SMARTHEAT INC.
Form 10-Q
February 17, 2017

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

FORM 10-Q

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

For the quarterly period ended June 30, 2016

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 Shenyang Economic and Technological Development Zone 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, or a smaller reporting company. See the definitions of “large accelerated filer, “accelerated filer,” “non-accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer (do not check if a smaller reporting company)	Smaller reporting company

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

As of June 30, 2016 there were 8,283,399 shares of common stock outstanding.

SmartHeat Inc.

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NOTE ABOUT FORWARD-LOOKING STATEMENTS AND OTHER INFORMATION

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

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

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

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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.

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Part I – Financial Information

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

	JUNE 30, 2016 (UNAUDITED)	DECEMBER 31, 2015
ASSETS		
CURRENT ASSETS		
Cash and equivalents	$ 1,322,555	$ 1,736,971
Accounts receivable, net	970,306	673,186
Retentions receivable, net	-	15,183
Advances to suppliers, net	3,814	6,070
Other receivables (net), prepayments and deposits	1,151,514	1,356,767
Inventories, net	2,040,933	3,053,189
Taxes receivable	6,397	7,986
Notes receivable - bank acceptances	-	162,327
Total current assets	5,495,519	7,011,679
NONCURRENT ASSETS		
Long term investment	367,529	-
Property and equipment, net	224,656	916,245
Intangible assets, net	344,401	423,505
Total noncurrent assets	936,586	1,339,750
TOTAL ASSETS	$ 6,432,105	$ 8,351,429
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 392,640	$ 224,389
Advances from customers	1,213,187	1,156,178
Taxes payable	26,734	32,507
Accrued liabilities and other payables	6,379,146	3,577,891
Total current liabilities	8,011,707	4,990,965
CREDIT LINE PAYABLE	2,795,335	2,455,335
DEFERRED TAX LIABILITY	2,554	15,238
TOTAL LIABILITIES	10,809,596	7,461,538

COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY (DEFICIT)		
Common stock, $0.001 par value; 75,000,000 shares authorized, 8,283,399 shares issued and outstanding as of June 30, 2016 and December 31, 2015, respectively	8,283	8,283
Paid-in capital	85,924,857	98,435,254
Statutory reserve	780,682	780,682
Accumulated other comprehensive income	15,099,035	12,495,370
Accumulated deficit	(112,534,511)	(118,011,345)
Dividend	(50,000)	-
Total Company stockholders' deficit	(10,771,654)	(6,291,756)
NONCONTROLLING INTEREST	6,394,163	7,181,647
TOTAL EQUITY (DEFICIT)	(4,377,491)	889,891
TOTAL LIABILITIES AND EQUITY	$ 6,432,105	$ 8,351,429

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

	SIX MONTHS ENDED JUNE 30,		THREE MONTHS ENDED JUNE 30,	
	2016	2015	2016	2015
	(UNAUDITED)		(UNAUDITED)	
Net sales	$274,528	$491,010	$136,481	$382,245
Cost of sales	621,311	2,584,889	179,427	1,076,705
Gross loss	(346,783)	(2,093,879)	(42,946)	(694,460)
Operating expenses				
Selling	521,623	818,269	263,304	452,877
General and administrative	2,045,351	1,194,990	1,240,110	551,084
Provision (Reversal of provision) for bad debts	(362,682)	175,487	7,666	250,184
Total operating expenses	2,204,292	2,188,746	1,511,080	1,254,145
Loss from operations	(2,551,075)	(4,282,625)	(1,554,026)	(1,948,605)
Non-operating income (expenses)				
Interest income	2,073	3,900	1,119	1,365
Interest expense	(169,450)	(171,973)	(88,732)	(91,554)
Financial expense	(86,028)	(50,580)	(42,045)	(19,689)
Other income (expenses), net	18,337	(12,087)	3,034	8,969
Total non-operating expenses, net	(235,068)	(230,740)	(126,624)	(100,909)
Loss before income tax (benefit)	(2,786,143)	(4,513,365)	(1,680,650)	(2,049,514)
Income tax expense (benefit)	(19,697)	8,890	(10,727)	(14,468)
Loss from continuing operations	(2,766,446)	(4,522,255)	(1,669,923)	(2,035,046)
Cumulative foreign currency translation gain / loss on disposed entities	682,036	11,915,632	-	-
Loss from operations of discontinued entities, net of tax	(83,475)	(268,653)	-	(179,484)
Loss on disposal of discontinued entities, net of tax	(2,764,701)	(47,151,307)	-	-
Net loss including noncontrolling interest	(4,932,586)	(40,026,583)	(1,669,923)	(2,214,530)
Less: loss attributable to noncontrolling interest from continuing operations	(783,081)	(13,200)	(300,654)	(5,141)
	(1,002)	(3,224)	-	(2,154)

