

ANIXTER INTERNATIONAL INC
 Form 4
 August 02, 2013

FORM 4

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

OMB APPROVAL

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STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

(Print or Type Responses)

1. Name and Address of Reporting Person *
 Berardesca Giulio

2. Issuer Name and Ticker or Trading Symbol
 ANIXTER INTERNATIONAL INC
 [AXE]

5. Relationship of Reporting Person(s) to Issuer
 (Check all applicable)

(Last) (First) (Middle)
 2301 PATRIOT BLVD.
 (Street)

3. Date of Earliest Transaction (Month/Day/Year)
 08/01/2013

____ Director _____ 10% Owner
 Officer (give title below) _____ Other (specify below)
 Executive VP - Wire & Cable

GLENVIEW, IL 60026
 (City) (State) (Zip)

4. If Amendment, Date Original Filed(Month/Day/Year)

6. Individual or Joint/Group Filing(Check Applicable Line)
 Form filed by One Reporting Person
 ____ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1. Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)	4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)	5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Ownership (Instr. 4)
			Code	V Amount (A) or (D) Price \$			
Common stock	08/01/2013		S	835 (1) D 83.5 (2)	35,698 (3)	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (e.g., puts, calls, warrants, options, convertible securities)

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1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount of Underlying Securities (Instr. 3 and 4)	8. Price of Derivative Security (Instr. 5)	9. Number of Derivative Securities Owned Following Reporting Transaction (Instr. 6)
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Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Berardesca Giulio 2301 PATRIOT BLVD. GLENVIEW, IL 60026			Executive VP - Wire & Cable	

Signatures

Michele Nelson, by power of attorney
 Date: 08/02/2013
 Signature of Reporting Person: _____

Explanation of Responses:

- * If the form is filed by more than one reporting person, see Instruction 4(b)(v).
- ** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. See 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
- (1) The shares covered by this Form 4 have been sold pursuant to a Rule 10b5-1(c) sales plan dated April 24, 2013.
- (2) All shares sold at the price of \$83.50.
- (3) Includes 18,808 common stock units.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, see Instruction 6 for procedure. Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. t>

%	3
Income tax expense (benefit)	(50,657)
)	(0.1)
)%	493,624

	1
% Noncontrolling interest	
)	(319,904)
)%	(1)
)	(28,897)
)%	(0)
Net Loss to SmartHeat Inc.	
\$	(40,522,748)
)	
)%	(91)
\$	(29,217,082)
)	
)%	(61)

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

	2013		2012	
	\$	% of Sales	\$	% of Sales
Sales	\$ 38,882,321		\$ 42,074,895	
Cost of sales	36,076,054	93%	27,412,639	65%
Gross profit	2,806,266	7%	14,662,255	35%
Operating expenses	37,992,759	98%	36,142,111	86%
Loss from operations	(35,186,493)	(91)%	(21,479,856)	(51)%
Non-operating expenses, net	(1,154,267)	(3)%	(339,647)	(1)%
Income tax expense	9,456	0.02%	561,218	1%
Noncontrolling interest	(305,710)	(1)%	(737)	(0)%
Net Loss to SmartHeat Inc.	\$ (36,044,506)	(93)%	\$ (22,379,983)	(53)%

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

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

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

We have a review process for approving each sales contract, including sales price. Sales price is determined under each contract in proportion to our estimated cost in order to ensure our gross profit. Our sales price varies according to each sale depending primarily on each customer's specific requirements and our negotiation of the contract amount and term.

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

We performed an inventory impairment assessment as of December 31, 2013 and 2012, for the write-down of raw materials and finished goods in inventory. We stock inventory, consisting of raw materials and finished goods, according to projected sales and customer orders, with steel plates and components for our products generally ordered two to three months in advance of anticipated production needs. As part of our impairment analysis, we performed an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory

can be utilized and will be consumed within the next few months through new customer orders or substitute orders, no impairment is recorded. We collected information about delayed and canceled contracts and met with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that we do not expect to be reinstated and contracts for which we have been unable to find substitute customers become impaired. We performed an evaluation of these finished goods stored over one year and recorded an impairment accordingly. We also analyzed whether to take a reserve for conversion costs of finished goods in inventory for resale to substitute customers. Following the completion of our impairment analysis, we had inventory impairment provision of \$12,067,544 and \$5,433,879 as of December 31, 2013 and 2012, respectively.

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

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Operating Expenses. Operating expenses consisting of selling, general and administrative expenses totaled \$43.91 million in year ended December 31, 2013, compared to \$45.36 million in 2012, a decrease of \$1.45 million or 3.19%. Operating expenses as a percentage of sales were 98% in the year ended December 31, 2013, compared to 95% in 2012. The decrease in operating expenses was mainly due to decreased selling expense of \$6.86 million and general and administrative expense of \$10.40 million for the year ended December 31, 2013, compared with \$9.92 million selling expense and \$12.35 million general and administrative expense for 2012 as a result of decreased sales and slowdown of our business. In addition, we had \$2.08 million goodwill impairment for SmartHeat Germany in 2012.

We recorded a bad debt allowance of \$18.81 million for accounts receivable (consisting of \$18.64 million for PHEs and related products and \$0.17 million for HPs and related products), \$8.43 million for bad debt allowance for other receivables (consisting of \$8.41 million for PHEs and related products and \$23,495 for HPs and related products), and \$(0.59) million for allowance for advances to suppliers (consisting of \$(0.68) million for PHEs related and \$89,134 for HPs related), respectively, for the year ended December 31, 2013, compared with \$17.52 million for bad debt allowance for accounts receivable, \$1.27 million for bad debt allowance for other receivables, and \$2.22 for allowance for advance to suppliers for 2012. The increased bad debt allowance for accounts and other receivables was primarily attributable to payment delays caused by the working capital difficulties of many of our state-owned customers. Due to the deflationary fiscal policy of the PRC government in 2012 that continued into 2013, some of our state-owned customers encountered difficulties in obtaining grants from the government and loans from state-owned banks, both of which typically are used to finance the purchase of our products, which resulted in unexpected delays in the payment of our accounts receivable in a timely manner. Generally, we reserve for 50% of accounts receivable with aging over 180 days and 100% of accounts receivable with aging over 360 days as bad debt allowance. We do not expect a significant risk with respect to the overdue accounts receivable for which we took the bad debt allowance and continue to work to collect all amounts due. We believe the stringent fiscal policy impacting our customers in China will be temporary and the expansion and training of our marketing team and other employees will increase sales and improve the efficiency of our operations.

Non-operating income (expenses), net. Our net non-operating expenses for the year ended December 31, 2013 was \$1.29 million compared to net non-operating income of \$1.24 million for 2012, an increase of expenses of \$2.53 million or 204%. The increase in non-operating expenses was due mainly to increased interest expense of \$1,816,456 for the year ended December 31, 2013, compared with \$1,548,937 for 2012, and decreased net other income of \$1,314,945 for the year ended December 31, 2013, compared with \$2,643,786 for 2012. The net other income of \$1,314,945 for the year ended December 31, 2013 mainly consisted of income (net), from selling of raw material of \$810,653, government subsidy of \$457,717 and other non-operating income of \$245,119, but offset by loss (net) from after-sales services of \$198,544. The net other income of \$2,643,786 for the year ended December 31, 2012, mainly consisted of income (net), from selling of raw material of \$582,200; income from providing technical service of \$450,700; income (net) from after-sales services of \$186,730, gain on settlement of debts of \$813,245 through issuance of shares, and insurance compensation of \$496,260 for the fire loss. In addition, we incurred \$842,491 loss on sale of 40% equity interest on Taiyu, Siping, Shenyang Energy, Ruicheng and Xinrui in 2013.

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

Net Loss. Our net loss for the year ended December 31, 2013, was \$40.53 million compared to net loss of \$29.22 million for 2012, an increase of \$11.31 million or 39%. Net loss as a percentage of sales was 91% in the year ended December 31, 2013, and net loss as a percentage of sales was 61% in 2012. This increase in net loss was attributable to increased inventory impairment provision, increased provision for bad debts, and increased non-operating expenses as described above.

Liquidity and Capital Resources

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

Presently, the Company's U.S. parent company is experiencing difficulty up streaming cash. As a consequence, the Company obtained a revolving line of credit providing for borrowings of up to \$2.5million, to address the cash needs of the Company's U.S. parent. In 2013 and 2012, the Company issued 200,000 and 1,300,000 Restricted Shares of Common Stock, respectively, in cancellation of \$100,000 and \$1,301,300, respectively, of indebtedness under the Credit Facility. The remaining balance under the Credit Agreement as of December 31, 2013 was \$1.40 million.

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

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

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

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

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

Our agreements with our customers generally provide that 30% of the purchase price is due upon the placement of an order, 30% upon delivery and 30% upon installation and acceptance of the equipment after customer testing. As a common practice in the heating manufacturing business in China, payment of the final 10% of the purchase price is due no later than the termination date of the standard warranty period, which ranges from 3 to 24 months from the acceptance date, or up to 2 heating seasons. Our receipts from sales of our products depend on the complexity of the equipment ordered, which impacts manufacturing, delivery, installation, testing times and warranty periods. For example, PHEs and HPs are less complex than PHE Units and therefore have a shorter manufacturing, acceptance, warranty and payment schedule. We experience payment delays from time to time, which historically have been from 1 to 3 months from the due date, but given the temporary financial difficulties in 2013 and 2012 of some of our state-owned customers resulting from tightened fiscal policies in China, we have experienced longer payment delays from these customers. Our accounts receivable and inventory turnover are relatively low and days sales outstanding ratio relatively high. Consequently, collection on our sales is slow and capital is tied up in inventories, which may result in pressure on cash flows. The low accounts receivable turnover and high days outstanding in the year ended December 31, 2013, was due primarily to the temporary financial difficulties of some of our state-owned customers that resulted in delays in payment. The low inventory turnover rate in the year ended December 31, 2013, was due to overall less purchase orders received from our state-owned customers in China who are having temporary financial difficulties.

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

Our accounts receivable typically remain outstanding for a significant period of time based on the standard payment terms with our customers described above. The increase in amount of accounts receivable outstanding for more than 180 days in 2013 and 2012 was due mainly to payment delays from certain state-owned customers that experienced working capital difficulties because of the current deflationary fiscal policy of the PRC government. Bad debt allowance was reserved in accordance with the Company's accounting policy, though the Company continues to work to collect all funds due.

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We recognize the final 5-10% of the purchase price as retention receivable, which is due no later than the termination of our warranty period. The deferral of the final payment is a common practice in the heating manufacturing business in China. Sometimes our customers are required to deposit 5-10% of the sales price on high value products, like an assembled heat exchanger unit or the main part of a PHE, into designated bank accounts as restricted cash for securing the payment after such period expires. Based on our historical experience, there have been no defaults on such deferrals. Therefore, we believe the potential risks and uncertainty associated with defaults on such receivables are not material. As of December 31, 2013, the Company collected 55% of the accounts receivable that were outstanding as of December 31, 2012.

