

China Internet Cafe Holdings Group, Inc.  
Form 10-Q  
November 12, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

**(Mark One)**

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2014**

**OR**

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from            to**

**COMMISSION FILE NUMBER: 000-52832**

**CHINA INTERNET CAFE HOLDINGS GROUP, INC.**

(Exact Name of small business issuer as specified in its charter)

**Nevada**                                **98-0500738**  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

**#1707, Block A, Genzon Times Square, Longcheng Blvd, Centre City, Longgang District, Shenzhen,**  
**Guangdong Province, People's Republic of China 518172**

(Address of principal executive offices) (Zip Code)

Issuer's telephone Number: **+86-755-8989-6008**

**N/A**

(Former Address)

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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)

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

As of November 3, 2014, there were 5,538,002 shares of common stock outstanding.

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CHINA INTERNET CAFE HOLDINGS GROUP, INC.

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## **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This report contains certain statements of a forward-looking nature. Such forward-looking statements, including but not limited to statements regarding projected growth, trends and strategies, future operating and financial results, financial expectations and current business indicators are based upon current information and expectations and are subject to change based on factors beyond the control of the Company. Forward-looking statements typically are identified by the use of terms such as “look,” “may,” “should,” “might,” “believe,” “plan,” “expect,” “anticipate,” “estimate” and other similar words, although some forward-looking statements are expressed differently. The accuracy of such statements may be impacted by a number of risks and uncertainties that could cause actual results to differ materially from those projected or anticipated, including but not limited to those set forth herein and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2013.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. Except as required by the federal securities laws, we undertake no obligation to update forward-looking information. Nonetheless, the Company reserves the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this report. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.

**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements (Unaudited).**

**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES**

**CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014**

**(UNAUDITED)**

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**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

ASSETS	September 30, 2014	December 31, 2013
Current assets:		
Cash and cash equivalents	\$23,351,691	\$40,241,459
Rental deposit	230,523	6,606
Equipment deposit	3,218	3,240
Inventory	-	36,200
Deferred tax assets	-	77,646
Total current assets	23,585,432	40,365,151
Property, plant and equipment, net	18,993,346	9,463,573
Intangible assets, net	26,886	62,007
Rental deposit-long-term portion	197,397	456,940
Total assets	\$42,803,061	\$50,347,671
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Short term loan	\$-	\$163,655
Accounts payable	82,308	227,981
Registration penalties payable	641,200	641,200
Deferred revenue	1,481,292	2,293,794
Payroll and payroll related liabilities	349,524	366,619
Income and other taxes payable	96,879	1,011,814
Accrued expenses	387,450	605,029
Amount due to a shareholder	1,710,847	3,063,633
Dividend payable on preferred stock	186,565	186,565
Total current liabilities	4,936,065	8,560,290
Stockholders' Equity:		
Common stock (\$0.00001 par value, 20,000,000 shares authorized, 5,538,002 and 5,138,002 shares issued and outstanding as of September 30, 2014 and December 31, 2013, respectively)	55	51
Additional paid-in capital	6,232,961	5,732,965
Statutory surplus reserves	718,744	718,744
Retained earnings	28,432,631	32,548,107
Accumulated other comprehensive income	2,482,605	2,787,514
Total stockholders' equity	37,866,996	41,787,381
Total liabilities and stockholders' equity	\$42,803,061	\$50,347,671

The accompanying notes are an integral part of the condensed consolidated financial statements





**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED****STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)**

	For The Nine Months Ended September 30,		For The Three Months Ended September 30,	
	2014	2013	2014	2013
Revenue	\$ 13,788,938	\$ 21,166,465	\$ 1,423,831	\$ 6,959,619
Cost of revenue	13,148,341	12,045,782	4,776,535	3,980,038
Gross profit	640,597	9,120,683	(3,352,704)	2,979,581
Operating Expenses				
General and administrative expenses	880,916	512,795	630,916	145,746
Loss on disposal of equipment	2,930,003	-	-	-
Total operating expenses	3,810,919	512,795	630,916	145,746
Income (loss) from operations	(3,170,322 )	8,607,888	(3,983,620)	2,833,835
Non-operating income				
Change in fair value of derivative financial instrument - preferred stock	-	64,280	-	-
Change in fair value of derivative financial instrument - warrants	-	310,173	-	2,123
Interest income	90,194	13,630	21,314	4,596
Interest expense	(7,037 )	(9,116 )	-	(3,724 )
Other expenses	(46,842 )	(232 )	9	(42 )
Total non-operating income	36,315	378,735	21,323	2,953
Income (Loss) before income taxes	(3,134,007 )	8,986,623	(3,962,297)	2,836,788
Income taxes	981,469	2,207,690	-	718,954
Net income/(loss)	(4,115,476 )	6,778,933	(3,962,297)	2,117,834
Dividend on preferred stock	-	(113,836 )	-	(113,836 )
Net income (loss) attributable to China Internet Cafe Holdings Group, Inc. common stockholders	\$(4,115,476 )	\$6,665,097	\$(3,962,297)	\$2,003,998
Other comprehensive income (loss)				
Net income (loss)	\$(4,115,476 )	\$6,778,933	\$(3,962,297)	\$2,117,834
Foreign currency translation	(304,909 )	978,856	17,746	237,854
Total comprehensive income (loss)	\$(4,420,385 )	\$7,757,789	\$(3,944,551)	\$2,355,688
Earnings (loss) per share				
- Basic	\$(0.78 )	\$1.34	# \$(0.72 )	\$0.39
- Diluted	\$(0.78 )	\$1.32	# \$(0.72 )	\$0.39

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Weighted average common stock outstanding				
- Basic	5,258,148	4,975,653	5,494,524	5,137,905
- Diluted	5,258,148	5,137,905	5,494,524	5,137,905

# The earnings per share and weighted average number of common shares for September 30, 2013 were retroactively restated to reflect the one-for-five reverse stock split effective on June 16, 2014.

The accompanying notes are an integral part of the condensed consolidated financial statements

**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES****UNAUDITED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014**

	Common Stock					Accumulated	Total
	Number	Amount	Additional	Statutory	Retained	Other	Stockholders'
	of Shares		Paid-in	Reserves	Earnings	Comprehensive	Equity
			Capital			Income	
Balance at January 1, 2014	5,138,002	\$ 51	\$5,732,965	\$718,744	\$32,548,107	\$ 2,787,514	\$41,787,381
Net income (loss) for the period	-	-	-	-	(4,115,476 )	-	(4,115,476 )
Issuance of common stock	400,000	4	499,996	-	-	-	500,000
Foreign currency translation difference	-	-	-	-	-	(304,909 )	(304,909 )
Balance at September 30, 2014	5,538,002	\$ 55	\$6,232,961	\$718,744	\$28,432,631	\$ 2,482,605	\$ 37,866,996

# The issued common stock and additional paid-in capital as of January 1, 2014 were retroactively restated to reflect the one-for-five reverse stock split effective on June 16, 2014.