Less: loss attributable to noncontrolling interest from discontinued operations, net of tax				
Net loss to SmartHeat Inc.	(4,148,503)	(40,010,159)	(1,369,269)	(2,207,235)
Other comprehensive item				
Foreign currency translation gain (loss) attributable to discontinued operations	(17,327)	(293,326)	-	45,397
Foreign currency translation gain (loss) attributable to SmartHeat Inc.	2,620,784	(280,418)	(80,299)	28,187
Foreign currency translation gain (loss) attributable to noncontrolling interest	(3,193)	3,672	(4,272)	412
Comprehensive loss attributable to SmartHeat Inc.	$(1,545,046)	$(40,583,903)	$(1,449,568)	$(2,133,651)
Comprehensive loss attributable to noncontrolling interest	$(787,276)	$(12,752)	$(304,926)	$(6,883)
Basic and diluted weighted average shares outstanding	8,283,399	6,783,399	8,283,399	6,783,399
Basic and diluted loss per share from continuing operations	$(0.24)	$(0.66)	$(0.17)	$(0.30)
Basic and diluted loss per share from discontinued operations	$(0.26)	$(5.23)	$-	$(0.03)
Basic and diluted net loss per share	$(0.50)	$(5.90)	$(0.17)	$(0.33)

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	SIX MONTHS ENDED JUNE 30,	
	2016	2015
	(UNAUDITED)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss including noncontrolling interest	$(4,932,586)	$(40,026,583)
Adjustments to reconcile loss including noncontrolling interest to net cash used in operating activities:		
Depreciation and amortization	186,606	236,856
Provision (Reversal of provision) for bad debts	(367,906)	175,487
Provision for inventory impairment	319,424	2,043,135
Changes in warranty reserves	-	2,777
Gain on debt waiver	-	(8,790,015)
Loss on sale of equity interest of subsidiaries	2,082,665	44,025,690
Changes in deferred tax	(12,559)	(25,109)
(Increase) decrease in assets and liabilities:		
Accounts receivable	388,627	879,076
Retentions receivable	23,903	72,282
Advances to suppliers	2,163	(32,384)
Other receivables, prepayments and deposits	(193,435)	(1,397,481)
Inventories	101,270	(420,484)
Taxes receivable	(6,428)	38,895
Accounts payable	(131,558)	(575,635)
Advances from customers	82,252	273,829
Accrued liabilities and other payables	1,705,008	1,189,260
Net cash used in operating activities	(752,554)	(2,330,404)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Change in restricted cash	-	53,355
Cash disposed from equity interest sale of subsidiaries	(132,631)	(9,490,641)
Acquisition of property and equipment	(347)	(7,160)
Notes receivable	161,414	-
Net cash provided by (used in) investing activities	28,436	(9,444,446)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Change in credit line payable	340,000	310,000
Net cash provided by financing activities	340,000	310,000
EFFECT OF EXCHANGE RATE CHANGE ON CASH AND EQUIVALENTS	(30,298)	(43,656)
NET DECREASE IN CASH AND EQUIVALENTS	(414,416)	(11,508,506)

CASH AND EQUIVALENTS, BEGINNING OF PERIOD	1,736,971	13,682,624
CASH AND EQUIVALENTS, END OF PERIOD	$1,322,555	$2,174,118
Supplemental cash flow data:		
Income tax paid	$-	$-
Interest paid	$-	$-

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SMARTHEAT INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2016 (UNAUDITED) AND DECEMBER 31, 2015

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

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

On August 23, 2013, the Company formed two new wholly-owned subsidiaries in the State of Nevada, Heat HP Inc., and HEAT PHE Inc. On 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.

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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 loss and the management decided to sale it at a minimal or no cost due to its higher operating cost.

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 interim financial information as of June 30, 2016 and for the six and three months ended June 30, 2016 and 2015, were prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with US GAAP are not included. The interim consolidated financial information should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K, for the fiscal year ended December 31, 2015, previously filed with the SEC.

In the opinion of management, all adjustments (which include normal recurring adjustments) necessary to present a fair statement of the Company's consolidated financial position as of June 30, 2016, its consolidated results of operations for the six and three months ended June 30, 2016 and 2015, and its consolidated cash flows for the six months ended June 30, 2016 and 2015, as applicable, were made. The interim results of operations are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Principles of Consolidation

For the six and three months ended June 30, 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 net loss from continuing operations of $2.77 million for the six months ended June 30, 2016. In addition, the Company recognized a loss of $2.08 million from the 85% equity interest sale on SmartHeat Germany. These conditions raise a substantial doubt about the Company's ability to continue as a going concern. However, since demand in China for heat pump products is increasing, the Company will put more resources and efforts to grow its heat pump business after completing the operational restructuring due to disposing of its PHE business. The Company expects to be able to obtain necessary bank loans for expanding the HP business.

Cost Method Investee

After the 85% equity interest sale on SmartHeat Germany on January 20, 2016, SmartHeat Pump owned remaining 15% of SmartHeat Germany, which were accounted for under the cost method of accounting (FASB ASC Subtopic 325-20). The investment was recorded at the original cost, dividends are the basis for recognition of earnings. The investor recognizes as income dividends received that are distributed from net accumulated earnings of the investee. Dividends received in excess of earnings are considered a return of investment and are recorded as reductions of cost of the investment.

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, 2016 and December 31, 2015, 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	Germany	Total
June 30, 2016	$-	$1,322,555	$-	$1,322,555
December 31, 2015	$6,822	$1,575,771	$154,378	$1,736,971

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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 $1.01 million and $1.41 million at June 30, 2016 and December 31, 2015, respectively.

At June 30, 2016 and December 31, 2015, the Company had retentions receivable from customers for product quality assurance of $0.15 million and $0.17 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 $0.15 million and $0.16 million at June 30, 2016 and December 31, 2015, respectively.