Dividend Distribution

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

Off-Balance Sheet Arrangements

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

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Contractual Obligations

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

	2013	2012	Subsidiary obligated
From a commercial bank in the PRC for RMB 50,000,000 entered into on February 17, 2012. The loan bore interest at 7.872% with maturity on January 16, 2013. The loan was repaid at maturity.	\$ -	\$ 7,954,817	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on July 12, 2012. The loan bore interest at 7.87% with maturity on July 11, 2013. The loan was repaid at maturity.	-	1,590,963	Siping
From a commercial bank in the PRC for RMB 10,000,000 entered into on August 23, 2012. The loan bore interest at 6.30% with maturity on August 22, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,590,963	Taiyu
From a commercial bank in the PRC for RMB 9,000,000 entered into on September 7, 2012. The loan bore interest at 6.3% with maturity on September 6, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,431,867	Taiyu
From a commercial bank in the PRC for RMB 8,000,000 entered into on September 13, 2012. The loan bore interest at 6.3% with maturity on September 12, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,272,771	Taiyu
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 21, 2012. The loan bore interest at 6.6% with maturity on August 20, 2013. The loan was repaid at maturity.	-	4,772,890	Taiyu
From a commercial bank in the PRC for RMB 9,600,000 entered into on September 13, 2012. The loan bore interest at 6.6% with maturity on March 3, 2013. This loan was guaranteed by accounts receivable. The loan was repaid at maturity.	-	1,527,325	Taiyu
From a commercial bank in the PRC for RMB 13,344,190 entered into on June 26, 2012. The loan bore interest at 6.16% with maturity on January 18, 2014. This loan was repaid at maturity.	2,188,684	2,354,626	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on November 30, 2012. The loan bore interest at 7.87% with maturity on November 22, 2014. The loan was guaranteed by Taiyu.	1,640,178	1,590,963	Siping
From a commercial bank in the PRC for RMB 13,000,000 entered into on December 12, 2011. The loan bore interest at 6.65% with maturity on October 26, 2013. This loan was pledged with Taiyu's building and	-	2,068,252	Taiyu

Explanation of Responses:

land. This loan was repaid at maturity.			
From a commercial bank in the PRC for RMB 40,000,000 entered into on March 11, 2013. The loan bore interest at 6.60% with maturity on March 10, 2014. The loan was guaranteed by Siping, HeatPump and management of Chinese subsidiaries. This loan was repaid at maturity.	6,560,711	-	Taiyu
From a commercial bank in the PRC for RMB 8,550,000 entered into on January 9, 2013. The loan bore interest at 6.00% with maturity on December 10, 2013. This loan was repaid at maturity.	-	-	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on May 21, 2013. The loan bore interest at 6.60% with maturity on May 20, 2014.	1,640,178	-	Taiyu
From a commercial bank in the PRC for RMB 10,570,234 entered into on June 3, 2013. The loan bore interest at 6.16% with maturity on December 30, 2013. This loan was repaid at maturity.	-	-	Taiyu
From a commercial bank in the PRC for RMB 5,000,000 entered into on August 29, 2013. The loan bore interest at 7.20% with maturity on August 29, 2014. The loan was guaranteed by Taiyu.	820,089		Siping
From a commercial bank in the PRC for RMB 5,000,000 entered into on September 4, 2013. The loan bore interest at 7.20% with maturity on September 4, 2014. The loan was guaranteed by Taiyu.	820,089		Siping
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 8, 2013. The loan bore interest at 6.90% with maturity on August 7, 2014.	4,920,533	-	Taiyu
From a commercial bank in the PRC for RMB 9,900,000 entered into on September 18, 2013. The loan bore interest at 6.0% with maturity on September 17, 2014. This loan was pledged by Taiyu's accounts receivable.	1,623,776	-	Taiyu
From a commercial bank in the PRC for RMB 9,900,000 entered into on October 11, 2013. The loan bore interest at 6.0% with maturity on October 10, 2014. This loan was pledged by Taiyu's accounts receivable.	1,623,776	-	Taiyu
From a commercial bank in the PRC for RMB 16,000,000 entered into on July 10, 2013. The loan bore interest at 6.0% with maturity on January 9, 2014. This loan was pledged by Taiyu's accounts receivable. This loan was repaid at maturity.	2,624,285	-	Taiyu
TOTAL	\$ 24,462,299	\$ 26,155,437	

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Of the loans listed above that are guaranteed by a third party, the guarantees were provided by Liaoning Wugang Metal Trading Co., Ltd. (“Liaoning Wugang”), with a maximum guarantee amount of RMB 46 million (\$7.32 million). The guarantee is for the loans entered or will be entered from February 20, 2012 to August 16, 2013 with the guarantee length equal to the loan term; the guarantee service was extended for the loans entered or will be entered from September 18, 2013 to September 12, 2014 with the guarantee length equal to the loan term, the maximum guarantee amount was revised to RMB 44 million (\$7.05 million). The Company was not required to pay any guarantee fees; however, the Company contracted to provide similar guarantees for up to RMB 20 million (\$3.18 million) to Liaoning Guorui Commercial Trading Co., Ltd. (“Guorui”). The guarantee is for the loans entered from January 12, 2012 to January 11, 2013 with the guarantee length equal to the loan term, the Company does not require Guorui to pay any guarantee fees. The Company did not extend the guarantee term for Guorui after January 11, 2013. These arrangements are common to the banking industry in China, and there are no other relationships between the Company and Liaoning Wugang or Guorui, both of whom were referred to the Company by the lending bank.

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

The Company entered into a long-term loan of \$2,132,231(RMB 13 million) with China Construction Bank on November 30, 2013 with maturity on November 29, 2015. The interest rate for the loan is variable currently at 6.46%, and to be paid on the 20th of each month. This loan is guaranteed by Taiyu’s building and land.

Contingencies

On August 31, 2012, a putative class action lawsuit, Steven Leshinsky v. James Wang, et. al., which purported to allege federal securities law claims against the Company and certain of its former officers and directors, was filed in the United States District Court for the Southern District of New York. Thereafter, two plaintiffs filed competing motions to be appointed lead plaintiff in the proceeding. A lead plaintiff was appointed and an amended complaint was filed on January 28, 2013, by the Rosen Law Firm. The amended complaint included Oliver Bialowons, our President, and Michael Wilhelm, our former Chief Financial Officer, as defendants in the proceeding though they were not officers of the Company during the alleged class period. A second amended complaint was filed on April 8, 2013, under the caption Stream Sicav, Dharanendra Rai et al. v. James Jun Wang, SmartHeat, Inc. et al., removing Messrs. Wilhelm and Bialowons as defendants. The second amended complaint alleges two counts against the Company, both for violations of the federal securities laws arising from alleged insider sales or management sales of securities and alleged false disclosures relating to those sales. On May 8, 2013, we filed a motion to dismiss the second amended complaint on the grounds that, among other things, the plaintiffs did not, in fact, allege that a member of our senior management team had sold their shares. The motion to dismiss was subsequently denied and the court set a discovery and class briefing schedule.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Not required.

Item 8. Financial Statements and Supplementary Data

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

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

None.

Explanation of Responses:

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our President and Acting Chief Accountant, our principal executive officer and acting principal financial officer, respectively, evaluated the effectiveness of our disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our President and Acting Chief Accountant, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, our President and Acting Chief Accountant concluded that, as of December 31, 2013, our disclosure controls and procedures were not effective as of such date because of a material weakness identified in our internal control over financial reporting related to our internal level of U.S. GAAP expertise. We lack sufficient personnel with the appropriate level of knowledge, experience and training in U.S. GAAP for the preparation of financial statements in accordance with U.S. GAAP. None of our internal accounting staff, including our Acting Chief Accountant, that are primarily responsible for the preparation of our books and records and financial statements in compliance with U.S. GAAP holds a license such as Certified Public Accountant in the U.S., nor have any attended U.S. institutions or extended educational programs that would provide enough of the relevant education relating to U.S. GAAP.

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Management's Annual Report on Internal Control over Financial Reporting

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

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

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

Our management carried out an evaluation of the effectiveness of our internal control over financial reporting based on the framework in "Internal Control – Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based upon this evaluation, our management concluded that our internal control over financial reporting was not effective as of December 31, 2013, because of a material weakness related to our internal level of U.S. GAAP expertise. We lack sufficient personnel with the appropriate level of knowledge, experience and training in U.S. GAAP for the preparation of financial statements in accordance with U.S. GAAP. None of our internal accounting staff, including our Chief Financial Officer, that are primarily responsible for the preparation of our books and records and financial statements in compliance with U.S. GAAP holds a license such as Certified Public Accountant in the U.S., nor have any attended U.S. institutions or extended educational programs that would provide enough of the relevant education relating to U.S. GAAP.

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

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

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

Changes in Internal Control over Financial Reporting

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

Item 9B. Other Information

None.

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PART III

Item 10. Directors, Executive Officers and Corporate Governance

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

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

Oliver Bialowons, President and Director

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

Yingkai Wang, Acting Chief Accountant

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

Huajun Ai, Corporate Secretary

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

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

Kenneth Scripta, Director

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

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Weiguo Wang, Director

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

Xin Li, Director

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

Qingtai Kong, Director

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

Legal Proceedings

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

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

Explanation of Responses:

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

- the subject of any bankruptcy petition filed by or against any business of which such person was a general partner or executive officer either at the time of the bankruptcy or within two years prior to that time;

- convicted in a criminal proceeding or is subject to a pending criminal proceeding (excluding traffic violations and other minor offenses);

- subject to any order, judgment or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction, permanently or temporarily enjoining, barring, suspending or otherwise limiting his involvement in any type of business, securities or banking activities;

- found by a court of competent jurisdiction (in a civil action), the SEC or the Commodity Futures Trading Commission to have violated a federal or state securities or commodities law, that has not been reversed, suspended, or vacated;

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

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

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

Audit Committee and Audit Committee Financial Expert

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

- appointment of independent auditors, determination of their compensation and oversight of their work;
- review the arrangements for and scope of the audit by independent auditors;
- review the independence of the independent auditors;
- consider the adequacy and effectiveness of the internal controls over financial reporting;
- pre-approve audit and non-audit services;
- establish procedures regarding complaints relating to accounting, internal accounting controls, or auditing matters;
- review and approve any related party transactions;
- discuss with management our major financial risk exposures and our risk assessment and risk management policies; and
- discuss with management and the independent auditors our draft quarterly interim and annual financial statements and key accounting and reporting matters.