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For The Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities		
Net income (loss)	\$(4,115,476 )	\$6,778,933
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Change in fair value of derivative financial instrument - preferred stock	-	(64,280 )
Change in fair value of derivative financial instrument- warrants	-	(310,173 )
Advisory fee	500,000	-
Depreciation	5,167,553	2,909,561
Amortization	34,732	28,952
Loss on disposal of equipment	2,930,004	-
Deferred tax assets	77,200	3,138
Changes in operating assets and liabilities:		
Rental deposit	32,449	579
Inventory	35,992	(19,425 )
Accounts payable	(144,260 )	212,175
Deferred revenue	(797,470 )	548,909
Payroll and payroll related liabilities	(14,551 )	11,819
Income and other taxes payable	(909,002 )	337,936
Accrued expenses	(214,699 )	140,795
Amount due to a shareholder	(1,343,754 )	264,146
Net cash provided by operating activities	1,238,718	10,843,065
Cash flows from investing activities		
Purchase of property, plant and equipment	(18,163,789)	(72,056 )
Proceeds from the sale of equipment	458,304	-
Net cash used in investing activities	(17,705,485)	(72,056 )
Cash flows from financing activities		
Proceeds from short term loan	-	161,991
Short term loan repayments	(162,715 )	(161,991 )
Net cash flows used in financing activities:	(162,715 )	-
Effect of foreign currency translation on cash	(260,286 )	791,421
Net increase/(decrease) in cash and cash equivalents	(16,889,768)	11,562,430
Cash and cash equivalents - beginning of period	40,241,459	25,818,041
Cash and cash equivalents - end of period	\$23,351,691	\$37,380,471

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Cash paid during the year for:

Interest paid	\$7,037	\$9,116
Income taxes paid	\$1,443,851	\$1,409,950

Supplemental disclosures of non-cash transactions:

Dividend payable on preferred stock	\$-	\$186,565
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The accompanying notes are an integral part of the condensed consolidated financial statements

**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2014 AND DECEMBER 31, 2013**

**(UNAUDITED)**

**1. Organization, Recapitalization and Nature of Business**

**China Internet Cafe Holdings Group, Inc. (“China Internet Cafe”)**

China Internet Cafe Holdings Group, Inc. (formerly known as China Unitech Group, Inc.) (“China Internet Café”, “the Company”, “we”, “us”, “our”) was incorporated in the State of Nevada on March 14, 2006. The Company was a development company from incorporation until the quarter ended June 30, 2010. On July 2, 2010, the Company successfully closed a share exchange transaction with the shareholders of Classic Bond Development Limited, a British Virgin Islands corporation (“Classic Bond”). The Company will operate through its variable interest entities in China to execute the current business plan of those affiliates which involves the operation of a chain of China-based internet cafes, the “Business.” On February 1, 2011, the Company changed its name from China Unitech Group, Inc. to China Internet Cafe Holdings Group, Inc.

**Recapitalization of Classic Bond Development Limited**

On July 2, 2010, the Company entered into a share exchange transaction with Classic Bond Development Limited, a British Virgin Islands corporation (“Classic Bond”), and the shareholders of Classic Bond. Pursuant to the Share Exchange Agreement, China Internet Cafe acquired 100% of the issued and outstanding capital stock of Classic Bond in exchange for 3,800,000 newly issued shares of the Company’s common stock, which represented approximately 94% of the 4,040,000 issued and outstanding shares of common stock after the transaction and after the coincident cancellation of 994,720 shares of common stock held by the Company’s former majority stockholder. The business, assets and liabilities did not change as a result of the reverse acquisition.

This share exchange transaction resulted in the shareholders of Classic Bond obtaining a majority voting interest in the Company. Generally accepted accounting principles require that the Company whose shareholders retain the majority interest in a combined business be treated as the acquirer for accounting purposes, resulting in a reverse acquisition with Classic Bond as the accounting acquirer and China Internet Cafe as the acquired party. Accordingly, the share exchange transaction has been accounted for as a recapitalization of Classic Bond whereby Classic Bond is deemed to be the continuing, surviving entity for accounting purposes, but through reorganization, has deemed to have adopted the capital structure of China Internet Cafe. The equity section of the accompanying financial statements has been restated to reflect the recapitalization of the Company due to the reverse acquisition as of the first day of the first period presented.

Accordingly, all references to common shares of Classic Bond's common stock have been restated to reflect the equivalent number of China Internet Cafe's common shares. In other words, the 2,000,000 Classic Bond shares outstanding are restated as 4,040,000 common shares, as of July 2, 2010. Each share of Classic Bond is restated to 2.2 shares of China Internet Cafe.

The book value of the net assets that for accounting purposes, were deemed to have been acquired by Classic Bond from China Internet Cafe, as of the date of acquisition (July 2, 2010) were \$3,333.

During the recapitalization, the Company incurred restructuring expenses of \$300,000, related legal and professional fee of \$129,033 and the interest expenses of \$6,053 related to the short term loan for paying restructuring expenses. All of these expenses amounting to \$435,086 in total were recorded as reorganizational expenses in statement of income.

#### **Classic Bond Development Limited ("Classic Bond")**

Classic Bond Development Limited was incorporated on November 2, 2009 in the British Virgins Islands ("BVI") with 50,000 authorized common shares with no par value. On November 2, 2009, 50,000 common shares at \$0.129 (HK\$1) each were issued for \$6,452 (HK\$50,000) cash to several shareholders including Mr. Guo Dishan who is the 65% equity interest shareholder and the sole director of the Company.

On June 23, 2010, the Company issued 1,950,000 shares of common stock of Classic Bond to 42 individuals for an aggregate of \$84,093 (HK\$651,721) for 641,046 shares and 1,308,954 shares associated with the reorganization of the Company at a value of \$167,519 (HK\$1,308,954) which is reflected as contributed capital by existing shareholders of Junlong and the total amount was \$251,612. As of June 30, 2010, 2,000,000 shares of Common Stock were issued and outstanding.

Classic Bond is in the business of operating internet cafés, throughout the Longang District of Shenzhen in Province of Guangdong of People's Republic of China ("PRC"). The Company conducts its operations through the following subsidiaries: (a) a wholly-owned subsidiary of the Company located in the PRC: Shenzhen Zhonghefangda Network Technology Co., Ltd. ("Zhonghefangda") and (b) an entity located in the PRC: Shenzhen Junlong Culture Communication Co., Ltd. ("Junlong"), which is controlled by the Company through contractual arrangements between Zhonghefangda and Junlong, as if Junlong were a wholly-owned subsidiary of Classic Bond.

### **Shenzhen Zhonghefangda Network Technology Co., Ltd. ("Zhonghefangda")**

Zhonghefangda, Classic Bond's wholly-owned subsidiary, was incorporated in People's Republic of China ("PRC") on June 10, 2010 with registered capital of \$129,032 (HK\$1 million). Zhonghefangda is engaged in provision of management and consulting services and Mr. Guo Dishan is the legal representative of Zhonghefangda.

On June 11, 2010, to protect the Company's shareholders from possible future foreign ownership restrictions, Zhonghefangda and Junlong entered into a series of agreements. Under these agreements Zhonghefangda obtained the ability to direct the operations of Junlong and to receive a majority of the residual returns. Therefore, management determined that Junlong became a variable interest entity ("VIE") under the provisions of Financial Accounting Standards Board ("FASB") ASC 810-10 and Zhonghefangda was determined to be the primary beneficiary of Junlong. Accordingly, beginning June 11, 2010, Zhonghefangda is able to consolidate the assets, liabilities, results of operations and cash flows of Junlong in its financial statements. Because the legal representatives and ultimate major stockholder of Zhonghefangda and Junlong is the same person, Mr. Guo Dishan, Zhonghefangda and Junlong were deemed, until June 11, 2010, to be under common control.