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

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, 2016 and December 31, 2015, the Company had allowances for advances to suppliers of $2.24 million and $2.29 million, respectively.

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.

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

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 $5.51 million and $5.30 million as of June 30, 2016 and December 31, 2015, respectively. The Company recorded inventory impairment provision of $0.32 million and $2.04 million for the six months ended June 30, 2016 and 2015, respectively, which was included in the cost of sales. The Company recorded inventory impairment provision of $0 and $0.82 million for the three months ended June 30, 2016 and 2015, respectively, which was included in the cost of sales.

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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, 2016 and December 31, 2015, there was no significant impairment of its long-lived assets.

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.

Activity in the Company’s warranty reserve from January 1, 2015, to June 30, 2016, is as follows:

	2016	2015
Beginning balance	$ -	$472,558
Provisions	-	-
Actual costs incurred	-	(67,275)
Reversal of warranty reserve due to disposal of subsidiaries	-	(405,283)
Ending balance in current liabilities	$ -	$-

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, 2016 and 2015 were $0.

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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 month ended June 30, 2016 and 2015, 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, 2016 and 2015. 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. For the six months ended June 30, 2016 and 2015, revenue from after-sales services after the expiration of the warranty was $27,140 and $18,990, respectively. For the three months ended June 30, 2016 and 2015, revenue from after-sales services after the expiration of the warranty was $7,883 and $14,833, respectively. Such revenue was recorded in other income.

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.

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.

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

Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed similarly, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. Diluted EPS are based on the assumption that all dilutive convertible shares and stock options were converted or exercised. Dilution is computed by applying the treasury stock method. Under this method, options and warrants are assumed to have been exercised at the beginning of the period (or at the time of issuance, if later), and as if funds obtained thereby were used to purchase common stock at the average market price during the period. Basic and diluted shares outstanding are the same for each of the six and three months ended June 30, 2016 and 2015, respectively.

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 on 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.

RMB to USD and EUR to USD (until January 20, 2016) exchange rates in effect as of June 30, 2016 and December 31, 2015, and the average exchange rates for the six months ended June 30, 2016 and 2015 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. The exchange rates used in translation from EUR to USD were published by OANDA Rates.

	Average Exchange Rate For the Six Months Ended		Balance Sheet Date Exchange Rate	
	6/30/16	6/30/15	6/30/16	12/31/15
RMB - USD	6.5303	6.1288	6.6312	6.4936
EUR – USD (until disposal date of January 20, 2016)	0.9209	0.8952	0.9233	0.9169

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 two operating segments at December 31, 2014: 1) plate heating equipment, meters and related products; and 2) heat pumps and related products. These operating segments were determined based on the nature of the products offered. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. The Company's chief executive officer and acting chief accountant were identified as the chief operating decision makers. The Company's chief operating decision makers direct the allocation of resources to operating segments based on profitability, cash flows, and other measurement factors of each respective segment.

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As a result of the 100% Stock Sale of certain subsidiaries effective December 31, 2014, the Company is now concentrating on heat pump business, whereas the PHE business is very limited and will be gradually ceased. For the six month ended June 30, 2016, sales of PHEs was $35,817 and sales of heat pumps was $238,711. For the three month ended June 30, 2016, sales of PHEs was $22,530 and sales of heat pumps was $113,951. Both businesses report to the same executives. Accordingly, there was no segment reporting for the six and three month ended June 30, 2016 due to immaterially of PHE segment.

New Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (“FASB”) issued Presentation of Financial Statements — Going Concern. This standard requires management to evaluate for each annual and interim reporting period whether it is probable that the reporting entity will not be able to meet its obligations as they become due within one year after the date that the financial statements are issued. If the entity is in such a position, the standard provides for certain disclosures depending on whether or not the entity will be able to successfully mitigate its going concern status. This guidance is effective for annual periods ending after December 15, 2016 and interim periods within annual periods beginning after December 15, 2016. Early application is permitted. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

In July 2015, the FASB issued Accounting Standards Update ("ASU") No. 2015-11, Inventory, which requires an entity to measure inventory within the scope at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The effective date for the standard is for fiscal years beginning after December 15, 2016. Early adoption is permitted. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. To simplify the accounting for adjustments made to provisional amounts recognized in a business combination, the amendments eliminate the requirement to retrospectively account for those adjustments. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments in this update are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

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.

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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. Early adoption is permitted but requires all elements of the amendments to be adopted at once rather than individually. The Company is evaluating the effect that ASU No. 2016-09 will have on the Company's consolidated financial statements and related disclosures.

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.

Reclassification

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period including the sale of SmartHeat Germany. These reclassifications had no effect on the Company's balance sheet, net loss or stockholders' equity.

3. INVENTORIES, NET

Inventories at June 30, 2016 and December 31, 2015, were as follows:

	2016	2015
Raw materials	$6,252,332	$6,399,057
Work in process	498,664	509,231
Finished goods	796,666	1,447,090
Total	7,547,662	8,355,378
Inventory allowance	(5,506,729)	(5,302,189)
Inventories, net	$2,040,933	$3,053,189

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, 2016 and December 31, 2015, the Company was contingently liable for the notes endorsed to vendors of $0, respectively.

