

SMARTHEAT INC.  
Form S-1/A  
March 24, 2009

AS FILED WITH THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION ON MARCH 24, 2009

REGISTRATION NO. 333-154415

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

FORM S-1/A

AMENDMENT NO. 3

REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

SmartHeat Inc.  
(Name of Registrant as specified in its charter)

Nevada  
(State or other jurisdiction  
of incorporation)

000-53052  
(Commission File Number)

98 -0514768  
(IRS Employer  
Identification No.)

A-1, 10, Street 7  
Shenyang Economic and Technological Development Zone  
Shenyang, China 110027  
+86 (24) 2519-7699  
(Address and telephone number of principal executive offices and principal place of business)

Mr. Jun Wang  
Chief Executive Officer  
SmartHeat Inc.  
A-1, 10, Street 7  
Shenyang Economic and Technological Development Zone  
Shenyang, China 110027  
+86 (24) 2519-7699  
(Name, address and telephone number of agent for service)

Copies to:

Robert Newman, Esq.  
The Newman Law Firm, PLLC  
14 Wall Street, 20th Floor  
New York, NY 10005  
(212) 618 1968

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box:

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If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

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If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

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

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

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with section 8(a) of the Securities Act of 1933, as amended, or until the registration statement shall become effective on such date as the United States Securities and Exchange Commission, acting pursuant to said section 8(a), may determine.

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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting offers to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS; SUBJECT TO COMPLETION, MARCH 24, 2009

SMARTHEAT INC.

2,023,000 Shares of Common Stock

The selling shareholders identified in this prospectus may offer and sell up to an aggregate of 2,023,000 shares of our common stock which we have issued to them, or which we may issue to them upon the exercise of certain warrants issued to them. All of the shares and warrants were issued to the selling shareholders in a private placement transaction completed prior to the filing of the registration statement of which this prospectus is a part.

We are not selling any shares of our common stock in this offering and will not receive any proceeds from this offering. We may receive proceeds on exercise of outstanding warrants for shares of common stock covered by this prospectus if the warrants are exercised for cash.

The selling shareholders may offer the shares covered by this prospectus at fixed prices, at prevailing market prices at the time of sale, at varying prices or negotiated prices, in negotiated transactions, or in trading markets for our common stock. We will bear all costs associated with this registration.

Our common stock trades on the Nasdaq Global Market under the symbol "HEAT." The closing price of our common stock on the Nasdaq Global Market on March 20, 2009 was \$6.10 per share.

You should consider carefully the risk factors beginning on page 4 of this prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved these securities or determined that this prospectus is accurate or complete. Any representation to the contrary is a criminal offense.

The date of this preliminary prospectus is March 24, 2009.

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You may only rely on the information contained in this prospectus or that we have referred you to. We have not authorized anyone to provide you with different information. This prospectus does not constitute an offer to sell or a

solicitation of an offer to buy any securities other than the common stock offered by this prospectus. This prospectus does not constitute an offer to sell or a solicitation of an offer to buy any common stock in any circumstances in which such offer or solicitation is unlawful. Neither the delivery of this prospectus nor any sale made in connection with this prospectus shall, under any circumstances, create any implication that there has been no change in our affairs since the date of this prospectus or that the information contained by reference to this prospectus is correct as of any time after its date.

## ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement we filed with the Securities and Exchange Commission ("SEC"). You should rely only on the information provided in this prospectus and incorporated by reference in this prospectus. We have not authorized anyone to provide you with information different from that contained in or incorporated by reference into this prospectus. The selling shareholders are offering to sell, and seeking offers to buy, shares of common stock only in jurisdictions where offers and sales are permitted. The information in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or of any sale of common stock. The rules of the SEC may require us to update this prospectus in the future.

## PROSPECTUS SUMMARY

This summary highlights selected information contained elsewhere in this prospectus and does not contain all of the information you should consider in making your investment decision. Before investing in the securities offered hereby, you should read the entire prospectus, including our financial statements and related notes included in this prospectus and the information set forth under the headings "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." In this prospectus, the terms "SmartHeat," "we," "us," and "our" refer to SmartHeat Inc.

### Our Company

We are a leading provider of plate heat exchanger products to China's industrial, residential and commercial markets. We design, manufacture, sell, and service plate heat exchangers ("PHEs"), units which combine plate heat exchangers with various pumps, temperature sensors, valves, and automated control systems ("PHE Units"), and heat meters for a broad range of industries, including petroleum refining, petrochemicals, power generation, metallurgy, food & beverage and chemical processing. We sell PHEs under the Sondex brand and PHE Units designed by our engineers and assembled with Sondex plates under our Taiyu brand name. We are one of three authorized dealers of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is North China.

We were incorporated in the State of Nevada on August 4, 2006 under the name Pacific Goldrim Resources, Inc. as an exploration stage corporation that intended to engage in the exploration of silver, lead and zinc. On April 14, 2008 we changed our name to SmartHeat Inc, and acquired all of the equity interests in Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd. ("Taiyu"), a privately held company formed under the laws of the People's Republic of China ("China") engaged in the design, manufacture, sale, and servicing of plate heat exchange products in China. The acquisition of Taiyu's equity interests was accomplished pursuant to the terms of a Share Exchange Agreement dated April 14, 2008 (the "Share Exchange Agreement") by and among SmartHeat, Taiyu and all of the shareholders of Taiyu (the "Taiyu Shareholders"). At the closing under the Share Exchange Agreement, all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of Yuan 25,000,000 were exchanged for an aggregate of 18,500,000 shares of SmartHeat common stock (the "Share Exchange"). As a result of the Share Exchange, Taiyu became a wholly-owned subsidiary of SmartHeat.

Prior to our acquisition of Taiyu, we were in the development stage and had minimal business operations. We had no interest in any property, but had the right to conduct exploration activities on thirteen (13) mineral title cells covering 270,27 hectares (667,85 acres) in the Slocan Mining Division of southeastern British Columbia, Canada. In connection with the acquisition of Taiyu, the Company transferred all of its pre-closing assets and liabilities (other than the obligation to pay a \$10,000 fee to the Company's audit firm) to a wholly owned subsidiary, PGR Holdings, Inc., a Nevada corporation ("SplitCo"), under the terms of an Agreement of Conveyance, Transfer and Assignment of Assets and Assumption of Obligations dated April 14, 2008 (the "Transfer Agreement"). The Company also sold all of the outstanding capital stock of SplitCo to Jason Schlombs (the former director and officer, and a major shareholder,

of the Company) pursuant to a Stock Purchase Agreement dated April 14, 2008 (the "Split-Off Agreement") in exchange for the surrender of 2,500,000 shares of the Company's common stock held by Mr. Schlombs (the "Split-Off").

Our principal offices are located at A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110027. Our telephone number is +86 (24) 2519-7699.



## The Offering

|   |  |
|---|--|
| Common stock outstanding before the offering      | 24,179,900 shares  |
| Common stock offered by selling shareholders      | Up to 2,023,000 shares<br>The maximum number of shares to be sold by the selling shareholders, 2,023,000 shares, represents 8.23% of our outstanding stock, assuming full exercise of the warrants |
| Common stock to be outstanding after the offering | Up to 24,572,900 shares  |
| Use of proceeds                                   | We will not receive any proceeds from the sale of the common stock. However, we may receive proceeds from the exercise of the warrants. See "Use of Proceeds" for a complete description.          |
| Risk Factors                                      | The purchase of our common stock involves a high degree of risk. You should carefully review and consider "Risk Factors" beginning on page 4.  |

The above information regarding common stock to be outstanding after the offering is based on 24,179,900 shares of common stock outstanding as of March 20, 2009.

## RISK FACTORS

Our business and an investment in our securities are subject to a variety of risks. The following risk factors describe the most significant events, facts or circumstances that could have a material adverse effect upon our business, financial condition, results of operations, ability to implement our business plan, and the market price for our securities. Many of these events are outside of our control. The risks described below are not the only ones facing our company.

### Risks Related to Our Business

Our relationship with Sondex has substantially contributed to our business and its growth. We could be adversely affected if that relationship terminated

We are one of three authorized dealers appointed by Sondex A/S for PHEs for the industrial and energy sectors in China. Our territory is North China. Sondex is one of the world's leading PHE manufacturers. Our sales of Sondex PHEs have contributed to our reputation for the high quality of the products we manufacture and sell. If our relationship with Sondex were to terminate, our business, revenues, and results of operations could be adversely affected.

The markets we serve are subject to seasonality and cyclical demand, which could harm our business and make it difficult to project long-term performance

Demand for our products depends in large part upon the level of capital and maintenance expenditures of our customers and the end users. These expenditures have historically been cyclical in nature and vulnerable to economic downturns. Decreased capital and maintenance spending by our customers could have a material adverse effect on the

demand for our products and our business, financial condition and results of operations. In particular, an economic slowdown in the domestic economy may result in reduced orders for PHEs from the steel processing and petrochemical sectors and lower orders for PHE Units from the HVAC sector. To date, the Company has not been adversely affected by these trends and given the current demand visibility we do not currently foresee weakening in the demand for our products in the next year. However, the historically cyclical nature of the demand for our products limits our ability to make accurate long-term predictions about our performance. Changing world economic and political conditions may also reduce the willingness of our customers and prospective customers to purchase our products and services. The seasonality of our business results in significant operational challenges to our production and inventory control functions.

We derive a substantial part of our revenues from several major customers. If we lose any of these customers or they reduce the amount of business they do with us, our revenues may be seriously affected

Our ten largest customers accounted for 32% of our revenues for the year ended December 31, 2008. Our largest customer accounted for 6% of our revenues in the year ended December 31, 2008. These customers may not maintain the same volume of business with us in the future. If we lose any of these customers or they reduce the amount of business they do with us, our revenues may be seriously affected.

We cannot be certain that our product innovations and marketing successes will continue

We believe that our past performance has been based on, and our future success will depend, in part, upon our ability to continue to improve our existing products through product innovation and to develop, market and produce new products. We cannot assure you that we will be successful in introducing, marketing and producing any new products or product innovations, or that we will develop and introduce in a timely manner innovations to our existing products which satisfy customer needs or achieve market acceptance. Our failure to develop new products and introduce them successfully and in a timely manner could harm our ability to grow our business and could have a material adverse effect on our business, results of operations and financial condition.

Our technology may not satisfy the changing needs of our customers

With any technology, including the technology of our current and proposed products, there are risks that the technology may not successfully address all of our customers' needs. While we have already established successful relationships with our customers, their needs may change or vary. This may affect the ability of our present or proposed products to address all of our customers' ultimate technology needs in an economically feasible manner.

We may not be able to keep pace with rapid technological changes and competition in our industry

While we believe that we have hired or engaged personnel and outside consultants who have the experience and ability necessary to keep pace with advances in technology, and while we continue to seek out and develop "next generation" technology through our research and development efforts, there is no guarantee that we will be able to keep pace with technological developments and market demands in this evolving industry and market. In addition, our industry is highly competitive. Although we believe that we have developed strategic relationships to best penetrate the China market, we face competition from other manufacturers of product similar to our products. Some of our competitors' advantages over us in both the areas of products, marketing, and services include the following:

- Substantially greater revenues and financial resources;
- Stronger brand names and consumer recognition;
- The capacity to leverage marketing expenditures across a broader portfolio of products;
- Pre-existing relationships with potential customers;
- More resources to make acquisitions;
- Lower labor and development costs; and
- Broader geographic presence.

We will face different market dynamics and competition if we expand our market to other countries. In some international markets, our future competitors would have greater brand recognition and broader distribution than we have. We may not be as successful as our competitors in generating revenues in international markets due to our inability to provide products that are attractive to the market in other countries, the lack of recognition of our brand, and other factors. As a result, any international expansion efforts could be more costly and less profitable than our efforts in the domestic market in China.

If we are not as successful as our competitors in our target markets, our sales could decline, our margins could be negatively impacted and we could lose market share, any of which could materially harm our business

We depend on a limited number of suppliers of components for our products and if we are unable to obtain these components when needed, we would experience delays in manufacturing our products and our financial results could be adversely affected.

We acquire most of the components for the manufacture of our products from a limited number of suppliers. In order for us to have our products manufactured, these components must be available at the right level of quality and at the right price. Suppliers of some of these components require us to place orders with significant lead-time to assure supply in accordance with our requirements. Certain of these suppliers are currently the sole source of one or more components upon which we are dependent and alternative sources would not be available for those components unless we were to redesign our products. Other components could be obtained from alternative suppliers without redesign, but only at higher prices than we currently pay or for delivery later than required by our production schedule. We rely on Sondex for parts for our PHE products and PHE Units. If we were unable to obtain adequate supplies of parts from Sondex at commercially reasonable prices, our operations could be interrupted. We maintain a relatively small inventory of component parts for resale and our parts services business would suffer if the supply of replacement parts was reduced or terminated by our suppliers. If suppliers are not able to provide these critical components on the dates and at the prices scheduled, we may not be able to promptly and cost-effectively manufacture our products to meet customer orders which could harm our credibility and the market acceptance and sales of our products. Increased costs associated with supplied materials or components could increase our costs and reduce our profitability if we are unable to pass these cost increases on to our customers.

We are a major purchaser of certain goods and raw materials that we use in the manufacturing process of our products, and price changes for the commodities we depend on may adversely affect our profitability

Our profitability generally depends upon the margin between the cost to us of certain goods used in the manufacturing process, such as plates, pumps, water tanks, sensors and controlling systems and other raw materials as well as our fabrication costs associated with converting such goods and raw materials compared to the selling price of our products, and the overall supply of raw materials. It is our intention to base the selling prices of our products upon the associated raw materials costs to us. However, we may not be able to pass all increases in raw material costs and ancillary acquisition costs associated with taking possession of the raw materials through to our customers. Although we are currently able to obtain adequate supplies of raw materials, it is impossible to predict future availability. With the rapid growth of China's economy, the demand for certain raw materials is great while the supply may be more limited. This may affect our ability to secure the necessary raw materials in a cost-effective manner for production of our products at the volume of purchase orders that we anticipate receiving. The inability to offset price increases of raw material by sufficient product price increases, and our inability to obtain raw materials, would have a material adverse effect on our consolidated financial condition, results of operations and cash flows.

Our products may contain defects, which could adversely affect our reputation and cause us to incur significant costs

Despite testing, defects may be found in existing or new products. Any such defects could cause us to incur significant return and exchange costs, re-engineering costs, divert the attention of our engineering personnel from product development efforts, and cause significant customer relations and business reputation problems. Any such defects could force us to undertake a product recall program, which could cause us to incur significant expenses and could harm our reputation and that of our products. If we deliver products with defects, our credibility and the market acceptance and sales of our products could be harmed.

Due to the nature of our business and products, we may be liable for damages based on product liability and warranty claims

Due to the high pressures and temperatures at which many of our products are used and the fact that some of our products are relied upon by our customers or end users in their facilities or operations, or are manufactured for relatively broad consumer use, we face an inherent risk of exposure to claims in the event that the failure, use or misuse of our products results, or is alleged to result, in bodily injury, property damage or economic loss. We believe that we meet or exceed existing professional specification standards recognized or required in the industries in which we operate. We have been subject to claims in the past, none of which have had a material adverse effect on our financial condition or results of operations, and we may be subject to claims in the future. Although we currently maintain product liability coverage, which we believe is adequate for the continued operation of our business, such insurance may become difficult to obtain or may become unobtainable in the future on terms acceptable to us and may not cover warranty claims. A successful product liability claim or series of claims against us, including one or more consumer claims purporting to constitute class actions, in excess of our insurance coverage or a significant warranty claim or series of claims against us could materially decrease our liquidity and impair our financial condition.

We may experience delays in launching our products, which would negatively impact our position in the marketplace

We may experience delays in bringing new products to market, due to design, manufacturing or distribution problems. Such delays could adversely affect our ability to compete effectively and may adversely affect our relationship with our customers. Any such delays would adversely affect our revenues and our ability to become profitable.

If we are not able to manage our growth, we may not remain profitable

Our success will depend on our ability to expand and manage our operations and facilities. There can be no assurance that we will be able to manage our growth, meet the staffing requirements for our business or for additional collaborative relationships or successfully assimilate and train new employees. In addition, to manage our growth effectively, we may be required to expand our management base and enhance our operating and financial systems. If we continue to grow, there can be no assurance that the management skills and systems currently in place will be adequate or that we will be able to manage any additional growth effectively. Failure to achieve any of these goals could have a material adverse effect on our business, financial condition or results of operations.

Our business could be subject to environmental liabilities

As is the case with manufacturers of similar products, we use certain hazardous substances in our operations. Currently we do not anticipate any material adverse effect on our business, revenues or results of operations, as a result of compliance with Chinese environmental laws and regulations. However, the risk of environmental liability and charges associated with maintaining compliance with environmental laws is inherent in the nature of our business, and there is no assurance that material environmental liabilities and compliance charges will not arise in the future.

If we lose our key personnel or are unable to attract and retain additional qualified personnel, the quality of our services may decline and our business may be adversely impacted

We rely heavily on the expertise, experience and continued services of our senior management, including our president and chief executive officer. Loss of their services could adversely impact our ability to achieve our business objectives. We believe our future success will depend upon our ability to retain these key employees and our ability to attract and retain other skilled personnel. The rapid growth of the economy in China has caused intense competition for qualified personnel. We cannot guarantee that any employee will remain employed by us for any definite period of time or that we will be able to attract, train or retain qualified personnel in the future and the loss of personnel could have a material adverse effect on our business and company. Qualified employees periodically are in great demand

and may be unavailable in the time frame required to satisfy our customers' requirements. We need to employ additional personnel to expand our business. There is no assurance that we will be able to attract and retain sufficient numbers of highly skilled employees in the future. The loss of personnel or our inability to hire or retain sufficient personnel at competitive rates could impair the growth of our business.

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If we fail to establish and maintain an effective system of internal control, we may not be able to report our financial results accurately or to prevent fraud. Any inability to report and file our financial results accurately and timely could harm our business and adversely impact the trading price of our common stock

We are required to establish and maintain internal controls over financial reporting, disclosure controls, and to comply with other requirements of the Sarbanes-Oxley Act and the rules promulgated by the SEC thereunder. Our management, including our Chief Executive Officer and Chief Financial Officer, cannot guarantee that our internal controls and disclosure controls will prevent all possible errors or all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefit of controls must be relative to their costs. Because of the inherent limitations in all control systems, no system of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Further, controls can be circumvented by individual acts of some persons, by collusion of two or more persons, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, a control may become inadequate because of changes in conditions or the degree of compliance with policies or procedures may deteriorate. Because of inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and may not be detected.

We may need additional capital to execute our business plan and fund operations and may not be able to obtain such capital on acceptable terms or at all

Capital requirements are difficult to plan in our rapidly changing industry. Although we currently expect to have sufficient funding for the next 12 months, we expect that we will need additional capital to fund our future growth.

Our ability to obtain additional capital on acceptable terms or at all is subject to a variety of uncertainties, including:

- Investors' perceptions of, and demand for, companies in our industry;
- Investors' perceptions of, and demand for, companies operating in China;
- Conditions of the U.S. and other capital markets in which we may seek to raise funds;
- Our future results of operations, financial condition and cash flows;
- Governmental regulation of foreign investment in companies in particular countries;
- Economic, political and other conditions in the United States, China, and other countries; and
- Governmental policies relating to foreign currency borrowings.

We may be required to pursue sources of additional capital through various means, including joint venture projects and debt or equity financings. There is no assurance that we will be successful in locating a suitable financing transaction in a timely fashion or at all. In addition, there is no assurance that we will be successful in obtaining the capital we require by any other means. Future financings through equity investments are likely to be dilutive to our existing stockholders. Also, the terms of securities we may issue in future capital transactions may be more favorable for our new investors. Newly issued securities may include preferences, superior voting rights, the issuance of



warrants or other derivative securities, and the issuances of incentive awards under equity employee incentive plans, which may have additional dilutive effects. Further, we may incur substantial costs in pursuing future capital and/or financing, including investment banking fees, legal fees, accounting fees, printing and distribution expenses and other costs. We may also be required to recognize non-cash expenses in connection with certain securities we may issue, such as convertible notes and warrants, which will adversely impact our financial condition.

If we cannot raise additional funds on favorable terms or at all, we may not be able to carry out all or parts of our strategy to maintain our growth and competitiveness or to fund our operations. If the amount of capital we are able to raise from financing activities, together with our revenues from operations, is not sufficient to satisfy our capital needs, even to the extent that we reduce our operations accordingly, we may be required to cease operations.

We may be subject to claims that we have infringed the proprietary rights of others, which could require us to obtain a license or change our designs

Although we do not believe that any of our products infringe the proprietary rights of others, there is no assurance that infringement or invalidity claims (or claims for indemnification resulting from infringement claims) will not be asserted or prosecuted against us or that any such assertions or prosecutions will not materially adversely affect our business. Regardless of whether any such claims are valid or can be successfully asserted, defending against such claims could cause us to incur significant costs and could divert resources away from our other activities. In addition, assertion of infringement claims could result in injunctions that prevent us from distributing our products. If any claims or actions are asserted against us, we may seek to obtain a license to the intellectual property rights that are in dispute. Such a license may not be available on reasonable terms, or at all, which could force us to change our designs.

#### Risks Related to Doing Business in China

We are subject to economic and political risks in China over which we have little or no control and may be unable to alter our business practice in time to avoid the possibility of reduced revenues

Our business is conducted in China. Doing business outside the United States, particularly in China, subjects us to various risks, including changing economic and political conditions, major work stoppages, exchange controls, currency fluctuations, armed conflicts and unexpected changes in United States and foreign laws relating to tariffs, trade restrictions, transportation regulations, foreign investments and taxation. We have no control over most of these risks and may be unable to anticipate changes in international economic and political conditions and, therefore, unable to alter our business practice in time to avoid the possibility of reduced revenues.

Substantially all of our assets are located in China and all of our revenue is derived from our operations in China. Accordingly, our results of operations and prospects are subject, to a significant extent, to the economic, political and legal developments in China

While China's economy has experienced significant growth in the past twenty years, such growth has been uneven, both geographically and among various sectors of the economy. The Chinese government has implemented various measures to encourage economic growth and guide the allocation of resources. Some of these measures benefit the overall economy of China, but they may also have a negative effect on us. For example, our operating results and financial condition may be adversely affected by the government control over capital investments or changes in tax regulations. The economy of China has been changing from a planned economy to a more market-oriented economy. In recent years China has implemented measures emphasizing the utilization of market forces for economic reform and the reduction of state ownership of productive assets, and the establishment of corporate governance in business enterprises. However, a substantial portion of productive assets in China are still owned by the government. In addition, the government continues to play a significant role in regulating industry development by imposing industrial policies. It also exercises significant control over China's economic growth through the allocation of resources, the control of payment of foreign currency-denominated obligations, the setting of monetary policy and the provision of preferential treatment to particular industries or companies.

We may have difficulty establishing adequate management, legal and financial controls in China

China historically has not adopted a Western style of management and financial reporting concepts and practices, or modern banking, computer or other control systems. We may have difficulty in hiring and retaining a sufficient number of qualified employees to work in China. As a result of these factors, we may experience difficulty in establishing management, legal and financial controls, collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet Western standards.

Our bank accounts are not insured or protected against loss

We maintain our cash with various banks and trust companies located in China. Our cash accounts are not insured or otherwise protected. Should any bank or trust company holding our cash deposits become insolvent, or if we are otherwise unable to withdraw funds, we would lose the cash on deposit with that particular bank or trust company.