### **Exclusive Management and Consulting Agreement**

On June 11, 2010, Zhonghefangda signed an exclusive management and consulting services agreement with Junlong. Pursuant to the agreement, Zhonghefangda agreed to provide management and consulting services to Junlong, upon request, in connection with the operation of the Business. The agreement provides that Junlong will compensate Zhonghefangda by paying an amount equal to the aggregate net profit of Junlong for a period of twenty (20) years and for succeeding periods of the same duration until the agreement is terminated by both parties under agreed conditions. Zhonghefangda will reimburse Junlong the full amount of any net losses incurred by Junlong during the term of this agreement. As a result of entering into the exclusive management and consulting agreement, Zhonghefangda should be deemed to control Junlong as a Variable Interest Entity and Junlong is consolidated in the accompanying financial statements.

### **Shenzhen Jun Long Culture Communication Co., Ltd. ("Junlong")**

Junlong is a Chinese enterprise organized in the People's Republic of China ("PRC") on December 26, 2003 in accordance with the Laws of the People's Republic of China with the registered capital of \$0.136 million (equivalent to RMB 1 million). In 2001, the Chinese government imposed higher capital (RMB10 million for regional internet café



chain and RMB50 million for national internet café chain) and facility requirements for the establishment of internet cafes. On August 19, 2004, Junlong was granted approval from Shenzhen Municipal People's Government to increase its registered capital by \$1,230,500 from \$136,722 to \$1,367,222 million (increased by RMB 9 million, from RMB 1 million to RMB 10 million) The capital verification process has been completed. In April and July of 2010, Junlong acquired three internet cafes in Shenzhen.

In 2005, Junlong obtained internet cafe licenses to operate an internet café chain from the Ministry of Culture, and opened its first internet cafe in April, 2006 and our members can access the internet at our venues. We opened 7 internet cafes in 2006, 5 internet cafes opened in 2007, 11 internet cafes opened in 2008, 5 internet cafes opened in 2009, 16 internet cafes opened in 2010, 15 internet cafes opened in 2011, and 3 internet cafes opened during the year 2012. We closed 5 internet cafes in 2014. In total, as of September 30, 2014, we owned 57 internet cafes within Shenzhen, Guangdong.

## 2. Summary of Significant Accounting Policies

### *(a) Basis of presentation*

The Company's accounting policies used in the preparation of the accompanying financial statements conform to accounting principles generally accepted in the United States of America ("US GAAP") and have been consistently applied.

### *(b) Principle of consolidation*

The consolidated financial statements include the accounts of China Internet Cafe Holdings Group, Inc., Classic Bond Development Limited, Zhonghefangda and the VIE-Junlong. All significant intercompany balances and transactions have been eliminated in the consolidation. The consolidated financial statements included herein, presented in accordance with United States generally accepted accounting principles and stated in US dollars, have been prepared by the Company, pursuant to the rules and regulations of the Securities and Exchange Commission.

### *(c) Use of estimates*

In preparing financial statements in conformity with accounting principles generally accepted in the United States, 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 periods. These accounts and estimates include, but are not limited to, the valuation of receivables due from related parties, inventories and the estimation of useful lives of plant and machinery and intangibles assets. Actual results could differ from those estimates.

Warrants that could require cash settlement or have anti-dilution price protection provisions are recorded as liabilities at their estimated fair value at the date of issuance, with subsequent changes in estimated fair value recorded in other income (expense) in our statement of loss and comprehensive loss in each subsequent period. In general, warrants with anti-dilution provisions are measured using the binomial valuation model. The methodology based, in part, upon inputs for which there is little or no observable market data requires the Group to develop its own assumptions. The assumptions used in calculating the estimated fair value of the warrants represent our best estimates, however these estimates involve inherent uncertainties and the application of judgment. As a result, if factors change and different assumptions are used, the warrant liability and the change in estimated fair value could be materially different. Also see Note 11.

### *(d) Revenue recognition*

Internet café members purchase prepaid IC cards which include stored value or deposit money into members' SIM cards that will be deducted based on time usage of computers at the internet cafe. Revenues derived from the prepaid IC cards and SIM cards at the internet café are recognized when services are provided. This is based upon the usage of computer time at the internet cafe. Outstanding customer balances in the IC cards and SIM cards are included in deferred revenue on the balance sheets. The Company does not charge any service fees that cause a decrease to customer balances. There is no expiration date for IC cards and SIM cards.

The Company also records revenue from commissions received from the sale of third parties on-line gaming cards, snacks and drinks. Commission revenue amounting to 20% of the value of the on-line gaming cards, snacks and drinks is recognized at the time the gaming cards, etc. are sold to customers. During the nine months ended September 30, 2014 and 2013, the commission income was \$238,637 and \$338,798, respectively, less than 2% of total revenue.

*(e) Cost of revenue*

Cost of revenue consists primarily of depreciation of each internet café's computer equipment and hardware and overhead associated with the internet cafes including rental payments, utilities, value added taxes, and surcharges. Our value added taxes is 3% on gross revenue generated from selling time of internet surfing in our internet cafes. Our other surcharges are an education surcharge of 3% of value added tax amount, city development surcharge of 7% of value added tax amount, a culture development surcharge of 3% of gross revenue, and a snacks and drinks business tax of 5% of gross revenue.

*(f) Credit risk*

The Company may be exposed to credit risk from its cash at banks. An allowance has been considered for estimated irrecoverable amounts determined by reference to past default experience and the current economic environment. No allowance is considered necessary for the period.

*(g) Cash and cash equivalents*

Cash and cash equivalents include cash on hand, cash accounts, interest bearing savings accounts and time certificates of deposit with a maturity of three months or less when purchased.

*(h) Inventory*

Inventory represents the IC cards we purchased from IC card manufacturers. Inventories are stated at the lower of cost or market value. Cost is determined using the first-in, first-out (FIFO) method. In 2014, the Company changed its booking system for sales by using SIM cards and disposed all unused IC cards.

*(i) Fair Value of Financial Instruments*

The Company applies the provisions of accounting guidance, FASB Topic ASC 820 that requires all entities to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized on the balance sheet, for which it is practicable to estimate fair value, and defines fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties.

The Company adopted the provisions of Accounting Standards Codification (“ASC”) 820, Fair Value Measurements and Disclosures. ASC 820 clarifies the definition of fair value, prescribes methods for measuring fair value, and establishes a fair value hierarchy to classify the inputs used in measuring fair value as follows:

*Level 1* – Inputs are unadjusted quoted prices in active markets for identical assets or liabilities available at the measurement date.

*Level 2* – Inputs are unadjusted quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, inputs other than quoted prices that are observable, and inputs derived from or corroborated by observable market data.

*Level 3* – Inputs are unobservable inputs which reflect the reporting entity’s own assumptions on what assumptions the market participants would use in pricing the asset or liability based on the best available information.

The availability of inputs observable in the market varies from instrument to instrument and depends on a variety of factors including the type of instrument, whether the instrument is actively traded, and other characteristics particular to the transaction. For many financial instruments, pricing inputs are readily observable in the market, the valuation methodology used is widely accepted by market participants, and the valuation does not require significant management discretion. For other financial instruments, pricing inputs are less observable in the market and may require management judgment.