5. OTHER RECEIVABLES (NET), PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at June 30, 2016 and December 31, 2015, respectively:

	2016	2015
Advances to unrelated third party companies	$ 324,111	$ 599,605
Prepayment for freight, related insurance, advertisement and consulting expenses	69,932	100,000
Advances to employees	353,950	341,101
Other	446,219	359,664
Total	1,194,212	1,400,370
Less: bad debt allowance	(42,698)	(43,603)
Other receivables (net), prepayments and deposits	$ 1,151,514	$ 1,356,767

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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.

6. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at June 30, 2016 and December 31, 2015:

	2016	2015
Production equipment	$910,244	$1,583,894
Office equipment	193,723	197,828
Vehicles	207,287	230,237
Total	1,311,254	2,011,959
Less: accumulated depreciation	(1,086,598)	(1,095,714)
Property and equipment, net	$224,656	$916,245

Depreciation for the six months ended June 30, 2016 and 2015 was $37,904 and $117,482, respectively. Depreciation for the three months ended June 30, 2016 and 2015 was $5,604 and $57,821, 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, 2016 and December 31, 2015, respectively:

	Estimated Useful Life (In years)	2016	2015
Know-how technology	5–10	$562,995	$574,925
Software	5	140,662	152,455
Trademarks	7	274,494	280,310
Total		978,151	1,007,690
Less: accumulated amortization		(633,750)	(584,185)
Intangible assets, net		$344,401	$423,505

Amortization of intangible assets for the six months ended June 30, 2016 and 2015 was $62,988 and $69,553, respectively. Amortization of intangible assets for the three months ended June 30, 2016 and 2015 was $31,313 and $34,819, respectively. Annual amortization for the next five years from June 30, 2016 is expected to be $123,375, $93,977, $64,467, $61,829 and $753.

8. LONG TERM INVESTMENT

Long term investment represented 15% of investment into SmartHeat Germany, and the Company accounted for this investment under cost method. As of June 30, 2016, the Company had long term investment in SmartHeat Germany of $367,529, representing remaining 15% equity interest (See note 2).

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9. TAXES RECEIVABLE

Taxes receivable consisted of the following at June 30, 2016 and December 31, 2015:

	2016	2015
Value-added	$6,368	$5,706
Other	29	2,280
Taxes receivable	$6,397	$7,986

10. TAXES PAYABLE

Taxes payable consisted of the following at June 30, 2016 and December 31, 2015:

	2016	2015
Income	$19,796	$26,934
Value-added	5,645	3,967
Other	1,293	1,606
Taxes payable	$26,734	$32,507

11. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at June 30, 2016 and December 31, 2015:

	2016	2015
Advances from third parties	$2,310,252	$335,070
Other	1,124,228	1,415,585
Accrued expenses	2,944,666	1,827,236
Total accrued liabilities and other payables	$6,379,146	$3,577,891

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

Other represented payables for the Company’s certain construction and installation projects, and miscellaneous expenses including postage, business insurance, employee benefits, project bidding fee, medical insurance, etc.

As of June 30, 2016, accrued expenses mainly consisted of accrued property and land rental fee of $2.78 million, and accrued payroll of $0.16 million. As of December 31, 2015, accrued expenses mainly consisted of accrued property and land rental fee of $1.75 million, and accrued payroll of $69,123.

12. 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.

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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.

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.

As of June 30, 2016, 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.

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.

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13. DEFERRED TAX ASSET (LIABILITY)

As of June 30, 2016 and December 31, 2015, deferred tax asset (liability) consisted of the following:

	2016	2015
Deferred tax asset - current (bad debt allowance for accounts receivable)	$451,644	$559,197
Deferred tax asset - current (bad debt allowance for retention receivable)	36,773	39,766
Deferred tax asset - current (inventory impairment provision)	1,376,682	1,325,547
Deferred tax asset – current (bad debt allowance for other receivables)	10,675	10,901
Deferred tax asset – current (allowance for advance to supplier)	559,777	571,639
Deferred tax asset – noncurrent (NOL of US parent company)	3,241,981	3,037,305
Deferred tax asset – noncurrent (NOL of PRC subsidiaries)	4,393,916	3,746,826
Less: valuation allowance	(10,071,448)	(9,291,181)
Deferred tax assets, net	$-	$-
Deferred tax liability - noncurrent (depreciation of fixed assets)	$(2,554)	$(15,238)

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

14. 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 $9.54 million at June 30, 2016, 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, 2016 and 2015:

	2016	2015
US statutory benefit rates	(34.0)%	(34.0)%
Tax rate difference	(0.4)%	7.2 %
Other	(0.1)%	0.8 %
Valuation allowance	33.8 %	26.2 %
Tax expense (benefit) per financial statements	(0.7)%	0.2 %

The following table reconciles the US statutory rates to the Company's effective tax (benefit) rate for the three months ended June 30, 2016 and 2015:

	2016	2015
US statutory benefit rates	(34.0)%	(34.0)%
Tax rate difference	8.1 %	7.3 %
Other	0.2 %	0.1 %
Valuation allowance	25.1 %	25.9 %
Tax benefit per financial statements	(0.6)%	(0.7)%

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The income tax expense (benefit) for the six months ended June 30, 2016 and 2015, consisted of the following:

	2016	2015
Income tax expense (benefit) - current	$(7,138)	$33,999
Income tax benefit - deferred	(12,559)	(25,109)
Total income tax expense (benefit), net	$(19,697)	$8,890

The income tax expense (benefit) for the three months ended June 30, 2016 and 2015, consisted of the following:

	2016	2015
Income tax benefit - current	$(7,138)	$(1,987)
Income tax benefit - deferred	(3,589)	(12,540)
Total income tax benefit, net	$(10,727)	$(14,468)

15. 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.