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As we have limited business insurance coverage in China, any loss which we suffer may not be insured or may be insured to only a limited extent

The insurance industry in China is still in an early state of development and insurance companies located in China offer limited business insurance products. In the event of damage or loss to our properties, our insurance may not provide as much coverage as if we were insured by insurance companies in the United States.

Tax laws and regulations in China are subject to substantial revision, some of which may adversely affect our profitability

The Chinese tax system is in a state of flux, and it is anticipated that China's tax regime will be altered in the coming years. Tax benefits that we presently enjoy may not be available in the wake of these changes, and we could incur tax obligations to our government that are significantly higher than anticipated. These increased tax obligations could negatively impact our financial condition and our revenues, gross margins, profitability and results of operations may be adversely affected as a result.

Certain tax exemptions that we presently enjoy in China are scheduled to expire over the next several years

As a substantial portion of our operations are located in a privileged economic zone, we are entitled to certain tax benefits. When these exemptions expire, our income tax expenses will increase, reducing our net income below what it would be if we continued to enjoy these exemptions.

We may face judicial corruption in China

Another obstacle to foreign investment in China is corruption. There is no assurance that we will be able to obtain recourse in any legal disputes with suppliers, customers or other parties with whom we conduct business, if desired, through China's poorly developed and sometimes corrupt judicial systems.

If relations between the United States and China worsen, investors may be unwilling to hold or buy our stock and our stock price may decrease

At various times during recent years, the United States and China have had significant disagreements over political and economic issues. Controversies may arise in the future between these two countries. Any political or trade controversies between the United States and China, whether or not directly related to our business, could reduce the price of our common stock.

China could change its policies toward private enterprise or even nationalize or expropriate private enterprises

Our business is subject to significant political and economic uncertainties and may be affected by political, economic and social developments in China. Over the past several years, the Chinese government has pursued economic reform policies including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue to pursue these policies or may significantly alter them to our detriment from time to time with little, if any, prior notice.

Uncertainties with respect to the Chinese legal system could limit legal protections available to us

Our operating subsidiary, which conducts most of its operations in China, is generally subject to laws and regulations applicable to foreign investment in China. The Chinese legal system is based on written statutes, and prior court decisions may be cited for reference but have no precedential value. Since 1979, legislation and regulations have significantly enhanced the protections afforded to various forms of foreign investments in China. However, since

these laws and regulations are relatively new and the legal system in China continues to rapidly evolve, the interpretations of many laws, regulations and rules are not always uniform and enforcement of these laws, regulations and rules involve uncertainties, which may limit legal protections available to us. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention.

Limitations on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations

We are a holding company and conduct substantially all of our business through our operating subsidiary in China. We will of necessity rely on dividends paid by our subsidiaries 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, regulations in China currently permit payment of dividends only out of accumulated profits as determined in accordance with Chinese accounting standards and regulations. Our Chinese subsidiary is also required to set aside at least 10% of its after-tax profit based on Chinese accounting standards each year to its general reserves until the accumulative amount of such reserves reaches 50% of its registered capital. These reserves are not distributable as cash dividends. In addition, it is required to allocate a portion of its after-tax profit to its staff welfare and bonus fund at the discretion of its board of directors. Moreover, if our subsidiary incurs debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other distributions to us. Any limitation on the ability of our subsidiary 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.

Recent Chinese regulations relating to the establishment of offshore special purpose companies by Chinese residents and registration requirements for employee stock ownership plans or share option plans may subject our China resident shareholders to personal liability and limit our ability to acquire Chinese companies or to inject capital into our operating subsidiaries in China, limit our subsidiaries' ability to distribute profits to us, or otherwise materially and adversely affect us

The State Administration of Foreign Exchange ("SAFE") issued a public notice in October 2005, requiring PRC residents, including both legal persons and natural persons, to register with the competent local SAFE branch before establishing or controlling any company outside of China, referred to as an "offshore special purpose company," for the purpose of acquiring any assets of or equity interest in PRC companies and raising funds from overseas. In addition, any PRC resident that is the shareholder of an offshore special purpose company is required to amend his or her SAFE registration with the local SAFE branch, with respect to that offshore special purpose company in connection with any increase or decrease of capital, transfer of shares, merger, division, equity investment or creation of any security interest over any assets located in China. To further clarify the implementation of Circular 75, the SAFE issued Circular 124 and Circular 106 on November 24, 2005 and May 29, 2007, respectively. Under Circular 106, PRC subsidiaries of an offshore special purpose company are required to coordinate and supervise the filing of SAFE registrations by the offshore holding company's shareholders who are PRC residents in a timely manner. If these shareholders fail to comply, the PRC subsidiaries are required to report to the local SAFE authorities. If the PRC subsidiaries of the offshore parent company do not report to the local SAFE authorities, they may be prohibited from distributing their profits and proceeds from any reduction in capital, share transfer or liquidation to their offshore parent company and the offshore parent company may be restricted in its ability to contribute additional capital into its PRC subsidiaries. Moreover, failure to comply with the above SAFE registration requirements could result in liabilities under PRC laws for evasion of foreign exchange restrictions. Some of our PRC resident beneficial owners have not registered with the local SAFE branch as required under SAFE regulations. The failure or inability of these PRC resident beneficial owners to comply with the applicable SAFE registration requirements may subject these beneficial owners or us to fines, legal sanctions and restrictions described above.

On March 28, 2007, SAFE released detailed registration procedures for employee stock ownership plans or share option plans to be established by overseas listed companies and for individual plan participants. Any failure to comply with the relevant registration procedures may affect the effectiveness of our employee stock ownership plans or share option plans and subject the plan participants, the companies offering the plans or the relevant intermediaries, as the case may be, to penalties under PRC foreign exchange regime. These penalties may subject us to fines and legal

sanctions, prevent us from being able to make distributions or pay dividends, as a result of which our business operations and our ability to distribute profits to you could be materially and adversely affected.

In addition, the National Development and Reform Commission ("NDRC") promulgated a rule in October 2004, or the NDRC Rule, which requires NDRC approvals for overseas investment projects made by PRC entities. The NDRC Rule also provides that approval procedures for overseas investment projects of PRC individuals must be implemented with reference to this rule. However, there exist extensive uncertainties in terms of interpretation of the NDRC Rule with respect to its application to a PRC individual's overseas investment, and in practice, we are not aware of any precedents that a PRC individual's overseas investment has been approved by the NDRC or challenged by the NDRC based on the absence of NDRC approval. Our current beneficial owners who are PRC individuals did not apply for NDRC approval for investment in us. We cannot predict how and to what extent this will affect our business operations or future strategy. For example, the failure of our shareholders who are PRC individuals to comply with the NDRC Rule may subject these persons or our PRC subsidiary to certain liabilities under PRC laws, which could adversely affect our business.

Regulation of loans and direct investment by offshore holding companies to Chinese entities may delay or prevent us from making loans or additional capital contributions to our operating subsidiaries, which could materially and adversely affect our liquidity and our ability to fund and expand our business

As an offshore holding company of our Chinese operating subsidiaries, we may need to make loans to them, or we may need to make additional capital contributions to them.

Any loans to our operating subsidiaries are subject to Chinese regulations. For example, loans by us to our subsidiaries in China, which are foreign-invested enterprises, to finance their activities cannot exceed statutory limits and must be registered with the SAFE.

We may also decide to finance our subsidiaries by means of capital contributions. These capital contributions must be approved by the PRC Ministry of Commerce or its local counterpart. We cannot assure you that we will be able to obtain these government approvals on a timely basis, if at all, with respect to future capital contributions by us to our subsidiaries. If we fail to receive such approvals, our ability to use the proceeds of this offering and to capitalize our PRC operations may be negatively affected, which could adversely affect our liquidity and our ability to fund and expand our business.

Restrictions on currency exchange may limit our ability to receive and use our revenues effectively

The Renminbi is currently convertible under the “current account,” which includes dividends, trade and service-related foreign exchange transactions, but not under the “capital account,” which includes foreign direct investment and loans. Currently, our Chinese subsidiary may purchase foreign currencies for settlement of current account transactions, including payments of dividends to us, without the approval of SAFE. However, the relevant Chinese government authorities may limit or eliminate their ability to purchase foreign currencies in the future. Since a significant amount of our future revenues will be denominated in Renminbi, any existing and future restrictions on currency exchange may limit our ability to utilize revenues generated in Renminbi to fund our business activities outside China that are denominated in foreign currencies.

Foreign exchange transactions by our Chinese subsidiaries under the capital account continue to be subject to significant foreign exchange controls and require the approval of or need to register with Chinese governmental authorities, including SAFE. In particular, if our Chinese subsidiaries borrow foreign currency loans from us or other foreign lenders, these loans must be registered with SAFE, and if we finance our Chinese subsidiaries by means of additional capital contributions, these capital contributions must be approved by certain government authorities, including the NDRC, the Ministry of Commerce, or MOFCOM, or their respective local counterparts. These limitations could affect the ability of our Chinese subsidiaries to obtain foreign exchange through debt or equity financing.

We face risks associated with currency exchange rate fluctuations; any adverse fluctuation may adversely affect our operating margins

Almost all of our revenues are denominated in Renminbi. Conducting business in currencies other than US dollars subjects us to fluctuations in currency exchange rates that could have a negative impact on our reported operating results. Fluctuations in the value of the US dollar relative to other currencies impact our revenues, cost of revenues and operating margins and result in foreign currency translation gains and losses. If the exchange rate of the Renminbi is affected by lowering its value as against the US dollar, our reported profitability when stated in US dollars will decrease. Historically, we have not engaged in exchange rate hedging activities and have no current intention of doing so.





We may not be able to adequately protect our technology and other proprietary rights

Our success will depend in part on our ability to obtain and protect our products, methods, processes and other technologies, to preserve our trade secrets, and to operate without infringing on the proprietary rights of third parties both domestically and abroad. We have patents and patent applications pending in China, and have worked and continue to work closely with Chinese patent officials to preserve our intellectual property rights. Despite these efforts, any of the following occurrences may reduce the value of our intellectual property:

- Our applications for patents and trademarks relating to our business may not be granted and, if granted, may be challenged or invalidated;
- Issued patents and trademarks may not provide us with any competitive advantages;
- Our efforts to protect our intellectual property rights may not be effective in preventing misappropriation of our technology;
- Our efforts may not prevent the development and design by others of products or technologies similar to or competitive with, or superior to those we develop; or
- Another party may obtain a blocking patent and we would need to either obtain a license or design around the patent in order to continue to offer the contested feature or service in our products.

It will be extremely difficult to acquire jurisdiction and enforce liabilities against our officers, directors and assets based in China

Our executive officers and several of our directors, including the chairman of our Board of Directors, are Chinese citizens. It may be difficult, if not impossible, to acquire jurisdiction over these persons in the event a lawsuit is initiated against us and/or our officers and directors by a stockholder or group of stockholders in the United States. Also, because our operating subsidiaries and assets are located in China, it may be extremely difficult or impossible for you to access those assets to enforce judgments rendered against us or our directors or executive offices by United States courts. In addition, the courts in China may not permit the enforcement of judgments arising out of United States federal and state corporate, securities or similar laws. Accordingly, United States investors may not be able to enforce judgments against us for violation of United States securities laws.

#### Risks Related to Our Securities

Our common stock price is subject to significant volatility, which could result in substantial losses for investors.

During the nine month period ended January 28, 2009, the high and low bid prices of our common stock on the Over-The-Counter Bulletin Board ("OTCBB") were \$6.50 per share and \$2.00 per share, respectively. We began trading on the Nasdaq Stock Market on January 29, 2009 and were subsequently listed on the Nasdaq Global Market on March 10, 2009. The high and low sales prices of our common stock were \$7.50 and \$4.11, from January 29, 2009 to March 20, 2009. Prices for our shares are determined in the marketplace and may accordingly be influenced by many factors, including, but not limited to:

- the depth and liquidity of the market for the shares;
- quarter-to-quarter variations in our operating results;

- announcements about our performance as well as the announcements of our competitors about the performance of their businesses;
- investors' evaluations of our future prospects and the food industry generally,
- changes in earnings estimates by, or failure to meet the expectations of, securities analysts;

- our dividend policy; and
- general economic and market conditions.

In addition, the stock market often experiences significant price fluctuations that are unrelated to the operating performance of the specific companies whose stock is traded. These market fluctuations could adversely affect the trading price of our shares.

The price at which investors purchase shares of our common stock may not be indicative of the price that will prevail in the trading market. Investors may be unable to sell their shares of common stock at or above their purchase price, which may result in substantial losses.

Shares of our common stock lack a significant trading market.

On April 22, 2008, shares of our common stock began trading on the OTCBB. On January 29, 2009, shares of our common stock began trading on the Nasdaq Stock Market and were subsequently listed on the Nasdaq Global Market on March 10, 2009. Since April 22, 2008, our average daily trading volume has been less than 10,000 shares per day. As with most initial listings on the Nasdaq Stock Market, it will take time for a significant active trading market in our common stock to develop. There can be no assurance that a significant active trading market in our common stock will develop, or if such a market develops, that it will be sustained.

Our director and Chief Executive Officer has a substantial ownership interest in one of our major stockholders which gives him significant influence over certain major decisions on which our stockholders may vote and may discourage an acquisition of us

Mr. Jun Wang, our director and Chief Executive Officer, owns 50% of the equity in Beijing YSKN Machinery & Electronic Equipment Co., Ltd ("YSKN"), a company which is the record holder of 28.16% of our outstanding common stock. Mr. Wang has substantial influence over the actions of that substantial stockholder. As a result, Mr. Wang has significant influence over all corporate actions requiring stockholder approval, irrespective of how the Company's other stockholders may vote, including the following actions:

- electing or defeating the election of our directors;
- amending or preventing amendment of our certificate of incorporation or bylaws;
- effecting or preventing a merger, sale of assets or other corporate transaction; and
- controlling the outcome of any other matter submitted to the shareholders for vote.

The interests of Mr. Wang may differ from the interests of other stockholders. This may discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Company, which in turn could reduce our stock price or prevent our stockholders from realizing a premium over our stock price.

Because we obtained our present operations by means of a "reverse acquisition," we may not be able to attract the attention of major brokerage firms

There may be risks associated with our use of a "reverse acquisition" to obtain our present operations. Securities analysts of major brokerage firms may not provide coverage of us since there is no incentive to brokerage firms to recommend the purchase of our common stock. No assurance can be given that brokerage firms will, in the future, want to conduct any secondary offerings on our behalf.

Future sales of shares of our common stock by our stockholders could cause our stock price to decline

We cannot predict the effect, if any, that market sales of shares of our common stock or the availability of shares of common stock for sale will have on the market price prevailing from time to time. If our stockholders sell substantial amounts of our common stock in the public market upon the effectiveness of a registration statement, or upon the expiration of any holding period under Rule 144, such sales could create a circumstance commonly referred to as an "overhang" and in anticipation of which the market price of our common stock could fall. The existence of an overhang, whether or not sales have occurred or are occurring, also could make more difficult our ability to raise additional financing through the sale of equity or equity-related securities in the future at a time and price that we deem reasonable or appropriate. The 18,500,000 shares of common stock we issued in the share exchange with the former shareholders of Taiyu will be freely tradable upon the earlier of (i) effectiveness of a registration statement covering such shares; and (ii) the date on which such shares may be sold without registration pursuant to Rule 144 under the Securities Act of 1933, as amended (the "Securities Act"), and the sale of such shares could have a negative impact on the price of our common stock.

We may issue additional shares of our capital stock or debt securities to raise capital or complete acquisitions, which would reduce the equity interest of our stockholders

Our articles of incorporation authorize the issuance of up to 75,000,000 shares of common stock, par value \$.001 per share. There are approximately 50,408,000 authorized and unissued shares of our common stock which have not been reserved and are available for future issuance. Although we have no commitments as of the date of this offering to issue our securities, we may issue a substantial number of additional shares of our common stock, to complete a business combination or to raise capital. The issuance of additional shares of our common stock:

- may significantly reduce the equity interest of our existing stockholders; and
- may adversely affect prevailing market prices for our common stock.

We have not paid dividends in the past and do not expect to pay dividends in the future. Any return on investment may be limited to the value of our common stock

We have never paid cash dividends on our common stock and do not anticipate doing so in the foreseeable future. We presently do not intend to pay dividends in the foreseeable future. Our management intends to follow a policy of retaining all of our earnings to finance the development and execution of our strategy and the expansion of our business. In addition, the payment of dividends is limited by Chinese law. See "RISK FACTORS - Risks Relating to Doing Business in China - Limitations on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations."

## FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements that reflect our current expectations and views of future events. The forward looking statements are contained principally in the sections entitled “Prospectus Summary,” “Risk Factors,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Business.” Known and unknown risks, uncertainties and other factors, including those listed under “Risk Factors,” may cause our actual results, performance or achievements to be materially different from those expressed or implied by the forward-looking statements.

You can identify some of these forward-looking statements by words or phrases such as “may,” “will,” “expect,” “anticipate,” “aim,” “estimate,” “intend,” “plan,” “believe,” “is/are likely to,” “potential,” “continue” or other similar expressions. We have these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs. These forward-looking statements include statements relating to:

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

These forward-looking statements involve various risks and uncertainties. Although we believe that our expectations expressed in these forward-looking statements are reasonable, our expectations may later be found to be incorrect. Our actual results could be materially different from our expectations. Important risks and factors that could cause our actual results to be materially different from our expectations are generally set forth in “Risk Factors,” “Management’s

Discussion and Analysis of Financial Condition and Results of Operations,” “Business,” and other sections in this prospectus. You should read thoroughly this prospectus and the documents that we refer to with the understanding that our actual future results may be materially different from and worse than what we expect. We qualify all of our forward-looking statements by these cautionary statements. Other sections of this prospectus include additional factors which could adversely impact our business and financial performance.



This prospectus contains statistical data that we obtained from various publicly available government publications. Statistical data in these publications also include projections based on a number of assumptions. The market for the PHEs, PHE Units, and heat meters may not grow at the rate projected by market data, or at all. The failure of this market to grow at the projected rate may have a material adverse effect on our business and the market price of our securities. In addition, the rapidly changing nature of our customers' industries results in significant uncertainties in any projections or estimates relating to the growth prospects or future condition of our market. Furthermore, if any one or more of the assumptions underlying the market data is later found to be incorrect, actual results may differ from the projections based on these assumptions. You should not place undue reliance on these forward-looking statements.

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

The forward-looking statements made in this prospectus relate only to events or information as of the date on which the statements are made in this prospectus. Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise, after the date on which the statements are made or to reflect the occurrence of unanticipated events. You should read this prospectus and the documents that we refer to in this prospectus and have filed as exhibits to the registration statement, of which this prospectus is a part, completely and with the understanding that our actual future results may be materially different from what we expect.

#### AVAILABLE INFORMATION

This prospectus is part of a Registration Statement on Form S-1 we have filed with the SEC. We have not included in this prospectus all of the information contained in the registration statement and you should refer to our registration statement and its exhibits for further information.

We file annual, quarterly, and special reports, proxy statements, and other information with the SEC. You may read and copy any document we file at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Copies of these materials may also be obtained from the SEC at prescribed rates by writing to the Public Reference Section of the SEC, 100 F Street, N.E., Washington, D.C. 20549. You may obtain information about the operation of the SEC public reference room in Washington, D.C. by calling the SEC at 1-800-SEC-0330. Our filings are also available to the public from commercial document retrieval services and at the website maintained by the SEC at <http://www.sec.gov> ..

Our Web site address is <http://www.smartheatinc.com> .. The information on our Web site is not incorporated into this prospectus.

#### USE OF PROCEEDS

We will not receive any proceeds from sale of the shares of common stock covered by this prospectus by the selling shareholders. We will, however, receive proceeds on exercise of outstanding warrants for shares of common stock covered by this prospectus if the warrants are exercised for cash. The warrants may expire without having been exercised. Even if some or all of these warrants are exercised, we cannot predict when they will be exercised and when we would receive the proceeds. We intend to use any proceeds we receive upon exercise of the warrants for general working capital and other corporate purposes.



## MARKET FOR COMMON STOCK AND RELATED SHAREHOLDER MATTERS

## Market Information

On April 22, 2008, our common stock became eligible for quotation on the OTCBB under the symbol "SMHT." The following table set forth the range of the high and low bid prices per share of our common stock for each quarter (or portion thereof) beginning on April 22, 2008 and ending on March 9, 2009 as reported by the OTC Bulletin Board. These quotations represent inter-dealer prices, without retail mark-up, markdown, or commission and may not represent actual transactions..

|   | High    | Low     |
|---|---------|---------|
| Second Quarter 2008 (April 22, 2008 - June 30, 2008)          | \$ 4.60 | \$ 2.00 |
| Third Quarter 2008 (through September 30, 2008)               | \$ 4.75 | \$ 4.50 |
| Fourth Quarter 2008 (through December 31, 2008)               | \$ 6.50 | \$ 2.25 |
| First Quarter 2009 (January 1, 2009 through January 28, 2009) | \$ 6.20 | \$ 5.50 |

On January 29, 2009, our common stock commenced trading on the Nasdaq Stock Market under the symbol "HEAT" and were subsequently listed on the Nasdaq Global Market on March 10, 2009. The high and low sales prices of our common stock from January 29, 2009 through March 20, 2009 were \$7.50 and \$4.11, respectively. On March 20, 2009, the closing sales price of our common stock was \$6.10.

## Holders

As of March 10, 2009, there were 149 shareholders of record of our common stock. Since some of our shares of common stock are held in street or nominee name, it is believed that there are a substantial number of additional beneficial owners of our common stock.

## Dividend Policy

We have not paid any cash dividends on our common stock to date, and we have no intention of paying cash dividends in the foreseeable future. Whether we will declare and pay dividends in the future will be determined by our board of directors at their discretion, subject to certain limitations imposed under Nevada corporate law. In addition, our ability to pay dividends may be affected by the foreign exchange controls in China. See "RISK FACTORS - Limitation on the ability of our operating subsidiary to make payments to us could have a material adverse effect on our ability to conduct our business and fund our operations ." The timing, amount and form of dividends, if any, will depend on, among other things, our results of operations, financial condition, cash requirements and other factors deemed relevant by our board of directors.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION  
AND RESULTS OF OPERATIONS

Safe Harbor Declaration

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

Overview

We were incorporated in the State of Nevada on August 4, 2006 under the name Pacific Goldrim Resources, Inc. as an exploration stage corporation that intended to engage in the exploration of silver, lead and zinc. On April 14, 2008 we changed our name to SmartHeat Inc. and acquired all of the equity interests in Taiyu.

Prior to our acquisition of Taiyu, we were in the development stage and had minimal business operations. We had no interest in any property, but had the right to conduct exploration activities on thirteen (13) mineral title cells covering 270.27 hectares (667.85 acres) in the Slocan Mining Division of southeastern British Columbia, Canada. In connection with the acquisition of Taiyu, we transferred our prior assets and liabilities to a wholly owned subsidiary and sold all of the outstanding capital stock of that subsidiary to our former director and officer in exchange for 2,500,000 shares of our common stock.

Taiyu was formed in July 2002 under the laws of China and is headquartered in Shenyang City, Liaoning Province, China. As a result of our acquisition of Taiyu, we are a leading provider of plate heat exchange products to China's industrial, residential, and commercial markets, specializing in the manufacturing, sale, research, and servicing of PHEs, PHE Units and heat meters for a broad range of industries such as petroleum refinement, petrochemicals, power generation, metallurgy, food & beverage, and chemical processing. We sell PHEs under the Sondex brand and PHE Units that are designed by us and using PHEs that are assembled with Sondex plates under our Taiyu brand name.