*(j) Stock-Based Compensation*

Our advisor assists the Company for ongoing corporate compliance and development are accounted for under ASC 505-50. ASC 505-50-30-11 (previously EITF 96-18) further provides that an issuer measure the fair value of the equity instruments in these transactions using the stock price and other measurement assumptions as of the earlier of the following dates, referred to as the measurement date:

- i. The date at which a commitment for performance by the counterparty to earn the equity instruments is reached (a performance commitment); and
- ii. The date at which the counterparty's performance is complete.

*(k) Equipment deposits*

The Company prepaid equipment deposits amount of \$3,218 to purchase fire protection systems for its new headquarters in Shenzhen in 2012 and the provider did not obtain the inspection of the fire protection system as of September 30, 2014.

*(l) Property, plant and equipment*

Property, plant and equipment, comprising computer equipment and hardware, leasehold improvements, office furniture and vehicles are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives listed below.

	Estimated Useful Lives
Leasehold improvements	5 years
Cafe computer equipment and hardware	2-5 years
Cafe furniture and fixtures	5 years
Office furniture, fixtures and equipment	5 years
Motor vehicles	5 years

Leasehold improvements mainly result from decoration expense. All of the Company's leases have terms of 5 years and leasehold improvements are amortized over 5 years, which represents the shorter of useful life and lease term.

*(m) Intangible Assets*

Our intangible assets consist of definite-lived assets subject to amortization such as Business License and Customer Lists. The useful lives of the Business License are 9 to 15 years and we amortize the customer lists over 5 years. We calculate amortization of definite-lived intangible assets on a straight-line basis over the useful lives of the intangible assets. Development cost of internal-use software is insignificant and is recorded as expense in the period such cost occurs.

*(n) Deferred Revenue*

Deferred revenue represents unused balances of the prepaid amounts received for IC cards. The Outstanding customer balances are \$1,481,292 and \$2,293,794 as of September 30, 2014 and December 31, 2013, respectively, and are included in deferred revenue on the balance sheets. Management has evaluated the deferred revenue balance and has determined any potential revenue from the unused balance to be immaterial at the quarter ended September 30, 2014.

*(o) Comprehensive income (loss)*

The Company follows the FASB's accounting standard. Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. For the Company, comprehensive income (loss) for the periods presented includes net income (loss) and foreign currency translation adjustments.

*(p) Income taxes*

Income taxes are provided on an asset and liability approach for financial accounting and reporting of income taxes. Current tax is based on the profit or loss from ordinary activities adjusted for items that are non-assessable or disallowable for income tax purpose and is calculated using tax rates that have been enacted or substantively enacted at the balance sheet date. Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 740-10-50-2 requires that deferred tax assets and liabilities be recognized for future tax consequence attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the statement of income in the period that includes the enactment date. A valuation allowance is provided for deferred tax assets if it is more likely than not these items will either expire before the Company is able to realize their benefits, or that future deductibility is uncertain. Losses incurred by the Company in prior years provide for a net operating loss carry-forward. However, all net operating losses are from the U.S. shell company and we currently anticipate insufficient income to utilize these losses in the future, so the asset balance has been fully reserved for.

*(q) Consolidation of Variable Interest Entities*

According to the requirements of Statement of Financial Accounting Standards No. 810-10, “Variable interest Entities”, the Company has evaluated the economic relationships of its wholly owned subsidiary, Shenzhen Zhonghefangda Network Technology Co., Ltd. (“Zhonghefangda”) with Junlong and has determined that it is required to consolidate Zhonghefangda and Junlong pursuant to the rules of FASB ASC Topic 810-10. Therefore Junlong is considered to be a VIE, as defined by FASB ASC Topic 810-10 of which Classic Bond is the primary beneficiary as a result of its wholly owned subsidiary Zhonghefangda. Classic Bond, as mentioned above, will absorb a majority of the economic risks and rewards of the VIE that are being consolidated in the accompanying financial statements.

The carrying amount of the VIE’s’ assets and liabilities are as follows:

	September 30, 2014	December 31, 2013
Current assets and Long term rental deposit	\$23,753,529	\$40,805,688
Property, plant and equipment	18,993,347	9,463,574
Intangible assets	26,886	62,008
Total assets	42,773,762	50,331,270
Total liabilities	(7,977,628 )	(11,793,939)
Net assets	\$34,796,134	\$38,537,331

*(r) Foreign currency translation*

Assets and liabilities of the Company with a functional currency other than US\$ are translated into US\$ using period end exchange rates. Income and expense items are translated at the average exchange rates in effect during the period. Foreign currency translation differences are included as a component of Accumulated Other Comprehensive Income in Stockholders' Equity.

The exchange rates used to translate amounts in RMB into USD for the purposes of preparing the financial statements were as follows:

	September 30, 2014	September 30, 2013	December 31, 2013
Period-end RMB : USD exchange rate	6.1534	-	6.1104
Nine months average RMB : USD exchange rate	6.1457	6.2132	-

The RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that the RMB amounts could have been, or could be, converted into USD at the rates used in translation.

*(s) Post-retirement and post-employment benefits*

The Company contributes to a state pension plan in respect of its PRC employees. Other than the above, neither the Company nor its subsidiary or the consolidated VIE's provides any other post-retirement or post-employment benefits.

*(t) Earnings (loss) per share (EPS)*

Earnings(loss) per share is calculated in accordance with ASC 260-10 which requires the Company to calculate net income(loss) per share based on basic and diluted net income(loss) per share, as defined. Basic EPS excludes dilution and is computed by dividing net income (loss) by the weighted average number of shares outstanding for the period. Diluted EPS is similar to basic EPS but presents the dilutive effect on a per share basis of potential common shares (e.g., convertible securities, preferred stock and warrants) as if they had been converted at the beginning of the periods presented, or issuance date, if later. Potential common shares that have an anti-dilutive effect (i.e., those that increase income per share or decrease loss per share) are excluded from the calculation of diluted EPS. See Note 15 for details.

*(u) Retained earnings-appropriated*

In accordance with the relevant PRC regulations and Zhonghefangda and Junlong's articles of association, Zhonghefangda and Junlong are required to allocate their respective net income to statutory surplus reserve.



*(v) Statutory surplus reserves*

In accordance with the relevant laws and regulations of the PRC and the articles of associations of Zhonghefanda and Junlong, each is required to allocate 10% of its net income reported in the PRC statutory accounts, after offsetting any prior years' losses, to the statutory surplus reserve, on an annual basis. When the balance of such reserve reaches 50% of the respective registered capital of the company, no further allocation is optional.

As of September 30, 2014 and December 31, 2013, the statutory surplus reserves of Zhonghefanda and Junlong reached 50% of the registered capital of the subsidiary and the Company was not required to allocate any further amount to it.

The statutory surplus reserves can be used to offset prior years' losses, if any, and may be converted into registered capital, provided that the remaining balances of the reserve after such conversion is not less than 25% of registered capital. The statutory surplus reserve is non-distributable.

*(w)Recent Accounting Pronouncements*

The FASB has issued Accounting Standards Update (ASU) No. 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements. The guidance addresses the consolidation of lessors in certain common control leasing arrangements and is based on a consensus reached by the Private Company Council (PCC).