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.

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16. STOCKHOLDERS' EQUITY

On December 28, 2015, the Company entered into the Fourth Amendment to the Credit and Security Agreement with Northtech. The Amendment provides that SmartHeat to repay 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.

17. 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, 2016 and 2015 was $921,041 and $139,243, respectively. Rental expense for the three months ended June 30, 2016 and 2015 was $854,945 and $68,841, respectively. SmartHeat Pump was fined by a ruling to pay RMB 5.1 million ($0.78 million) unpaid rents to a third party during the six months ended June 30, 2016.

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, 2016, 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.

18. 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.

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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.

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	$-

On December 30, 2013, the Company, 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: Taiyu; SmartHeat Siping; SmartHeat Energy; Ruicheng; and XinRui (collectively, the "Target Companies"). The purchase price was RMB 5 million ($0.82 million). Ruicheng was 51% owned and XinRui was 46% owned by SmartHeat US parent company 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% consisted of: (i) consideration of RMB 8.5 million ($1.39 million) and (ii) the forgiveness of all net indebtedness of $11.75 million owing to the Target Companies by SmartHeat and each of its other subsidiaries as of December 31, 2014.

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 which consisted of: (i) approval of its stockholders and (ii) receipt by the 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 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.

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The following table summarizes the carrying value of the assets and liabilities disposed of as part of the sale of the remaining interests in Taiyu, SmartHeat Siping and SmartHeat Energy at the closing date of disposal. The excess of the carrying value of the net assets disposed over the selling price of $44,032,011 was recorded as disposal loss. The Company recorded a loss of $29,540 for disposal of Ruicheng and XinRui, which was 30.6% and 27.6% owned by the Company prior to the closing of the disposal.

Cash and equivalents	$9,490,641
Restricted cash	9,847,182
Accounts receivable, net	18,437,984
Retentions receivable, net	1,206,786
Advances to suppliers, net	3,012,776
Other receivables (net), prepayments and deposits	27,205,648
Inventories	42,233,818
Notes receivable – bank acceptances	2,271,131
Noncurrent assets, net	964,865
Accounts payable	(8,106,600)
Advance from customers	(1,992,933)
Other payable and accrued expenses	(31,832,558)
Notes payable – bank acceptances	(1,401,530)
Loans payable	(25,111,702)
Disposal loss	(44,032,011)
Selling price	$2,193,497

20. SUBSEQUENT EVENT

On July 31, 2016, the Company entered into the Fifth 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, July 14, 2014, and December 28, 2015 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.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.
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 with very limited sales of PHEs through SanDeKe subsidiary.

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. Our former subsidiaries also designed, manufactured and sold spiral heat exchangers and tube heat exchangers. Our former subsidiaries’ products and systems are an increasingly important element in providing a clean technology, mission-critical solution to energy consumption and air pollution problems in China and are commonly used in a wide variety of industrial processes where heat transfer is required. Common applications include energy conversion for heating, ventilation and air conditioning, or HVAC, and industrial use in petroleum refining, petrochemicals, metallurgy, food and beverage and chemical processing. Our former subsidiaries sell their products under the SmartHeat and Taiyu brand names and also sell PHEs under the Sondex brand name as an authorized dealer of Sondex PHEs in China.

Our current HP subsidiaries design and build specific to customer specifications and particular operating conditions, known for their high quality and efficiency. Our HP operating segment subsidiaries produce heat pumps in sizes that have applications in both the industrial and residential settings. We believe our subsidiaries' HPs reduce the cost of heating and cooling by using recycled air as a heat source thereby reducing heat loss promoting energy saving and efficiency. After the Stock Sale, our HP operating segment constitutes our sole line of business.

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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 loss and the management decided to sale it 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.

Principal Factors Affecting Our Financial Performance

Prior to the 100% equity interest sale of certain subsidiaries on December 31, 2014, our PHE segment revenues were subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry, changes in PRC government fiscal policies, inflation in China and other unpredictable factors that may affect customer ordering patterns. Our revenues fluctuated due to the seasonal nature of central heating services in the PRC because the equipment used in residential buildings must be delivered prior to the beginning of the heating season in late fall, which occurs during the third and fourth calendar quarters in China. We also experienced decreased sales volume in the first calendar quarter compared to other quarters, as our customers generally install and test our products during this period, and are in the process of budgeting their new projects. Additionally, any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines or impacts from the other factors mentioned above, could adversely affect our prior revenue growth or cause a decline in quarterly revenue.

The revenue of our heat pump business experiences some of the same factors impacting our historic PHE segment. The principal factors impacting the revenue of our existing business are related to China’s domestic economic and investment environments, such as the real estate market, and the quantity of real estate investment projects in China. In addition, changes in PRC government fiscal policies, inflation in China and other unpredictable factors may affect customer ordering patterns. Our revenues are expected to fluctuate due to the seasonal nature of heating services in the PRC with our peak season typically spanning July through November and reduced demand for our products in December through June. Our customers are primarily located in the Northeast, North and Northwestern regions of the PRC. Our sales are primarily impacted by a potential customer’s choice to use more energy efficient heat pump technology or less energy efficient traditional heating and cooling systems.