Our revenue is subject to fluctuations due to the timing of sales of high-value products, the impact of seasonal spending patterns, the timing and size of projects our customers perform, changes in overall spending levels in the industry and other unpredictable factors that may affect customer ordering patterns. Our quarterly revenues may fluctuate significantly due to the seasonal nature of central heating services in the PRC, whereas, the equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall. Additionally, any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines, or impacts from the other factors mentioned above, could adversely affect our revenue growth or cause a sequential decline in quarterly revenue. In particular, our 2009 sales may be affected by weaker demand from steel processing, petrochemical and HVAC sectors. To date, we have not been adversely affected by these trends. Moreover, the PRC government has recently passed an economic stimulus package and we believe that our sales will benefit from an increase in government spending on infrastructure as

provided in this package. However, due to the possibility of fluctuations in our revenue and net income or loss, we believe that quarterly comparisons of our operating results are not a good indication of future performance.

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

## Basis of Presentation

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

## Principle of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, SanDeKe, Taiyu, Taiyu's 55% owned subsidiary, Qingdao Yushi Heat Power Equipment Co., Ltd ("Yushi") which also disposed by the Company in August, 2008. Yushi is engaged in manufacturing and selling of heat power equipment. For purposes of this Annual Report, the "Company" refers collectively to SmartHeat, SanDeKe, Taiyu and Yushi. All significant inter-company accounts and transactions have been eliminated in consolidation.

## Use of Estimates

In preparing the financial statements in conformity with accounting principles generally accepted in the United States of America, 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 year. Significant estimates, required by management, include the recoverability of long-lived assets, allowance for doubtful accounts, and the reserve for obsolete and slow-moving inventories. Actual results could differ from those estimates.

## Accounts Receivable

Our policy is to maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Accounts receivable are net of unearned interest. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at our borrowing rate for the year.

## Inventories

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

## 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 ranging from 5 to 20 years as follows:

|                      |              |
|----------------------|--------------|
| Building             | 20 years     |
| Vehicles             | 5 years      |
| Office Equipment     | 5 years      |
| Production Equipment | 5 - 10 years |

## Revenue Recognition

Our revenue recognition policies are in compliance with Securities and Exchange Commission (SEC) Staff Accounting Bulletin (“SAB”) 104. Sales revenue is recognized when products are delivered, and for PHE and PHE units, when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of the Company exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

## Foreign Currency Translation and Comprehensive Income (Loss)

Our functional currency is the Chinese yuan renminbi ("RMB"). For financial reporting purposes, RMB has been translated into United States dollars ("USD") as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of shareholders' equity as "Accumulated other comprehensive income." Gains and losses resulting from foreign currency transactions are included in income. There has been no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

We use Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

## Recent Accounting Pronouncements

### Accounting for Financial Guarantee Insurance Contracts

In May 2008, FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60." The scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts, as described in this Statement, issued by enterprises included within the scope of Statement 60.

Accordingly, this Statement does not apply to financial guarantee contracts issued by enterprises excluded from the scope of Statement 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). This Statement also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement will not have an impact on the Company's financial statements.

### The Hierarchy of Generally Accepted Accounting Principles

In May 2008, FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 adoption will not have an impact on the Company's financial statements.

### Disclosures about Derivative Instruments and Hedging Activities

In March 2008, FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Based on current conditions, the Company does not expect the adoption of SFAS 161 to have a significant impact on its results of operations or financial position.

## Fair value of measurements



On January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements." SFAS 157 defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measures.. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) 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 fair value measurement.

As of December 31, 2008, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at fair value.

#### Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51

In December 2007, FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company expects SFAS 160 will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

#### Business Combinations

In December 2007, FASB issued SFAS No. 141 (Revised 2007), "Business Combinations." SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Non-controlling interests (formerly known as "minority interests" - see SFAS 160 discussion above) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;
- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and
- Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since the Company is a calendar year-end company and will continue to record and disclose business combinations following existing GAAP until January 1, 2009. The Company expects SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.



### Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities

In June 2007, FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. EITF 07-03 is effective for fiscal years beginning after December 15, 2008. Management is currently evaluating the effect of this pronouncement on our financial statements.

### Results of Operations

Year Ended December 31, 2008 Compared to the Year Ended December 31, 2007

The following table sets forth the results of our operations for the years indicated as a percentage of net sales:

|                              | Years Ended December 31 |            |            |            |
|------------------------------|-------------------------|------------|------------|------------|
|                              | 2008                    |            | 2007       |            |
|                              | \$                      | % of Sales | \$         | % of Sales |
| Sales                        | 32,676,082              |            | 13,273,151 |            |
| Cost of sales                | 21,717,735              | 66.0%      | 8,667,353  | 65.0%      |
| Gross Profit                 | 10,958,347              | 34.0%      | 4,605,798  | 35.0%      |
| Operating Expenses           | 3,416,670               | 10.0%      | 2,369,090  | 18.0%      |
| Income from Operation        | 7,541,677               | 23.0%      | 2,236,708  | 17.0%      |
| Other Income (Expenses), net | 93,289                  | 0.3%       | 24,957     | 0.2%       |
| Net Income                   | 6,335,340               | 19.0%      | 2,087,891  | 16.0%      |

Sales. Net sales for 2008 were approximately \$32.68 million, while our net sales in 2007 were approximately \$13.27 million, an increase in revenues of \$19.40 million, or 146%. Approximately \$14.76 million of the increase in sales was attributable to an increase in our sales volume with selling price determined based on our standard profit margin rate, of which, \$10.57 million of increased sales was from our existing customers and \$4.19 million of increased sales was from the new customers. We have a strict review process for approving each sales contract, especially with respect to the determination of selling price. Sales price under each contract is determined in proportion to our estimated cost in order to ensure our gross profit. Our selling price varies on each sale which mainly depends on each customer's specific needs and our negotiation of the contract amount and term. At September 23, 2008, we acquired SanDeKe Co., Ltd ("SanDeKe") which brought us additional \$1.98 million sales for 2008. We have also increased the number of our branch offices and sales representatives throughout China to develop new customers in more regions. These new regions' developments that occurred during 2008 accounted for approximately \$2.07 million of the increase in our revenues. In addition, we've increased our sales of heat meters by approximately \$0.52 million due to increased demand. As we continue to expand our customer base and increase our sales volume, we become less dependent on these customers for revenue. We believe that our sales will continue to grow because we are strengthening our sales efforts by hiring more sales personnel, increasing the sales channels, and improving the quality of our products.

Cost of Sales. Cost of sales for 2008 was approximately \$21.72 million, while our cost of sales in 2007 was approximately \$8.67 million, an increase of \$13.05 million, or 151%. Cost of sales mainly consisted of the cost of materials and labor, as well as factory overhead costs, with material costs accounting for 70% or more of our total cost of sales. The increase in cost of sales can be attributed to the increase of production and sales volume in 2008. Cost of sales as a percentage of sales was approximately 66% for 2008 and 65% for 2007. The slight increase in cost of sales was mainly due to relatively high cost of plate heat exchanger from SanDeKe. SanDeKe only produces plate

heat exchanger which normally has relatively higher cost of sales as a percentage of sales comparing with assembled heat exchange unit and meter. Even though raw materials are major components in the determination of our cost of sales, a change in the pricing of our raw materials would not adversely impact our revenue. We utilize a common pricing strategy in our industry, adjusting the price of our product as the cost of raw materials changes. As a result, we generally increase our sales price when raw material prices increase and decrease our sales price to remain competitive when raw material prices decrease. We believe our cost of sales will remain stable as a result of our current pricing strategy and the continued improvement in the efficiency of our manufacturing facility.

**Gross Profit.** Gross profit was \$10.96 million for 2008, as compared to \$4.61 million for 2007, representing gross margins of approximately 34% and 35% for 2008 and 2007, respectively. The increase in our gross profits but slight decrease in gross profit margin was mainly due to the increase of cost of goods sold as percentage of sales while the company's sales activities increased.

**Operating Expenses.** Operating expenses consisted of selling, general and administrative expenses totaled approximately \$3.42 million for 2008, as compared to \$2.37 million for 2007, an increase of approximately \$1.05 million or 44%. The increase in operating expenses was mainly due to a proportional increase in payroll, insurance, employee welfare and travel expenses with our increased sales and production; as well as the increase in audit, legal, consulting and filing expenses in connection with the Company of being public in US since April of 2008.

**Net Income.** Our net income for 2008 was \$6.34 million as compared to approximately \$2.09 million for 2007, an increase of \$4.25 million or 203%. This increase is attributable to economies of scale combined with rapid growth in revenue and efficiency of operations. Our management believes that net income will continue to increase as we continue to increase our sales, offer better quality products and control our manufacturing costs.

### Liquidity and Capital Resources

As of December 31, 2008, we had cash and cash equivalents of approximately \$1.44 million. Working capital was approximately \$13.64 million at December 31, 2008. The ratio of current assets to current liabilities was 2.90:1 at December 31, 2008.

The following is a summary of cash provided by or used in each of the indicated types of activities during years ended December 31, 2008 and 2007:

|                                    | For the Years Ended December 31, |             |
|------------------------------------|----------------------------------|-------------|
|                                    | 2008                             | 2007        |
| <b>Cash provided by (used in):</b> |                                  |             |
| Operating Activities               | \$ (761,033)                     | \$ (2,041)  |
| Investing Activities               | (507,110)                        | (1,045,195) |
| Financing Activities               | 2,307,620                        | 1,216,723   |

Net cash flow used in operating activities was \$761,033 in 2008, as compared to net cash flow used in operating activities of \$2,041 in 2007. The increase in net cash flow used in operating activities in 2008 was mainly due to \$2.39 million cash paid for accounts payable as we've increased our purchase due to increased production, less unearned revenue received from customers for approximately \$2.99 million and increases in our accounts receivables and retention receivables of approximately \$5.02 million. Our net income has increased rapidly compared to 2007 which brought more cash to the company, but at the same time, our accounts receivable have increased which held back our cash inflows. The significant increase in accounts receivable was due to the rapid increase in our sales with most of our accounts receivables aging within one year from the sales recognition date. Our inventory generally decreases in the latter part of the year as a significant share of PHE Unit deliveries must be completed by the beginning of heating season in late fall, which brought us about \$2.41 million cash inflow.

Net cash flow used in investing activities was \$507,110 in 2008, as compared to net cash used in investing activities of \$1,045,195 in 2007. The decrease of net cash flow used in investing activities in year 2008 was mainly due to less cash spend for acquisition of manufacturing equipment, office equipment and furniture during the year.

Net cash flow provided by financing activities was \$2,307,620 in 2008 as compared to net cash provided by financing activities of \$1,216,723 in 2007. The increase of net cash flow provided by financing activities in 2008 was mainly due to net proceeds of \$5,100,000 from the shares issued despite repayments of \$2.79 for the loans from third parties

and shareholders during the year.

Our products are generally paid for within one year from the date of sale; 30% of the purchase price is due upon the placement of an order, 30% is due on delivery and 30% is due within few months after the customer's acceptance depending on the actual terms negotiated with the customer. The final 10% of the purchase price may remain outstanding for up to 24 months as a quality assurance and is accounted for in our financial statements as Retentions Receivable. Indirect sales through distributors are usually paid in full on delivery. Our accounts receivable turnover and inventory turnover are relatively low, and days sales outstanding ratio relatively high. Consequently, collection on our sales is rather slow and capital is tied up in inventories which may result in pressure on cash flows. For 2008, we had accounts receivable turnover of 3.6, with days sales outstanding of 136 and inventory turnover of 3.1 on an annualized basis. For 2007, we had accounts receivable turnover of 2.8, with days sales outstanding of 167 and inventory turnover of 1.09 on an annualized basis.

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We are in the manufacturing and processing business. We purchase substantial amounts of raw materials before the high season (mid-April to mid-October) starts to meet production needs. There is no concern about inventory obsolescence since our product can be sold for a profit without time limitation as long as there is continued demand. Additionally, we have increased our sales force for developing new customers, which we believe will reduce on-hand inventory levels and increase inventory turnover going forward. Therefore, we believe the potential risks and uncertainties associated with lower inventory turnover are limited.

90% of the purchase price for our products can be collected within one year of sale; however, it may take up to 24 months to receive payment of the remaining 10% of the purchase price on each sale. This is the normal practice in the heating manufacturing business. In addition, we sometimes request our customers to deposit 5%-10% of the sales price on high value products like assembled heat exchanger unit and main part of plate heat exchanger into designated bank accounts as restricted cash for securing the payment after the quality assurance (warranty) period expires. Based on our historical experience, default on payment from our customers is very rare. Therefore, we believe the potential risks and uncertainty associated with high days outstanding of receivable are also very limited.

#### Recent Developments

There have been no material trends, events or transactions that have arisen subsequent to December 31, 2008 that have affected our financial condition and results of operations.

#### 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. We have not entered into any derivative contracts that are indexed to our shares and classified as shareholder's 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.

#### Contractual Obligations

The Company was obligated for the following short term loans payable as of December 31, 2008 and 2007:

|  | 2008       | 2007       |
|--|------------|------------|
| Short term loan with a commercial bank in the PRC for 6,000,000 RMB. This loan was entered into on Apr 28, 2007 and is due on Apr 12, 2008. This loan was renewed on Apr 12, 2008 with new maturity date on June 13, 2009. This loan currently bears interest at 7.159% per annum. The Company pledged its building in the value of approximately RMB 12,430,950 or approximately \$1,818,000 for this loan. | \$ 877,886 | \$ 822,526 |
| Short term loan with a foreign commercial bank with branch in the PRC for 10,200,000 RMB. This loan was entered into on Jun 25, 2007 and was due on Jun 24, 2008. This loan born interest at 5.265% per annum. This loan was repaid in June, 2008.   | —          | 1,302,333  |
| The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per  | 1,126,621  | 1,412,003  |



annum for 2007. The Company repaid RMB 2,600,000 in 2008 and had RMB 7,700,000 outstanding as of December 31, 2008.

The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB. These loans were due on various dates in year 2008. These loans bore variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007. The loans were paid in full at December 31, 2008.

- 390,701

The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bears no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31, 2006. This loan was paid in full at December 31, 2008.

- 692,293

The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB. This loan is due on June 30, 2009 with interest rate of 8.591% per annum.

438,943

\$ 2,443,450 \$ 4,619,856

## OUR BUSINESS

We are a leading provider of plate heat exchanger products to China's industrial, residential and commercial markets. We design, manufacture, sell, and service plate heat exchangers ("PHEs"), units which combine plate heat exchangers with various pumps, temperature sensors, valves, and automated control systems ("PHE Units") and heat meters for a broad range of industries, including petroleum refining, petrochemicals, power generation, metallurgy, food & beverage and chemical processing. We sell PHEs under the Sondex brand and PHE Units designed by our engineers and assembled with Sondex plates under our Taiyu brand name. We are an authorized dealer of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is northern and eastern China..

### Our Products

#### PHEs

A plate heat exchanger ("PHE") is a device which transfers energy, usually in the form of heat, from one fluid to another across a solid surface. PHEs are constructed through the use of specifically manufactured stainless steel, titanium, and nickel plates welded together. Plates come in a variety of sizes and wave patterns, have large heat transfer surfaces and high thermal conductivity. The quantity and size of the plates used along with the total size of the PHE varies according to particular application requirements but generally do not exceed the size of a large refrigerator. Because of the larger heat transfer surface area of the PHE, and despite its relatively small size, PHEs have higher heat transfer coefficient than the traditional shell-and-tube heat exchangers..

Heat exchangers were first invented in the mid 1920s to control pressure and temperature during industrial production. Later innovations in heat transfer technology, including the development of PHEs, led to higher heat recovery rates leading to greater savings in fuel consumption and reductions in related pollution. In the diagram, cold and hot fluids (red and blue arrows) enter heat exchanger from opposite ends and flow in opposite directions through the plate heat exchanger maximizing heat transfer from one fluid to the other. Plate heat exchangers can be taken apart and plates can be added to increase heat transfer area. This flexibility translates into lower expenditures on installation and equipment purchases.

## DIAGRAM OF PLATE HEAT EXCHANGER

We are an authorized dealer of Sondex PHEs for the industrial and energy sectors in China. Our Sondex distribution territory is northern and eastern China. As an authorized dealer of Sondex PHEs in China, we import finished stainless steel plates from Sondex and assemble customized PHEs based on our clients' specifications. All design of our PHEs is done in-house by our engineers utilizing a combination of software provided by Sondex and our proprietary in-house designed software. In the initial year of our operations, the PHE was the cornerstone of our product line. As an authorized Sondex dealer, we have established a reputation as a high quality provider of PHEs in China. In May 2003, we began to sell customized PHE Units containing Sondex plates.

### PHE Units

PHE Units are mainly used in petroleum refining, chemicals and petrochemicals, energy generation, HVAC, steel, medical, electronics, food & beverage processing and other manufacturing sectors to reduce energy waste, improve temperature and pressure controls and cool equipment. PHE Units are built by integrating PHEs with various pumps, temperature sensors, valves, and automated control systems to form a "unit" which is used along with other units to form a "PHE network" installed in the local district heating systems. We specialize in making PHE Units for HVAC systems in residential and commercial buildings.

We began designing, manufacturing and selling our branded PHE Units in May 2003. Our PHE Units are designed in-house by our system engineers employing online customized CAD design software based on Solid Works software which is integrated with our real-time enterprise resource planning system databases. This advanced design platform provides the following benefits:

- We can provide accurate price quotes instantly;
- Our purchasing function is immediately notified of any additional material orders needed; and
- Our manufacturing operations are able to schedule production so that goods are delivered on a just-in-time basis.

The production and sale of PHE Units have been central to our growth. PHE Units require a comparatively higher level of technical skill and knowledge of the application markets and this is reflected in the price. In the recent years, PHE Unit sales have contributed significantly to our revenue growth and high margins. Less than five years after entering the market, we have emerged as a leading domestic producer of PHE Units, with a market share of approximately 8% in China in 2007.

## SMARTHEAT'S PLATE HEAT EXCHANGER UNIT

### Heat Meters

While heating companies in many western countries have long used meters to measure customer heat usage and invoice customers, Chinese residents and commercial customers are largely billed based on the square footage of their utilized space. Meters indicate heat in legal heat units and the calibration of meters in many countries is regulated by government agencies and subject to local or national guidelines. Due to rising energy costs and the increased sensitivity to environmental issues, Chinese government and local utility companies have made the use of heat meters compulsory in China. As of January 2003, heat meters were required by law nationally for new construction and the law was extended in April of 2008 by the Energy Conservation Law, Article 38, to existing buildings being retrofitted.

Using our established relationships with provincial governments and utility companies throughout China, we introduced our patented heat meters to the market during the second quarter of 2006. Sales to date have been insignificant. However, we plan to work with the various government entities to establish a national heating standard and become an active participant in China's heat meter market in the coming years.

## SMARTHEAT'S HEAT METERS

### Market Overview

Heat transfer technology was introduced to China in the 1960's from Russia, mainly for applications in the petroleum industry. Foreign manufacturers began to sell in China on a large commercial scale in the 1980's and have since dominated the Chinese market. As domestic producers sprang up in the late 1980's and 1990's they began to take an increasingly larger share of the market. The past decade has seen the rise of many domestic manufacturers along with joint venture operations between local and international firms. Today the market is split between domestic firms, foreign JVs and direct imports.

Today, heat exchangers are used in heat and power generation, HVAC and refrigeration, chemicals & petrochemicals, steel & metallurgy, aeronautics, textiles, food and beverage processing and various other manufacturing industries. Heat transfer equipment is also being employed in new energy applications such as wind, solar, biomass and waste disposal.

PHEs are replacing the less efficient shell-and-tube heat exchanges. PHEs can be installed in existing buildings and facilities as well as in new ones since they are smaller than traditional heat exchangers and can fit within existing installations.

PHEs are used in a wide range of industries with the principal demand originating in the petroleum refining, petrochemicals, power generation, metallurgy, food & beverage, and chemical processing industries.

Within the PHE industry, manufacturers are differentiated primarily based upon their reputation and the technology, improved efficiency, and durability of their products. Given the growing importance of energy conservation and waste reduction, PHEs are likely to play an increasingly important role in many industries.

China Heat Association believes that the domestic market for PHEs was approximately \$2.4 billion in 2007 and that it is expected to grow at an annual rate of about 30% until 2010 due to the continuation of industrialization and urbanization trends in China. China Heat Association also believes that the domestic market for PHE Units was approximately \$139 million in 2007 and it is expected to grow at an annual rate of 70% until 2010.

The global market for heat transfer products and compact PHE Units in 2007 was approximately \$12 billion and \$2.3 billion, respectively according to Alfa Laval, a leading manufacturer in our industry. Large international PHE producers include: Alfa Laval, Sondex, GEA, Tranter SWEP, Danfoss, and Hisaka Works.

New environmental policies and regulations are also expected to have a positive impact on the demand for PHE products.

#### Production

Until recently, we conducted all of our manufacturing activities at our Shenyang plant. On September 25, 2008 we acquired SanDeKe, a PHE manufacturing company located in Pudong district, Shanghai. SanDeKe leases a manufacturing facility and business offices.

We generally operate on an 8 hour shift, with the exception of the high season from May to November, during which we may operate the plant for 11-12 hours a day. Production is driven by orders from clients and is scheduled on a just-in-time delivery basis. Our Shenyang facility currently has the capacity to produce 10 PHEs, 3 PHE Units, and 50 heat meters per day and our SanDeKe facility has the capacity to produce 17 PHEs per day.

#### Marketing

Since our entry into the market for PHE Units in May 2003, the Taiyu brand name has been promoted in conjunction with quality production and first-rate service by means of our successful track record, industry trade fairs and establishing and maintaining positive relationships with local governments in Beijing, Shenyang, Urumqi, Shandong, Jiangsu and Shanghai. We attend the bi-annual HVAC trade fair in Shanghai and Chinese environmental protection forums and we visit the local utilities companies, oil refiners, steel and food & beverage companies. Marketing costs are generally funded through working capital and expensed as incurred.

#### Suppliers

Plates

Plates are supplied by Sondex under the terms of our Sondex authorized dealer arrangement. We generally order stainless steel plates 2-3 months in advance based on production needs and forecasted sales. Plate purchases generally constitute 40% of our total annual raw material purchases. While we are an authorized dealer, annual or quarterly purchasing prices are not fixed and fluctuate according to Sondex's most recent pricing list.

## Components

Components generally include pumps, valves, pipes, and electronic meters purchased from a variety of international (Siemens, Wilo A.G., Honeywell) and domestic suppliers who have been certified to meet Taiyu's quality specifications. Components are ordered on an as needed basis. Plates and components together constituted approximately 98% of raw material purchases in 2007.

## Customers

We sell both directly through our sales force and through a network of 29 national distributors located throughout China. Our customer base consists mainly of large companies with our 10 largest customers accounting for over 32% of our total sales of \$32,676,082 in the fiscal year ended 2008. Our 10 largest customers and our respective revenue from them during 2008 are as follows:

| Customer Name  | Sales         | % of Sales 2008 |
|--|---------------|-----------------|
| Shanghai Guoshe Electromechanical Engineering CO., LTD | \$ 1,800,104  | 6%              |
| Dalkai( Jiamusi ) City Heat CO., LTD                   | 1,787,756     | 5%              |
| Shanghai Langu mechanical engineering CO., LTD         | 1,085,753     | 3%              |
| Eerduosi Dongsheng District House Property Bureau      | 1,012,013     | 3%              |
| Urumqu Heat Head Office                                | 939,388       | 3%              |
| Dalkai Sunny( Harbin ) thermoelectricity Co., LTD      | 828,572       | 3%              |
| China Precision Machinery Import and Export CO., LTD   | 789,433       | 2%              |
| CPCC Shengli Oil Field                                 | 753,611       | 2%              |
| Jiangxi Saiwei LDK SolarEnergy Hightech Co., LTD       | 748,237       | 2%              |
| Wuhu Qiaohong International CO., LTD                   | 675,776       | 2%              |
| Total  | \$ 10,420,642 | 32%             |

Each sale can range from \$2,500 to \$500,000 and up depending on the client's needs. Contract implementation generally takes one to six months. Outstanding receivables are collected upon completion of work with the exception of an approximate 10% warranty hold-back that remains unpaid and outstanding for 3 to 24 months following delivery and contract completion. All of our work is performed based on written contracts and there are no oral contracts. Historically, the Company has not had any uncollected warranty hold-backs.