Procedures for Shareholder Recommendations of Nominees to the Board of Directors

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

Code of Ethics

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

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Section 16(a) Beneficial Ownership Reporting Compliance

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

Item 11. Executive Compensation

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

Executive Compensation

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

Summary Compensation Table

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

(1)

Explanation of Responses:

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

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

Name	Outstanding Equity Awards at Fiscal Year-End for 2013			
	Option Awards		Option Exercise Price (\$)	Option Expiration Date
	Number of Securities Underlying Unexercised Options			
	(#) Exercisable	(#) Unexercisable		
Jun Wang	-	-	-	-
Zhijuan Guo	-	-	-	-
Xudong Wang	2,500	(1)	118.50	06/30/2016

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

Agreements with Personnel

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

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

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

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

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

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

our policies and the relevant laws and regulations of local governmental authorities and the PRC.

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

Grants of Plan-Based Awards

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

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

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

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

Change-In-Control and Separation Agreements

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

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

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

Compensation of Directors

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

Director Compensation Table for 2013					
Name	Fees Earned or Paid in Cash (\$)	Option Awards (\$)	All Other Compensation (\$)	Total (\$)	
Kenneth Scipta	25,000	-	-	25,000	
Weiguo Wang	12,000	-	-	12,000	
Xin Li	17,910	-	-	17,910	
Qingtai Kong	3,750	-	-	3,750	

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

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

Explanation of Responses:

directors.

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

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

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

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

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

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

* Represents less than 1% of shares outstanding.

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

- (2) Disclosed on the Schedule 13G for Yang In Cheol filed on April 25, 2008, for beneficial ownership as of April 14, 2008.
- (3) Disclosed on the Schedule 13D for William J & Mary Ann P McGrath Foundation filed on November 7, 2013.
- (4) Disclosed on the Schedule 13G for ShenYang ZhiCe Investment Co., Ltd (“ShenYang ZhiCe”) filed on April 25, 2008, for beneficial ownership as of April 14, 2008. ShenYang ZhiCe has sole power to vote and dispose of the shares owned by it.
- (5) Disclosed on the Schedule 13D for Northtech Holdings filed on March 7, 2013, as amended on August 29, 2013.

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Securities Authorized for Issuance under Equity Compensation Plans

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

Equity Compensation Plan Information

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

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

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

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

Certain Relationships and Related Transactions

On July 27, 2012, we entered into a secured revolving credit facility under the terms of a Secured Credit Agreement with Northtech Holdings, Inc., an entity owned by certain members of the Company's former management, Jun Wang, our former Chief Executive Officer, Xudong Wang, our former Vice President of Strategy and Development, and Wen Sha, our former Vice President of Marketing. Huajun Ai, our current Corporate Secretary, is also a part owner of Northtech. As amended on December 21, 2012, the Credit Agreement provides for borrowings of up to \$2,500,000 with any amounts borrowed maturing on April 30, 2014. Borrowings under the Credit Agreement are secured by 55% of the equity interest in each of our wholly-, directly-owned subsidiaries and are repayable, at our option, in shares of our common stock. On December 21, 2012, we elected to repay \$1,301,300 of the \$1,384,455 outstanding under the

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

On December 30, 2013, the Company closed the transactions contemplated by the Equity Interest Purchase Agreement discussed above (See Sale of Equity Interests). The buyers consist of a group of 25 natural persons, all of whom are P.R.C. citizens, including Wen Sha, Jun Wang and Xudong Wang, managers of the Company's subsidiaries engaged in the PHE segment of its business, and Huajuan Ai and Yingkai Wang, the Company's Corporate Secretary and Acting Chief Accountant, respectively.

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

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

Director Independence

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

Item 14. Principal Accounting Fees and Services

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

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

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

foregoing categories.

Audit Committee's Pre-Approval Policy

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

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PART IV

Item 15. Exhibits, Financial Statement Schedules

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

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

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SMARTHEAT INC.

Consolidated Financial Statements
Years Ended December 31, 2013 and 2012

Index to Financial Statements

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Financial Statements	
<u>Consolidated Balance Sheets as of December 31, 2013 and 2012</u>	F-3
<u>Consolidated Statements of Operations and Comprehensive Loss years ended December 31, 2013 and 2012</u>	F-4
<u>Consolidated Statements of Stockholders' Equity years ended December 31, 2013 and 2012</u>	F-5
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<u>Notes to Consolidated Financial Statements</u>	F-7

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders of
SmartHeat Inc.

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

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

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

/s/ Goldman Kurland and Mohidin, LLP
Goldman Kurland and Mohidin, LLP
Encino, California
April 11, 2014

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	December 31, 2013	December 31, 2012
ASSETS		
CURRENT ASSETS		
Cash & equivalents	\$13,602,399	\$18,336,163
Restricted cash	2,458,758	994,455
Accounts receivable, net	12,167,565	32,250,817
Retentions receivable	4,202,109	3,812,376
Advances to suppliers, net	6,584,833	3,279,007
Other receivables (net), prepayments and deposits	2,644,522	6,467,280
Inventories, net	56,324,363	58,297,562
Taxes receivable	989,635	-
Notes receivable - bank acceptances	2,759,251	2,797,551
Total current assets	101,733,434	126,235,211
NONCURRENT ASSETS		
Long term investment	934,805	865,773
Restricted cash	135,926	36,592
Retentions receivable	237,882	421,731
Advance to supplier for equipment	-	1,744,056
Construction in progress	1,340,905	1,298,841
Property and equipment, net	10,185,160	10,947,480
Intangible assets, net	14,885,623	14,920,603
Total noncurrent assets	27,720,301	30,235,076
TOTAL ASSETS	\$129,453,735	\$156,470,287
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$6,683,860	\$8,574,981
Advance from customers	5,618,301	5,481,960
Taxes payable	197,078	769,167
Accrued liabilities and other payables	14,226,766	5,006,127
Notes payable - bank acceptances	2,590,025	736,698
Loans payable	24,462,299	26,155,437
Total current liabilities	53,778,329	46,724,370
CREDIT LINE PAYABLE	1,396,378	83,537
LONG-TERM LOAN	2,132,231	-

DEFERRED TAX LIABILITY	17,177	93,054
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, \$0.001 par value; 75,000,000 shares authorized, 6,133,399 and 5,733,399 shares issued and outstanding as of December 31, 2013 and 2012, respectively		
	6,133	5,733
Paid-in capital	81,901,266	103,607,559
Statutory reserve	5,389,057	5,396,014
Accumulated other comprehensive income	8,991,269	11,273,497
Accumulated deficit	(51,991,839)	(11,771,349)
Total Company stockholders' equity	44,295,886	108,511,454
NONCONTROLLING INTEREST	27,833,734	1,057,872
TOTAL EQUITY	72,129,620	109,569,326
TOTAL LIABILITIES AND EQUITY	\$ 129,453,735	\$ 156,470,287

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

	YEARS ENDED DECEMBER 31,	
	2013	2012
Net sales	\$44,709,526	\$47,850,292
Cost of goods sold	40,401,380	32,481,271
Gross profit	4,308,146	15,369,021
Operating expenses		
Selling	6,864,059	9,922,607
General and administrative	10,400,323	12,345,739
Goodwill impairment	-	2,083,586
Provision for bad debts	27,240,939	18,790,256
Provision for advance to supplier	(593,838)	2,216,156
Total operating expenses	43,911,483	45,358,344
Loss from operations	(39,603,338)	(29,989,323)
Non-operating income (expenses)		
Investment income	153,237	142,411
Interest income	159,972	164,454
Interest expense	(1,816,456)	(1,548,937)
Financial expense	(249,681)	(170,220)
Foreign exchange transaction gain (loss)	(9,495)	5,474
Loss on sale of equity interest	(842,491)	-
Other income, net	1,314,945	2,643,786
Total non-operating income (expenses), net	(1,289,971)	1,236,968
Loss before income tax	(40,893,309)	(28,752,355)
Income tax (benefit) expense	(50,657)	493,624
Net loss before noncontrolling interest	(40,842,652)	(29,245,979)
Less: Loss attributable to noncontrolling interest	(319,904)	(28,897)
Net loss to SmartHeat Inc.	(40,522,748)	(29,217,082)
Other comprehensive item		
Foreign currency translation gain (loss) attributable to SmartHeat Inc.	(2,282,228)	153,610
Foreign currency translation gain (loss) attributable to noncontrolling interest	(31,371)	2,532

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Comprehensive loss attributable to SmartHeat Inc.	\$(42,804,976)	\$(29,063,472)
Comprehensive loss attributable to noncontrolling interest	\$(351,275)	\$(26,365)
Basic and diluted weighted average shares outstanding	5,870,111	4,129,400
Basic and diluted loss per share	\$(6.90)	\$(7.08)

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

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

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Sale of equity interest and deconsolidation	-	-	(21,915,893)	(9,537)	(4,924,845)	304,838	(26,545,437)	27,127,
Net loss for year	-	-	-	-	-	(40,522,748)	(40,522,748)	(319,90
Transfer to statutory reserves	-	-	-	2,580	-	(2,580)	-	-
Foreign currency translation gain	-	-	-	-	2,642,617	-	2,642,617	(31,371
Balance at December 31, 2013	6,133,399	\$6,133	\$81,901,266	\$5,389,057	\$8,991,269	\$(51,991,839)	\$44,295,886	\$27,833,

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SMARTHEAT INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED
DECEMBER 31,
2013 2012

CASH FLOWS FROM OPERATING ACTIVITIES:

Loss including noncontrolling interest	\$(40,842,652)	\$(29,245,979)
Adjustments to reconcile loss including noncontrolling interest to net cash used in operating activities:		
Investment income	(153,237)	(142,411)
Depreciation and amortization	2,151,325	1,892,084
Provision for bad debts	27,240,939	18,790,256
Provision for inventory impairment	6,343,530	1,590,721
Provision for advance to suppliers	(593,838)	2,216,156
Changes in warranty reserves	(44,518)	-
Loss on disposal of fixed asset	19,133	-
Loss on sale of equity interest	842,491	-
Unearned interest on accounts receivable	13,476	(45,244)
Stock option expense	-	37,919
Stock compensation expense in connection with shares issued to executives	-	75,000
Amortization of loan amendment fee paid by shares	31,315	-
Shares issued for equity interest sale consent	30,000	-
Gain (Loss) on settlement of debts by shares	20,000	(813,245)
Goodwill impairment	-	2,083,586
Changes in deferred tax	(77,269)	(96,512)
(Increase) decrease in assets and liabilities:		
Accounts receivable	1,134,956	(2,607,336)
Retentions receivable	(73,493)	30,374
Advances to suppliers	1,461,069	12,153,058
Other receivables, prepayments and deposits	(6,846,995)	951,546
Inventories	(2,746,109)	(6,070,050)
Taxes receivable	(827,925)	-
Accounts payable	3,967	(4,099,812)
Advance from customers	(32,609)	602,864
Taxes payable	(676,552)	(408,863)
Accrued liabilities and other payables	9,077,728	(2,337,900)
Net cash used in operating activities	(4,545,268)	(5,443,788)