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. We monitor the commodities markets for pricing trends and changes, but do not engage in hedging to protect against raw material fluctuations. Instead, we attempt to mitigate the short-term risks of price swings by purchasing raw materials in advance based on production needs and projected sales. We continue to experience stronger sales during the second half of the year, which is the start of fall and winter in China, during which we expect to generate the majority of our revenue. However, we believe we have more flexibility to increase and decrease our pricing of heat pumps with increases and decreases in material prices. While we historically increased our inventory and advances to suppliers during the first three quarters of each year in anticipation of our historical high season for production, we will periodically increase our heat pump raw materials if we foresee shortages. However, significant unfavorable fluctuations in the price, quality or availability of required raw materials could negatively affect our cash flows and ability to meet the demands of our customers, which could result in the loss of future sales.

Our profitability depends upon the margin between the cost of goods used in the manufacturing process, such as compressors, copper piping and wiring and other raw materials, as well as our fabrication costs associated with assembling heat pumps compared to the selling price of our products, and the overall supply of raw materials. We typically base the selling prices of our products upon the associated raw materials costs to us and labor costs. We may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of raw materials through to our customers, however, and there may be a time lag as we bid on new projects and renegotiate pricing with our existing customers. We continue to monitor our fixed costs and implement improvements to our manufacturing process to better control labor cost and improve manufacturing efficiency.

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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. As of June 30, 2016 and December 31, 2015, the outstanding credit line payable to Northtech was $2,795,335 and $2,455,335, respectively. As of June 30, 2016, 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. 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.

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.

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, 2016, 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.

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 $1.01 million and $1.41 million at June 30, 2016 and December 31, 2015, 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 but was concentrating on heat pumps business for the six and three months ended June 30, 2016 and 2015.

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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. For the six months ended June 30, 2016 and 2015, revenue from after-sales services after the expiration of the warranty period was $27,140 and $18,990, respectively. For the three months ended June 30, 2016 and 2015, revenue from after-sales services after the expiration of the warranty period was $7,883 and $14,833, respectively.

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, 2016 and December 31, 2015, there was no significant impairment of its long-lived assets.

Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board ("FASB") issued Presentation of Financial Statements — Going Concern. This standard requires management to evaluate for each annual and interim reporting period whether it is probable that the reporting entity will not be able to meet its obligations as they become due within one year after the date that the financial statements are issued. If the entity is in such a position, the standard provides for certain disclosures depending on whether or not the entity will be able to successfully mitigate its going concern status. This guidance is effective for annual periods ending after December 15, 2016 and interim periods within annual periods beginning after December 15, 2016. Early application is permitted. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

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In July 2015, the FASB issued Accounting Standards Update ("ASU") No. 2015-11, Inventory, which requires an entity to measure inventory within the scope at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The effective date for the standard is for fiscal years beginning after December 15, 2016. Early adoption is permitted. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

In September 2015, the FASB issued ASU No. 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. To simplify the accounting for adjustments made to provisional amounts recognized in a business combination, the amendments eliminate the requirement to retrospectively account for those adjustments. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments in this update are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not anticipate that this adoption will have a significant impact on its consolidated financial position, results of operations, or cash flows.

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. Early adoption is permitted but requires all elements of the amendments to be adopted at once rather than individually. The Company is evaluating the effect that ASU No. 2016-09 will have on the Company's consolidated financial statements and related disclosures.

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.

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Results of Operations

Six months ended June 30, 2016 Compared to six months ended June 30, 2015

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.

	2016		2015	
	$	% of Sales	$	% of Sales
Sales	$274,528		$491,010	
Cost of sales	621,311	226 %	2,584,889	526 %
Gross loss	(346,783)	(126)%	(2,093,879)	(426)%
Operating expenses	2,204,292	803 %	2,188,746	446 %
Loss from operations	(2,551,075)	(929)%	(4,282,625)	(872)%
Non-operating expenses, net	(235,068)	(86)%	(230,740)	(47)%
Income tax expense (benefit)	(19,697)	(7)%	8,890	2 %
Loss from continuing operations	(2,766,446)	(1008)%	(4,522,255)	(921)%
Foreign currency translation gain/loss on sold entities	682,036	248 %	11,915,632	2427 %
Loss from operations of discontinued entities, net of tax	(83,475)	(30)%	(268,653)	(55)%
Loss on disposal of discontinued entities, net of tax	(2,764,701)	(1007)%	(47,151,307)	(9603)%
Less: loss attributable to noncontrolling interest from continuing operations	(783,081)	(285)%	(13,200)	(3)%
Less: loss attributable to noncontrolling interest from discontinued operations, net of tax	(1,002)	- %	(3,224)	(1)%
Net Loss to SmartHeat Inc.	$(4,148,503)	(1511)%	$(40,010,159)	(8149)%

Sales. Net sales in the six months ended June 30, 2016, were $0.27 million, while net sales in the six months ended June 30, 2015, were $0.49 million, an overall decrease of $0.22 million or 44%, which was due to slow economy in China and less orders received. The 44% decrease in total revenue was due primarily to the decrease in sales of heat pumps in the six months ended June 30, 2016, compared to the same period of 2015.

