $0.11 million or 70%. The decrease in operating expenses is mainly attributable to decreased general and administrative expenses of $21,529 in the three months ended June 30, 2017, compared to $0.10 million general and administrative expenses in the comparable period of 2016. Operating expenses as a percentage of sales were 141% in the three months ended June 30, 2017, compared to 690% in the comparable period of 2016, the decreased operating expenses as percentage of sales resulted from decreased general and administrative expenses.

Generally, we reserve for 50% of accounts receivable with aging over 180 days and 100% of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and continue to work to collect all amounts due.

Non-Operating Expenses, net. Our net non-operating expenses for the three months ended June 0, 2017 was $0.07 million compared to net non-operating expense of $0.13 million for the comparable period of 2016, a decrease of expenses of $59,173 or 46%. The decrease in non-operating expenses is mainly attributable to decreased financial expense of $3,541 in the three months ended June 30, 2017 compared to $41,984 in the comparable period of 2016.

Loss from Discontinued Operations. We had loss from operation of discontinued entity of $8,557 from SmartHeat Pump in the three months ended June 30, 2017, compared to loss from operation of discontinued entities of $1.42 million including $1.3 million loss from operations of SmartHeat Pump and $83,475 loss from operations of SmartHeat Germany for the three months ended June 30, 2016.

Net Loss. Our net loss to SmartHeat Inc. for the three months ended June 30, 2017 was $0.11 million compared to net loss of $1.4 million for the comparable period of 2016 a decrease of $1.3 million or 92%. Net loss as a percentage of sales was 349% in the three months ended June 30, 2017, and net loss as a percentage of sales was 6078% in the comparable period of 2016.

Liquidity and Capital Resources

As of June 30, 2017, we had cash and equivalents of $1.2 million. Working capital deficit was $6.91 million at June 30, 2017. The ratio of current assets to current liabilities was 0.29:1 at June 30, 2017.

The Company had revolving line of credit providing for borrowings of up to $2.50 million with maturity on July 31, 2016, and extended to October 31, 2017 with increased borrowing amount up to $3.5 million, to address the cash needs of the Company's US parent company. The outstanding balance under the Credit Agreement as of June 30, 2017 was $2.88 million.

The following is a summary of cash provided by or used in each of the indicated types of activities during the six months ended June 30, 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| Cash provided by (used in): | | |
| Operating activities | $170,292 | $(752,554) |
| Investing activities | $- | $28,436 ) |
| Financing activities | $- | $340,000 |

Net cash flow provided by operating activities was $0.17 million in the six months ended June 30, 2017, compared to net cash flow used in operating activities of $0.75 million in the comparable period of 2016. The decrease in net cash outflow in operating activities was due mainly to decreased net loss, and cash inflow of $15,872 from other receivables and prepayments in the six months ended June 30, 2017, compared with $193,435 cash outflow in the six months ended June 30, 2017; and cash inflow of $29,020 from accounts payable in the six months ended June 30, 2017, compare with cash outflow of $131,558 in the same period of 2016.

Table of Contents

Net cash flow provided by investing activities was $0 in the six months ended June 30, 2017, compared to net cash used in investing activities of $28,436 in the comparable period of 2016. In the six months ended June 30, 2016, we had $0.16 million cash inflow from notes receivable, but offset with $0.13 million cash disposed from sale of equity interest on SmartHeat Germany and $347 cash outflow for purchase of fixed assets.

Net cash provided by financing activities was $0 in the six months ended June 30, 2017, compared to $0.3 million cash provided by financing activities in the comparable period of 2016, which was the proceeds from a credit line.

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

The terms of our contracts in our heat pump business require an advance payment upon the execution of a contract or purchase order and a final payment prior to shipping goods which should reduce our outstanding receivables due in the future. In addition, we provide replacement parts and maintenance on our products if they break down within prescribed periods.

Dividend Distribution

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

Off-Balance Sheet Arrangements

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

Contingencies

The Company's former operations were conducted in the PRC and were 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.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures.

Our management, with the participation of our President and Acting Chief Accountant, our principal executive officer and principal financial officer, respectively, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our President and Acting Chief Accountant, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our President and Acting Chief Accountant concluded that, as of June 30, 2017, our disclosure controls and procedures were not effective as of such date because of a material weakness identified in our internal control over financial reporting related to our internal level of US GAAP expertise. We lack sufficient personnel with the appropriate level of knowledge, experience and training in US GAAP for the preparation of financial statements in accordance with US GAAP. None of our internal accounting staff, including our Acting Chief Accountant, that are primarily responsible for the preparation of our books and records and financial statements in compliance with US GAAP holds a license such as Certified Public Accountant in the US, nor have any attended US institutions or extended educational programs that would provide enough of the relevant education relating to US GAAP.

Changes in Internal Control over Financial Reporting.

There were no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2017, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Table of Contents

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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

### Item 1A. Risk Factors

You should consider carefully the factors discussed in the "Risk Factors" in our Annual Report on Form 10-K, as amended, for the year ended December 31, 2016, as amended, which could materially affect our business.

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

None.

### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Mine Safety Disclosures

Not applicable.

### Item 5. Other Information

None.

### Item 6. Exhibits

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

Table of Contents

EXHIBIT INDEX

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

† Filed herewith
‡ Furnished herewith

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

| | | |
|---|---|---|
| | | SMARTHEAT INC.<br>(Registrant) |
| Date: April 27, 2018 | By: | /s/ Kenneth Scipta<br>Mr. Kenneth Scipta<br>Acting President<br>(Principal Executive Officer and Duly Authorized Signatory) |