## Intellectual Property

We use the Taiyu brand name on all the PHE Units and heat meters we sell. We have registered and received approval from the China Trademark Bureau for this trade name. We believe that the Taiyu brand name is recognized in China's heating industry for quality and efficiency. We have six registered patents in China for both PHE products and heat meters. Four of our patents expire in 2014, one expires in 2016 and the last expires in 2017.

These patents are integral to our ability to create and design PHEs and PHE Units. To the extent third parties utilize such patents in their work, we do not receive royalties or licensing fees from any such third parties.

## Research and Development

To maintain our competitive edge in the marketplace and keep pace with new technologies, constant research and development work is required to find improved efficiencies in design, cost, and energy capture. While the core technology for plate production remains with Sundex, our competitive advantage in the market stems from our engineering and system design capabilities.

Research and development costs are funded through working capital and expensed as incurred. Research and development costs for 2007 and 2008 were \$343,800 and \$1,020,000, respectively. We plan to spend approximately \$300,000 in 2009 on identifying new industry applications for PHEs, improving the accuracy of heat meters, designing heat meters for industrial usage, developing multifunctional PHE units and modifying PHE designs to meet the current market demand.



While we have no formal written alliances with the universities, we work with several professors who are heat transfer experts on an individual consulting basis.

#### Governmental and Environmental Regulation

While our PHE & PHE Units business and products are not subject to any material regulation by the Chinese government or other national agency, we have obtained National Safety Certification for our PHE products and we are an ISO 9000 certified manufacturer. The National Safety Certification is not required for either production or sale of PHE products. However, obtaining this certification confirms our commitment to safety and quality. For companies in industries utilizing high temperatures or pressure in their production processes, the certification is of critical importance in choosing a PHE provider. Of over 500 companies selling PHEs in China, we believe that only 30 companies have obtained this certification.

Our heat meters require a license for production and sale. We obtained this license on August 12, 2005. The license is valid through April 1, 2009. We have applied for a renewal of this license. We currently anticipate that we will have a renewed license in place before April 1, 2009. The Safety Bureau conducts site visits and inspections of documents on a periodic basis to verify adherence to the standards.

Legislation has been passed requiring the installation of heat meters. As of January 2003, heat meters were required by law nationally for new construction and the law was extended in April of 2008 by the Energy Conservation Law, Article 38, to existing buildings being retrofitted.

Our business and company registrations are in compliance with the laws and regulations of the municipal governments of Shenyang and China.

We are subject to China's National Environmental Protection Law as well as local laws regarding pollutant discharge, air, water, and noise pollution, with which we comply. The cost of compliance with these regulations is not material.

#### Competition

The Company competes only in the domestic Chinese market. We believe our competitive advantages lie in our superior engineering and design skills, our affiliation with Sondex, the longevity and efficiency of the Sondex plates we use, our just-in-time delivery and the reliable after sale service we provide through our local service centers.

#### PHEs

Alfa Laval has the largest market share in mainland China. An assortment of other foreign producers hold an aggregate market share of 20%, and the rest of the market is divided among multiple domestic producers. We believe the quality of our PHEs is considered on par with Alfa Laval's, as are our prices. In comparison with the other domestic producers, our prices are approximately 15% higher.

#### PHE Units

According to data from the China Heating Association, we were the leading producer and seller of PHE Units in China in 2007, representing 8% of the market, followed by Danfoss, and Accessen (a Sino-US JV established by Denmark's Accessen and utilizing Alfa Laval plates as well as their own plates in their PHE Units). Danfoss competes directly with us for the local heat and power companies' contracts in larger cities, while Accessen targets the petrochemical, metallurgy and HVAC sectors.

As the majority of projects are awarded on a bid basis, prices among leading competitors are difficult to assess. For certain projects, we do not bid, but negotiate directly with the customers. We have done prior projects with some of the customers we negotiate with, including one of our largest customers in 2008, Dalkia, a JV between Dalkia and the local government in Heilongjiang province. Dalkia is the leading provider of energy services in Europe, active in multiple energy projects in China and is a subsidiary of Veolia EDF.

## Heat Meters

The market for heat meters is extremely fragmented with multiple overseas and domestic producers and no established leaders. Currently, the industry lacks National product standards which will be needed because of the legislation requiring heat meters for all residential and commercial spaces. Two of our goals for the near future are to become an integral player in the establishment of national heat meter standards and a leading supplier of heat meters in China.

## Seasonality

We typically experience stronger sales in the third and fourth calendar quarters. Our quarterly revenues may fluctuate significantly due to the seasonal nature of central heating services in China, whereas, the equipment used in residential buildings must be delivered and installed prior to the beginning of the heating season in late fall.

## Employees

As of December 31, 2008, we had 210 full-time employees.

We maintain strong ties with our employees and staff and retention is stable. Our employee contracts adhere to both State and Provincial employment and all social security regulations. All compensation including social insurance is paid in a timely manner to authorities and employees. There have been no disputes and there are no collective bargaining agreements.

Our sales personnel are eligible to receive annual bonuses based on pre-established sales targets. Production employees are also eligible for annual bonuses based on product quality ratios, customer complaint ratios, new product invention, and product inventory.

## Our Corporate History

We were incorporated in the State of Nevada on August 4, 2006 under the name Pacific Goldrim Resources, Inc. as an exploration stage corporation that intended to engage in the exploration of silver, lead and zinc. On April 14, 2008, we changed our name to SmartHeat Inc. and acquired all of the equity interests in Taiyu.

Prior to our acquisition of Taiyu, we were in the development stage and had minimal business operations. We had no interest in any property, but had the right to conduct exploration activities on thirteen (13) mineral title cells covering 270.27 hectares (667.85 acres) in the Slocan Mining Division of southeastern British Columbia, Canada. In connection with the acquisition of Taiyu, we transferred our pre-acquisition assets and liabilities (other than our liability for the fees of our prior auditor of up to \$10,000) to a wholly owned subsidiary and sold all of the outstanding capital stock of that subsidiary to our former director and officer in exchange for 2,500,000 shares of our common stock.

Taiyu was formed in July 2002 under the laws of China and is headquartered in Shenyang City, Liaoning Province, China. Our acquisition of Taiyu was accomplished pursuant to a share exchange with the former shareholders of Taiyu. Under the terms of the share exchange, the former shareholders of Taiyu received an aggregate of 18,500,000 shares of the Company's common stock in exchange for all of their equitable and legal rights, title and interests in and to Taiyu's share capital.

On September 25, 2008, we acquired all of the outstanding capital stock of San De Ke. San De Ke has an annual production capacity of approximately 4,000 PHEs. In 2007, San De Ke's unaudited revenue was approximately US\$2.59 million. San De Ke was founded in October 2004 to capitalize and expand on the increasing need for energy saving and environmentally friendly products within China. Its client base spans a wide range of industries including

manufacturing, consumer, chemical, and energy.

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## Our Corporate Information

Our principal executive offices are located at A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110027. Our telephone number is 86 (24) 2519-7699. Our website is <http://www.smartheatinc.com>. The information contained on our website is not a part of this prospectus.

## OUR PROPERTY

Our headquarters and manufacturing facilities are located in Shenyang's Economic and Technological Development Zone, Shenyang City, Liaoning Province, PRC. We own two buildings which include our office headquarters and primary manufacturing facilities. We have been granted the right to use the land in Shenyang by the Municipal administration of state-owned land through June 2055.

In addition to the two buildings in Shenyang, we own four vehicles, two dual beam cranes and other special equipment.

San De Ke is located in Shanghai, Pudong District, PRC. San De Ke leases a 1,500 square meter manufacturing facility and 200 square meters of office space.

## LEGAL PROCEEDINGS

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

## MANAGEMENT

## Executive Officers and Directors

As of December 31, 2008, the directors and executive officers of SmartHeat were:

| Name                | Age | Position  |
|---------------------|-----|---|
| Jun Wang            | 41  | Chairman of the Board of Directors, President & Chief Executive Officer |
| Zhijuan Guo         | 44  | Chief Financial Officer and Treasurer                                   |
| Huajun Ai           | 38  | Corporate Secretary   |
| Frederic Rittreiser | 72  | Director  |
| Arnold Staloff      | 64  | Director  |
| Weiguo Wang         | 44  | Director  |
| Wenbin Lin          | 64  | Director  |

Our directors hold office for one-year terms and until their successors have been elected and qualified. Our officers are elected annually by the board of directors and serve at the discretion of the board. Messrs. Rittreiser, Staloff, Wang and Lin were appointed as directors on June 19, 2008.

## Biographies

Jun Wang, Chairman of the Board of Directors, President & CEO

Mr. Wang is one of the original founders of Taiyu in 2002. Prior to that, from 2000 to 2002, he was the Vice General Manager of Beijing HotNet Company. From 1996 to 1999, he was a sales manager for Honeywell International Inc. From 1994 to 1996, he was a sales manager for Alfa Laval. Mr. Wang obtained his Master's degree in Engineering from Tsinghua University in 1989.

Zhijuan Guo, CFO & Treasurer

Ms. Guo was appointed Chief Financial Officer of Taiyu in 2002. Prior to that time, from December 2000 to June 2002, she served as the Production Planning Director of Shenyang Thermoelectric Co. Ltd. From March 1999 to November 2000, she served as Auditing Director of Shenyang Dongyu Group Corp. From July 1993 to February 1999, Ms. Guo served as Finance Manager of Shenyang Dongyu Real Estate Development Company. Ms. Guo obtained her MBA degree from Shenyang NorthEastern University in 2001.

Huajun Ai, Corporate Secretary

Ms. Ai joined Taiyu in 2002 as Corporate Secretary. Prior to that time, 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 Jincheng Industrial Corp. Ms. Ai obtained her Bachelor's degree in Foreign Trade Accounting from Shenyang North Eastern University in 1994.

Frederic Rittreiser, Director

Mr. Rittreiser has served on the Board of Directors of AgFeed Industries, Inc. since 2007. From October 1996 until retiring in 2002, Mr. Rittreiser served as Chairman of the Board and Chief Executive Officer of Ashton Technology Group, Inc., a company that develops and commercializes online transaction systems for the financial industry. Mr.

Rittereiser has been appointed to each of the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee of SmartHeat.

Arnold Staloff, Director

Mr. Staloff has served on the Boards of Directors of Exchange Lab Inc. since 2001, AgFeed Industries, Inc. since 2007 and Shiner International Inc. since 2007. From December 2005 to May 2007, Mr. Staloff served as Chairman of the Board of SFB Market Systems, Inc., a New Jersey-based company that provides technology solutions for the management and generation of options series data. From March 2003 to December 2005, Mr. Staloff was an independent consultant. From June 1990 to March 2003, Mr. Staloff served as President and Chief Executive Officer of Bloom Staloff Corporation, an equity and options market-making firm and foreign currency options floor broker. Additionally, Mr. Staloff served on the Board of Directors of Lehman Brothers Derivative Products Inc. from 1998 until 2008 and Lehman Brothers Financial Products Inc. from 1994 until 2008. Mr. Staloff holds a Bachelor of Business Administration from the University of Miami. Mr. Staloff has been appointed to each of the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee of SmartHeat.

Weiguo Wang, Director

Dr. Wang serves as Assistant Secretary General of the China Standardization Committee on Boilers and Pressure Vessels, a position he has held since March 2005. Additionally, Dr. Wang has served as a Director of the China Special Equipment Inspection and Research Agency since January 2007 and Deputy General Manager of Boilers Standard (Beijing) Technology Services Center Co., Ltd. since March 2004. From July 2001 to December 2003, Dr. 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. Dr. Wang has been appointed to each of the Audit Committee, Compensation Committee and Nominating and Corporate Governance Committee of SmartHeat.

Wenbin Lin, Director

Mr. Lin is one of the original founders of Taiyu in 2002. From December 2003 to October 2004, Mr. Lin served as Deputy Chairman and General Manager of Shenyang Huanggu Thermoelectricity Heating Inc. From November 2002 to December 2003, Mr. Lin served as Chairman and General Manager of Shenyang Heat Power Co. Ltd. From September 1999 to May 2002, Mr. Lin served as Chairman of Shenyang Thermoelectric Corp. From January 1991 to August 1999, Mr. Lin held a variety of positions within the government of Shenyang City in the PRC, including Director of the Economic Development & Reform Commission from February 1998 to August 1999, Director of Shenyang City's Economics & Trade Commission from May 1995 to January 1998 and Deputy Director for the Economic Planning Commission from January 1991 to April 1995. Mr. Lin holds a Bachelor's degree in Press Machinery from China's Anshan Steel Technical College. Mr. Lin has been appointed to each of the Compensation Committee and Nominating and Corporate Governance Committee of SmartHeat.

Family relationships

None.

Involvement in certain legal proceedings

No bankruptcy petition has been 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. No director has been convicted in a criminal proceeding and is not subject to a pending criminal proceeding (excluding traffic violations and other minor offenses).



No director has been 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.

No director has been 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.

## The Board of Directors and Committees

Subject to certain exceptions, under the listing standards of NASDAQ, a listed company's board of directors must consist of a majority of independent directors. Currently, our board of directors has determined that each of Messrs. Rittreiser and Staloff and Dr. Wang is an "independent" director as defined by the listing standards of NASDAQ currently in effect and approved by the SEC and all applicable rules and regulations of the SEC. We have established the following standing committees of the board: Audit, Compensation and Corporate Governance and Nominating. All members of the Audit Committee and a majority of the members of the 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 discussion 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 with the Company. The board of directors considered relationships and transactions between each director or any member of his immediate family and the Company and its subsidiaries and 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 the NASDAQ rules. Mr. Lin is not deemed an independent director within the meaning of applicable NASDAQ and SEC rules; however, the Board of Directors has determined that, in light of the relative newness of SmartHeat as a public company and the unique circumstances relating to conducting our operations in China, it is advisable and in the best interests of SmartHeat and its shareholders that Mr. Lin be appointed to each of the Compensation Committee and Nominating and Corporate Governance Committee of SmartHeat.

### Audit Committee

We established our Audit Committee in June 2008. The Audit Committee consists of Messrs. Rittreiser and Staloff and Dr. Wang, each of whom is an independent director. Mr. Staloff, 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. The Audit Committee's responsibilities include:

- The appointment, replacement, compensation, and oversight of work of the independent auditor, including resolution of disagreements between management and the independent auditor regarding financial reporting, for the purpose of preparing or issuing an audit report or performing other audit, review or attest services.
- Reviewing and discussing with management and the independent auditor various topics and events that may have significant financial impact on our company or that are the subject of discussions between management and the independent auditors.

The board of directors has adopted a written charter for the Audit Committee. A copy of the Audit Committee Charter is posted on our website at [www.smartheatinc.com](http://www.smartheatinc.com) ..

### Compensation Committee

We established our Compensation Committee in June 2008. The Compensation Committee consists of Messrs. Rittreiser and Staloff and Dr. Wang, each of whom is an independent director, and Mr. Lin. Dr. Wang is the Chairman of the Compensation Committee. The Compensation Committee is responsible for the design, review, recommendation and approval of compensation arrangements for our directors, executive officers and key employees, and for the administration of our equity incentive plans, including the approval of grants under such plans to our

employees, consultants and directors. The Compensation Committee also reviews and determines compensation of our executive officers, including our Chief Executive Officer. The board of directors has adopted a written charter for the Compensation Committee. A current copy of the Compensation Committee Charter is posted on our website at [www.smartheatinc.com](http://www.smartheatinc.com) ..

#### Nominating and Corporate Governance Committee

We established our Nominating and Corporate Governance Committee in June 2008. The Nominating and Corporate Governance Committee consists Messrs. Rittereiser and Staloff and Dr. Wang, each of whom is an independent director, and Mr. Lin. Mr. Rittereiser is the Chairman of the Nominating and Corporate Governance Committee. The Nominating and Corporate Governance Committee assists in the selection of director nominees, approves director nominations to be presented for shareholder approval at our annual general meeting and fills any vacancies on our board of directors, considers any nominations of director candidates validly made by shareholders, and reviews and considers developments in corporate governance practices. The board of directors has adopted a written charter for the Nominating and Corporate Governance Committee. A current copy of the Nominating and Corporate Governance Committee Charter is posted on our website at [www.smartheatinc.com](http://www.smartheatinc.com).

## Code of Conduct

Our board of directors has adopted a Code of Conduct, which applies to all directors, officers and employees. The purpose of the Code is to promote honest and ethical conduct. The Code is posted on our website located at [www.smartheatinc.com](http://www.smartheatinc.com), and is available in print, without charge, upon written request to SmartHeat at A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110027. We intend to post promptly any amendments to or waivers of the Code on our website.

## CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

Beijing YSKN Machinery & Electronic Equipment Co., Ltd ("YSKN") holds 6,808,000 shares, approximately 30.19%, of our common stock. YSKN was one of our sales agents in 2006 and 2007 and one of our suppliers in 2006. Sales through YSKN amounted to \$226,105 and \$174,901 in 2006 and 2007, respectively. During 2006 we purchased raw material from YSKN in the amount of \$215,031. Our sales agency relationship with YSKN ceased on April 14, 2008. As of December 31, 2008, we do not owe any amounts to YSKN. YSKN is owned by Messrs. Jun Wang, our Chairman of the Board, President and CEO, and Fang Li, each holding 50% of the equitable and legal rights, title and interests in and to the share capital of YSKN.

## EXECUTIVE COMPENSATION

## Summary Compensation Table

The following table sets forth information concerning the compensation for the years ended December 31, 2008 and 2007 of the principal executive officer, principal financial officer, in addition to our three most highly compensated officers whose annual compensation exceeded \$100,000, and up to two additional individuals for whom disclosure would have been required but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last fiscal year.

| Name and<br>Principal Position                       | Year | Salary (\$) (1) | Other Annual<br>Compensation (\$) | Total (\$) (1) |
|--|------|-----------------|-----------------------------------|----------------|
| Jun Wang<br>President and Chief Executive Officer    | 2008 | 18,000          | —                                 | 18,000         |
|  | 2007 | 18,000          | —                                 | 18,000         |
| Zhijuan Guo<br>Treasurer and Chief Financial Officer | 2008 | 10,684          | —                                 | 10,684         |
|  | 2007 | 10,684          | —                                 | 10,684         |

(1) based on an exchange rate of RMB7.3 = US\$1.00

## Narrative Disclosure to Summary Compensation Table.

## Employment Agreements

On January 1, 2008, Taiyu entered into a three year employment agreement with Mr. Jun Wang, which agreement may be renewed at the end of the initial term upon mutual agreement between Mr. Jun Wang and Taiyu. Either party shall give written notice to the other party of its intention not to renew the agreement at least 30 days prior to the end of the initial term. Pursuant to the terms of the employment agreement, Mr. Jun 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. In addition, Mr. Jun Wang shall be entitled to overtime pay in accordance with the applicable law.

On January 1, 2008, Taiyu entered into a three year employment agreement with Ms. Zhijuan Guo, at terms identical to the terms of the employment agreement with Mr. Jun Wang.

## Outstanding Equity Awards at Fiscal Year-End

As of December 31, 2008, there were no outstanding equity awards held by executive officers of our company.

## Stock Incentive Plans

We had no stock incentive plan during 2006, 2007 or 2008.

## Director Compensation

On June 19, 2008, Messrs. Rittreiser, Staloff and Dr. Wang joined the board of directors as independent directors, satisfying the definition of "independence" as defined in Rule 4200 of the NASDAQ Rules. Additionally, Mr. Lin

joined the board of directors on June 19, 2008. Mr. Lin is not an "independent" director. We agreed to pay the following annual compensation to our independent directors. Mr. Staloff is entitled to receive \$50,000 in cash per year, paid in equal quarterly installments. This fee includes \$10,000 for serving as Chairman of the audit committee. Mr. Rittereiser is entitled to receive \$40,000 in cash per year, paid in equal quarterly installments. Mr. Wang is entitled to receive \$12,000 in cash per year, paid in equal quarterly installments. In addition, on July 17, 2008, each of Messrs. Staloff and Rittereiser were awarded options to purchase 10,000 shares of our common stock, expiring on July 17, 2013, at an exercise price of \$4.60 per share, with a three year vesting schedule.

### Section 16 Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), requires our officers and directors and persons who own more than ten percent (10%) of our common stock to file with the SEC initial reports of ownership and reports of changes in ownership of our common stock. Such officers, directors and ten percent (10%) shareholders are also required by applicable SEC rules to furnish to us copies of all forms filed with the SEC pursuant to Section 16(a) of the Exchange Act. Based solely on our review of copies of forms filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, as amended, and written representations from certain reporting persons, we believe that during fiscal 2008 all reporting persons timely complied with all filing requirements applicable to them.

## SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following tables set forth certain information as of March 20, 2009 regarding the number of shares of common stock beneficially owned by (i) each person or entity known to us to own more than 5% of our common stock; (ii) our named executive officers; (iii) our directors; and (iv) all of our executive officers and directors as a group.

Unless otherwise indicated, each of the shareholders named in the table below has sole voting and investment power with respect to such shares of common stock. Except as otherwise indicated, the address of each of the shareholders listed below is: c/o Shenyang Taiyu Electronic & Machinery Co., Ltd., A-1, 10, Street 7, Shenyang Economic and Technological Development Zone, Shenyang, China 110027.

Except as otherwise noted, the individual or his or her family members had sole voting and investment power with respect to such shares. The percentages of beneficial ownership set forth below are based on 24,179,900 shares of our common stock issued and outstanding as of March 20, 2009.

| Name of Beneficial Owner   | Number of<br>Shares<br>Beneficially<br>Owned (1) | Percentage<br>Beneficially<br>Owned |
|--|--|-------------------------------------|
| <b>5% Shareholders:</b>  |  |                                     |
| Beijing YSKN Machinery & Electronic Equipment Co., Ltd (2)<br>Rm 1106, Huapu International Plaza No.19,<br>Chaowai Street, Chaoyang District<br>Beijing, China | 6,808,000  | 28.16%                              |
| Yang In Cheol (3)<br>#630-5, Namchon-Dong<br>Namdong-Yu<br>Incheon, South Korea 302-405  | 3,848,000  | 15.9%                               |
| ShenYang ZhiCe Investment Co., Ltd (4)<br>No. 1 Yuebin Street<br>Shenhe District<br>Shenyang, China 110027   | 2,960,000  | 12.42%                              |
| <b>Directors and Named Executive Officers</b>  |  |                                     |
| Jun Wang, Chairman of the Board, President and CEO (2)   | 3,404,000  | 14.08%                              |
| Zhijuan Guo, CFO   | 0  | —                                   |
| Frederic Rittereiser, Director   | 0  | —                                   |
| Arnold Staloff, Director   | 11,500   | *                                   |
| Weiguo Wang, Director  | 0  | —                                   |
| Wenbin Lin, Director   | 473,600(5)                                       | 1.96%                               |
| All Directors and named Executive Officers as a group (6 persons)  | 3,889,100  | 16.08%                              |

\* Less than 1% of shares outstanding.