CASH FLOWS FROM INVESTING ACTIVITIES:

Change in restricted cash	(1,502,829)	1,861,726
Equity method investment	-	(722,750)
Cash disposed on equity interest sale	(399,241)	-
Acquisition of property & equipment	(565,295)	(827,626)
Acquisition of intangible asset	(79,169)	(81,854)
Sale of equity interest	804,609	-
Notes receivable	122,483	(872,787)

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

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

1. ORGANIZATION AND DESCRIPTION OF BUSINESS

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

On April 14, 2008, the Company entered into a Share Exchange Agreement (the “Share Exchange Agreement”) to acquire Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd., subsequently renamed SmartHeat Taiyu (Shenyang) Energy Technology Co., Ltd. (“Taiyu”), a privately held Sino-foreign joint venture company formed under the laws of the People’s Republic of China (“PRC”) on July 24, 2002, and engaged in the design, manufacture, sale and servicing of plate heat exchange products in China. The Share Exchange Agreement was entered into by SmartHeat, Taiyu and the shareholders of Taiyu. Pursuant to the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu’s share capital of RMB 25,000,000 (\$3.95 million) were exchanged for 1,850,000 shares of SmartHeat’s common stock (the “Share Exchange”). SmartHeat received PRC government approval on May 28, 2008, of its subscription for 71.6% of the registered capital of Taiyu, and approval on June 3, 2009, of the transfer of the remaining 28.4% ownership of Taiyu from the original joint venture shareholders who had received shares of SmartHeat common stock in the Share Exchange. Concurrent with the Share Exchange, one of SmartHeat’s shareholders cancelled 250,000 issued and outstanding shares of SmartHeat common stock pursuant to a split-off agreement dated April 14, 2008. As a result of the Share Exchange, Taiyu became a wholly foreign-owned enterprise of SmartHeat.

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

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

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

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

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

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

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

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

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

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

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

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

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

After the assignment, Heat HP Inc. owned 100% of SmartHeat Investment, SmartHeat Trading, SmartHeat Jinhui, SmartHeat Germany and 98.8% of SmartHeat (Shenyang) Heat Pump.

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

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

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

On December 30, 2013, the Company, closed the transaction contemplated by the Equity Interest Purchase Agreement dated October 10, 2013, whereby the buyers purchased 40% of the Company’s equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.;

SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the “Target Companies”). The purchase price was RMB 5,000,000. Urumchi XinRui was 46% owned by SmartHeat US parent company.

The 40% equity interest sale of Taiyu, Siping, Shenyang Energy Equipment changes the parent company’s ownership interest while it retains controlling financial interest in the subsidiaries and is accounted for as an equity transaction (investments by owners and distributions to owners acting in their capacity as owners). No gain or loss was recognized in consolidated net income or comprehensive income. The carrying amount of the non-controlling interest was adjusted to reflect the change in the parent’s ownership interest in the subsidiaries. Any difference between the fair value of the consideration received or paid and the amount by which the non-controlling interest is adjusted is recognized in equity attributable to the parent. The amount of difference recognized and allocated to non-controlling interest was \$27.58 million including \$4.86 million the carrying amount of accumulated other comprehensive income (ASC Topic: 810-10-45-23 & 24). The 40% equity interest sale of Ruicheng and Xinrui changes the parent’s ownership interest and the parent lost controlling interest; accordingly, an \$842,491 loss was recognized from the sale.

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The Company retains an option to repurchase the equity interests of the Target Companies from the buyers at a purchase price of RMB 5,600,000 which terminated on February 28, 2014 unexercised. The buyers shall have the option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000 which was exercised on March 27, 2014 subject to satisfaction of the terms set forth in the Equity Interest Purchase Agreement including, without limitation, requisite approval of the Company's shareholders prior to completing the sale. In the event such approval is not obtained, the buyers may terminate the Equity Interest Purchase Agreement. Should the Company's shareholders approve the sale, the Company has the option to require the Buyers to purchase the remaining 20% equity interest for a purchase price of RMB 2,500,000.

The Company retains an option to repurchase the equity interests of the Target Companies from the buyers at a purchase price of RMB 5,600,000 which terminates on February 28, 2014. In the event the Company does not exercise its option to repurchase the equity interest, the buyers shall have the option to purchase an additional 40% equity interest in the Target Companies for an additional purchase price of RMB 6,000,000. In the event the buyers exercise their option to purchase the additional 40% equity interest, the Company will seek the approval of its shareholders prior to completing the sale. In the event such approval is not obtained, the buyers may terminate the Equity Interest Purchase Agreement. Should the buyers exercise their option to purchase the additional 40% equity interest, and the Company's shareholders approve the sale, the Company has the option to require the Buyers to purchase the remaining 20% equity interest for a purchase price of RMB 2,500,000. As of this report date, the Company did not exercise the option to repurchase the equity interest of the Target Companies.

The buyers consist of a group of 25 natural persons, all of whom are P.R.C. citizens, including Wen Sha, Jun Wang and Xudong Wang, managers of the Company's subsidiaries engaged in the PHE segment of its business, and Huajuan Ai and Yingkai Wang, the Company's Corporate Secretary and Acting Chief Accountant, respectively. Huajuan Ai, Wen Sha, Jun Wang and Xudong Wang are also principals in Northtech Holdings Inc.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

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

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat's U.S. parent, its subsidiaries Heat HP and Heat PHE, and their subsidiaries Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment, SmartHeat Shenyang Energy, SmartHeat Trading, Ruicheng, SmartHeat Germany and SmartHeat Shenyang Heat Pump, which are collectively referred to as the "Company." All significant intercompany accounts and transactions were eliminated in consolidation. After the sale of 40% equity interest of Taiyu, Siping, Shengyang Energy, Ruicheng and Xinrui (See Note 9) on December 30, 2013, the Company now owns 60% of Taiyu, Siping and Shenyang Energy, and 30.6% of Ruicheng, which will be accounted for by equity method accounting.

Equity Method Investee

In April 2012, the Company invested \$722,700 to establish XinRui. The Company owns 46% of XinRui and accounts for this investment under the equity method of accounting (ASC 323-30). The Company recorded its investment at original cost. This investment will increase with income and decrease for dividends and losses that accrue to the Company. After 40% equity interest sale on December 30, 2013, the Company now owns 30.6% of Ruicheng (See Note 9) and 27.6% of XinRui. For accounting purposes, Ruicheng assets and liabilities were not consolidated as at

December 31, 2013 while its income and expenses remain part of the consolidated financial statements as the change in ownership interest may not change financials results substantially between December 30, 2013 and December 31, 2013. Similarly for XinRui, the equity method investment income was recorded using 46% ownership interest for the year ended December 31, 2013, as the change in ownership interest may not change financials results substantially between December 30, 2013 and December 31, 2013 (See Note 9). The Company recorded \$400,941 and \$441,550 loss on sale of 40% equity interest of Xinrui and Ruicheng, respectively.

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Noncontrolling Interest

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

After the sale of 40% equity interest of Taiyu, Siping, Shengyang Energy, Ruicheng and Xinrui (See Note 9) on December 30, 2013, the Company now owns 60% of Taiyu, Siping and Shenyang Energy, and 30.6% of Ruicheng and 27.6% of Xinrui. For accounting purposes net loss of Taiyu, Siping, Shenyang Energy were not allocated to noncontrolling interest between December 30, 2013 and December 31, 2013, as the change in ownership interest may not change financial results substantially between December 30, 2013 and December 31, 2013.

Use of Estimates

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

Cash and Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. As of December 31, 2013 and 2012, the Company maintained restricted cash deposit in several bank accounts for the purposes described below.

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

The following table presents in U.S. dollars ("USD") the amount of cash and equivalents held by the Company as of December 31, 2013 and 2012, based on the jurisdiction of deposit. The Company's U.S. parent holds cash and equivalents in U.S. bank accounts denominated in USD.

	United States	China	Germany	Total
December 31, 2013	\$ 251,461	\$ 11,326,282	\$ 2,024,656	\$ 13,602,399

Explanation of Responses:

December 31, 2012	\$	82,479	\$	15,311,830	\$	2,941,854	\$	18,336,163
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Accounts and Retentions Receivable

The Company maintains reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Based on historical collection activity, the Company had allowances of \$48.25 million and \$28.2 million at December 31, 2013 and 2012, respectively.

At December 31, 2013, and 2012, the Company had retentions receivable from customers for product quality assurance of \$4.44 and \$4.23 million, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 to 24 months depending on the shipping date, and for PHE Units, the customer acceptance date, of the products and the number of heating seasons that the warranty period covers.

Accounts receivable is net of unearned interest of \$26,655 and \$12,532 at December 31, 2013 and 2012, respectively. Unearned interest is imputed interest on accounts receivable with due dates over 1 year from the invoice date discounted at the Company's borrowing rate of 6.15% at December 31, 2012. The Company did not record additional unearned interest during 2013 due to no long-term accounts receivable.

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Bad Debt Allowance

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

Advance to Suppliers

The Company makes advances to certain vendors to purchase raw material and equipment for production. The advances are interest-free and unsecured.

Inventories

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

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

As part of inventory impairment analysis, the Company performs an evaluation of raw materials stored over one year and not anticipated to be consumed, and an evaluation of potential impairment to the quality of these raw materials. If management anticipates that obsolete raw materials in inventory can be utilized and will be consumed within the next six months through new customer orders or substitute orders, no impairment is recorded. The Company collects information about delayed and canceled contracts and met with affected customers to discuss their financing situation and their projections of future orders. Finished goods manufactured for delayed and canceled contracts that the Company does not expect to be reinstated and contracts for which the Company has been unable to find substitute customers become impaired.

Property and Equipment

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are expensed as incurred; additions, renewals and betterments are capitalized. When property and equipment are retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts and any gain or loss is included in operations. Depreciation of property and equipment is provided using the straight-line method with a 10% salvage value and estimated lives as follows:

Buildings	20 years
Vehicles	5 years
Office equipment	5 years
	5-10 years

Production
equipment

Land Use Rights

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

Impairment of Long-Lived Assets

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

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Recoverability of long-lived assets to be held and used is measured by comparing the carrying amount of an asset to the estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated undiscounted future cash flows, an impairment charge is recognized based on the excess of the carrying amount over the fair value (“FV”) of the assets. FV generally is determined using the asset’s expected future discounted cash flows or market value, if readily determinable. The Company evaluates goodwill and intangible assets with indefinite lives for impairment annually using a two-step approach (codified in FASB ASC Topic 350). Based on this valuation approach, the Company concluded that the goodwill balance of \$2.08 million for SmartHeat Germany was impaired as of December 31, 2012, as discussed under Goodwill below. Based on its review, the Company believes that, as of December 31, 2013, and 2012, there were no significant impairments of its other long-lived assets.