Under current U.S. GAAP, a company is required to consolidate an entity in which it has a controlling financial interest. The assessment of controlling financial interest is performed under either: (a) a voting interest model; or (b) a variable interest entity model. In a variable interest entity model, the company has a controlling financial interest when it has: (a) the power to direct the activities that most significantly affect the economic performance of the entity; and (b) the obligation to absorb losses or the right to receive benefits of the entity that could be potentially significant to the entity.

To determine which model applies, a company preparing financial statements must first determine whether it has a variable interest in the entity being evaluated for consolidation and whether that entity is a variable interest entity.

The new guidance allows a private company to elect (when certain conditions exist) not to apply the variable interest entity guidance to a lessor under common control. Instead, the private company would make certain disclosures about the lessor and the leasing arrangement.

Under the amendments in this ASU, a private company lessee could elect an alternative not to apply variable interest entity guidance to a lessor when:

- (1) The private company lessee and the lessor are under common control;
- (2) The private company lessee has a leasing arrangement with the lessor;
- (3) Substantially all of the activity between the private company lessee and the lessor is related to the leasing activities (including supporting leasing activities) between those two companies, and
- (4) If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor related to the asset leased by the private company, then the principal amount of the obligation at inception does not exceed the value of the asset leased by the private company from the lessor.

If elected, the accounting alternative should be applied to all leasing arrangements meeting the above conditions. The alternative should be applied retrospectively to all periods presented, and is effective for annual periods beginning

after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted for all financial statements that have not yet been made available for issuance.

The adoption of ASU 2014-07 is not expected to have a material impact on the Company's financial position or results of operations.

The FASB has issued Accounting Standards Update (ASU) No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The amendments in the ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. It also addresses sources of confusion and inconsistent application related to financial reporting of discontinued operations guidance in U.S. GAAP.

Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment.

In addition, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations.

The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. This disclosure will provide users with information about the ongoing trends in a reporting organization's results from continuing operations.

The amendments in this ASU enhance convergence between U.S. GAAP and International Financial Reporting Standards (IFRS). Part of the new definition of discontinued operation is based on elements of the definition of discontinued operations in IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations.

The amendments in the ASU are effective in the first quarter of 2015 for public organizations with calendar year ends. For most nonpublic organizations, it is effective for annual financial statements with fiscal years beginning on or after December 15, 2014. Early adoption is permitted.

The adoption of ASU 2014-08 is not expected to have a material impact on the Company's financial position or results of operations.

### 3. Cash and cash equivalents

Cash and cash equivalents are summarized as follows:

	September 30, 2014	December 31, 2013
Cash and cash equivalents at bank	\$23,342,624	\$40,217,223
Cash on hand	9,067	24,236
	\$23,351,691	\$40,241,459

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash and cash equivalents. As of September 30, 2014 and December 31, 2013, \$23,316,657 and \$40,204,156 of the Company's cash and cash equivalents were held by major banks located in the PRC, which management believes are of high credit quality, and \$15,551 and \$2,534 of the Company's cash and cash equivalents were held by Chase Bank, respectively.

### 4. Property, Plant and Equipment, net

Property, plant and equipment, net, consist of the following:

	September 30, 2014	December 31, 2013
Leasehold improvements	\$5,169,965	\$4,234,152
Cafe computers equipment and hardware	22,024,109	17,307,427
Cafe furniture and fixtures	1,956,967	2,176,149
Office furniture, fixtures and equipment	339,161	355,974
Motor vehicles	483,302	486,703
	\$29,973,504	\$24,560,405
Less: Accumulated depreciation	(10,980,158)	(15,096,832)
Property, plant and equipment, net	\$18,993,346	\$9,463,573

For the nine months ended September 30, 2014, depreciation expense amounted to \$5,167,553, of which \$4,950,888 and \$216,665 were recorded as cost of sales and general and administrative expense, respectively.

### 5. Loss on Disposal of Equipment

In the second quarter of 2014, the Company has disposed all of its café computers purchased before 2012 and installed 12,659 new café computers. All disposed café computers were sold for RMB 200 each. The proceeds from the disposal of café computers were \$458,304 in total. As of September 30, 2014, the loss on disposal of café computers equipment as following:

	September 30, 2014
Disposal of cafe computers equipment	\$ 12,278,527
Accumulated depreciation	8,890,219
Proceeds from disposal of café computers equipment	458,304
Loss on disposal of café computers equipment	\$ 2,930,004

**6. Short Term Loan**

The short term loan due within one year as of September 30, 2014 and December 31, 2013 consists of the following:

Bank	Loan Period	Interest rate	September 30, 2014	December 31, 2013
China Construction Bank	June 13, 2013 to June 12, 2014	9 %	\$ -	\$ 163,655

On June 13, 2013, the Company entered into a loan agreement with China Construction Bank for \$162,288 (RMB 1,000,000), which was secured by a director's guarantee. The annual interest rate is approximately 9%. The loan was paid in full on June 12, 2014.

For the three and nine months ended September 30, 2014, the interest expense on this loan was \$-0- and \$7,037, respectively.

**7. Income and Other Taxes Payable**

Income and other tax payables consist of the following:

	September 30, 2014	December 31, 2013
Value added taxes	\$ 43,023	\$ 218,231
Income tax	-	567,419
Withholding individual income tax payable	5,555	4,064
Other tax payable	48,301	222,100
Total	\$ 96,879	\$ 1,011,814

**8. Due To Related Party**

	September 30, 2014	December 31, 2013
Mr. Dishan Guo	\$ 1,710,847	\$ 3,063,633

The amount due to Mr. Dishan Guo is unsecured with no stated interest and is payable on demand. The amount due as of September 30, 2014, represents amounts accumulated since 2007 used to pay daily operating expenses and professional fees. In May of 2014, \$1,507,429 was paid to Mr. Dishan Guo per his demand.

## **9. Income Tax**

The Company is subject to U.S. federal income tax, and the Company's subsidiary and affiliated entity incorporated in the PRC are subject to enterprise income taxes in the PRC. The Company's applicable enterprise income tax rate in PRC is 25% of its net income.

For the three and nine months ended September 30, 2014 and 2013, the Company did not record any uncertain tax benefits.

Aggregate undistributed earnings of approximately \$31.2 million as of September 30, 2014 of the Company's affiliated entity that are available for distribution to the Company are considered to be indefinitely reinvested, and, accordingly, no provision has been made for the Chinese dividend withholding taxes that would be payable upon distribution to the Company. Additionally, the Chinese tax authorities have clarified that distributions made out of pre-January 1, 2008 retained earnings would not be subject to the withholding tax.

The tax authorities may examine the tax returns of the Company three years after its fiscal year ended.

## **10. Employee Benefits**

The Company contributes to a state pension scheme organized by municipal and provincial governments in respect of its employees in PRC. The pension expense related to this plan is calculated at a range of 8% of the average monthly salary. The pension expense was \$9,223 and \$9,506 for the nine months ended September 30, 2014 and 2013, respectively. The pension expense was \$2,902 and \$3,536 for the three months ended September 30, 2014 and 2013, respectively.