- (1) The shares of our common stock beneficially owned are reported on the basis of regulations of the SEC governing the determination of beneficial ownership of securities. Under the rules of the SEC, 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 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 a right to acquire beneficial ownership within 60 days. Securities that can be so acquired are deemed to be outstanding for purposes of computing such person's ownership percentage, but not for purposes of computing any other person's percentage. Under these rules, more than one person may be deemed 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. Except as otherwise indicated in these footnotes, each of the beneficial owners has, to our knowledge, sole voting and investment power with respect to the indicated shares of common stock.

- (2) The information for YSKN and Mr. Jun Wang is derived from Amendment No. 1 to Schedule 13D, dated June 30, 2008, which was filed with the SEC to report the shares beneficially owned by such persons as of May 7, 2008. The Schedule 13D states that YSKN has sole power to vote and dispose of 6,808,000 shares owned by YSKN and that Messrs. Wang and Li each hold 50% of the equitable and legal rights, title and interests in and to the share capital of YSKN and, as a result of such ownership each of Messrs. Wang and Li has shared power to vote and dispose of the shares owned directly by YSKN.
- (3) The information for Yang In Cheol is derived from a Schedule 13G, dated April 25, 2008, which was filed with the SEC to report the shares beneficially owned by him as of April 14, 2008. The Schedule 13G states that Yang In Cheol has sole power to vote and dispose of 3,848,000 shares owned by him.
- (4) The information for ShenYang ZhiCe Investment Co., Ltd is derived from a Schedule 13G, dated April 25, 2008, which was filed with the SEC to report the shares beneficially owned by it as of April 14, 2008. The Schedule 13G states that ShenYang ZhiCe Investment Co., Ltd has sole power to vote and dispose of 2,960,000 shares owned by it. ShenYang ZhiCe Investment Co. is owned by Ms. Huiqin Wang, Ms. Dongmei Li and Mr. Zhaohui Lin, with each of them having a voice in the voting and disposition of the shares held by ShenYang ZhiCe Investment Co. Ms. Li and Mr. Lin are adult children of Wenbin Lin, a director of SmartHeat. Neither Mr. Wenbin Lin nor SmartHeat have any interest in, or other relationship with, ShenYang ZhiCe Investment Co.
- (5) Includes 473,600 shares beneficially owned by Mr. Lin's spouse through her ownership of 16% equity interest in ShenYang ZhiCe Investment Co., Ltd., which holds an aggregate of 2,960,000 shares of common stock of SmartHeat. Mr. Lin disclaims beneficial ownership of these shares.

## SELLING SHAREHOLDERS

The shares of common stock included in this prospectus (including shares issuable pursuant to the terms of outstanding warrants) were issued in a private placement transaction pursuant to which we sold an aggregate of 1,630,000 shares of our common stock and warrants to purchase 244,500 additional shares of our common stock at a purchase price of \$3.50 per unit (each unit consisting of one share of common stock, and a warrant to purchase 15% of one share of common stock at an exercise price of \$6.00 per share). In addition, this prospectus includes 148,500 shares of our common stock which are issuable pursuant to the terms of outstanding warrants we issued to the placement agents in the private placement transaction. The warrants are immediately exercisable, expire on the third anniversary of their issuance and entitle their holders, in the aggregate, to purchase up to 393,000 shares of our common stock at an initial exercise price of \$6.00 per share. The original issuance of the shares of common stock and warrants was exempt from the registration requirements of the Securities Act. The private placement was completed in two closings on July 7, 2008 and August 22, 2008.

The selling shareholders may sell all, some or none of their shares in this offering. See “Plan of Distribution.”

The table below lists the selling shareholders and other information regarding the beneficial ownership of the shares of common stock by each of the selling shareholders. The second column lists the number and percentage of shares of common stock beneficially owned by each selling shareholder, based on its ownership of shares and warrants, as of March 20, 2009, assuming exercise of all of the warrants held by the selling shareholders on that date, without regard to any limitations on exercise. The third column lists the shares of common stock being offered by this prospectus by the selling shareholders. Each selling shareholder’s percentage of ownership in the following table is based on 24,179,900 shares of common stock outstanding as of March 20, 2009.

| Shareholder  | Beneficial Ownership<br>Before Offering |              | Shares of Common<br>Stock Included<br>in Prospectus | Beneficial Ownership<br>After the Offering |              |
|--|---|--------------|---|--|--------------|
|  | Number                                  | Percentage * |   | Number                                     | Percentage * |
| Allied Diesel Service<br>Inc. Employee Profit<br>Sharing Plan #2 (i) | 11,500                                  |              | 11,500  | 0  |              |
| Barson, Kalman A.<br>Roth IRA  | 11,500                                  |              | 11,500  | 0  |              |
| Berkowitz, Daniel<br>IRA, Pershing LLC as<br>Custodian               | 11,500                                  |              | 11,500  | 0  |              |
| Berlinger, Michael A.  | 11,500                                  |              | 11,500  | 0  |              |
| Chasanoff, Teddy   | 11,500                                  |              | 11,500  | 0  |              |
| Choudhary, Chirag (ii)   | 2,550                                   |              | 2,550   | 0  |              |
| Clarke, Kevin IRA,<br>Pershing LLC as<br>Custodian                   | 11,500                                  |              | 11,500  | 0  |              |
| Clemente, Ann V.   | 11,500                                  |              | 11,500  | 0  |              |
| Domaco Venture<br>Capital Fund<br>Partnership (iii)                  | 11,500                                  |              | 11,500  | 0  |              |
| Elias Sayour<br>Foundation Inc. (iv)                                 | 11,500                                  |              | 11,500  | 0  |              |
| Engelbert, Marc  | 11,500                                  |              | 11,500  | 0  |              |
| Eximius bvba (v)   | 11,500                                  |              | 11,500  | 0  |              |

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|  |        |        |   |
|--|--------|--------|---|
| Falda, Evie and David  | 11,500 | 11,500 | 0 |
| Funcorp Associates<br>Ltd. (vi)  | 23,000 | 23,000 | 0 |
| G & S I Fund LP (vii)  | 69,000 | 69,000 | 0 |
| Geri Investments N.V.<br>(viii)  | 34,500 | 34,500 | 0 |
| Gibralt Capital<br>Corporation (ix)                                      | 81,650 | 81,650 | 0 |
| Gross, John  | 11,500 | 11,500 | 0 |
| Grossman, Andrew<br>Profit Sharing Plan,<br>Pershing LLC as<br>Custodian | 11,500 | 11,500 | 0 |
| Harmon Corporation<br>A.V.V. (x)   | 11,500 | 11,500 | 0 |

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|   |              |         |   |
|---|--------------|---------|---|
| Hight, Norton and Joan  | 11,500       | 11,500  | 0 |
| Hight, Randall W.   | 11,500       | 11,500  | 0 |
| Hou, Yuzhen   | 69,000       | 69,000  | 0 |
| Jaigobind, Ramnarain<br>(xi)                                  | 12,031       | 12,031  | 0 |
| Kelly, Maura  | 11,500       | 11,500  | 0 |
| Knox, Thomas  | 57,500       | 57,500  | 0 |
| La legetaz Private<br>Foundation (xii)                        | 34,500       | 34,500  | 0 |
| Lazar, Ronald M. IRA,<br>Pershing LLC as<br>Custodian (xiii)  | 11,500       | 11,500  | 0 |
| Lord, Eric (xiv)  | 2,278        | 2,278   | 0 |
| Luvera, Florence E.   | 11,500       | 11,500  | 0 |
| Mangan, Kevin (xv)  | 216          | 216     | 0 |
| Model, Wolfe F.   | 11,500       | 11,500  | 0 |
| Monte, Barney (xvi)   | 4,000        | 4,000   | 0 |
| Palmero, Nancy and<br>Herman                                  | 11,500       | 11,500  | 0 |
| Pirasteh, Ross  | 11,500       | 11,500  | 0 |
| Polak, Anthony G. (xvii)                                      | 11,500       | 11,500  | 0 |
| Polak, Anthony G. IRA,<br>Pershing LLC as<br>Custodian (xvii) | 11,500       | 11,500  | 0 |
| Polak, Jack IRA,<br>Pershing LLC as<br>Custodian (xviii)      | 11,500       | 11,500  | 0 |
| Quinn, David L. and<br>Tracy                                  | 11,500       | 11,500  | 0 |
| RL Capital Partners, LP<br>(xix)                              | 34,500       | 34,500  | 0 |
| Roman, Steve  | 11,500       | 11,500  | 0 |
| Rothschild, Jonathan  | 11,500       | 11,500  | 0 |
| Shapiro, Sandra G. and<br>Robert S.                           | 11,500       | 11,500  | 0 |
| Shearer, C. Robert  | 17,250       | 17,250  | 0 |
| Stadtmauer, Gary  | 11,500       | 11,500  | 0 |
| Stadtmauer, Murray and<br>Clare                               | 11,500       | 11,500  | 0 |
| Stadtmauer, Rhea D.<br>and Maiman, Janice                     | 11,500       | 11,500  | 0 |
| Staloff, Arnold   | 11,500       | 11,500  | 0 |
| Strong Growth Capital<br>Ltd (xx)                             | 977,500 3.9% | 977,500 | 0 |
| Sun Fun Investing Inc.<br>(xxi)                               | 11,500       | 11,500  | 0 |
| Swerdloff, David IRA,<br>Pershing LLC as<br>Custodian         | 11,500       | 11,500  | 0 |
|   | 23,000       | 23,000  | 0 |

The USX China Fund  
(xxii)

|   |        |        |   |
|---|--------|--------|---|
| Tornay, Suellyn P.                      | 11,500 | 11,500 | 0 |
| White Sand Investor Group, L.P. (xxiii) | 16,100 | 16,100 | 0 |
| William H. Peterson Living Trust (xxiv) | 11,500 | 11,500 | 0 |
| Four Tong Investments Ltd (xxv)         | 91,000 | 91,000 | 0 |
| Maxim Group LLC (xxvi)                  | 10,000 | 10,000 | 0 |
| Rodman & Renshaw LLC (xxvii)            | 25,425 | 25,425 | 0 |
| Seaboard Securities Inc. (xxviii)       | 1,000  | 1,000  | 0 |

\* Less than 1%, unless otherwise specified

- (i) Ralph A. Darienzo, Sr. and Ralph A. Darienzo, Jr., trustees of the Allied Diesel Service Inc. Employee Profit Sharing Plan #2, and Ronald Lazar (a registered representative of Maxim Group, LLC, a registered broker-dealer and FINRA member firm), investment advisor to the Plan, have voting and dispositive control over the shares held by the Allied Diesel Service Inc. Employee Profit Sharing Plan #2.
- (ii) Chirag Choudhary is a registered representative of Rodman & Renshaw LLC, a registered broker-dealer and FINRA member firm. Mr. Choudhary acquired his shares from Rodman & Renshaw LLC as compensation for placement agent services.
- (iii) Jack Polak, father of Anthony Polak (a registered representative of Maxim Group, LLC, a registered broker-dealer and FINRA member firm) and general partner of Domaco Company, parent of the Domaco Venture Capital Fund, has voting and dispositive control over the shares held by Domaco Venture Capital Fund.
- (iv) Paul Sayour and Mary Jane Josen, trustees of the Elias Sayour Foundation, Inc., have shared voting and dispositive control over the shares held by the Elias Sayour Foundation, Inc.
- (v) Jos Moons, manager and owner of Eximius bvba, has sole voting and dispositive power with respect to the shares of our common stock that are beneficially owned by Eximius bvba.
- (vi) Herman J. Behr (Managing Director), Gisele M. Sjak Shie (Managing Director), Raoul A. Behr (Managing Director), Randolph K. Arends (Attorney-in-fact A), Reginald D. Schotborgh (Attorney-in-fact A), Godefridus H.J. Konings (Attorney-in-fact B), Gustaaf J. Barhorst (Attorney-in-fact B), and Remir F. Sinlae (Attorney-in-fact B) have joint voting and investment power with respect to these shares of common stock under the following two restrictions: Any Managing Director or any Attorney-in-fact A can act jointly with any other Managing Director, Attorney-in-fact A or Attorney-in-fact B. Any Attorney-in-fact B must act jointly with any Managing Director or any Attorney-in-fact A, but may not act jointly with any other Attorney-in-fact B.
- (vii) Charles E. Shearer and Michael Gray are members of Gray & Shearer Capital Management LLC, the general partner of G&S I Fund LP, and have shared voting and dispositive power with respect to the shares of our common stock that are beneficially owned by G&S I Fund LP.
- (viii) Marimus J. Dekver, director of Geri Investments N.V., has voting and dispositive control over the shares held by Geri Investments N.V.
- (ix) Sam Belzberg has voting and dispositive power with respect to the shares of our common stock that are beneficially owned by Gibralt Capital Corporation.
- (x) Herman J. Behr (Managing Director), Gisele M. Sjak Shie (Managing Director), Raoul A. Behr (Managing Director), Randolph K. Arends (Attorney-in-fact A), Reginald D. Schotborgh (Attorney-in-fact A), Godefridus H.J. Konings

(Attorney-in-fact B), Gustaaf J. Barhorst (Attorney-in-fact B), and Remir F. Sinlae (Attorney-in-fact B) have joint voting and investment power with respect to these shares of common stock under the following two restrictions: Any Managing Director or any Attorney-in-fact A can act jointly with any other Managing Director, Attorney-in-fact A or Attorney-in-fact B. Any Attorney-in-fact B must act jointly with any Managing Director or any Attorney-in-fact A, but may not act jointly with any other Attorney-in-fact B.

- (xi) Ramnarain Jaigobind is a registered representative of Rodman & Renshaw LLC, a registered broker-dealer and FINRA member firm. Mr. Jaigobind acquired his shares from Rodman & Renshaw LLC as compensation for placement agent services.



- (xii) Herman J. Behr (Managing Director), Gisele M. Sjak Shie (Managing Director), Raoul A. Behr (Managing Director), Randolph K. Arends (Attorney-in-fact A), Reginald D. Schotborgh (Attorney-in-fact A), Godefridus H.J. Konings (Attorney-in-fact B), Gustaaf J. Barhorst (Attorney-in-fact B), and Remir F. Sinlae (Attorney-in-fact B) have joint voting and investment power with respect to these shares of common stock under the following two restrictions: Any Managing Director or any Attorney-in-fact A can act jointly with any other Managing Director, Attorney-in-fact A or Attorney-in-fact B. Any Attorney-in-fact B must act jointly with any Managing Director or any Attorney-in-fact A, but may not act jointly with any other Attorney-in-fact B.
- (xiii) Ronald Lazar is a registered representative of Maxim Group, LLC, a registered broker-dealer and FINRA member firm. Mr. Lazar purchased his shares in the ordinary course of business and, at the time of purchase, had no agreements or understandings, directly or indirectly, with any person to distribute the shares.
- (xiv) Eric Lord is a registered representative of Rodman & Renshaw LLC, a registered broker-dealer and FINRA member firm. Mr. Lord acquired his shares from Rodman & Renshaw LLC as compensation for placement agent services.
- (xv) Kevin Mangan is a registered representative of Rodman & Renshaw LLC, a registered broker-dealer and FINRA member firm. Mr. Mangan acquired his shares from Rodman & Renshaw LLC as compensation for placement agent services.
- (xvi) Barney Monte is a registered representative of Rodman & Renshaw LLC, a registered broker-dealer and FINRA member firm. Mr. Monte acquired his shares from Rodman & Renshaw LLC. as compensation for placement agent services
- (xvii) Anthony G. Polak is a registered representative of Maxim Group, LLC, a registered broker-dealer and FINRA member firm. Mr. Polak purchased his shares in the ordinary course of business and, at the time of purchase, had no agreements or understandings, directly or indirectly, with any person to distribute the shares.
- (xviii) Jack Polak is father of Anthony Polak (a registered representative of Maxim Group, LLC, a registered broker-dealer and FINRA member firm).
- (xix) Ronald M. Lazar and Anthony G. Polak are managing members of RL Capital Management LLC, the general partner of RL Capital Partners, LP, and have voting and dispositive control over the shares held by RL Capital Partners, LP. Messrs. Lazar and Polak are registered representatives of the Maxim Group, LLC, a registered broker-dealer and FINRA member firm. RL Capital Partners, LP purchased its shares in the ordinary course of business and, at the time of purchase, had no agreements or understandings, directly or indirectly, with any person to distribute the shares.
- (xx) Lee Ming has sole voting and dispositive power with respect to the shares of our common stock that are beneficially owned by Strong Growth Capital Ltd.
- (xxi)

Wim C. Odems, managing director of Trufima International Corporation Ltd., owner of Sun Fun Investing Inc., has voting and dispositive power with respect to the shares of our common stock that are beneficially owned by Sun Fun Investing Inc.

- (xxii) Stephen L. Parr, Managing Member of Parr Financial Group, LLC, investment adviser to the USX China Fund, has voting and dispositive power with respect to the shares of our common stock that are beneficially owned by the USX China Fund.
- (xxiii) Elliott Donnelley II has sole voting and dispositive power with respect to the shares of our common stock that are beneficially owned by White Sand Investor Group, LP.
- (xxiv) William H. Peterson, trustee of the William H. Peterson Living Trust, has voting and dispositive control over the shares of our common stock that are beneficially owned by William H. Peterson Living Trust.
- (xxv) Wei Li has sole voting and dispositive power with respect to the shares of our common stock that are beneficially owned by Four Tong Investments LLC. Four Tong Investments LLC is a broker-dealer that received its warrants as compensation for placement agent services.

- (xxvi) Michael Rabinowitz has sole voting and dispositive power with respect to the shares of common stock that are beneficially owned by Maxim Group, LLC. Maxim Group, LLC is a broker-dealer that received its warrants as compensation for placement agent services from Rodman & Renshaw LLC.
- (xxvii) Thomas G. Pinou has sole voting and dispositive power with respect to the shares of common stock that are beneficially owned by Rodman & Renshaw LLC. Rodman & Renshaw is a broker-dealer that received its warrants as compensation for placement agent services.
- (xxviii) Anthony DiGiovanni Sr. has voting and dispositive power with respect to the shares of common stock that are beneficially owned by Seaboard Securities Inc. Seaboard Securities Inc. is a broker-dealer that received its warrants as compensation for placement agent services.

## PLAN OF DISTRIBUTION

The selling shareholders identified in this prospectus may offer and sell up to an aggregate of 2,023,000 shares of our common stock which we have issued to them, or which we may issue to them upon the exercise of certain warrants issued to them. The selling shareholders may sell all or a portion of their shares through public or private transactions at prevailing market prices or at privately negotiated prices.

All of the shares and warrants described above were previously issued in a private placement transaction completed prior to the filing of the registration statement of which this prospectus is a part.

The selling shareholders may sell all or a portion of the shares of common stock beneficially owned by them and offered hereby from time to time directly or through one or more underwriters, broker-dealers or agents. If the shares of common stock are sold through underwriters or broker-dealers, the selling shareholders will be responsible for underwriting discounts or commissions or agent's commissions. The shares of common stock may be sold in one or more transactions at fixed prices, at prevailing market prices at the time of the sale, at varying prices determined at the time of sale, or at negotiated prices. These sales may be effected in transactions, which may involve crosses or block transactions,

- on any national securities exchange or quotation service on which the securities may be listed or quoted at the time of sale;
- in the over-the-counter market;
- in transactions otherwise than on these exchanges or systems or in the over-the-counter market;
- through the writing of options, whether such options are listed on an options exchange or otherwise;
- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- short sales;
- sales pursuant to Rule 144;
- broker-dealers may agree with the selling securityholders to sell a specified number of such shares at a stipulated price per share;

- a combination of any such methods of sale; and
- any other method permitted pursuant to applicable law.

If the selling shareholders effect such transactions by selling shares of common stock to or through underwriters, broker-dealers or agents, such underwriters, broker-dealers or agents may receive commissions in the form of discounts, concessions or commissions from the selling shareholders or commissions from purchasers of the shares of common stock for whom they may act as agent or to whom they may sell as principal (which discounts, concessions or commissions as to particular underwriters, broker-dealers or agents may be in excess of those customary in the types of transactions involved). In connection with sales of the shares of common stock or otherwise, the selling shareholders may enter into hedging transactions with broker-dealers, which may in turn engage in short sales of the shares of common stock in the course of hedging in positions they assume. The selling shareholders may also sell shares of common stock short and deliver shares of common stock covered by this prospectus to close out short positions and to return borrowed shares in connection with such short sales. The selling shareholders may also loan or pledge shares of common stock to broker-dealers that in turn may sell such shares.

The selling shareholders may pledge or grant a security interest in some or all of the warrants or shares of common stock owned by them and, if they default in the performance of their secured obligations, the pledgees or secured parties may offer and sell the shares of common stock from time to time pursuant to this prospectus or any amendment to this prospectus under Rule 424(b)(3) or other applicable provision of the Securities Act amending, if necessary, the list of selling shareholders to include the pledgee, transferee or other successors in interest as selling shareholders under this prospectus. The selling shareholders also may transfer and donate the shares of common stock in other circumstances in which case the transferees, donees, pledgees or other successors in interest will be the selling beneficial owners for purposes of this prospectus.

The selling shareholders and any broker-dealer participating in the distribution of the shares of common stock may be deemed to be “underwriters” within the meaning of the Securities Act, and any commission paid, or any discounts or concessions allowed to, any such broker-dealer may be deemed to be underwriting commissions or discounts under the Securities Act. At the time a particular offering of the shares of common stock is made, a prospectus supplement, if required, will be distributed which will set forth the aggregate amount of shares of common stock being offered and the terms of the offering, including the name or names of any broker-dealers or agents, any discounts, commissions and other terms constituting compensation from the selling shareholders and any discounts, commissions or concessions allowed or reallocated or paid to broker-dealers.

Under the securities laws of some states, the shares of common stock may be sold in such states only through registered or licensed brokers or dealers. In addition, in some states the shares of common stock may not be sold unless such shares have been registered or qualified for sale in such state or an exemption from registration or qualification is available and is complied with.

There can be no assurance that any selling shareholder will sell any or all of the shares of common stock registered pursuant to the shelf registration statement of which this prospectus is a part.

The selling shareholders and any other person participating in such distribution will be subject to applicable provisions of the Exchange Act and the rules and regulations thereunder, including, without limitation, Regulation M of the Exchange Act, which may limit the timing of purchases and sales of any of the shares of common stock by the selling shareholders and any other participating person. Regulation M may also restrict the ability of any person engaged in the distribution of the shares of common stock to engage in market-making activities with respect to the shares of common stock. All of the foregoing may affect the marketability of the shares of common stock and the ability of any person or entity to engage in market-making activities with respect to the shares of common stock.

We have agreed to pay all expenses of the registration of the shares of common stock including, without limitation, SEC filing fees and expenses of compliance with state securities or “blue sky” laws; provided, however, that a selling shareholder will pay all underwriting discounts and selling commissions, if any. We will indemnify the selling shareholders against liabilities, including some liabilities under the Securities Act, in accordance with our agreement to register the shares, or the selling shareholders will be entitled to contribution. We may be indemnified by the selling shareholders against civil liabilities, including liabilities under the Securities Act, that may arise from any written information furnished to us by the selling shareholder specifically for use in this prospectus, in accordance with the related registration rights agreements, or we may be entitled to contribution.

Once sold under the registration statement of which this prospectus is a part, the shares of common stock will be freely tradable in the hands of persons other than our affiliates.