Warranties

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

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

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

Research and Development Costs

Research and development (“R&D”) costs are expensed as incurred and included in general and administrative expenses. These costs primarily consist of cost of materials used, salaries paid for the Company’s development department and fees paid to third parties. R&D costs for the years ended December 31, 2013 and 2012, were \$1,424,400 and \$1,530,000, respectively.

Income Taxes

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

The Company follows FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” (codified in FASB ASC Topic 740). When tax returns are filed, it is likely that some positions taken would be sustained upon

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

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

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Revenue Recognition

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

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

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

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

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

Sales returns and allowances were \$0 for 2013 and 2012. The Company does not provide a right of return, price protection or any other concessions to its customers.

The Company provides a standard warranty to all customers, which is not considered an additional service; rather, an integral part of the product's sale. The Company believes the existence of its standard product warranty in a sales contract does not constitute a deliverable in the arrangement and thus there is no need to apply the EITF 00-21 (codified in FASB ASC Topic 605-25) separation and allocation model for a multiple deliverable arrangement. SFAS 5 (codified in FASB ASC Topic 450) specifically addresses the accounting for standard warranties and neither SAB 104 nor EITF 00-21 supersedes SFAS 5. The Company believes that accounting for its standard warranty pursuant to SFAS 5 does not impact revenue recognition because the cost of honoring the warranty can be reliably estimated.

The Company charges for after-sales services provided after the expiration of the warranty period, with after-sales services mainly consisting of cleaning PHEs and repairing and exchanging parts. The Company recognizes such revenue when the service is provided. For 2013 and 2012, revenue from after-sales services after the expiration of the warranty period was \$24,732 and \$346,653, respectively, which was recorded in other income.

Cost of Goods Sold

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

Advance from Customers

Explanation of Responses:

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

Concentration of Credit Risk

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

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

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

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Goodwill

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

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

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

Statement of Cash Flows

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

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

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

Basic and diluted shares outstanding are the same for 2013 and for 2012, because the common stock equivalent of the convertible securities outstanding, consisting of unexercised options issued to the Company’s directors and an officer, are anti-dilutive and, accordingly, were excluded from the computation of diluted loss per share. At December 31, 2013 and 2012, options to purchase 2,500 and 3,500 shares of common stock were outstanding and exercisable, respectively.

Fair Value of Financial Instruments

For certain of the Company’s financial instruments, including cash and equivalents, restricted cash, accounts receivable, accounts payable, accrued liabilities and short-term debt, the carrying amounts approximate their fair

Explanation of Responses:

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

- Level 1 inputs to the valuation methodology are quoted prices for identical assets or liabilities in active markets.
- Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 inputs to the valuation methodology are unobservable and significant to the FV measurement.

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

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

Foreign Currency Translation and Comprehensive Income (Loss)

The accounts of the U.S. parent company are maintained in USD. The functional currency of the Company’s China subsidiaries is the Chinese Yuan Renminbi (“RMB”) and the functional currency of SmartHeat Germany, the Company’s subsidiary in Germany, is the Euro (“EUR”). The accounts of the China subsidiaries and German subsidiary were translated into USD in accordance with SFAS No. 52, “Foreign Currency Translation” (codified in FASB ASC Topic 830). According to SFAS No. 52, all assets and liabilities were translated at the exchange rate on the balance sheet date, stockholders’ equity was translated at the historical rates and statement of operations items were translated at the average exchange rate for the period. The resulting translation adjustments are reported under other comprehensive income in accordance with SFAS No. 130, “Reporting Comprehensive Income” (codified in FASB ASC Topic 220).

The RMB to USD exchange rates and EUR to USD exchange rates in effect as of December 31, 2013 and 2012, and the average exchange rates for the years ended December 31, 2013 and 2012 are as following. The exchange rates used in translation from RMB to USD were published by State Administration of Foreign Exchange of the People’s Republic of China (“SAFE”). The exchange rates used in translation from EUR to USD were published by OANDA Rates.

	Average Exchange Rate For the Years Ended		Balance Sheet Date Exchange Rate	
	12/31/13	12/31/12	12/31/13	12/31/12
RMB - USD	6.2142	6.3125	6.0969	6.2855
EUR - USD	0.7530	0.7777	0.7263	0.7777

Stock-Based Compensation

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

Segment Reporting

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

The Company has two operating segments: 1) plate heating equipment, meters and related products; and 2) heat pumps and related products. These operating segments were determined based on the nature of the products offered. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in

assessing performance. The Company's chief executive officer and acting chief accountant were identified as the chief operating decision makers. The Company's chief operating decision makers direct the allocation of resources to operating segments based on the profitability, cash flows, and other measurement factors of each respective segment. Historically they were not segmented because the heat pump business was relatively small compared to the plate heating business and both businesses reported to the same executives; however, the Company's Board and senior management determined that it is useful and efficient to analyze and manage these businesses separately starting from 2013.

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

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	Years Ended December 31,	
	2013	2012
Revenue from unaffiliated customers:		
Plate heating, meters and related	\$ 38,882,321	\$ 42,074,895
Heat pumps and related	5,959,011	5,797,898
Inter-segment elimination	(131,806)	(22,501)
Consolidated	\$ 44,709,526	\$ 47,850,292
Operating loss:		
Plate heating, meters and related	\$ (35,186,493)	\$ (21,479,856)
Heat pumps and related	(2,886,815)	(6,435,921)
Corporation	(1,531,085)	(2,073,546)
Inter-segment elimination	1,055	-
Consolidated	\$ (39,603,338)	\$ (29,989,322)
Net loss:		
Plate heating, meters and related	\$ (36,044,506)	\$ (22,379,983)
Heat pumps and related	(2,095,207)	(5,715,209)
Corporation	(2,384,090)	(1,121,889)
Inter-segment elimination	1,055	-
Consolidated	\$ (40,522,748)	\$ (29,217,082)
Depreciation and amortization:		
Plate heating, meters and related	\$ 1,537,002	\$ 1,591,210
Heat pumps and related	511,846	300,875
Corporation	133,792	-
Consolidated	\$ 2,182,640	\$ 1,892,084
Total assets:		
Plate heating, meters and related	\$ 127,649,910	\$ 152,830,853
Heat pumps and related	13,674,622	14,340,054
Corporation	4,282,942	4,031,567
Inter-segment elimination	(16,153,739)	(14,732,187)
Consolidated	\$ 129,453,735	\$ 156,470,287

New Accounting Pronouncements

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

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

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

Reclassification

Certain prior year amounts were reclassified to conform to the manner of presentation in the current period, including the reclassification of credit line payable of \$83,537 from other payables in the balance sheet, and reclassification of proceeds from credit line payable of \$1,284,837 to financing activities from operating activities in the cash flow statement.

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3. INVENTORIES

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

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

4. NOTES RECEIVABLE – BANK ACCEPTANCES

The Company sold goods to its customers and received commercial notes (bank acceptance) from them in lieu of payments for accounts receivable. The Company discounted the commercial notes with the bank or endorsed the commercial notes to vendors for payment of their own obligations or to get cash from third parties. Most of the commercial notes have a maturity of less than six months. As of December 31, 2013, the Company was contingently liable for the notes endorsed to vendors of \$1.37 million.

5. PROPERTY AND EQUIPMENT, NET

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

	2013	2012
Buildings	\$ 4,980,184	\$ 4,830,751
Production equipment	8,599,701	8,160,111
Office equipment	1,124,176	1,120,799
Vehicles	940,624	937,364
Total	15,644,685	15,049,025
Less: accumulated depreciation	(5,459,525)	(4,101,545)
Property & equipment, net	\$ 10,185,160	\$ 10,947,480

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

6. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

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

	2013	2012
Advance to third parties	\$ 10,059,572	\$ 4,813,659
Deposit for public bids of sales contracts	758,465	1,397,375
Prepayment for freight, related, insurance, advertisement and consulting expenses	73,773	332,415
Other deposits	53,863	93,816
Advance to employees	926,441	729,422
Others	680,588	376,738
Total	12,552,702	7,743,425

Explanation of Responses:

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Less: bad debt allowance	(9,908,180)	(1,276,145)
Other receivables (net), prepayments & deposits	\$ 2,644,522	\$ 6,467,280

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Advance to third parties were short-term unsecured advances to unrelated parties with payment usually due within a year and includes an advance to SipingBeifang of RMB 22.13 million (\$3.63 million) that is non-interest bearing and with due date extended to September 2014, and an advance to unrelated company of RMB 39.20 million (\$6.43 million) that is non-interest bearing and will be collected by the end of June 2014. Deposits for public bidding represented the deposits for bidding on expected contracts, which will be returned to the Company after the bidding process is completed, usually within three to four months from the payment date. Prepayment for freight, related insurance expenses and advertisement represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products and prepaid advertising expense. Other deposits mainly consisted of deposits for rents, payroll expense and utilities. Advance to employees represented short-term loans to employees and advances for business trips and related expenses. Other receivables (consisting of advance to third parties and employees, deposit for public bids and others), prepayments and deposits are reimbursed or settled within 12 months.

7. INTANGIBLE ASSETS

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

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

	Estimated Useful Life (In years)	2013	2012
Land use rights	50	\$ 15,167,552	\$ 14,712,441
Know-how technology	5 – 10	911,423	884,076
Customer lists	5	214,841	208,395
Covenants not to compete	5	116,873	113,366
Software	5	680,049	590,344
Trademarks	7	298,549	289,591
Total		17,389,287	16,798,213
Less: accumulated amortization		(2,503,664)	(1,877,610)
Intangible assets, net		\$ 14,885,623	\$ 14,920,603

Amortization of intangible assets for the years ended December 31, 2013 and 2012, was \$566,300 and \$452,300, respectively. Annual amortization for the next five years from December 31, 2013, is expected to be \$491,515, \$460,940, \$445,847, \$438,158 and \$386,002, and \$12,368,273 thereafter.

8. CONSTRUCTION IN PROGRESS

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

- 1) SmartHeat Energy is building a factory for a total estimated cost of \$9.00 million, of which the Company paid \$0.46 million as of December 31, 2013 and 2012. The Company temporarily halted construction on this factory because of the current economic and market conditions in China.
- 2) SmartHeat Siping has a construction project of \$36,000 for the laying of a foundation for its machinery installation. This foundation project will be completed by the end of June 2014.
- 3) Taiyu paid \$0.83 million for equipment and installation, this project was completed in July 2013 and is in the stage of final inspection by the authority. The Company expects to complete the inspection by the end of May 2014.

9. LONG TERM INVESTMENT

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

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

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

On December 30, 2013, the Company sold 40% equity interest of XinRui and owns 27.6% of Xinrui after the sale (See Note 2). The investment of Xinrui after the sale was \$612,808.