## **11. Stockholders' Equity**

### **Common Stock**

On July 2, 2010, China Internet Cafe entered into a share exchange transaction with Classic Bond and the shareholders of Classic Bond. Pursuant to the Share Exchange Agreement, China Internet Cafe acquired 100% of the issued and outstanding capital stock of Classic Bond in exchange for 3,800,000 newly issued shares of the Company's common stock, which represented approximately 94% of the 4,040,000 issued and outstanding shares of common stock after the transaction and after the coincident cancellation of 994,720 shares of common stock held by the Company's former majority stockholder. The business, assets and liabilities did not change as a result of the reverse acquisition.

On June 16, 2014 the Company effected a one (1)-for-five (5) reverse stock split of the Company's issued and outstanding shares of common stock, decreasing the number of outstanding shares from 25,689,524 to 5,138,002. These statements have been adjusted to reflect this reverse split on a historical pro-forma basis.

As of September 30, 2014 and December 31, 2013, there were 5,538,002 and 5,138,002 shares of Common Stock issued and outstanding, respectively.

### **Series A Preferred Stock**

On February 16, 2011, the Company filed with the Secretary of State of Nevada, as an amendment to its Articles of Incorporation, a Certificate of Designation, Preferences and Rights for the 5% Series A Convertible Preferred Stock, par value \$0.00001 per share (the "Series A Preferred Stock"). On February 22, 2011, the Company issued 854,941 shares of its Series A Preferred Stock.

For each outstanding share of Series A Preferred Stock, dividends are payable quarterly, at the rate of 5% per annum (\$0.675 per share), on or before each date that is thirty days following the last day of March, June, September, and



December of each year, commencing September 30, 2011. Dividends on the Series A Preferred Stock accrue and are cumulative from and after the date of initial issuance. For the quarter ended September 30 and December 31 of 2012 and from January 1, 2013 to February 22, 2012, dividends have been accrued as dividends payable and are not paid as of June 30, 2014.

The Series A Preferred Stock was not subject to mandatory redemption (except on liquidation) but was redeemable in certain circumstances. Because of the possible redemption conditions, the Series A Preferred Stock was classified as mezzanine equity.

Each share of Series A Preferred Stock may be converted at any time, at the option of the holder, into a number of fully paid and non-assessable shares of Common Stock equal to the quotient of (i) the Series A Liquidation Preference of \$1.35 per share divided by (ii) the conversion price in effect as of the date of the Conversion Notice. The initial conversion price of the Series A Preferred Stock was \$1.35 per share.

In addition to the holder's right to convert the Series A Preferred Stock at any time, provided that the Common Stock underlying the Series A Preferred Stock is registered under an effective registration statement or is available for resale under Rule 144, without limitation, all outstanding shares of the Series A Preferred Stock automatically convert into shares of Common Stock at the earlier to occur of (i) February 22, 2013, the 24 month anniversary of the Closing Date of the issuance of the Series A Preferred Stock, or (ii) at such time that the volume-weighted average price of the Company's Common Stock is equal to or greater than \$3.00 (as may be adjusted for any stock splits or combinations of the Common Stock) for a period of ten consecutive trading days and such Common Stock has an average daily trading volume, for ten consecutive trading days, equal to or greater than 50,000 shares.

On February 22, 2013, in accordance with its terms, all 854,941 shares of Series A Preferred Stock outstanding automatically converted into 854,941 shares of common stock.

### Securities Purchase Agreement

On February 22, 2011 (the “Closing Date”), the Company completed a private placement (the “Offering”) of 474,967 units at a purchase price of \$13.50 per unit, each unit consisting of: (i) nine shares of the Company’s Series A Preferred Stock, convertible on a one to one basis into nine shares of the Company’s common stock; (ii) one share of Common Stock; (iii) two three-year Series A Warrants (the “Series A Warrants”), each exercisable for the purchase of one share of Common Stock, at an exercise price of \$2.00 per share; and (iv) two three-year Series B Warrants (the “Series B Warrants”), each exercisable for the purchase of one share of Common Stock, at an exercise price of \$3.00 per share. The Company received aggregate gross proceeds of \$6,412,055. The Offering was conducted pursuant to a Securities Purchase Agreement (the “Agreement”) between the Company and various accredited investors (the “Investors”).

Because certain of the instruments issued in the Offering are derivative instruments which will be initially and continuously carried at fair value, we believe the aggregate proceeds received should be allocated following the principles implicit in the guidance at ASC 815-15-30-2. The proceeds are first allocated to those derivative instruments that will initially and continuously be carried at fair value. The remaining proceeds, if any, are then allocated between the non-derivative host contract and other non-derivative instruments on a relative fair value basis.

The Company reviewed the features of the Series A Preferred Stock, other than the conversion feature, and concluded that, on balance, the terms and features of the host contract should be considered to be more akin to a debt instrument. Accordingly, the embedded conversion option may be required to be bifurcated and accounted for as a derivative instrument unless it meets the exemption provided by ASC 815-10-15-74a.

The conversion price of the Series A Preferred Stock is subject to adjustment if the Company subsequently sells Common Stock at a lower price. Also, as described below for the Warrants, the conversion option is denominated in U.S. dollars, a currency other than the Company’s functional currency. Accordingly, the embedded conversion option is not considered to be indexed only to the Company’s common stock. In addition, the Company may be required to redeem the Series A Preferred Stock for cash if, on receipt of a conversion request, it is unable to issue shares registered for resale for any reason. In addition, the conversion price of the Series A Preferred Stock is subject to adjustment if the Company subsequently sells Common Stock at a lower price but there is no explicit limit on the number of shares that the Company may be required to issue. As a result of the foregoing, the exemption provided by ASC 815-10-15-74a is not available and the embedded conversion option has been bifurcated and accounted for as a derivative liability. Because the embedded conversion option has been bifurcated and accounted for as a derivative liability, no beneficial conversion option was required to be recognized.

### Warrants

The Series A and Series B Warrants are exercisable at any time and from time to time at an exercise price of \$2.00 and \$3.00 per share, respectively, and expired on February 22, 2014. The holder may elect a cashless exercise of the Warrants beginning 12 months after the issuance date but only if the shares underlying the Warrants are not registered

for sale.

The Warrants contain standard anti-dilution adjustments for stock splits and similar events but the exercise price is not otherwise subject to adjustment.

The Company may call the Series A and Series B Warrants for redemption at a redemption price of \$0.01 per Warrant share if the shares underlying the Warrants are registered for sale and the volume-weighted average price of the Company's Common Stock is equal to or greater than \$6.00 per share or \$9.00 per share, respectively, for a period of ten consecutive trading days and such Common Stock has an average daily trading volume, for ten consecutive trading days, equal to or greater than 15,000 shares per day.

The Warrants are free-standing derivative instruments. Although the Company is a U.S. entity, the Company has no U.S. operations and all of its operations are conducted, through its subsidiaries, in the People's Republic of China. Accordingly, because the Company is fully invested in China and those operations in China represent the Company's only source of future revenues or income, the Company concluded that its functional currency should be considered to be the RMB. As a result, because the Warrants are denominated in U.S. dollars, they are denominated in a currency different from the Company's functional currency and therefore, in accordance with the guidance at ASC 815-40-15-7I, the Warrants are not considered to be indexed only to the Company's common stock. As a result, the exemption provided by ASC 815-10-15-74a is not available and the Warrants are recorded as a derivative liability.