Cost of Sales. Cost of sales ("COS") was $0.62 million in the six months ended June 30, 2016, compared to $2.58 million in the comparable period of 2015, a decrease of $1.96 million or 76%. The decrease in our COS is attributable to decreased provision for inventory impairment for Sandeke. COS mainly consisted of the cost of materials, factory overhead and labor. Materials cost was 16% of total cost, while factory overhead cost was 72% and labor was 12% during the six months ended June 30, 2016. Materials cost was 37% of total cost, while factory overhead cost was 51% and labor was 12% during the six months ended June 30, 2015. Our materials cost as a percentage of total costs decreased to 16% from 37% as a result of decreased raw material price. Our products are custom-made; the raw material prices vary based on the place of origin, which was chosen at customers' choice. The COS as a percentage of sales was 226% in the six months ended June 30, 2016 compared with 526% for the same period of 2015 due to decreased provision for inventory impairment.

We performed an inventory impairment assessment as of June 30, 2016 and December 31, 2015, 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 $5,506,730 and $5,302,189 as of June 30, 2016 and December 31, 2015, respectively. We recorded inventory impairment provision of $0.32 million for the six months ended June 30, 2016, compared to $2.04 million for the same period of 2015.

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Gross Loss. Gross loss was $0.35 million in the six months ended June 30, 2016, compared to gross loss of $2.09 million in the comparable period of 2015. Loss margin was (126)% and (426)% for the six months ended June 30, 2016 and 2015 respectively. The decreased in loss margin was due to decreased provision for inventory impairment.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $2.20 million in the six months ended June 30, 2016, compared to $2.19 million in the comparable period of 2015, an increase of $0.02 million or 1%. Operating expenses as a percentage of sales were 803% in the six months ended June 30, 2016, compared to 446% in the comparable period of 2015, the increased operating expenses as percentage of sales resulted from decreased sales.

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, 2016 was $0.24 million compared to net non-operating expense of $0.23 million for the comparable period of 2015, a slight increase of expenses of $0.004 million or 2%.

Loss from Discontinued Operations. We had loss from discontinued operations of $2.17 million for the sale of 85% equity interest of SmartHeat Germany for the six months ended June 30, 2016, compared to loss from discontinued operations of $35.23 million for the sale of Taiyu, SmartHeat Siping, SmartHeat Energy, Ruicheng and Xinrui for the comparable period of 2015, and $0.27 million loss from operations of SmartHeat Germany for the six month ended June 30, 2015 for comparison purpose.

Net Loss. Our net loss for the six months ended June 30, 2016 was $4.15 million compared to net loss of $40.01 million for the comparable period of 2015, a decrease of $35.86 million or 90%. Net loss as a percentage of sales was 1511% in the six months ended June 30, 2016, and net loss as a percentage of sales was 8149% in the comparable period of 2015. This decrease in net loss was mainly attributable to a significant loss on sale of 100% equity interest of Taiyu, SmartHeat Siping, SmartHeat Energy, Ruicheng and Xinrui of $35.23 million in the six months ended June 30, 2015.

Three months ended June 30, 2016 Compared to three months ended June 30, 2015

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.

	2016		2015	
	$	% of Sales	$	% of Sales
Sales	$136,481		$382,245	
Cost of sales	179,427	131 %	1,076,705	282 %
Gross loss	(42,946)	(31)%	(694,460)	(182)%
Operating expenses	1,511,080	1107 %	1,254,145	328 %
Loss from operations	(1,554,026)	(1139)%	(1,948,605)	(510)%
Non-operating expenses, net	(126,624)	(93)%	(100,909)	(26)%
Income tax benefit	(10,727)	(8)%	(14,468)	(4)%
Loss from continuing operations	(1,669,923)	(1224)%	(2,035,046)	(532)%

Loss from operations of discontinued entities, net of tax	-	- %	(179,484)	(47)%
Less: loss attributable to noncontrolling interest from continuing operations	(300,654)	(220)%	(5,141)	(1)%
Less: loss attributable to noncontrolling interest from discontinued operations, net of tax	-	- %	(2,154)	(1)%
Net Loss to SmartHeat Inc.	$(1,369,269)	(1003)%	$(2,207,235)	(577)%

Sales. Net sales in the three months ended June 30, 2016, were $0.14 million, while net sales in the three months ended June 30, 2015, were $0.38 million, an overall decrease of $0.25 million or 64%, which was due to slow economy in China and less orders received. The 64% decrease in total revenue was due primarily to the decrease in sales of heat pumps in the three months ended June 30, 2016, compared to the same period of 2015.

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Cost of Sales. Cost of sales ("COS") was $0.18 million in the three months ended June 30, 2016, compared to $1.08 million in the comparable period of 2015, a decrease of $0.90 million or 83%. The decrease in our COS is attributable to decreased provision for inventory impairment for Sandeke. COS mainly consisted of the cost of materials, factory overhead and labor. Materials cost was 3% of total cost, while factory overhead cost was 84% and labor was 13% during the three months ended June 30, 2016. Materials cost was 54% of total cost, while factory overhead cost was 44% and labor was 2% during the three months ended June 30, 2015. Our materials cost as a percentage of total costs decreased to 3% from 54% as a result of decreased raw material price. Our products are custom-made; the raw material prices vary based on the place of origin, which was chosen at customers' choice. The COS as a percentage of sales was 131% in the three months ended June 30, 2016 compared with 282% for the same period of 2015 due to decreased provision for inventory impairment.