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

10. MAJOR CUSTOMERS AND VENDORS

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

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

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

11. TAXES RECEIVABLE

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

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

12. TAXES PAYABLE

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

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

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13. ACCRUED LIABILITIES AND OTHER PAYABLES

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

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

Advances from third parties were short-term, non-interest-bearing advances from third parties due on demand. Payable to Siping Beifang representing loans to them without interest and payable upon demand. Refund of land use right previously purchased represented the partial refund received for the land use right Shenyang Energy purchased previously, but Shenyang Energy later decided to cancel the purchase. The local government approved such cancellation and refunded Shenyang Energy \$4.63 million as of December 31, 2013, and is committed to refund Shenyang Energy the full purchase price of the land use right within a few years (See Note 7). Shenyang Energy will make the ownership change of the land use right upon receiving the full amount of refund from the local authority. Others represented payables for the Company's certain construction and installation projects, and miscellaneous expenses including postage, business insurance, employee benefits, project bidding fee, \$213,149 for to-be-reimbursed expenses, and \$25,000 to the Company's audit committee chairman for performing market research for the HP products in North America. Accrued expenses mainly consisted of accrued payroll, interest and utility.

14. NOTES PAYABLE – BANK ACCEPTANCES

Notes payable represented the conversion of accounts payable into notes payable, which were issued by a bank. The Company deposited a portion of the acceptance amount into the bank as collateral. The terms of the notes range from 3-6 months and bear no interest. At December 31, 2013 and 2012, the Company deposited \$1.30 million and \$0.37 million with the bank as restricted cash for the bank issuing the notes (See note 2). The restricted cash is refundable when the notes are repaid.

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15. LOANS PAYABLE

Short-Term Bank Loans

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

	2013	2012	Subsidiary obligated
From a commercial bank in the PRC for RMB 50,000,000 entered into on February 17, 2012. The loan bore interest at 7.872% with maturity on January 16, 2013. The loan was repaid at maturity.	\$ -	\$ 7,954,817	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on July 12, 2012. The loan bore interest at 7.87% with maturity on July 11, 2013. The loan was repaid at maturity.	-	1,590,963	Siping
From a commercial bank in the PRC for RMB 10,000,000 entered into on August 23, 2012. The loan bore interest at 6.30% with maturity on August 22, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,590,963	Taiyu
From a commercial bank in the PRC for RMB 9,000,000 entered into on September 7, 2012. The loan bore interest at 6.3% with maturity on September 6, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,431,867	Taiyu
From a commercial bank in the PRC for RMB 8,000,000 entered into on September 13, 2012. The loan bore interest at 6.3% with maturity on September 12, 2013. The loan was guaranteed by a third party. The loan was repaid at maturity.	-	1,272,771	Taiyu
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 21, 2012. The loan bore interest at 6.6% with maturity on August 20, 2013. The loan was repaid at maturity.	-	4,772,890	Taiyu
From a commercial bank in the PRC for RMB 9,600,000 entered into on September 13, 2012. The loan bore interest at 6.6% with maturity on March 3, 2013. This loan was guaranteed by accounts receivable. The loan was repaid at maturity.	-	1,527,325	Taiyu
From a commercial bank in the PRC for RMB 13,344,190 entered into on June 26, 2012. The loan bore interest at 6.16% with maturity on January 18, 2014. The loan was repaid at maturity.	2,188,684	2,354,626	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on November 30, 2012. The loan bore interest at 7.87% with maturity on November 22, 2014. The loan was guaranteed by Taiyu.	1,640,178	1,590,963	Siping
From a commercial bank in the PRC for RMB 13,000,000 entered into on December 12, 2011. The	-	2,068,252	Taiyu

Explanation of Responses:

loan bore interest at 6.65% with maturity on October 26, 2013. This loan was pledged with Taiyu's building and land. This loan was repaid at maturity.			
From a commercial bank in the PRC for RMB 40,000,000 entered into on March 11, 2013. The loan bore interest at 6.60% with maturity on March 10, 2014. The loan was guaranteed by Siping, HeatPump and management of Chinese subsidiaries. This loan was repaid at maturity.	6,560,711	-	Taiyu
From a commercial bank in the PRC for RMB 8,550,000 entered into on January 9, 2013. The loan bore interest at 6.00% with maturity on December 10, 2013. This loan was repaid at maturity.	-	-	Taiyu
From a commercial bank in the PRC for RMB 10,000,000 entered into on May 21, 2013. The loan bore interest at 6.60% with maturity on May 20, 2014.	1,640,178	-	Taiyu
From a commercial bank in the PRC for RMB 10,570,234 entered into on June 3, 2013. The loan bore interest at 6.16% with maturity on December 30, 2013. This loan was repaid at maturity.	-	-	Taiyu
From a commercial bank in the PRC for RMB 5,000,000 entered into on August 29, 2013. The loan bore interest at 7.20% with maturity on August 29, 2014. The loan was guaranteed by Taiyu.	820,089		Siping
From a commercial bank in the PRC for RMB 5,000,000 entered into on September 4, 2013. The loan bore interest at 7.20% with maturity on September 4, 2014. The loan was guaranteed by Taiyu.	820,089		Siping
From a commercial bank in the PRC for RMB 30,000,000 entered into on August 8, 2013. The loan bore interest at 6.90% with maturity on August 7, 2014.	4,920,533	-	Taiyu
From a commercial bank in the PRC for RMB 9,900,000 entered into on September 18, 2013. The loan bore interest at 6.0% with maturity on September 17, 2014. This loan was pledged by Taiyu's accounts receivable.	1,623,776	-	Taiyu
From a commercial bank in the PRC for RMB 9,900,000 entered into on October 11, 2013. The loan bore interest at 6.0% with maturity on October 10, 2014. This loan was pledged by Taiyu's accounts receivable.	1,623,776	-	Taiyu
From a commercial bank in the PRC for RMB 16,000,000 entered into on July 10, 2013. The loan bore interest at 6.0% with maturity on January 9, 2014. This loan was pledged by Taiyu's accounts receivable. This loan was repaid at maturity.	2,624,285	-	Taiyu
TOTAL	\$ 24,462,299	\$ 26,155,437	

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Of the loans listed above that are guaranteed by a third party, the guarantees were provided by Liaoning Wugang Metal Trading Co., Ltd. (“Liaoning Wugang”), with a maximum guarantee of RMB 46 million (\$7.32 million). The guarantee is for the loans entered from February 20, 2012 to August 16, 2013, with the guarantee length equal to the loan term; the guarantee service was extended for the loans entered or will be entered from September 18, 2013 to September 12, 2014 with the guarantee length equal to the loan term, the maximum guarantee amount was revised to RMB 44 million (\$7.05 million). The Company was not required to pay any guarantee fees. However, the Company has contracted to provide similar guarantees for up to RMB 20 million (\$3.18 million) to Liaoning Guorui Commercial Trading Co., Ltd. (“Guorui”). The guarantee is for the loans entered from January 12, 2012 to January 11, 2013 with the guarantee length equal to the loan term, the Company does not require Guorui to pay any guarantee fees. The Company did not extend the guarantee term for Guorui after January 11, 2013. These arrangements are common to the banking industry in China, and there are no other relationships between the Company and Liaoning Wugang or Guorui, both of whom were referred to the Company by the lending bank.

Holding Company Credit Agreement – Credit Line Payable

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

Borrowings under the Credit Facility are secured by the Company’s deposit accounts located in the United States, its trademarks in the PRC and 55% of its equity in each of its wholly-, directly owned subsidiaries. An origination fee of 4% of the Committed Amount was accrued to Northtech upon the signing of the Credit Agreement. As amended, Borrowings bear interest of 10% annually, payable quarterly, and the Credit Facility matured on April 30, 2013. At the Company’s option, the maturity date of the Credit Facility may be extended for up to four successive 9-month periods for an extension fee of 4% of the Committed Amount for each extension. Generally, borrowings may be prepaid at any time without premium or penalty, provided however that if the Company prepays any amount due under the Credit Facility from the proceeds of another instrument or agreement of indebtedness, the Company shall pay a 10% prepayment fee. All amounts due under the Credit Facility may, at the Company’s option, be paid in either cash or restricted shares of the Company’s common stock.

On December 21, 2012, the Company entered into an amendment to the credit and security agreement, which (1) redefined the “average share price” to state that in no event would the average share price be lower than \$0.50 or higher than \$3.50; (2) raised the maximum credit line to \$2.5 million; (3) changed the initial maturity date to April 30, 2014; (4) redefined the calculation of the Restricted Shares of common stock if repaid by Restricted Shares; (5) redefined the purpose of the proceeds of the credit line; (6) raised the security interest from 35% to 55% of the Company’s equity interests in each of its wholly-, directly owned subsidiaries.

On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, the Company entered into second amendment to the credit and security agreement with Northtech, which redefined the “base rate”, and adjusted the base rate to 10% annually, compounded quarterly, effective January 1, 2013. The Company delivered to Northtech 100,000 restricted shares of the Company’s common stock as an Amendment Fee (see Note 19), issued in September 2013, and pledged shares representing 55% security interest in each of its wholly-, directly-owned subsidiaries.

On December 21, 2012, the Company’s Board of Director (“BOD”) approved the issuance of 1,300,000 Restricted Shares of Common Stock to Northtech in cancellation of \$1,301,300 of indebtedness under the Credit Facility. The balance owing to Northtech under the Credit Agreement as of December 31, 2013 and 2012 was \$1,396,378 and

\$83,537, respectively, and was recorded as a noncurrent obligation under ASC 470-10-45-12 through ASC 470-10-45-14 due to the Note being secured by 55% of the equity interest in each of HEAT PHE Inc. and HEAT HP Inc., and the Company's option to repay the note by issuance of the Company's shares. The Company amortized \$73,589 of the \$100,000 extension fee during the year ended December 31, 2013, \$24,194 will be amortized in one year, the unamortized extension fee was recorded as prepaid expense. The Company amortized \$31,315 of the \$60,000 amendment fee during the year ended December 31, 2013, \$28,685 will be amortized in one year, the unamortized amendment fee was recorded as prepaid expense.

The Company had \$100,000 payable to a consulting firm that was paid by a third party on behalf of the Company during 2012, this payable to the third party was assumed by Northtech on August 23, 2013, in exchange for 200,000 shares of the Company's common stock issued in September 2013, and payable for a credit line balance from Northtech. The stock price was \$0.60 on August 23, 2013, the Company recognized \$20,000 loss for the settlement of this payable by shares with Northtech.

On March 26, 2014, the Company gave notice to Northtech pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 3, 2015. The Company elected to pay the extension fee of 4% by issuing 200,000 shares of its common stock to Northtech. The terms of the Credit Agreement were previously approved by the Company's shareholders on December 11, 2012.

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Long-Term Bank Loan

The Company entered into a long-term loan of \$2,132,231(RMB 13 million) with China Construction Bank on November 30, 2013 with maturity on November 29, 2015. The interest rate for the loan is variable currently at 6.46%, and to be paid on the 20th of each month. This loan is guaranteed by Taiyu's building and land.