### Registration Rights Agreement

In connection with the Offering, the Company entered into a Registration Rights Agreement with the Investors, in which the Company agreed to file a registration statement to register for resale the Common Stock and the Common Stock issuable upon conversion of the Series A Preferred Stock and exercise of the Series A and Series B Warrants, within 45 calendar days of the Closing Date, and to have the registration statement declared effective within 150 calendar days of the Closing Date or within 180 calendar days of the Closing Date in the event of a full review of the registration statement by the Securities and Exchange Commission. If the Company does not comply with the foregoing obligations under the Registration Rights Agreement, the Company will be required to pay cash liquidated damages to each Investor, at the rate of 1% of the applicable subscription amount for each 30 day period or part thereof in which we are not in compliance; provided, that such liquidated damages will be capped at 10% of the subscription amount of each Investor and will not apply to any securities that may be sold pursuant to Rule 144 under the Securities Act, or which are subject to an SEC restriction with respect to Rule 415 under the Securities Act.

The required registration statement was filed by the required due date. However, the Company did not meet the deadline to render its S-1 registration statement effective. At September 30, 2014, the Company has accrued \$641,200 for the estimated liquidated damages it expects to pay.

### Placement Agent Fees

In connection with the Offering, the Company paid its placement agents (i) a cash fee of 7% of the gross proceeds from sale of the Units, (ii) a cash management fee of 1% and (iii) a 0.5% non-accountable expense allowance. In addition to these placement agent cash fees aggregating \$545,025, the Company paid \$181,415 in legal fees and other expenses related to the Offering. After payment of the placement agent cash fees and legal and other expenses, the Company received net proceeds of \$5,675,614.

In addition, the placement agents received warrants to purchase such number of securities as is equal to 9% of the aggregate number of shares of common stock issuable in connection with the Units (the "Placement Agent Warrants"). The Placement Agent Warrants expire after three years and are exercisable at the following prices: (i) 85,548 Warrants - \$1.35 per share (ii) 17,099 Series A Warrants - \$2.00 per share and (iii) 85,494 Series B Warrants - \$3.00 per share. The terms of the Warrants, including anti-dilution protection for stock splits and similar events, are similar to the Warrants issued to the Investors, except that the 85,548 Warrants do not permit the Company to call the Warrants.

### Securities Escrow Agreement

In connection with the Offering, we also entered into a Securities Escrow Agreement with the Investors and Mr. Dishan Guo (the "Stockholder"), the Company's chairman and principal stockholder, pursuant to which the Stockholder placed in escrow one share of our Common Stock for each \$10 of Units sold to the Investors, equal to 641,205 shares of Common Stock (the "Escrow Shares"). The escrow agreement establishes a performance threshold for the Company based on net income (as defined and subject to certain non-cash adjustments) for the year ending December 31, 2011

of \$10,000,000. If the Company achieves 95% or more of the performance threshold, the shares will be returned to the Stockholder. If the Company's net income is less than \$9,500,000, then the shares will be delivered to the Investors in the amount of 10% of the escrow shares for each full percentage point by which such performance threshold was not achieved, up to a maximum of the 641,205 shares placed in escrow.

The Stockholder's agreement to place the shares in escrow was undertaken in his capacity as a major stockholder of the Company. In accordance with the guidance at ASC 718-10-S99-2, the Company does not believe the potential return of the shares to the Stockholder is compensatory because such return is not contingent on his continued employment with the Company. The Investors who may receive shares under the escrow arrangement have no relationship with the Company other than in their capacity as shareholders.

The shares are outstanding and are included in the weighted average shares outstanding for purposes of computing basic earnings per share.

#### Lock-up Agreement

On the Closing Date, the Company entered into a lock-up agreement (the "Lock-Up Agreement") with the Stockholder whereby the Stockholder is prohibited from selling our securities that he directly or indirectly owns (the "Lock-Up Shares") until nine months after the Registration Statement is declared effective (the "Lock-Up Period"). In addition, the Stockholder further agreed that during the 12 months immediately following the Lock-Up Period, the Stockholder will not offer, sell, contract to sell, assign or transfer more than 0.833% of the Lock-Up Shares during each calendar month following the Lock-Up Period, other than engaging in a transfer in a private sale of the Lock-Up Shares if the transferee agrees in writing to be bound by and subject to the terms of the Lock-Up Agreement.

### *Accounting for Derivative Instruments*

The Warrants and Placement Agent Warrants are derivative instruments as defined in ASC 815-10-15-83. ASC 815-10-15-74 provides that a contract that would otherwise meet the definition of a derivative instrument but that is both (a) indexed to a company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. FASB ASC 815-40-15 and 815-40-25 provide guidance for determining whether those two criteria are met. For purposes of this evaluation, the Company has concluded that the Company's functional currency is the Renminbi. Because the Warrants are denominated in U.S. Dollars, FASB ASC 815-40-15-7I provides that they are not considered to be indexed only to the Company's Common Stock. Accordingly, the exemption in FASB ASC 815-10-15-74 is not available and the Warrants are classified as a derivative instrument liability.

The Series A Preferred Stock is a hybrid financial instrument that embodies the risks and rewards typically associated with both equity and debt instruments. Accordingly, we are required to evaluate the features of this contract to determine its nature as either an equity-type contract or a debt-type contract. We determined that the Series A Preferred Stock is generally more akin to a debt-type contract, principally due to its potential redemption requirements, its fixed rate quarterly dividend requirement and its lack of voting rights. This determination is subjective. However, in complying with the guidance provided in FASB ASC 815, we concluded, based upon the preponderance and weight of all terms, conditions and features of the host contract, that the Series A Preferred Stock was more akin to a debt instrument for purposes of considering the clear and close relationship of the embedded derivative features to the host contract. ASC 815 requires bifurcation when the embedded derivative features and the host contract have risks that are not clearly and closely related. Certain exemptions to this rule, such as that for conventional convertible instruments that are convertible into a fixed number of shares, were not available to us because the conversion price of the Series A Preferred Stock is not fixed and will be adjusted if the Company sells shares of Common Stock at a price lower than the conversion price. Also, because the conversion price of the Series A Preferred Stock is denominated in U.S. Dollars, as for the warrants discussed above, the embedded conversion option is not considered to be indexed only to the Company's Common Stock. In addition, the Company may be required to redeem the Series A Preferred Stock if it is unable to deliver registered shares on conversion. Accordingly, the exemption in FASB ASC 815-10-15-74 is not available and the embedded conversion option, along with certain other features of the Series A Preferred Stock that have risks of equity, required bifurcation and classification in liabilities as a compound embedded derivative financial instrument.

Derivative financial instruments are initially measured at their fair value and are then re-valued at each reporting date, with changes in the fair value reported as charges or credits to income.

### *Valuation of Derivative Instruments*

The Warrants and the Placement Agent Warrants were initially valued, using a binomial model, at \$649,821 and \$262,966, respectively, based on the quoted market price of the Common Stock of \$1.00 per share, a term equal to the remaining life of the Warrants, an expected dividend yield of 0%, a risk-free interest rate of 1.32% based on constant maturity rates published by the U.S. Federal Reserve applicable to the remaining life of the Warrants and estimated volatility of 85%, based on a review of the historical volatility of publicly-traded companies considered by

management to be comparable to the Company.