We performed an inventory impairment assessment as of June 30, 2016 and December 31, 2015, 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 $5,506,730 and $5,302,189 as of June 30, 2016 and December 31, 2015, respectively. We recorded reversal of inventory impairment provision of $0.005 million for the three months ended June 30, 2016, compared to $0.82 million inventory impairment provision for the same period of 2015.

Gross Loss. Gross loss was $0.04 million in the three months ended June 30, 2016, compared to gross loss of $0.69 million in the comparable period of 2015. Loss margin was (31)% and (182)% for the three months ended June 30, 2016 and 2015 respectively.

Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled $1.51 million in the three months ended June 30, 2016, compared to $1.25 million in the comparable period of 2015, an increase of $0.26 million or 20%. Operating expenses as a percentage of sales were 1107% in the three months ended June 30, 2016, compared to 328% in the comparable period of 2015. The increase in operating expenses was mainly because we had $1.24 million selling, general and administrative expense for the three months ended June 30, 2016, compared to $0.55 million for the same period of 2015, although we had $7,666 provision for bad debts for the three months ended June 30, 2016, compared with $0.25 million provision for bad debts for the three months ended June 30, 2015.

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 30, 2016 was $0.13 million compared to net non-operating expense of $0.10 million for the comparable period of 2015, an increase of expenses of $0.03 million or 25%. The increase in non-operating expenses was due mainly to financial expense of

$42,045 for the three months ended June 30, 2016 which mainly consisted of Northtech loan extension fee, compared to financial expense of $19,689 for the comparable period of 2015.

Loss from Discontinued Operations. We had loss from discontinued operations of $0 for the three months ended June 30, 2016 resulting from the disposal of SmartHeat Germany on January 20, 2016, compared to $0.18 million loss from operations of SmartHeat Germany for the three month ended June 30, 2015 for comparison purpose.

Net Loss. Our net loss for the three months ended June 30, 2016 was $1.37 million compared to net loss of $2.21 million for the comparable period of 2015, a decrease of $0.83 million or 38%. Net loss as a percentage of sales was 1003% in the three months ended June 30, 2016, and net loss as a percentage of sales was 577% in the comparable period of 2015. This decrease in net loss was mainly attributable to decreased gross loss of $0.04 million resulting from reversal of inventory impairment provision for the three months ended June 30, 2016, compared with $0.69 million in the three months ended June 30, 2015.

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Liquidity and Capital Resources

As of June 30, 2016, we had cash and equivalents of $1.32 million. Working capital deficit was $2.52 million at June 30, 2016. The ratio of current assets to current liabilities was 0.69:1 at June 30, 2016.

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. The outstanding balance under the Credit Agreement as of June 30, 2016 was $2.80 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, 2016 and 2015:

	2016	2015
Cash provided by (used in):		
Operating activities	$(752,554)	$(2,330,404)
Investing activities	$28,436	$(9,444,446)
Financing activities	$340,000	$310,000

Net cash flow used in operating activities was $0.75 million in the three months ended June 30, 2016, compared to net cash flow used in operating activities of $2.33 million in the comparable period of 2015. The decrease in net cash outflow in operating activities was due mainly to decreased cash outflow from other receivables, prepayments and deposits of $0.19 million in the six months ended June 30, 2016, compared with $1.40 million in the six months ended June 30, 2015, decreased cash outflow on accounts payable of $0.13 million in the six months ended June 30, 2016, compared to $0.57 million in the six months ended June 30, 2015. In addition, we had $0.10 million cash inflow from inventory in the six months ended June 30, 2016, compared with $0.42 million cash outflow in the six months ended June 30, 2015.

Net cash flow provided by investing activities was $0.03 million in the six months ended June 30, 2016, compared to net cash used in investing activities of $9.44 million in the comparable period of 2015. 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; while in the same period of 2015, we had $0.05 million cash inflow from restricted cash, offset with $9.49 million cash disposed from sale of equity interest on certain subsidiaries, and $7,160 cash outflow for purchase of fixed assets.

Net cash provided by financing activities was $0.34 million in the six months ended June 30, 2016, compared to $0.31 million cash provided by financing activities in the comparable period of 2015. The cash inflow in the six months ended June 30, 2016 consisted of proceeds from a credit line of $0.34 million. In the six months ended June 30, 2015, we had proceeds from this credit line of $0.31 million.

As of June 30, 2016, we had gross accounts receivable (including retention receivable) of $2,131,503, of which $0 was with aging within 30 days, $299,648 with aging between 31 and 90 days, $273,025 with aging between 91 and 180 days, $1,022,684 with aging between 181 and 360 days, and $536,146 with aging over 360 days. At June 30, 2016, net accounts receivable was $970,306, which was the gross accounts receivable (including retention receivable) of $2,131,503 less bad debt allowance of $1,161,197.

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.

Our current operations are conducted in Germany with the sales of our products taking place principally in China. Accordingly, we may still be exposed to certain political and economic risks in China as discussed above and currency fluctuations between the Euro and the RMB. However, our sales, purchase and expense transactions in Germany are denominated in Euros.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable.

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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, 2016, 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, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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, 2015, 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.

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SIGNATURES

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

	SMARTHEAT INC. (Registrant)
Date: February 17, 2017	By: /s/ Kenneth Scipta Mr. Kenneth Scipta Acting President (Principal Executive Officer and Duly Authorized Signatory)

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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