16. DEFERRED TAX ASSET (LIABILITY)

Deferred tax asset (liability) represented differences between the tax bases and book bases of property and equipment and intangible assets arising from the acquisition of SanDeKe and SmartHeat Pump, and bad debt allowance and provision of inventory impairment booked by the Company which was not allowed per tax purpose. As of December 31, 2013 and 2012, deferred tax asset (liability) consisted of the following:

	2013	2012
Deferred tax asset - current (bad debt allowance)	\$ 7,715,041	\$ 5,147,303
Deferred tax asset - current (inventory allowance)	2,321,878	959,388
Deferred tax asset – current (allowance to other receivable)	2,099,125	-
Deferred tax asset – current (allowance for advance to supplier)	398,224	-
Deferred tax asset – current (reserve for warranty)	75,808	-
Less: valuation allowance	(12,610,076)	(6,106,691)
Deferred tax assets, net	\$ -	\$ -
Deferred tax liability - noncurrent (depreciation of fixed assets)	\$ (17,177)	\$ (93,054)

17. INCOME TAXES

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

SmartHeat, the parent company, was incorporated in the U.S. and has net operating losses ("NOL") for income tax purposes, which can be carried forward for up to 20 years from the year the loss is incurred. SmartHeat has NOL carry forwards for income taxes of approximately \$7.25 million at December 31, 2013, which may be available to reduce future years' taxable income. Management believes the realization of benefits from these losses remains uncertain due to SmartHeat's limited operating history and continuing losses. Accordingly, a 100% deferred tax asset valuation allowance was provided.

Taiyu and SanDeKe are governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at 25% on income reported in the statutory financial statements after appropriate tax adjustments. Under the Income Tax Law that became effective January 1, 2008, new high-tech enterprises given special support by the PRC government are subject to an income tax rate of 15%. Taiyu has been classified as a high-tech enterprise since 2009 and eligible for an income tax rate of 15% through 2013. The local PRC government reviews the high-tech status of such enterprises annually. The income tax rate for SanDeKe is 13% for 2012, because of its foreign-invested enterprise status, and its income tax rate increased to 24% in 2013.

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

Consolidated foreign pretax loss approximated \$38.36 million and \$27.95 million for 2013 and 2012, respectively. Pretax earnings of a foreign subsidiary are subject to U.S. taxation when effectively repatriated. The Company provides income taxes on the undistributed earnings of non-U.S. subsidiaries except to the extent those earnings are invested indefinitely outside the United States. At December 31, 2013, approximately 0.94 million of accumulated undistributed earnings of non-U.S. subsidiaries was invested indefinitely. At the existing U.S. federal income tax rate, additional taxes of \$94,500 would have to be provided if such earnings were remitted currently.

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

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

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

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

18. STATUTORY RESERVES AND RESTRICTED NET ASSETS

The Company's ability to pay dividends primarily depends on the Company receiving funds from its subsidiaries. Relevant PRC statutory laws and regulations permit payments of dividends by the Company's PRC subsidiaries only out of the subsidiary's retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. The results of operations reflected in the financial statements prepared in accordance with U.S. GAAP differ from those reflected in the statutory financial statements of the Company's PRC subsidiaries.

In accordance with the PRC Regulations on Enterprises with Foreign Investment and their articles of association, a foreign-invested enterprise ("FIE") established in the PRC is required to provide certain statutory reserves, which are appropriated from net profit as reported in the FIE's PRC statutory accounts. An FIE is required to allocate at least 10% of its annual after-tax profit to the surplus reserve until such reserve has reached 50% of its respective registered capital based on the FIE's PRC statutory accounts. Appropriations to other funds are at the discretion of the board of directors for all FIEs. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. Additionally, shareholders of an FIE are required to contribute capital to satisfy the registered capital requirement of the FIE. Until such contribution of capital is satisfied, the FIE is not allowed to repatriate profits to its shareholders, unless otherwise approved by the State Administration of Foreign Exchange. Taiyu, SanDeKe, SmartHeat Siping, Jinhui, SmartHeat Investment and Ruicheng were established as FIEs and therefore are subject to the above-mandated restrictions on distributable profits. As of December 31, 2013, the Company met all registered capital requirements for its FIEs except for SmartHeat Investment, for which the Company is committed to contribute an additional \$40.00 million in registered capital by April 2015.

Additionally, in accordance with the Company Law of the PRC, a domestic enterprise is required to provide surplus reserve at least 10% of its annual after-tax profit until such reserve has reached 50% of its respective registered capital based on the enterprise's PRC statutory accounts. A domestic enterprise is also required to provide discretionary surplus reserve, at the discretion of the board of directors, from the profits determined in accordance with the enterprise's PRC statutory accounts. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. SmartHeat Energy, SmartHeat Trading and SmartHeat Pump were established as domestic enterprises and therefore are subject to the above-mentioned restrictions on distributable profits.

As a result of these PRC laws and regulations that require annual appropriations of 10% of after-tax income to be set aside prior to payment of dividends as general reserve fund, the Company's PRC subsidiaries are restricted in their ability to transfer a portion of their net assets to the Company as a dividend.

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19. STOCKHOLDERS' EQUITY

Stock Options to Independent Directors and Officer

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

On February 1, 2010, the Company issued stock options to an officer. The terms of the options were 5,000 shares at an exercise price per share of \$118.50, with a life of five years and vesting over two years as follows: 2,500 shares vested on June 30, 2011, and 2,500 shares vested on June 29, 2012. The options were valued using a volatility of 74%, risk free interest rate of 2.76%, and dividend yield of 0%. The grant-date FV of the options was \$367,107. On May 25, 2012, the officer resigned from his position as VP of Strategy and Development of the Company, and was not entitled to the remaining unvested options. The remaining obligations of the Company to the officer were released pursuant to a severance agreement and mutual release.

Based on the FV method under SFAS No. 123 (Revised), "Share Based Payment" ("SFAS 123(R)") (codified in FASB ASC Financial Instruments, Topic 718 & 505), the FV of each stock option granted is estimated on the date of the grant using the Black-Scholes option-pricing model. The Black-Scholes option-pricing model has assumptions for risk-free interest rates, dividends, stock volatility and expected life of an option grant. The risk-free interest rate is based upon market yields for U.S. Treasury debt securities at a maturity near the term remaining on the option. Dividend rates are based on the Company's dividend history. The stock volatility factor is based on the historical volatility of the Company's stock price. The expected life of an option grant is based on management's estimate. The FV of each option grant to independent directors is calculated by the Black-Scholes method and is recognized as compensation expense over the vesting period of each stock option award.

Following is a summary of the option activity:

	Number of Shares	Average Exercise Price per Share	Weighted Average Remaining Contractual Term in Years
Outstanding at January 1, 2012	6,000	106.40	2.83
Exercisable at January 1, 2012	3,500	97.80	2.65
Granted	-	-	-
Exercised	-	-	-
Forfeited	2,500	118.50	-
Outstanding at December 31, 2012	3,500	\$ 97.80	1.65

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Exercisable at December 31, 2012	3,500	\$ 97.80	1.65
Granted	-	-	-
Exercised	-	-	-
Forfeited	1,000	46.00	-
Outstanding at December 31, 2013	2,500	\$ 118.5	1.34
Exercisable at December 31, 2013	2,500	\$ 118.5	1.34

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

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Common Stock Issued

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

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

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

The Company had \$100,000 payable to a consulting firm that was paid by a third party on behalf of the Company during 2012, this payable to the third party was assumed by Northtech on August 23, 2013, for 200,000 shares of the Company’s common stock issued in September 2013. The stock price was \$0.60 on August 23, 2013, the Company recognized \$20,000 loss for the settlement of this payable by shares with Northtech (see Note 15).

On June 25, 2013, the Board approved second amendment to the credit and security agreement and on August 23, 2013, the Company entered into second amendment to the credit and security agreement with Northtech, which redefined the “base rate”, and adjusted the base rate to 10% annually, compounded quarterly, effective January 1, 2013. The Company delivered Northtech 100,000 restricted shares of the Company’s common stock as an Amendment Fee. The FV of the stocks issued for the Amendment fee was \$60,000 (See Note 15).

On September 17, 2013, the Company’s BOD approved the issuance of 100,000 restricted shares of common stock to Northtech for their consent to the Company to enter into an Equity Interest Purchase Agreement as contemplated by the stalking horse proposal and approved by the Company’s Board. The stock price on the approval date is \$0.30, the fair value of the shares issued was \$30,000. Under the terms of the Equity Interest Purchase Agreement, the buyers agreed to purchase 40% of the Company’s equity interests in the following PHE segment subsidiaries: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the “Target Companies”). The purchase price is RMB 5,000,000 (\$801,000), was paid by the buyers on December 30, 2013.

20. OTHER INCOME

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

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21. COMMITMENTS

Executive Agreements

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

The shares are restricted from being sold or transferred to more than 10 persons or entities, until June 30, 2017. The Company has the option to repurchase the shares for \$0.20 per share until January 31, 2013, \$0.40 per share until September 30, 2013, \$0.60 per share until June 30, 2014, and \$0.80 per share until January 31, 2016.

Lease Agreements

The Company leased offices for its sales representative in several different cities under various one-year, non-cancellable and renewable operating lease agreements. Rental expense for the years ended December 31, 2013 and 2012, was \$425,400 and \$766,000, respectively.

Capital Contribution

The Company formed SmartHeat Investment on April 7, 2010, as an investment holding company with registered capital of \$70 million to enable its establishment and investment in new businesses in China. Under PRC company law, registered capital must be used in the operations of the domestic company within its approved business scope. SmartHeat Investment was established as a separate subsidiary of the Company to allow allocation of capital to new businesses in China separate from its existing subsidiaries and operations. As a PRC investment holding company, the \$70 million in approved registered capital of SmartHeat Investment is deemed a planned investment amount for the entity, not a traditional registered capital requirement under PRC corporate law. The Company contributed \$30 million in capital to SmartHeat Investment on April 15, 2010, from proceeds of its public offering that closed on September 22, 2009. On April 12, 2010, SmartHeat Investment formed SmartHeat Energy, a wholly owned subsidiary in Shenyang with registered capital of \$30 million, subsequently satisfied out of the registered capital of SmartHeat Investment, for the research, development, manufacturing and sale of energy products. As of December 31, 2013, the Company is committed to contributing the remaining \$40 million in registered capital to SmartHeat Investment by April 2015. The Company may satisfy this contribution through cash flow provided by operations, sales of assets, such as physical assets, financial assets, or interests in its subsidiaries, and funds raised through offerings of its securities, if and when the Company determines such offerings are required, and at such time that the Company identifies a new acquisition, investment or business opportunity to be financed through SmartHeat Investment, although no specific investment candidate has been identified to date.