## DESCRIPTION OF SECURITIES

The following description of our securities and provisions of our articles of incorporation and bylaws is only a summary. You should refer to our articles of incorporation, a copy of which has been incorporated by reference as an exhibit to the Form SB-2 we filed with the SEC on December 22, 2006, and bylaws, a copy of which has been incorporated by reference as an exhibit to the Form 8-K we filed with the SEC on October 16, 2008. The following discussion is qualified in its entirety by reference to such exhibits.

### Authorized Capital Stock

The total number of stock authorized that may be issued by us is 75,000,000 shares of common stock with a par value of \$0.001 per share. We have no other authorized class of stock.

### Capital Stock Issued and Outstanding

As of March 20, 2009, 24,179,900 shares of common stock were issued and outstanding and held of record by 149 shareholders. An additional 393,000 shares are reserved for issuance upon the exercise of outstanding warrants. The warrants are immediately exercisable, expire on the third anniversary of their issuance and entitle their holders to purchase up to 393,000 shares of our common stock at an initial exercise price of \$6.00 per share. We have also reserved an additional 20,000 shares for issuance upon the exercise of outstanding stock options granted to two of our directors. Each option vests in one-third increments on the first three anniversaries of the grant date, entitles the holder to purchase 10,000 shares of our common stock at an exercise price of \$4.60 per share and expires on the fifth anniversary of the grant date.

### Description of Common Stock

The holders of common stock are entitled to one vote per share. Our Articles of Incorporation does not provide for cumulative voting. The holders of common stock are entitled to receive ratably such dividends, if any, as may be declared by our board of directors out of legally available funds; however, the current policy of our board of directors is to retain earnings, if any, for operations and growth. Upon liquidation, dissolution or winding-up, the holders of common stock are entitled to share ratably in all assets that are legally available for distribution. The holders of common stock have no preemptive, subscription, redemption or conversion rights.

### Market Information

On April 22, 2008, shares of our common stock began trading on the OTCBB under the trading symbol "SMHT." On January 29, 2009, shares of our common stock began trading on the Nasdaq Stock Market under the trading symbol "HEAT" and were subsequently listed on the Nasdaq Global Market on March 10, 2009. Since April 22, 2008, our average daily trading volume has been less than 10,000 shares per day. As with most initial listings on the Nasdaq Stock Market, it will take time for a significant active trading market in our common stock to develop. There can be no assurance that a significant active trading market in our common stock will develop, or if such a market develops, that it will be sustained.

## INTEREST OF NAMED EXPERTS

No expert or counsel named in this registration statement as having prepared or certified any part of this statement or having given an opinion upon the validity of the securities being registered or upon other legal matters in connection with the registration or offering of the common stock was employed on a contingency basis, or had, or will receive, in connection with the offering, a substantial interest, direct or indirect, in the registrant. Nor was any such person

connected with the registrant as a promoter, managing or principal underwriter, voting trustee, director, officer, or employee.

The audited financial statements of Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd as of December 31, 2007 were audited by Goldman, Parks, Kurland, Mohidin LLP, an independent registered public accounting firm, to the extent set forth in its report and are included herein in reliance upon the authority of this firm as experts in accounting and auditing.



## LEGAL MATTERS

The validity of our common stock offered hereby will be passed upon for us by Holland & Hart LLP.

### CHANGE IN THE COMPANY'S INDEPENDENT ACCOUNTANT

On April 14, 2008, we dismissed Dale Matheson Carr Hilton Labonte LLP ("DMCHL") as our independent accountants. DMCHL had previously been engaged as the principal accountant to audit our financial statements. The reason for the dismissal of DMCHL is that, following the consummation of the Share Exchange on April 14, 2008, (i) the former stockholders of Taiyu own a significant amount of the outstanding shares of our common stock and (ii) our primary business became the business previously conducted by Taiyu. The independent registered public accountant of Taiyu for US accounting purposes was the firm of Goldman Parks Kurland Mohidin LLP ("GPKM"). We believe that it is in our best interest to have GPKM continue to work with our business, and we therefore retained GPKM as our new principal independent registered accounting firm, effective as of April 15, 2008. GPKM is located at 16133 Ventura Blvd., Suite 880, Encino, CA 91436. The decision to change accountants was approved by our board of directors on April 14, 2008.

The report of DMCHL on our financial statements for the period from August 4, 2006 (inception) through our fiscal year ended October 31, 2007 did not contain an adverse opinion or disclaimer of opinion, nor was it qualified or modified as to uncertainty, audit scope or accounting principles, except that the report was qualified as to our ability to continue as a going concern.

From our inception through April 15, 2008, there were no disagreements with DMCHL on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of DMCHL, would have caused it to make reference to the matter in connection with its reports.

From our inception through April 14, 2008, we did not consult GPKM regarding either: (i) the application of accounting principles to a specific completed or contemplated transaction, or the type of audit opinion that might be rendered on our financial statements; or (ii) any matter that was the subject of a disagreement as described in Item 304(a)(1)(iv) of Regulation S-K.

## INDEMNIFICATION OF DIRECTORS AND OFFICERS

The Nevada Revised Statutes provide that a director or officer is not individually liable to the corporation or its shareholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that his act or failure to act constituted a breach of his fiduciary duties as a director or officer and his breach of those duties involved intentional misconduct, fraud or a knowing violation of law. The Articles of Incorporation or an amendment thereto may, however, provide for greater individual liability. Furthermore, directors may be jointly and severally liable for the payment of certain distributions in violation of Chapter 78 of the Nevada Revised Statutes.

This provision is intended to afford directors and officers protection against and to limit their potential liability for monetary damages resulting from suits alleging a breach of the duty of care by a director or officer. As a consequence of this provision, shareholders of our company will be unable to recover monetary damages against directors or officers for action taken by them that may constitute negligence or gross negligence in performance of their duties unless such conduct meets the requirements of Nevada law to impose such liability. The provision, however, does not alter the applicable standards governing a director's or officer's fiduciary duty and does not eliminate or limit the right of our company or any shareholder to obtain an injunction or any other type of non-monetary relief in the event of a breach of fiduciary duty.

The Nevada Revised Statutes also provide that under certain circumstances, a corporation may indemnify any person for amounts incurred in connection with a pending, threatened or completed action, suit or proceeding in which he is, or is threatened to be made, a party by reason of his being a director, officer, employee or agent of the corporation or serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, if such person (a) is not liable for a breach of fiduciary duty involving intentional misconduct, fraud or a knowing violation of law or such greater standard imposed by the corporation's articles of incorporation; or (b) acted in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. Additionally, a corporation may indemnify a director, officer, employee or agent with respect to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor, if such person (a) is not liable for a breach of fiduciary duty involving intentional misconduct, fraud or a knowing violation of law or such greater standard imposed by the corporation's articles of incorporation; or (b) acted in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, however, indemnification may not be made for any claim, issue or matter as to which such a person has been adjudged by a court to be liable to the corporation or for amounts paid in settlement to the corporation, unless the court determines that the person is fairly and reasonably entitled to indemnity for such expenses as the court deems proper. To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to above, or in defense of any claim, issue or matter therein, the corporation shall indemnify him against expenses, including attorneys' fees, actually and reasonably incurred by him in connection with the defense.

Our By-Laws provide, among other things, that a director, officer, employee or agent of the corporation will be indemnified against all expense, liability, and loss (including attorneys' fees, judgments, fines, taxes, penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered in connection with any threatened, pending, or completed action suit, or proceeding, whether civil, criminal, administrative, or investigative provided that he or she either is not liable pursuant to Nevada Revised Statutes 78.138 (relating to liability of directors and officers to the corporation in certain instances) or acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation and, in the case of a criminal proceeding, had no reasonable cause to believe that his or her conduct was unlawful.

Insofar as indemnification for liabilities arising under the Securities Act, may be provided for directors, officers, employees, agents or persons controlling an issuer pursuant to the foregoing provisions, the opinion of the SEC is that such indemnification is against public policy as expressed in the Securities Act, and is therefore unenforceable.

SMARTHEAT CORPORATION  
Consolidated Financial Statements  
For the Years Ended December 31, 2008, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the shareholders of SmatHeat, Inc.,  
fka (Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd.)

We have audited the consolidated balance sheets of SmartHeat, Inc, fka (Shenyang Taiyu Machinery & Electronic Equipment Co., Ltd.) and Subsidiary (the “Company”) as of December 31, 2008 and 2007 and the related consolidated statements of income and other comprehensive income, shareholders’ equity and cash flows for each of the two years ended December 31, 2008 and 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 financial statement 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, 2008 and 2007, and the consolidated results of its operations and its cash flows for the years ended December 31, 2008 and 2007 in conformity with U.S. generally accepted accounting principles.

Goldman Parks Kurland Mohidin LLP  
Encino, California  
March 11, 2009

SMARTHEAT, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

AS OF  
DECEMBER 31, 2008      AS OF  
DECEMBER 31, 2007

| ASSETS                                      |    |            |               |
|---|----|------------|---------------|
| <b>CURRENT ASSETS</b>                       |    |            |               |
| Cash & cash equivalents                     | \$ | 1,435,212  | \$ 393,147    |
| Restricted cash                             |    | 462,048    | 537,098       |
| Accounts receivable, net                    |    | 11,390,169 | 4,762,822     |
| Retentions receivable                       |    | 290,852    | 191,319       |
| Advances to suppliers                       |    | 412,524    | 158,750       |
| Other receivables, prepayments and deposits |    | 698,834    | 766,231       |
| Inventories                                 |    | 6,107,583  | 7,928,408     |
| Due from related party                      |    | -          | 118,560       |
| Note receivable                             |    | 14,631     | -             |
| Total current assets                        |    | 20,811,853 | 14,856,335    |
| <b>NON-CURRENT ASSETS</b>                   |    |            |               |
| Restricted cash                             |    | 219,472    | -             |
| Accounts receivable, net                    |    | 310,810    | 949,998       |
| Retentions receivable                       |    | 166,912    | 169,309       |
| Intangible assets, net                      |    | 1,155,131  | 534,208       |
| Property and equipment, net                 |    | 2,436,553  | 2,040,809     |
| Total noncurrent assets                     |    | 4,288,878  | 3,694,324     |
| <b>TOTAL ASSETS</b>                         | \$ | 25,100,731 | \$ 18,550,659 |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |    |            |               |
| <b>CURRENT LIABILITIES</b>                  |    |            |               |
| Accounts payable                            | \$ | 1,210,906  | \$ 3,128,585  |
| Unearned revenue                            |    | 850,408    | 3,125,406     |
| Taxes payable                               |    | 1,327,775  | 503,010       |
| Accrued liabilities and other payables      |    | 1,330,812  | 807,700       |
| Due to related party                        |    | -          | 445,990       |
| Due to minority shareholder                 |    | 5,303      | -             |
| Loans payable                               |    | 2,443,450  | 4,619,856     |
| Total current liabilities                   |    | 7,168,654  | 12,630,547    |
| DEFERRED TAX LIABILITY                      |    | 38,854     | -             |
| <b>COMMITMENTS AND CONTINGENCIES</b>        |    |            |               |
| <b>MINORITY INTEREST</b>                    |    |            |               |
|   |    | -          | -             |

## STOCKHOLDERS' EQUITY

Common stock, \$0.001 par value; 75,000,000 shares authorized,  
24,179,900 and 18,500,000 shares issued and outstanding at  
December 31, 2008 and December 31, 2007, respectively

|   |                      |                      |
|---|----------------------|----------------------|
|   | 24,180               | 18,500               |
| Paid in capital                                   | 8,223,453            | 3,102,132            |
| Statutory reserve                                 | 1,150,542            | 506,532              |
| Accumulated other comprehensive income            | 984,629              | 473,859              |
| Retained earnings                                 | 7,510,419            | 1,819,089            |
| <b>Total stockholders' equity</b>                 | <b>17,893,223</b>    | <b>5,920,112</b>     |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 25,100,731</b> | <b>\$ 18,550,659</b> |

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SMARTHEAT, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME AND OTHER COMPREHENSIVE INCOME

|   | FOR THE YEARS ENDED<br>DECEMBER 31, |               |
|---|-------------------------------------|---------------|
|   | 2008                                | 2007          |
| Net sales                                   | \$ 32,676,082                       | \$ 13,273,151 |
| Cost of goods sold                          | 21,717,735                          | 8,667,353     |
| Gross profit                                | 10,958,347                          | 4,605,798     |
| Operating expenses                          |                                     |               |
| Selling expenses                            | 1,564,977                           | 1,681,624     |
| General and administrative expenses         | 1,851,693                           | 687,466       |
| Total operating expenses                    | 3,416,670                           | 2,369,090     |
| Income from operations                      | 7,541,677                           | 2,236,708     |
| Non-operating income (expenses)             |                                     |               |
| Interest income                             | 405,266                             | 175,084       |
| Interest expense                            | (314,192)                           | (230,905)     |
| Other income                                | 11,738                              | 45,126        |
| Other expenses                              | (13,709)                            | (16,939)      |
| Exchange loss                               | (12,044)                            | -             |
| Subsidy income                              | 16,230                              | 52,591        |
| Total non-operating income                  | 93,289                              | 24,957        |
| Income before income tax                    | 7,634,966                           | 2,261,665     |
| Income tax expense                          | 1,293,660                           | 175,647       |
| Income after income tax                     | 6,341,306                           | 2,086,018     |
| Less: minority interest                     | 5,966                               | (1,873)       |
| Net income                                  | 6,335,340                           | 2,087,891     |
| Other comprehensive item                    |                                     |               |
| Foreign currency translation                | 510,770                             | 333,449       |
| Comprehensive Income                        | \$ 6,846,110                        | \$ 2,421,340  |
| Basic weighted average shares outstanding   | 22,176,322                          | 18,500,000    |
| Diluted weighted average shares outstanding | 22,176,432                          | 18,500,000    |



|                            |    |      |    |      |
|----------------------------|----|------|----|------|
| Basic earnings per share   | \$ | 0.29 | \$ | 0.11 |
| Diluted earnings per share | \$ | 0.29 | \$ | 0.11 |

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SMARTHEAT INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

|  | Common stock |           | Paid in      | Statutory  | Other                   | Retained   | Total        |
|--|--------------|-----------|--------------|------------|-------------------------|------------|--------------|
|  | Shares       | Amount    | capital      | reserves   | comprehensive<br>income | earnings   |              |
| Balance at<br>December 31,<br>2005                           | 18,500,000   | \$ 18,500 | \$ 1,806,405 | \$ 211,701 | \$ 38,741               | \$ 113,767 | \$ 2,189,114 |
| Balance at<br>December 31,<br>2006                           | 18,500,000   | \$ 18,500 | \$ 2,181,782 | \$ 296,364 | \$ 140,410              | \$ 861,716 | \$ 3,498,772 |
| Stock dividend<br>declared                                   | -            | -         | 920,350      | -          | -                       | -920,350   | -            |
| Net income for<br>the year                                   | -            | -         | -            | -          | -                       | 2,087,891  | 2,087,891    |
| Transfer to<br>statutory<br>reserves                         | -            | -         | -            | 210,168    | -                       | -210,168   | -            |
| Foreign<br>currency<br>translation gain                      | -            | -         | -            | -          | 333,449                 | -          | 333,449      |
| Balance at<br>December 31,<br>2007                           | 18,500,000   | 18,500    | 3,102,132    | 506,532    | 473,859                 | 1,819,089  | 5,920,112    |
| Recapitalization<br>on reverse<br>acquisition                | 4,049,900    | 4,050     | -4,050       | -          | -                       | -          | -            |
| Shares issued  | 1,630,000    | 1,630     | 5,119,758    | -          | -                       | -          | 5,121,388    |
| Net income for<br>the period                                 | -            | -         | -            | -          | -                       | 6,335,340  | 6,335,340    |
| Stock<br>compensation<br>expense related<br>to stock options | -            | -         | 5,613        | -          | -                       | -          | 5,613        |
|  | -            | -         | -            | 644,010    | -                       | -644,010   | -            |

Transfer to  
statutory  
reserves

Foreign  
currency  
translation gain

|   |   |   |   |         |   |         |
|---|---|---|---|---------|---|---------|
| - | - | - | - | 510,770 | - | 510,770 |
|---|---|---|---|---------|---|---------|

Balance at  
December 31,  
2008

|            |           |              |              |            |              |               |
|------------|-----------|--------------|--------------|------------|--------------|---------------|
| 24,179,900 | \$ 24,180 | \$ 8,223,453 | \$ 1,150,542 | \$ 984,629 | \$ 7,510,419 | \$ 17,893,223 |
|------------|-----------|--------------|--------------|------------|--------------|---------------|

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SMARTHEAT, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED  
DECEMBER 31,  
2008                      2007

|   |              |              |
|---|--------------|--------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                  |              |              |
| Net income  | \$ 6,335,340 | \$ 2,087,891 |
| Adjustments to reconcile net income to net cash used in operating activities: |              |              |
| Depreciation and amortization   | 252,598      | 104,055      |
| Unearned interest on accounts receivable                                      | (127,819)    | (122,379)    |
| Stock option compensation expense   | 5,613        | -            |
| Decrease in deferred tax liability  | (163)        | -            |
| Minority interest   | 5,966        | (1,873)      |
| (Increase) decrease in current assets:  |              |              |
| Accounts receivable   | (4,943,868)  | (2,526,521)  |
| Retentions receivable   | (74,797)     | 70,446       |
| Advances to suppliers   | 62,759       | (45,386)     |
| Other receivables, prepayments and deposits                                   | 182,577      | (327,734)    |
| Inventory   | 2,405,678    | (2,184,063)  |
| Receivables from related party  | -            | (86,242)     |
| Increase (decrease) in current liabilities:                                   |              |              |
| Accounts payable  | (2,389,649)  | 979,881      |
| Unearned revenue  | (2,993,636)  | 1,265,085    |
| Taxes payable   | 779,408      | 326,053      |
| Accrued liabilities and other payables  | (261,040)    | 513,507      |
| Payables to related party   | -            | (54,761)     |
| Net cash used in operating activities   | (761,033)    | (2,041)      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                  |              |              |
| Increase in restricted cash   | (108,040)    | (135,915)    |
| Cash purchased at acquisition   | 55,426       | -            |
| Acquisition of property & equipment   | (439,861)    | (909,280)    |
| Note receivable   | (14,635)     | -            |
| Net cash used in investing activities   | (507,110)    | (1,045,195)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                  |              |              |
| Change in due to minority shareholders  | (663)        | -            |
| Change in due from / (to) shareholder   | (343,913)    | (558,243)    |
| Short term loans  | (2,447,804)  | 1,774,966    |
| Capital contribution  | 5,100,000    | -            |
| Net cash provided by financing activities                                     | 2,307,620    | 1,216,723    |
| EFFECT OF EXCHANGE RATE CHANGE ON CASH & CASH EQUIVALENTS                     | 2,588        | 21,365       |

|  |              |            |
|--|--------------|------------|
| NET INCREASE IN CASH & CASH EQUIVALENTS    | 1,042,065    | 190,852    |
| CASH & CASH EQUIVALENTS, BEGINNING OF YEAR | 393,147      | 202,295    |
| CASH & CASH EQUIVALENTS, END OF YEAR       | \$ 1,435,212 | \$ 393,147 |
| Supplemental Cash flow data:               |              |            |
| Income tax paid                            | \$ 660,127   | \$ 134,033 |
| Interest paid                              | \$ 274,969   | \$ 280,719 |

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

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 is engaged in the manufacturing and sale of plate heat exchangers and various packages, thermometer testing devices and heat usage calculators through its wholly owned operating subsidiary in China.

On April 14, 2008, the Company entered into a Share Exchange Agreement with Shenyang Taiyu Machinery and Electronic Equipment Co., Ltd. ("Taiyu") and the Taiyu Shareholders. The Company issued 18,500,000 shares of its common stock to the shareholder of Taiyu in exchange for all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of RMB 25,000,000. Concurrent with the share exchange, one of SmartHeat's shareholders cancelled 2,500,000 shares out of 6,549,900 of total issued and outstanding shares of SmartHeat pursuant to the Split-Off Agreement dated April 14, 2008. As a result of the share exchange and the cancellation of the 2,500,000 shares of the Company's common stock, there are 22,549,900 shares of the Company's common stock issued and outstanding, approximately 82.04% of which are held by the former Taiyu Shareholders. The shareholders of the Company immediately prior to the completion of these transactions hold the remaining 17.96% of the issued and outstanding share capital of SmartHeat. Taiyu became a wholly-owned subsidiary of SmartHeat.

Prior to the acquisition of Taiyu, the Company was a non-operating public shell. Pursuant to Securities and Exchange Commission ("SEC") rules, the merger or acquisition of a private operating company into a non-operating public shell with nominal net assets is considered a capital transaction in substance, rather than a business combination. Accordingly, for accounting purposes, the transaction was treated as a reverse acquisition and a recapitalization, and pro-forma information is not presented. Transaction costs incurred in the reverse acquisition were charged to expense.

Taiyu was incorporated in the Liaoning Province, People's Republic of China ("PRC" or "China") in July, 2002. Taiyu is engaged in the manufacturing and sale of plate heat exchangers and various packages, thermo meter testing devices and heat usage calculators. The Company is an authorized dealer of the SONDEX brand; SONDEX is the second largest plate heat exchanger manufacturer in the world.

On September 25, 2008, the Company entered into a Share Exchange Agreement (the "Agreement") between Asialink (Far East) Limited ("Asialink") and the Company providing for the acquisition by the Company from Asialink of all of the outstanding capital stock of SanDeKe Co., Ltd., a Shanghai based manufacturer of heat plate exchangers ("SanDeKe"). The purchase price for the SanDeKe shares was \$741,516, of which \$222,455 was payable within 15 days after the signature date of the Agreement, \$370,758 is payable within 15 days after all necessary documents have been filed with government agencies, and \$148,303 of which is payable within 15 days after the purchase has been approved and registered by the government agencies. Under the terms of the Agreement, two of the shareholders of SanDeKe agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of SmartHeat, SanDeKe, Taiyu, Taiyu's 55% owned subsidiary, Qingdao Yushi Heat Power Equipment Co., Ltd ("Yushi") which also disposed by the Company in August, 2008. Yushi is engaged in manufacturing and selling of heat power equipment. For purposes of

this Annual Report, the "Company" refers collectively to SmartHeat, SanDeKe, Taiyu and Yushi. All significant inter-company accounts and transactions have been eliminated in consolidation.

#### Use of Estimates

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

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

#### Cash and Cash 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, 2008 the Company maintained total restricted cash of \$681,520 in several bank accounts, represented cash deposits from customers for securing the payment from customers after the warranty period expires while incentivizing the Company to fulfill its obligation during the warranty period, of which, \$462,048 was the cash that will be release to the Company within one year. As of December 31, 2007, the Company maintained restricted cash of \$537,098 in several bank accounts, of which, approximately \$4,900 was collateralized for certain letters of credit that were issued by several banks to the Company; and approximately \$532,000 was cash deposits from customers for securing the payment from customers after the warranty period expires while incentivizing the Company to fulfill its obligation during the warranty period. Restricted cash was held in an interest bearing bank account.

#### Accounts and Retentions Receivable

The Company's policy is to maintain reserves for potential credit losses on accounts receivable. Management reviews the composition of accounts receivable and analyzes historical bad debts, customer concentrations, customer credit worthiness, current economic trends and changes in customer payment patterns to evaluate the adequacy of these reserves. Based on historical collection activity, the Company had allowances of \$629,687 and \$330,518 at December 31, 2008 and 2007, respectively.