Restructuring Agreement with a Consulting Firm

On April 23, 2012, the Company entered into an agreement ("Agreement") with Nimbus Restructuring Manager LLC ("Nimbus"), for advice on raising capital and restructuring the Company to maximize value for the benefit of all of the stockholders of the Company. The agreement ran to January 23, 2013.

Upon execution of the Agreement, the Company paid \$200,000 as a deposit and a \$50,000 advance for future expenses incurred by Nimbus. Additionally, the Company paid \$70,000 per month for 6 months. An additional

\$600,000 is to be paid upon the completion of the Company's restructuring to the satisfaction of the Board.

The Company also issued and sold to Nimbus 300,000 shares of the Company's restricted common stock for \$15,000, or \$0.05 per share, the Company has the right to repurchase such shares for \$0.20 per share until January 31, 2013, \$0.40 per share until September 30, 2013, \$0.60 per share until June 30, 2014, \$0.80 per share until March 31, 2015 and \$1.00 per share until January 31, 2016. On October 12, 2012, the Company issued 300,000 shares of stock to an affiliate of Nimbus at \$0.05 per share in accordance with the restructuring agreement.

The Company shall reimburse Nimbus and its affiliates for all reasonable and appropriate out-of-pocket expenses actually incurred in performance of the services specified in the Agreement.

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On May 9, 2013, the Company entered a Restated Restructuring Agreement with Nimbus, which was intended to be a legally binding restatement of the Restructuring Agreement entered on April 23, 2012. Pursuant to the Restated Restructuring Agreement, the term was extended for an additional 12 monthly periods until January 22, 2014. A monthly service fee of \$30,000 is to be paid on the first day of each month for 10 months through November 2013. In addition, a \$300,000 termination fee will be paid on the earlier of the expiration of the stated term or the termination by the Company.

On September 18, 2013, the Company entered Amendment #1 to the Restated Restructuring Agreement with Nimbus, pursuant to the Amendment, the service term was revised after the initial expiration date of January 23, 2013, for an extension of 10 additional month until November 2013, and thereafter extended for 4 additional months until March 2014. The termination fee of \$300,000 will be paid in 4 equal monthly payments of \$75,000 each commencing in December 2013 and running through March 2014 or on the earlier of the expiration of the Stated Term or the earlier termination by the Company.

22. CONTINGENCIES

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

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

The Company's sales, purchases and expense transactions in China are denominated in RMB and all of the Company's assets and liabilities in China are also denominated in RMB. The RMB is not freely convertible into foreign currencies under the current PRC law. In China, foreign exchange transactions are required by law to be transacted only by authorized financial institutions. Remittances in currencies other than RMB may require certain supporting documentation in order to affect the remittance.

Legal Proceedings

On August 31, 2012, a putative class action lawsuit, Steven Leshinsky v. James Wang, et. al., which purported to allege federal securities law claims against the Company and certain of its former officers and directors, was filed in the United States District Court for the Southern District of New York. Thereafter, two plaintiffs filed competing motions to be appointed lead plaintiff in the proceeding. A lead plaintiff was appointed and an amended complaint was filed on January 28, 2013, by the Rosen Law Firm. The amended complaint included Oliver Bialowons, our President, and Michael Wilhelm, our former Chief Financial Officer, as defendants in the proceeding though they were not officers of the Company during the alleged class period. A second amended complaint was filed on April 8, 2013, under the caption Stream Sicav, DharanendraRai et al. v. James Jun Wang, SmartHeat, Inc. et al., removing Messrs. Wilhelm and Bialowons as defendants. The second amended complaint alleges two counts against the Company, both for violations of the federal securities laws arising from alleged insider sales or management sales of securities and alleged false disclosures relating to those sales. On May 8, 2013, we filed a motion to dismiss the second amended complaint on the grounds that, among other things, the plaintiffs did not, in fact, allege that a member of our senior management team had sold their shares. The motion to dismiss was subsequently denied and the

court set a discovery and class briefing schedule. On March 17, 2014 the court, denied, the lead plaintiff's motion for class certification, without prejudice to move again for such certification pending (1) the resolution of Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. 2014) by the Supreme Court of the United States regarding the viability of the efficient market theory and the plaintiffs' claim that reliance, and therefore injury, can be determined on a classwide basis and (2) defendants' compliance with their discovery obligations.

23. CONDENSED FINANCIAL INFORMATION OF U.S. PARENT

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

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CONDENSED BALANCE SHEETS

	2013	2012
ASSETS		
Cash and equivalents	\$ 251,461	\$ 82,479
Investment in subsidiaries	43,777,097	107,327,917
Other current assets	3,830,224	3,083,928
TOTAL ASSETS	\$ 47,858,782	\$ 110,494,324
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accrued liabilities and other payables	\$ 3,562,896	\$ 1,982,870
STOCKHOLDERS' EQUITY:		
Common stock	\$ 6,133	\$ 5,733
Additional paid-in capital	81,901,266	103,607,559
Statutory reserve	5,389,056	5,396,014
Other comprehensive income	8,991,270	11,273,497
Retained earnings	(51,991,839)	(11,771,349)
Total stockholders' equity	44,295,886	108,511,454
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 47,858,782	\$ 110,494,324

CONDENSED STATEMENTS OF OPERATIONS

Operating expenses		
General and administrative expenses	\$ 1,531,085	\$ 2,073,546
Loss from operations	(1,531,085)	(2,073,546)
Non-operating income (expenses)	(1,006,242)	809,246
Equity loss in subsidiaries	(37,985,421)	(27,952,782)
Total non-operating loss	(38,991,663)	(27,143,536)
Loss before income tax	(40,522,748)	(29,217,082)
Income tax	-	-
Net loss	\$ (40,522,748)	\$ (29,217,082)

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CONDENSED STATEMENTS OF CASH FLOWS

	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (40,522,748)	\$ (29,217,082)
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation	-	37,919
Stock issued for consulting service	-	75,000
Shares issued for loan consenting fee	30,000	-
Loss (Gain) on settlement of debt	20,000	(813,245)
Amortization of loan origination and extension fee	102,477	-
Amortization of loan amendment fee paid by shares	31,315	-
Equity loss in subsidiaries	37,985,421	27,952,782
Loss on sale of equity interest	842,491	-
Increase in current assets	-	880,750
Increase in current liabilities	367,185	2,001,959
Net cash (used in) provided by operating activities	(1,143,858)	918,083
CASH FLOWS FROM INVESTING ACTIVITIES		
Investment in subsidiaries	-	(2,422,800)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Credit line payable	1,312,841	1,284,837
Proceeds from issuance of common stock	-	20,000
Net cash provided by financing activities	1,312,841	1,304,837
NET INCREASE (DECREASE) IN CASH & EQUIVALENTS	168,982	(199,880)
CASH & EQUIVALENTS, BEGINNING OF YEAR	82,479	282,359
CASH & EQUIVALENTS, END OF YEAR	\$ 251,461	\$ 82,479

24. SUBSEQUENT EVENTS

On March 27, 2014, SmartHeat Inc. received notice pursuant to the Equity Interest Purchase Agreement, dated October 10, 2013, whereby the buyers thereunder exercised their option to purchase an additional 40% of the equity interests in the following PHE segment subsidiaries from the Company: SmartHeat Taiyu (Shenyang) Energy; SmartHeat Siping Beifang Energy Technology Co., Ltd.; SmartHeat (Shenyang Energy Equipment) Co. Ltd.; Hohot Ruicheng Technology Co., Ltd.; and Urumchi XinRui Technology Limited Liability Company (collectively, the "Target Companies"). The closing of transaction will be scheduled to occur after satisfaction of the conditions set forth in the Equity Interest Purchase Agreement, including, without limitation, approval of the transaction by a majority of the Company's shareholders entitled to vote.

On March 26, 2014, the Company gave notice to Northtech Holdings, Inc. pursuant to the terms of the Credit and Security Agreement between the Company and Northtech, dated July 27, 2012, as amended, extending the maturity date on the Credit Agreement from April 30, 2014 to January 3, 2015. The Company elected to pay the extension fee of 4% by issuing 200,000 shares of its common stock to Northtech. The terms of the Credit Agreement were previously approved by the Company's shareholders on December 11, 2012.

On March 27, 2014, The Compensation Committee of the Board approved to grant certain individuals the Company's common stock in recognition of their valuable services to the Company and its subsidiaries in 2013. The individual and number of shares granted is as follows: 100,000 shares to Bialowons, 50,000 shares to Jane Ai, 50,000 shares to Rhett Wang and 50,000 shares to Ken Scripta. The stock price is \$0.13 on grant date, and the FV of the shares granted at the grant date is \$32,500.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: April 14, 2014	SMARTHEAT INC. (Registrant) By: /s/ Oliver Bialowons Oliver Bialowons President (Principal Executive Officer)
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Power of Attorney

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Oliver Bialowons his or her attorney-in-fact for him or her in any and all capacities, to sign any amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that said attorney-in-fact, or his substitute or substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Oliver Bialowons Oliver Bialowons	President and Director (Principal Executive Officer)	April 14, 2014
/s/ Yingkai Wang Yingkai Wang	Acting Chief Accountant (Principal Financial and Accounting Officer)	April 14, 2014
/s/ Kenneth Scipta Kenneth Scipta	Director	April 14, 2014
/s/ Weiguo Wang Weiguo Wang	Director	April 14, 2014
/s/ Xin Li Xin Li	Director	April 14, 2014
/s/ Qingtai Kong Qingtai Kong	Director	April 14, 2014

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EXHIBIT INDEX

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

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

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10.13	December 2012 Amendment to the Credit and Security Agreement between SmartHeat Inc., and Northtech Holdings, Inc., dated December 21, 201
10.14	August 2013 Amendment to the Credit and Security Agreement between SmartHeat Inc. and Northtech Holdings Inc., dated August 23, 2013 (Incorporated herein by reference to Exhibit 10.14 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.15	Assignment and Assumption Agreement between SmartHeat Inc., and Northtech Holdings Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.15 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.16	Assignment Agreement between SmartHeat Inc. and Heat HP, Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.16 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.17	Assignment Agreement between SmartHeat Inc. and Heat PHE, Inc., dated August 23, 2013(Incorporated herein by reference to Exhibit 10.17 to the Company's Current Report on Form 8-K filed on August 6, 2010)
10.18	Equity Interest Purchase Agreement by and between SmartHeat Inc. and the Buyers, dated October 10, 2013 (Incorporated herein by reference to Exhibit 10.18 to the Company's Current Report on Form 8-K filed on October 10, 2010)
21.1†	<u>Subsidiaries of the Registrant</u>
24.1†	Power of Attorney (Included on the Signature Page of this Annual Report on Form 10-K)
31.1†	<u>Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2†	<u>Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1‡	<u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Executive Officer</u>
32.2‡	<u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, as signed by the Chief Financial Officer</u>
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

Indicates management contract or compensatory plan, contract or arrangement.

† Filed herewith.

‡ Furnished herewith.