At December 31, 2008 and 2007, the Company had retentions receivable from customers for product quality assurance in the amount of \$457,764 and \$360,628, respectively. The retention rate varies from 5% to 20% of the sales price with variable terms from 3 months to two years depending on the shipping date of the products and the number of heating seasons that the warranty period covers.

Accounts receivable is net of unearned interest of \$28,526 and \$148,421 at December 31, 2008 and 2007, respectively. Unearned interest represents imputed interest on accounts receivable with due dates over one year from the invoice date discounted at the Company's borrowing rate which was 7.04% in 2008 and 2007.

#### Inventories

Inventories are valued at the lower of cost or market with cost determined on a moving weighted average basis. Cost of work in progress and finished goods comprises direct material, direct production cost and an allocated portion of production overheads.

#### 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 ranging from 5 to 20 years as follows:

|          |          |
|----------|----------|
| Building | 20 years |
|----------|----------|



|                      |            |
|----------------------|------------|
| Vehicles             | 5 years    |
| Office Equipment     | 5 years    |
| Production Equipment | 5-10 years |

Land Use Right

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

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

### Impairment of Long-Lived Assets

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

Recoverability of long-lived assets to be held and used is measured by a comparison of 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 by the amount by which the carrying amount of the asset exceeds the fair value of the assets. Fair value is generally determined using the asset's expected future discounted cash flows or market value, if readily determinable. Based on its review, the Company believes that, as of December 31, 2008 and 2007, there were no significant impairments of its long-lived assets.

### Income Taxes

The Company utilizes Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been 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 adopted the provisions of the Financial Accounting Standards Board's ("FASB") Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. As a result of the implementation of FIN 48, the Company made a comprehensive review of its portfolio of tax positions in accordance with recognition standards established by FIN 48. As a result of the implementation of Interpretation 48, the Company recognized no material adjustments to liabilities or shareholders' equity. When tax returns are filed, it is highly certain 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 percent 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 income. The adoption of FIN 48 did not have a material impact on the Company's financial statements.

### Revenue Recognition

The Company's revenue recognition policies are in compliance with Securities and Exchange Commission (SEC) Staff Accounting Bulletin ("SAB") 104. Sales revenue is recognized when products are delivered and for PHE and PHE units, when customer acceptance occurs, the price is fixed or determinable, no other significant obligations of the Company exist and collectibility is reasonably assured. Payments received before all of the relevant criteria for revenue recognition are recorded as unearned revenue.

Sales revenue represents the invoiced value of goods, net of value-added tax ("VAT"). All of the Company's products that are sold in the PRC are subject to Chinese value-added tax of 17% of the gross sales price. This VAT may be offset by VAT paid by the Company on raw materials and other materials included in the cost of producing their finished product. The Company recorded VAT payable and VAT receivable net of payments in the financial statements. The VAT tax return is filed offsetting the payables against the receivables.

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

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 both 2008 and 2007. The Company does not provide unconditional right of return, price protection or any other concessions to its customers. The Company provides free after-sale service for a period of one year. After-sale expense was \$95,638 and \$383,177 for 2008 and 2007, respectively.

#### Cost of Goods Sold

Cost of goods sold consists primarily of material costs, direct labor, and manufacturing overhead which are directly attributable to the production of products. Write-down of inventories to lower of cost or market is also recorded in cost of goods sold.

#### Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist primarily of accounts receivable and other receivables. The Company does not require collateral or other security to support these receivables. The Company conducts periodic reviews of its clients' financial condition and customer payment practices to minimize collection risk on accounts receivable.

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

#### Statement of Cash Flows

In accordance with SFAS No. 95, "Statement of Cash Flows," cash flows from the Company's operations are calculated based upon the local currencies. As a result, amounts related to assets and liabilities reported on the statement of cash flows may not necessarily agree with changes in the corresponding balances on the balance sheet. Cash flows from operating, investing and financing activities exclude the effect of the acquisition of SanDeKe.

#### Basic and Diluted Earnings 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 similarly computed, 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 net earnings per share 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.

The following table presents a reconciliation of basic and diluted earnings per share:

For the Years

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|   | Ended December 31 |              |
|---|-------------------|--------------|
|   | 2008              | 2007         |
| Net income                                    | \$ 6,335,340      | \$ 2,087,891 |
| Weighted average shares outstanding - basic   | 22,176,322        | 18,500,000   |
| Effect of dilutive securities:                |                   |              |
| Unexercised warrants and options              | 110               | —            |
| Weighted average shares outstanding - diluted | 22,176,432        | 18,500,000   |
| Earnings per share - basic                    | \$ 0.29           | \$ 0.11      |
| Earnings per share - diluted                  | \$ 0.29           | \$ 0.11      |

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

#### Fair Value of Financial Instruments

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires the Company disclose estimated fair values of financial instruments. The carrying amounts reported in the statements of financial position for current assets and current liabilities qualifying as financial instruments are a reasonable estimate of fair value.

#### Foreign Currency Translation and Comprehensive Income (Loss)

The Company's functional currency is the RMB (RMB). For financial reporting purposes, RMB has been translated into United States dollars (USD) as the reporting currency. Assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Revenues and expenses are translated at the average rate of exchange prevailing during the reporting period. Translation adjustments arising from the use of different exchange rates from period to period are included as a component of shareholders' equity as "Accumulated other comprehensive income". Gains and losses resulting from foreign currency transactions are included in income. There has been no significant fluctuation in exchange rate for the conversion of RMB to USD after the balance sheet date.

The Company uses SFAS No. 130, "Reporting Comprehensive Income." Comprehensive income is comprised of net income and all changes to the statements of shareholders' equity, except those due to investments by shareholders, changes in paid-in capital and distributions to shareholders.

#### 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." The Company recognizes in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees.

#### Segment Reporting

SFAS No. 131, "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.

SFAS 131 has no effect on the Company's financial statements as substantially all of the Company's operations are conducted in one industry segment. All of the Company's assets are located in the PRC.

#### Registration Rights Agreement

The Company accounts for payment arrangements under registration rights agreement in accordance with FASB Staff Position EITF 00-19-2, which requires that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies.

New Accounting Pronouncements

Accounting for Financial Guarantee Insurance Contracts

In May 2008, FASB issued SFAS No. 163, "Accounting for Financial Guarantee Insurance Contracts, an interpretation of FASB Statement No. 60." The scope of this Statement is limited to financial guarantee insurance (and reinsurance) contracts, as described in this Statement, issued by enterprises included within the scope of Statement 60.

Accordingly, this Statement does not apply to financial guarantee contracts issued by enterprises excluded from the scope of Statement 60 or to some insurance contracts that seem similar to financial guarantee insurance contracts issued by insurance enterprises (such as mortgage guaranty insurance or credit insurance on trade receivables). This Statement also does not apply to financial guarantee insurance contracts that are derivative instruments included within the scope of FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement will not have an impact on the Company's financial statements.

SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

The Hierarchy of Generally Accepted Accounting Principles

In May 2008, FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS 162 adoption will not have an impact on the Company's financial statements.

Disclosures about Derivative Instruments and Hedging Activities

In March 2008, FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133." SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Based on current conditions, the Company does not expect the adoption of SFAS 161 to have a significant impact on its results of operations or financial position.

Fair value of measurements

On January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements," SFAS 157 defines fair value, establishes a three-level valuation hierarchy for disclosures of fair value measurement and enhances disclosures requirements for fair value measurements. The three levels are defined as follow:

- Level 1 inputs to the valuation methodology are quoted prices (unadjusted) 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 fair value measurement.

As of December 31, 2008, the Company did not identify any assets and liabilities that are required to be presented on the balance sheet at fair value.

Non-Controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51

In December 2007, FASB issued SFAS No. 160, "Non-controlling Interests in Consolidated Financial Statements - An Amendment of ARB No. 51." SFAS 160 establishes new accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. Specifically, this statement requires the recognition of a non-controlling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the non-controlling interest will be included in consolidated



net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the non-controlling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its non-controlling interest. SFAS 160 are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company expects SFAS 160 will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

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### Business Combinations

In December 2007, FASB issued SFAS No. 141 (Revised 2007), "Business Combinations." SFAS 141R will significantly change the accounting for business combinations. Under SFAS 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. SFAS 141R will change the accounting treatment for certain specific items, including:

- Acquisition costs will be generally expensed as incurred;
- Non-controlling interests (formerly known as "minority interests" - see SFAS 160 discussion above) will be valued at fair value at the acquisition date;
- Acquired contingent liabilities will be recorded at fair value at the acquisition date and subsequently measured at either the higher of such amount or the amount determined under existing guidance for non-acquired contingencies;
- In-process research and development will be recorded at fair value as an indefinite-lived intangible asset at the acquisition date;
- Restructuring costs associated with a business combination will be generally expensed subsequent to the acquisition date; and
- Changes in deferred tax asset valuation allowances and income tax uncertainties after the acquisition date generally will affect income tax expense.

SFAS 141R also includes a substantial number of new disclosure requirements. SFAS 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. Accordingly, since the Company is a calendar year-end company and will continue to record and disclose business combinations following existing GAAP until January 1, 2009. The Company expects SFAS 141R will have an impact on accounting for business combinations once adopted but the effect is dependent upon acquisitions at that time.

### Accounting for Non-Refundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities

In June 2007, FASB issued FASB Staff Position No. EITF 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for use in Future Research and Development Activities," which addresses whether non-refundable advance payments for goods or services that used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed. EITF 07-03 is effective for fiscal years beginning after December 15, 2008. Management is currently evaluating the effect of this pronouncement on our financial statements.

### 3. INVENTORIES

Inventories at December 31, 2008 and December 31, 2007 were as follows:

|                 | 2008         | 2007         |
|-----------------|--------------|--------------|
| Raw materials   | \$ 4,411,298 | \$ 3,865,575 |
| Work in process | 652,472      | 48,627       |
| Finished Goods  | 1,043,813    | 4,014,206    |
| Total           | \$ 6,107,583 | \$ 7,928,408 |

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#### 4. PROPERTY AND EQUIPMENT, NET

Property and equipment consisted of the following at December 31, 2008 and 2007:

|                                | 2008         | 2007         |
|--------------------------------|--------------|--------------|
| Building                       | \$ 1,818,827 | \$ 1,624,651 |
| Production equipment           | 441,065      | 298,242      |
| Office equipment               | 231,975      | 156,368      |
| Vehicles                       | 300,956      | 134,724      |
|                                | 2,792,823    | 2,213,985    |
| Less: Accumulated depreciation | (356,270)    | (173,176)    |
|                                | \$ 2,436,553 | \$ 2,040,809 |

Depreciation expense for 2008 and 2007 was approximately \$168,000 and \$45,000, respectively.

#### 5. OTHER RECEIVABLES, PREPAYMENTS AND DEPOSITS

Other receivables, prepayments and deposits consisted of the following at December 31, 2008 and December 31, 2007, respectively:

|   | 2008       | 2007       |
|---|------------|------------|
| Cash advance to third parties                         | \$ 89,628  | \$ 474,631 |
| Deposit for public bid                                | 353,399    | 130,724    |
| Prepayment for freight and related insurance expenses | 95,888     | 68,683     |
| Deposits  | 42,783     | 15,346     |
| Advance to employees                                  | 117,136    | 76,847     |
| Total   | \$ 698,834 | \$ 766,231 |

Cash advance to third parties was the short term cash advances to customers and vendors with quick repayment usually within three to six months. Deposits for public bidding represented the deposits for bidding the contracts, the deposit will be returned to the Company after the bidding process is completed unusually within three to four months from the payment date. Prepayment for freight and /or related insurance expenses represented prepaid shipping and freight insurance expenses for customers and is generally repaid upon customer receipt of products. Deposits mainly consisted of deposits for rents and utilities. Cash advance to employees mainly represented short term loan to employees and advance to employees for business trip and related expenses. Other receivables, prepayments and deposits are reimbursed or settled within 12 months.

#### 6. RELATED PARTY TRANSACTIONS

##### Due from Related Party

Due from related party of \$118,560 at December 31, 2007 arose from sales to the shareholder of \$174,901 during 2007. Due from related party was paid in full in November 2008.

##### Due to Related Party

Due to related party represented advance from the same shareholder with variable interest rate tied to the bank interest rate, 8.591% per annum for 2008 and 6.903% per annum for 2007, principal and interest were payable on demand, this advance was paid in full by September 30, 2008. During 2008 and 2007, the Company recorded interest expense to this shareholder of approximately \$6,500 and \$63,000, respectively.

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## 7. INTANGIBLE ASSETS

Intangible assets mainly consisted of land use rights, computer software, know-how technology, customer list and covenant 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 approximately \$440,000 (RMB 3,549,682). 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, 2008 and 2007, respectively:

|                                | 2008         | 2007       |
|--------------------------------|--------------|------------|
| Land use right                 | \$ 519,369   | \$ 486,618 |
| Know-how technology            | 266,808      | -          |
| Customer list                  | 191,652      | -          |
| Covenant not to compete        | 104,258      | -          |
| Software                       | 190,166      | 140,476    |
|                                | 1,272,253    | 627,094    |
| Less: accumulated amortization | (117,122)    | (92,886)   |
|                                | \$ 1,155,131 | \$ 534,208 |

Amortization expense of intangible assets for 2008 and 2007 was approximately \$63,000 and \$52,000, respectively. Annual amortization expense for the next five years is expected to be as follows: \$180,000, \$180,000, \$180,000, \$180,000 and \$140,000.

## 8. MAJOR CUSTOMERS AND VENDORS

Five major customers accounted for 20% and 51% of the Company’s net revenue for 2008 and 2007, respectively. For 2008, each customer accounted for about 6%, 5%, 3%, 3% and 3% of the sales. For 2007, each customer accounted for about 21%, 9%, 8%, 7% and 6% of the sales. At December 31, 2008 and 2007, the total receivable balance due from these five customers was approximately \$5,073,000 and \$2,824,000, respectively.

One major vendor provided 7% and 22% of the Company’s purchases of raw materials for 2008 and 2007, respectively. The Company had approximately \$19,101 and \$0 in accounts payable to this vendor at December 31, 2008 and 2007, respectively.

## 9. TAXES PAYABLE

Taxes payable consisted of the following at December 31, 2008 and December 31, 2007:

|                         | 2008         | 2007       |
|-------------------------|--------------|------------|
| Income tax payable      | \$ 723,958   | \$ 74,981  |
| Value added tax payable | 597,676      | 421,009    |
| Other taxes payable     | 6,141        | 7,020      |
|                         | \$ 1,327,775 | \$ 503,010 |

## 10. ACCRUED LIABILITIES AND OTHER PAYABLES

Accrued liabilities and other payables consisted of the following at December 31, 2008 and December 31, 2007:

|   | 2008                | 2007              |
|---|---------------------|-------------------|
| Advance from third parties                    | \$ 453,625          | \$ 139,945        |
| Payable for purchase consideration of SanDeKe | 741,516             | -                 |
| Other Payables                                | 99,418              | 667,755           |
| Accrued liabilities                           | 36,253              | -                 |
| <b>Total</b>                                  | <b>\$ 1,330,812</b> | <b>\$ 807,700</b> |

Advance from third parties represented short term, non interest bearing advances from third parties. Other payables mainly consisted of payables for the Company's miscellaneous expenses including postage, business insurance, employee benefits, etc. Accrued liabilities mainly consisted of accrued interest, payroll, and utility.

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## 11. LOANS PAYABLE - SHORT TERM

The Company is obligated for the following short term loans payable as of December 31, 2008 and December 31, 2007:

|   | 2008         | 2007         |
|---|--------------|--------------|
| Short term loan with a commercial bank in the PRC for 6,000,000 RMB. This loan was entered into on Apr 28, 2007 and was due on Apr 12, 2008. This loan was renewed on Apr 12, 2008 with new maturity date on June 13, 2009. This loan currently bears interest at 7.159% per annum. The Company pledged its building in the value of approximately RMB 12,430,950 or approximately \$1,818,000 for this loan.   | \$ 877,886   | \$ 822,526   |
| Short term loan with a foreign commercial bank with branch in the PRC for 10,200,000 RMB. This loan was entered into on Jun 25, 2007 and was due on Jun 24, 2008. This loan born interest at 5.265% per annum. This loan was repaid in June, 2008.  | —            | 1,302,333    |
| The Company entered into a series of short term loans during 2006 and 2007 with a third party company in the PRC for total of 10,300,000 RMB. Some of the loans will mature on various dates in year 2008 and some of the loans are payable on demand. These loans bear variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007. The Company repaid RMB 2,600,000 in 2008 and had RMB 7,700,000 outstanding as of December 31, 2008. | 1,126,621    | 1,412,003    |
| The Company entered into a series of short term loans during 2006 with another third party company in the PRC for total of 2,850,000 RMB. These loans were due on various dates in year 2008. These loans bore variable interest at 8.591% per annum for 2008 and 6.903% per annum for 2007. The loans were paid in full at December 31, 2008.  | -            | 390,701      |
| The Company entered into a short term loan with another third party company in the PRC for 5,050,000 RMB. This loan was entered into on Aug 31, 2005 and was due on Aug 31, 2006. This loan bore no interest. Imputed interest on the loan was immaterial. This loan became payable on demand after Aug 31, 2006. This loan was paid in full at December 31, 2008.  | -            | 692,293      |
| The Company entered into a one year loan on July 1, 2008 with another third party company in the PRC for total of 3,000,000 RMB. This loan is due on June 30, 2009 with interest rate of 8.591% per annum.  | 438,943      | —            |
|   | \$ 2,443,450 | \$ 4,619,856 |

## 12. DEFERRED TAX LIABILITY



Deferred tax liability represented differences between the tax bases and book bases of property and equipment and intangible assets arising from the acquisition of SanDeKe.

### 13. MINORITY INTEREST AND DUE TO MINORITY SHAREHOLDER

Minority interest represented a 45% interest in Yushi. At August 31, 2008, the Company liquidated Yushi and planned to distribute the remaining assets of \$5,303 to its minority shareholders. At August 31, 2008, minority interest was zero due to the liquidation of Yushi; at December 31, 2007, minority interest was zero as minority's share of cumulative losses exceeded its equity interest in Yushi. Minority's share of income for 2008 was \$5,966 as the forgiveness of the accounts payable by Taiyu, minority's share of loss for 2007 were limited to \$1,873.

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#### 14. INCOME TAXES

The Company is governed by the Income Tax Law of the PRC concerning privately-run enterprises, which are generally subject to tax at a statutory rate of 25% on income reported in the statutory financial statements after appropriated tax adjustments.

Taiyu, as a manufacturing business, is subject to a 15% income tax rate. Taiyu was exempted from income tax for two years starting from the 1st profitable year since incorporation, and was entitled to a 50% discount on the 15% income tax rate for 2005 through 2007. According to the new income tax law that became effective January 1, 2008, for those enterprises to which the 15% tax rate was applicable previously, the applicable rates shall gradually increase over a five-year period as follows:

| Year | Tax Rate |
|------|----------|
| 2007 | 15%      |
| 2008 | 18%      |
| 2009 | 20%      |
| 2010 | 22%      |
| 2011 | 24%      |
| 2012 | 25%      |

SanDeKe is subject to an 18% income tax rate after 7% reduction in federal income tax rate given by federal government. SanDeKe, is also exempt from income tax for two years starting from the 1st profitable year, and is entitled to a 50% discount on the 18% income tax rate for 2010 through 2012.

The Company's net income will be lower by approximately \$91,000 or \$0,004 earnings per share had SanDeKe not been exempted from income tax for 2008. The Company's net income would have been lower by approximately \$175,000 or \$0.01 earnings per share had Taiyu not been subject to a 50% discount on the 15% income tax rate for 2007.

The following table reconciles the U.S. statutory rates to the Company's effective tax rate for the year ended December 31, 2008 and 2007:

|                              | 2008    | 2007  |
|------------------------------|---------|-------|
| US statutory rates           | 34.0%   | 34.0% |
| Tax rate difference          | (16.4)% | (1)%  |
| Effect of tax holiday        | (1.2)%  | (25)% |
| Valuation allowance          | 0.5%    | -     |
| Tax per financial statements | 16.9%   | 8.0%  |

#### 15. STATUTORY RESERVES

Pursuant to the new corporate law of the PRC effective January 1, 2006, the Company is now only required to maintain one statutory reserve by appropriating from its after-tax profit before declaration or payment of dividends. The statutory reserve represents restricted retained earnings.

Surplus Reserve Fund

The Company is now only required to transfer 10% of its net income, as determined under PRC accounting rules and regulations, to a statutory surplus reserve fund until such reserve balance reaches 50% of the Company's registered capital.

The surplus reserve fund is non-distributable other than during liquidation and can be used to fund previous years' losses, if any, and may be utilized for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholding or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issue is not less than 25% of the registered capital.

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Common Welfare Fund

The common welfare fund is a voluntary fund that provides that the Company can elect to transfer 5% to 10% of its net income to this fund. This fund can only be utilized on capital items for the collective benefit of the Company's employees, such as construction of dormitories, cafeteria facilities, and other staff welfare facilities. This fund is non-distributable other than upon liquidation.

16. STOCKHOLDERS' EQUITY

Common Stock with Warrants Issued for Cash

In August 2008, the Company closed a private placement offering of Units pursuant to which SmartHeat sold an aggregate of 1,630,000 Units at an offering price of \$3.50 per Unit for aggregate gross proceeds of approximately \$5.7 million. Each "Unit" consists of one share of SmartHeat's common stock and a three year warrant to purchase 15% of one share of common stock at an exercise price of \$6.00 per share. The Units sold represent an aggregate of 1,630,000 million shares of common stock and warrants to purchase 244,500 shares of Common Stock. In connection with the private placement offering, the Company paid commission of approximately \$340,000 and issued warrants to purchase 148,500 shares of common stock to its placement agents. The warrants are immediately exercisable and expire on the third anniversary of their issuance. The warrants require the Company to settle in its own shares. There is no provision for cash settlement, except in lieu of fractional shares. Net proceeds of approximately \$5.1 million have been received by the Company. The value of warrants was determined by using the Black-Scholes pricing model with the following assumptions: discount rate – 2.76%; dividend yield – 0%; expected volatility – 15% and term of 3 years. The value of the warrant was \$70,246. There were no warrants exercised from the grant date to December 31, 2008.

Stock Options to Independent Directors

On July 17, 2008, the Company granted non-statutory stock options to each of its two independent US directors. The terms of each option are: 10,000 shares at an exercise price per share of \$4.60, with a life of five years and vesting over three years as follows: 3,333 shares shall vest on July 17, 2009; 3,333 shares shall vest on July 17, 2010; and 3,334 shares shall vest on July 17, 2011, subject in each case to the director continuing to be associated with the Company as a director.

Based on the fair value method under SFAS No. 123 (Revised) "Share Based Payment" ("SFAS 123(R)"), the fair value 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 United States 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 fair value 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. For stock options issued, the fair value was estimated at the date of grant using the following range of assumptions:

The options vest over a period of three years and have a life of 5 years, 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.

The Company recorded \$5,613 of compensation expense for stock options to its independent directors for the year ended December 31, 2008. There were no options exercised during 2008.

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Following is a summary of the warrant activity:

|                                  | Number of<br>Shares | Average<br>Exercise<br>Price per Share | Weighed<br>Average<br>Remaining<br>Contractual<br>Term in Years |
|----------------------------------|---------------------|--|---|
| Outstanding at December 31, 2007 | -                   |  |   |
| Exercisable at December 31, 2007 | -                   |  |   |
| Granted                          | 393,000             | 6.00                                   |   |
| Exercised                        |                     |  |   |
| Forfeited                        |                     |  |   |
| Outstanding at December 31, 2008 | 393,000             | 6.00                                   | 2.51  |
| Exercisable at December 31, 2008 | 393,000             |  | 2.51  |

Following is a summary of the option activity:

|                                  | Number of<br>Shares | Average<br>Exercise<br>Price per Share | Weighed<br>Average<br>Remaining<br>Contractual<br>Term in Years |
|----------------------------------|---------------------|--|---|
| Outstanding at December 31, 2007 | -                   |  |   |
| Exercisable at December 31, 2007 | -                   |  |   |
| Granted                          | 20,000              | 4.60                                   |   |
| Exercised                        |                     |  |   |
| Forfeited                        |                     |  |   |
| Outstanding at December 31, 2008 | 20,000              | 4.60                                   | 4.54  |
| Exercisable at December 31, 2008 | 20,000              |  | 4.54  |

## 17. COMMITMENTS

### Employment Agreements

On January 1, 2008, the Company entered into a three year employment agreement with Mr. Jun Wang, which agreement may be renewed at the end of the initial term upon mutual agreement between Mr. Jun Wang and the Company. Either party shall give written notice to the other party of its intention not to renew the agreement at least 30 days prior to the end of the initial term. Pursuant to the terms of the employment agreement, Mr. Jun 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, currently \$18,000 per annum. In addition, Mr. Jun Wang shall be entitled to overtime pay in accordance with the applicable law.

On January 1, 2008, The Company entered into a three year employment agreement with Ms. Zhijuan Guo, at terms identical to the terms of the employment agreement with Mr. Jun Wang with current salary of \$10,684 per annum.

### Lease agreements

The Company leased several offices for its sales representative in different cities under various one-year, non-cancellable, and renewable operating lease agreements.

At December 31, 2008, future minimum rental payments required under these operating leases are as follows:

| Year Ending December 31, | Amount     |
|--------------------------|------------|
| 2009                     | \$ 87,000  |
| 2010                     | 87,000     |
| Total                    | \$ 174,000 |

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Total rental expense for the years ended December 31, 2008 and 2007 was approximately \$87,000 and \$52,000, respectively.

#### 18. CONTINGENCIES

The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in governmental 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 are denominated in RMB and all of the Company's assets and liabilities are also denominated in RMB. The RMB is not freely convertible into foreign currencies under the current 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.

The Company is required to file the Registration Statement with the SEC within 60 days of the closing of the private placement offering. The Registration Statement must be declared effective by the SEC within 180 days of the final closing of the offering. Subject to certain grace periods, the Registration Statement must remain effective and available for use until the Investors can sell all of the securities covered by the Registration Statement without restriction pursuant to Rule 144. If the Company fails to meet the filing or effectiveness requirements of the Registration Statement, SmartHeat is required to pay liquidated damages of 2% of the aggregate purchase price paid by such Investor for any Registrable Securities then held by such Investor on the date of such failure and on each anniversary of the date of such failure until such failure is cured. Given the length of time it took the last investor in the private placement to complete his paperwork, the Company believes that the last closing under the private placement did not occur until September 23rd or 24th and that the 180 day period for effectiveness of the registration statement under the Registration Rights Agreement will not end until March 23rd. At March 10, 2009, the registration statement has not declared effective yet.

#### 19. ACQUISITION OF SANDEKE CO., LTD.

On September 25, 2008, the Company entered into a Share Exchange Agreement ("Agreement") for the acquisition by the Company of all of the outstanding capital stock of SanDeKe. The purchase price for the SanDeKe shares was \$741,516, of which \$222,455 was payable within 15 days after the signature date of the Agreement, \$370,758 is payable within 15 days after all necessary documents have been filed with government agencies, and \$148,303 of which is payable within 15 days after the purchase has been approved and registered by the government agencies. Under the terms of the Agreement, two of the shareholders of SanDeKe have agreed not to compete with the business of SanDeKe for a period of four years after the completion of the purchase. At March 10, 2009, the Company has not paid the purchase consideration yet.

The operating results of SanDeKe are included in the accompanying consolidated statements of income from the acquisition date. For convenience of reporting the acquisition for accounting purposes, September 1, 2008 has been designated as the acquisition date.



The following table summarizes the fair values of the assets acquired and liabilities assumed at the date of acquisition. The fair value of the net assets acquired exceeded the total consideration for the acquisition by approximately \$117,000 (RMB 800,000). The excess (negative goodwill) was allocated on a pro rata basis to long-lived assets.

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|                           |            |
|---------------------------|------------|
| Cash                      | \$ 59,245  |
| Accounts receivable       | 489,527    |
| Advance to suppliers      | 329,951    |
| Other receivables         | 128,646    |
| Inventory                 | 92,370     |
| Property and equipment    | 73,324     |
| Intangible assets         | 563,567    |
| Accounts payable          | (332,276)  |
| Advance from customers    | (557,216)  |
| Deferred tax liability    | (39,076)   |
| Other current liabilities | (66,546)   |
| Purchase price            | \$ 741,516 |

The intangible asset consisted of know-how technology is amortized over 5 years, the customer list is amortized over 5 years and covenants not to compete, is amortized over 4 years.

The pro forma financial information of the consolidated operations of the Company as if the acquisition of SanDeKe had occurred as of the beginning of the year is presented below:

| For the year ended<br>December 31, 2008 | SmartHeat<br>and subsidiaries | SanDeKe      | Pro forma<br>Adjustments | Pro forma<br>Consolidated |
|---|-------------------------------|--------------|--------------------------|---------------------------|
| Net revenue                             | \$ 32,676,082                 | \$ 2,135,837 | \$ -                     | \$ 34,811,919             |
| Cost of revenue                         | 21,717,735                    | 1,752,951    | -                        | 23,470,686                |
| Gross profit                            | 10,958,347                    | 382,886      | -                        | 11,341,233                |
| Selling expense                         | 1,564,977                     | (607)        | -                        | 1,564,370                 |
| General & administrative expense        | 1,851,117                     | 286,591      | 78,131                   | 2,215,839                 |
| Total operating expenses                | 3,416,094                     | 285,984      | 78,131                   | 3,780,209                 |
| Income (loss) from operations           | 7,542,253                     | 96,902       | (78,131)                 | 7,561,024                 |
| Non-operating income (expenses), net    | 93,288                        | (401)        | -                        | 92,887                    |
| Income (loss) before income tax         | 7,634,966                     | 96,501       | (78,131)                 | 7,653,337                 |
| Income tax                              | 1,293,660                     | 163          | -                        | 1,293,823                 |
| Minority interest                       | 5,966                         | -            | -                        | 5,966                     |
| Net income (loss)                       | \$ 6,335,340                  | \$ 96,339    | \$ (78,131)              | \$ 6,353,548              |

- a) Pro forma adjustment is to record additional amortization expense of \$76,835 and depreciation expense of \$1,296 for the increase in basis of the intangible assets and decrease in basis of the fixed assets as a result of the purchase.

| For the year ended<br>December 31, 2007 | Taiyu         | SanDeKe      | Pro forma<br>Adjustments | Pro forma<br>Consolidated |
|---|---------------|--------------|--------------------------|---------------------------|
| Net revenue                             | \$ 13,273,151 | \$ 2,334,369 | \$ -                     | \$ 15,607,520             |
| Cost of revenue                         | 8,667,353     | 2,059,235    | -                        | 10,726,588                |
| Gross profit                            | 4,605,798     | 275,134      | -                        | 4,880,932                 |
| Selling expense                         | 1,681,624     | -            | -                        | 1,681,624                 |
| General & administrative expense        | 687,466       | 283,689      | 107,693                  | 1,078,848                 |
| Total operating expenses                | 2,369,090     | 283,689      | 107,693                  | 2,760,472                 |

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|                           |              |             |              |              |
|---------------------------|--------------|-------------|--------------|--------------|
| Income from operations    | 2,236,708    | (8,555)     | (107,693)    | 2,120,460    |
| Non-operating income, net | 24,957       | (1,519)     | -            | 23,438       |
| Income before income tax  | 2,261,665    | (10,074)    | (107,693)    | 2,143,898    |
| Income tax                | 175,647      | 2,960       | -            | 178,607      |
| Minority interest         | (1,873)      | -           | -            | (1,873)      |
| Net income                | \$ 2,087,891 | \$ (13,033) | \$ (107,693) | \$ 1,967,165 |

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SMARTHEAT INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2008 AND 2007

- a) Pro forma adjustment is to record additional amortization expense of \$105,012 and depreciation expense of \$2,681 for the increase in basis of the intangible assets and decrease in basis of the fixed assets as a result of the purchase.

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SMARTHEAT INC.

2,023,000 SHARES OF COMMON STOCK

PRELIMINARY PROSPECTUS

MARCH 23, 2009

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## Part II

## INFORMATION NOT REQUIRED IN PROSPECTUS

## Item 13. Other Expenses of Issuance and Distribution

The following is an estimate of the expenses which will be incurred by the Company in connection with the issuance and distribution of the securities being registered.

The following table sets forth the estimated costs and expenses of the Company in connection with the offering described in the registration statement.

|                              |           |
|------------------------------|-----------|
| SEC Registration Fee         | \$ 346.00 |
| Accounting Fees and Expenses | \$        |
| Legal Fees and Expenses      | \$        |
| Total                        | \$        |

## Item 14. Indemnification of Directors and Officers

Section 78.138 of the Nevada Revised Statutes provides that a director or officer is not individually liable to the corporation or its shareholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that (1) his act or failure to act constituted a breach of his fiduciary duties as a director or officer and (2) his breach of those duties involved intentional misconduct, fraud or a knowing violation of law.

This provision is intended to afford directors and officers protection against and to limit their potential liability for monetary damages resulting from suits alleging a breach of the duty of care by a director or officer. As a consequence of this provision, shareholders of our company will be unable to recover monetary damages against directors or officers for action taken by them that may constitute negligence or gross negligence in performance of their duties unless such conduct falls within one of the foregoing exceptions. The provision, however, does not alter the applicable standards governing a director's or officer's fiduciary duty and does not eliminate or limit the right of our company or any shareholder to obtain an injunction or any other type of non-monetary relief in the event of a breach of fiduciary duty.

## Item 15. Recent Sales of Unregistered Securities

On August 8, 2006, we issued 2,500,000 shares of common stock to Mr. Jason Schlombs in consideration of \$ 0.001 per share for a total of \$2,500 in a transaction exempt from the registration requirements of the Securities Act pursuant to Regulation S promulgated by the SEC thereunder.

On August 25, 2006, we issued 4,000,000 shares of common stock to 15 individuals for consideration of \$0.0075 per share for a total of \$30,000 in a transaction exempt from the registration requirements of the Securities Act pursuant to Regulation S promulgated by the SEC thereunder.

On August 31, 2006, we issued 49,900 shares of common stock to 18 individuals in consideration of \$0.25 per share for a total of \$12,475 in a transaction exempt from the registration requirements of the Securities Act pursuant to Regulation S promulgated by the SEC thereunder.

On April 14, 2008, pursuant to the terms of a Share Exchange Agreement dated April 14, 2008, by and among SmartHeat, Taiyu and the Taiyu Shareholders, each of whom is a non-US person (as contemplated by Rule 902 under the Securities Act), all of the equitable and legal rights, title and interests in and to Taiyu's share capital in the amount of RMB25,000,000 (approximately \$3,571,939 based on an exchange rate of US\$1.00 = RMB6.999) were exchanged for an aggregate of 18,500,000 shares of SmartHeat common stock. These issuances were exempt from registration requirements under Regulation S under the Securities Act.

On July 7, 2008, we sold an aggregate of 1,620,000 Units at an offering price of \$3.50 per Unit for aggregate gross proceeds of approximately \$5.67 million to each of the following persons:

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|  |  |
|--|--|
| G & S I Fund LP  | IRA FBO Kevin Clarke, Pershing LLC as Custodian            |
| C. Robert Shearer  | RL Capital Partners, LP                                    |
| Nancy Palmero and Herman Palmero                               | Geri Investments N.V.                                      |
| Thomas Knox  | IRA FBO Daniel Berkowitz Pershing LLC as Custodian         |
| Arnold Staloff   | Harmon Corporation A.V.V.                                  |
| Domaco Venture Capital Fund Partnership                        | Funcorp Associates Ltd.                                    |
| Marc Engelbert   | La legetaz Private Foundation                              |
| Andrew Grossman Profit Sharing Plan, Pershing LLC as Custodian | Evie Falda & David Falda,                                  |
| Norton Hight & Joan Hight                                      | Ann V. Clemente  |
| Randall W. Hight   | William H. Peterson Living Trust                           |
| Maura Kelly  | Allied Diesel Service Inc. Employee Profit Sharing Plan #2 |
| Wolfe F. Model   | Florence E. Luvera   |
| Anthony G. Polak   | Kalman A. Barson (Roth IRA)                                |
| IRA FBO Anthony G. Polak, Pershing LLC as Custodian            | Steve Roman  |
| IRA FBO Jack Polak, Pershing LLC as Custodian                  | Suelyn P. Tornay   |
| Jonathan Rothschild  | Eximius bvba   |
| Elias Sayour Foundation Incorporated                           | IRA FBO David Swerdloff Pershing LLC as Custodian          |
| Gary Stadtmauer  | Michael A. Berlinger                                       |
| Rhea D. Stadtmauer and Janice Maiman                           | Sun Fun Investing Inc.                                     |
| Teddy Chasanoff  | Strong Growth Capital Ltd                                  |
| Ross Pirasteh  | Yuzhen Hou   |
| Sandra G. Shapiro & Robert S. Shapiro                          | The USX China Fund   |
| John Gross   | White Sand Investor Group, L.P.                            |
| Murray Stadtmauer & Clare Stadtmauer                           | Gibralt Capital Corporation                                |
| IRA FBO Ronald M. Lazar Pershing As Custodian                  |  |

Each "Unit" consisted of one share of our common stock and a three year warrant to purchase 15% of one share of our common stock at an exercise price of \$6.00 per share (the "Warrants"). The Units sold represent an aggregate of 1,620,000 million shares of Common Stock and Warrants to purchase 243,000 shares of Common Stock. The offering and sale of the Units was exempt from the registration requirements of the Securities Act pursuant to Section 4(2) of the Securities Act and Regulation D and Regulation S promulgated by the SEC thereunder. We compensated three placement agents that assisted in the sale of the Units in this private placement offering by (i) paying them cash equal to 6.5% of the gross proceeds from the sales of Units placed and (ii) issuing them Warrants to purchase that number of shares of Common Stock equal to 10% of the Units placed as follows:

| Placement Agent            | Cash       | Warrants |
|----------------------------|------------|----------|
| Rodman & Renshaw, LLC      | \$ 23,888  | 56,500   |
| Maxim Group LLC            | \$ 104,650 | —        |
| Four Tong Investments Ltd. | \$ 207,025 | 91,000   |

The Warrants granted to these placement agents had the same terms and conditions as the Warrants granted in the offering.

On August 22, 2008, we sold an additional 10,000 Units at an offering price of \$3.50 per Unit for gross proceeds of approximately \$35,000 to David L. Quinn and Tracy Quinn. The offering and sale of the Units was exempt from the registration requirements of the Securities Act pursuant to Section 4(2) of the Securities Act and Regulation D promulgated by the SEC thereunder. We paid Seaboard Securities \$2,275 and issued to Seaboard Securities Warrants to purchase 1,000 shares of our common stock in connection with this transaction.



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Item 16. Exhibits and Financial Statement Schedules

The following is a complete list of Exhibits filed as part of this Registration Statement, which are incorporated herein:

(a) Exhibits

| Exhibit<br>Number | Description   |
|-------------------|---|
| 2.1               | Share Exchange Agreement and Plan of Reorganization by and among SmartHeat Inc. ("SmartHeat"), Shenyang Taiyu Electronic & Machinery Co., Ltd. ("Taiyu") and all of the shareholders of Taiyu (the "Taiyu Shareholders") dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.1 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008) |
| 2.2               | Articles of Exchange between Taiyu and SmartHeat, dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.2 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)  |
| 2.3               | Articles of Merger between Pacific Goldrim Resources, Inc. and SmartHeat, dated April 14, 2008 (Incorporated herein by reference to Exhibit 2.3 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)  |
| 3(i)              | Articles of Incorporation (Incorporated herein by reference to Exhibit 3.2 to the Company's Form SB-2 (Commission File No. 333-139649) filed on December 22, 2006)  |
| 3(ii)             | Amended and Restated By-Laws adopted April 15, 2008 (Incorporated herein by reference to Exhibit 3(ii) to the Current Report on Form 8-K (Commission File No. 000-53052) filed on October 16, 2008)   |
| 4.1               | Specimen Stock Certificate (incorporated by reference to Exhibit 10.13 of Amendment No. 2 to SmartHeat's Registration Statement on Form S-1/A (Commission File No. 333-154415), filed with the SEC on February 4, 2009)   |
| 4.2               | Form of Common Stock Purchase Warrant forming part of Units sold, and also issued as compensation to selected dealers in our private placement offering that had a final closing in August 2008. (Incorporated herein by reference to Exhibit 10.13 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on July 11, 2008)   |
| 5.1               | Opinion of Holland & Hart LLP   |
| 10.1              | English Translation of Employment Agreement between Taiyu and Jun Wang, dated January 1, 2008 (Incorporated herein by reference to Exhibit 10.1 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)  |
| 10.2              | English Translation of Employment Agreement between Taiyu and Zhijuan Guo, dated January 1, 2008 (Incorporated herein by reference to Exhibit 10.2 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)   |
| 10.3              | Certificate of Appointment by Sondex A/S of Taiyu as Authorized Dealer in China, dated March 2006 and letter naming Taiyu as Dealer of North China, dated May 5, 2006 (Incorporated herein by reference to Exhibit 10.3 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18,  |

2008)

- 10.4 Form of Purchase Order for with Sondex A/S (Incorporated herein by reference to Exhibit 10.4 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.5 English Translation of Sales Contract between Taiyu and Dalkia (Jiamusi) Urban Heating Company Ltd, dated June 18, 2007 (Incorporated herein by reference to Exhibit 10.5 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.6 Form of Purchase Order (Incorporated herein by reference to Exhibit 10.6 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)

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- 10.7 English Translation of Loan Agreement with Citibank (China) Co., Ltd., dated June 25, 2007 (Incorporated herein by reference to Exhibit 10.7 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.8 English Translation of Loan Agreement with China CITIC Bank, dated April 17, 2007 (Incorporated herein by reference to Exhibit 10.8 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.9 Resignation Letter from Jason Schlombs, dated April 15, 2008 (Incorporated herein by reference to Exhibit 10.9 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.10 Agreement of Conveyance, Transfer and Assignment of Assets and Assumption of Obligations between SmartHeat and Goldrim Holding, Inc., dated April 14, 2008 (Incorporated herein by reference to Exhibit 10.10 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.11 Stock Purchase Agreement between Jason Schlombs and SmartHeat, dated April 14, 2008 (Incorporated herein by reference to Exhibit 10.11 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on April 18, 2008)
- 10.12 Form of Registration Rights Agreement in connection with Units sold in our private placement offering completed in August 2008 (Incorporated herein by reference to Exhibit 10.13 to the Current Report on Form 8-K (Commission File No. 000-53052) filed on July 11, 2008)
- 10.13 English Translation of Share Exchange Agreement dated September 25, 2008 between the Company and Asialink (Far East) Limited (incorporated by reference to Exhibit 10.13 of Amendment No. 1 to SmartHeat's Registration Statement on Form S-1/A (Commission File No. 333-154415), filed with the SEC on December 12, 2008)
- 21 List of subsidiaries of the Company (incorporated by reference to Exhibit 21 of SmartHeat's Registration Statement on Form S-1 (Commission File No. 333-154415), filed with the SEC on October 17, 2008)
- 23.1 Consent of Holland & Hart LLP (included in Exhibit 5.1)
- 23.2 Consent of Goldman Parks Kurland Mohidin, LLP, independent registered public accounting firm

#### Item 17. Undertakings

The undersigned Registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this Registration Statement:

(i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the Registration Statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the Registration Statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the Registration Statement or any material change to such information in the Registration Statement.

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(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(4) That, for the purpose of determining liability under the Securities Act of 1933 to any purchaser:

(i) If the undersigned Registrant is relying on Rule 430B:

(A) Each prospectus filed by the Registrant pursuant to Rule 424(b)(3) shall be deemed to be part of the registration statement as of the date the filed prospectus was deemed part of and included in the registration statement; and

(B) Each prospectus required to be filed pursuant to Rule 424(b)(2), (b)(5), or (b)(7) as part of a registration statement in reliance on Rule 430B relating to an offering made pursuant to Rule 415(a)(1)(i), (vii), or (x) for the purpose of providing the information required by section 10(a) of the Securities Act of 1933 shall be deemed to be part of and included in the registration statement as of the earlier of the date such form of prospectus is first used after effectiveness or the date of the first contract of sale of securities in the offering described in the prospectus. As provided in Rule 430B, for liability purposes of the issuer and any person that is at that date an underwriter, such date shall be deemed to be a new effective date of the registration statement relating to the securities in the registration statement to which that prospectus relates, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof, Provided however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such effective date, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such effective date; or

(ii) If the undersigned Registrant is subject to Rule 430C, each prospectus filed pursuant to Rule 424(b) as part of a registration statement relating to an offering, other than registration statements relying on Rule 430B or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(5) That, for the purpose of determining liability of the undersigned Registrant under the Securities Act of 1933 to any purchaser in the initial distribution of the securities, the undersigned Registrant undertakes that in a primary offering of securities of the undersigned Registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned Registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

(i) Any preliminary prospectus or prospectus of the undersigned Registrant relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of the undersigned Registrant or used or referred to by the undersigned Registrant;

(iii) The portion of any other free writing prospectus relating to the offering containing material information about the undersigned Registrant or its securities provided by or on behalf of the undersigned Registrant; and

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(iv) Any other communication that is an offer in the offering made by the undersigned Registrant to the purchaser.

(6) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the Registrant pursuant to the foregoing provisions, or otherwise, the Registrant has been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act of 1933 and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a director, officer or controlling person of the Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question of whether such indemnification by it is against public policy as expressed in the Securities Act of 1933 and will be governed by the final adjudication of such issue.

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SIGNATURES

In accordance with the requirements of the Securities Act of 1933, the registrant certifies that it has reasonable grounds to believe that it meets all of the requirements of filing this Registration Statement on Form S-1 and authorized this Registration Statement to be signed on its behalf by the undersigned, in Shenyang, China, on the date indicated below.

SMARTHEAT INC

Date: March 24, 2009

By: /s/ Jun Wang  
 Jun Wang  
 Chief Executive Officer (Principal Executive Officer)

Date: March 24, 2009

By: /s/ Zhijuan Guo  
 Zhijuan Guo  
 Chief Financial Officer (Principal Accounting Officer)

In accordance with the requirements of the Securities Act of 1933, this Registration Statement on Form S-1 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/ Jun Wang<br>Jun Wang                                    | Chairman of the Board, President &<br>Chief Executive Officer | March 24, 2009 |
| /s/ Zhijuan Guo<br>Zhijuan Guo                              | Chief Financial Officer and Treasurer                         | March 24, 2009 |
| *<br>Frederick Rittreiser                                   | Director  | March 24, 2009 |
| *<br>Arnold Staloff   | Director  | March 24, 2009 |
| *<br>Weiguo Wang  | Director  | March 24, 2009 |
| *<br>Wenbin Lin   | Director  | March 24, 2009 |
| * By:<br>/s/ Jun<br>Wang<br>Jun Wang<br>Attorney<br>in Fact |   |                |