The compound embedded derivative financial instrument related to the Series A Preferred Stock, consisting primarily of the embedded conversion option, was initially valued, using a binomial model, at \$1,604,794, based on the quoted market price of the Common Stock of \$1.00, a term equal to the expected life of the conversion option, an expected dividend yield of 0%, a risk-free interest rate of 0.78% based on constant maturity rates published by the U.S. Federal Reserve applicable to the expected life and estimated volatility of 85%.

After allocating a portion of the proceeds received to the fair value of the Warrants and the embedded derivative instrument in the Series A Preferred Stock, the remaining proceeds were allocated to the Common Stock component of the Units and the carrying value of the Series A Preferred Stock host contract.

On February 22, 2013, all outstanding shares of the Series A Preferred Stock were converted to common stock. As of that date, the conversion feature of the Series A Preferred Stock was out-of-the-money and accordingly had no value. The aggregate change in the fair value of the embedded derivative instrument related to the Series A Preferred Stock between December 31, 2012 and February 22, 2013 of \$64,280 has been credited to income.

At December 31, 2013, the Warrants, the Placement Agent Warrants and the embedded derivative instrument related to the Series A Preferred Stock were re-valued at \$-0-, \$-0- and \$-0-, respectively, because of their short remaining life with expiration date on February 14, 2014 and the recent low volatility of the stock price. The aggregate change in the fair value of the derivative liabilities between December 31, 2012 and December 31, 2013 of \$393,534 has been credited to income.

On February 14, 2014, the Warrants, the Placement Agent Warrants and the embedded derivative instrument related to the Series A Preferred Stock expired.

#### *Accounting for Series A Preferred Stock*

\$3,682,473 of the proceeds received was allocated to the carrying value of the Series A Preferred Stock host contract. The 854,940 shares of Series A Preferred Stock have a liquidation value of \$5,770,849. Because the Series A Preferred Stock has conditions for its redemption that are outside our control, it is classified outside of Stockholders' Equity, in the mezzanine section of our balance sheet, in accordance with ASC 480-10-S99-3A. Because the Series A Preferred Stock is not currently redeemable and the Company currently believes that it is not probable that it will become redeemable, no adjustment of the carrying value of the Series A Preferred Stock has been recognized. If it becomes probable that the Series A Preferred Stock will be redeemed, it will be adjusted to its redemption value.

#### *Placement Agent Fees*

The placement agent cash fees of \$545,025, other expenses related to the sale of the Units of \$181,415 and the initial fair value of the Placement Agent Warrants of \$262,966, aggregating \$989,406, have been charged to additional paid-in capital.

#### *Advisory Fees*

On November 22, 2010, the Company entered into a 12 month Advisory Agreement with an affiliate of its placement agent, under which the affiliate agreed to render on-going financial advisory and investment banking services to the Company. As compensation for its services, the Company agreed to pay a monthly fee of \$10,000, payable on the first day of each month after the completion of a Transaction, as defined in the agreement between the Company and its placement agent. Payment of these fees commenced on March 1, 2011, following completion of the sale of the Units.



The Company also agreed to place in escrow for issuance to the affiliate a total of 80,000 shares of Common Stock, with 40,000 shares to be released following the completion of a Transaction, 20,000 shares to be released six months after the completion of a Transaction and 20,000 shares to be released 12 months after the completion of a Transaction. In accordance with ASC 505-50-25-7, the Company concluded that the value of the shares should be measured at the date the Transaction was completed because the shares are effectively fully vested as of that date and non-forfeitable and the agreement does not provide for any further specific performance criteria to be met. The Company valued the shares issued at \$1.00 per share (based on the quoted market price), resulting in compensation expense for the services rendered and to be rendered of \$400,000. The expense related to the services provided and to be provided was recognized over the period from November 22, 2010, the date from which services commenced under the agreement, to the one year anniversary, when the agreement expired. At December 31, 2011, the expense has been fully recognized.

In addition to the above fees, the Company issued 10,000 shares to its legal counsel, in consideration for their introducing the Company to the placement agent. The cost of these shares, which were valued at \$5.00 per share (determined as described above) were expensed during the year ended December 31, 2011.

On January 31, 2014, the Company entered into a 12 month Consultancy Agreement with Apex Marketing holding, under which Apex Marketing holding agreed to render financial advisory, acquisitions, and related matter services to the Company. As compensation for its services, the Company issued 400,000 shares to Apex Marketing holding for paying its fees \$500,000. Payment of its fees commenced on July 10, 2014.

### *Fair Value Considerations*

As required by FASB ASC 820, assets and liabilities measured at fair value are classified in their entirety based on the lowest level of input that is significant to their fair value measurement. Our derivative financial instruments that are measured at fair value on a recurring basis under FASB ASC 815 are all measured at fair value using Level 3 inputs. Level 3 inputs are unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Estimating fair values of derivative financial instruments requires the development of significant and subjective estimates that may, and are likely to, change over the duration of the instrument with related changes in internal and external market factors. In addition, valuation techniques are sensitive to changes in the estimated fair value of our common stock and our estimates of its volatility. Because derivative financial instruments are initially and subsequently carried at fair values, our income will reflect the volatility in these estimate and assumption changes.

### Options

On February 27, 2014, the Board approved the Company's 2014 Incentive Stock Plan (the "2014" Plan). The 2014 Plan provides for grant of incentive stock options, non-statutory stock options, restricted stock, restricted stock purchase offers and other types of stock-based awards to the Company's employees, officers, directors and consultants. Up to 513,790 shares of common stock are issuable pursuant to awards the 2014 Plan. Unless terminated earlier by the Board, the 2014 Plan shall terminate at the close of business on February 26, 2024. As of the date of this report, no shares have been issued under the 2014 Plan.

## **12. Commitments and Contingencies**

### *Operating Leases*

In the normal course of business, the Company leases office space and internet cafes under operating leases agreements, which expire through 2017. The Company rents internet cafe venues and office space, primarily for regional sales administration offices that are conducive to administrative operations. The operating lease agreements generally contain renewal options that may be exercised in the Company's discretion after the completion of the base rental terms. In addition, many of the leases provide for regular increases to the base rental rate at specified intervals, which usually occur on an annual basis.

As of September 30, 2014, the Company was obligated under operating leases requiring minimum rentals as follows:

Fiscal year

Remainder of 2014	\$597,848
2015	1,384,056
2016	261,964
2017	4,875
	\$2,248,743

During the three and nine months ended September 30, 2014, rent expenses amounted to \$638,047 and \$1,931,860, respectively, of which \$618,450 and \$1,877,385 was recorded as cost of sales, respectively.

During the three and nine months ended September 30, 2013, rent expenses amounted to \$877,862 and \$2,149,059, respectively, of which \$863,596 and \$2,107,465 was recorded as cost of sales, respectively

### **13. Concentrations**

The Company did not have any customer constituting greater than 10% of net sales for the three and six months ended September 30, 2014 and 2013.

At September 30, 2014 and December 31, 2013, there was one supplier of consignment snacks and drinks in the amount of \$82,308 and \$227,981, respectively, which accounted for 100% and 100% of the Company's accounts payable.

### **14. Operating Risk and Uncertainties**

#### *Interest rate risk*

The interest rates and terms of repayment of bank and other borrowings are disclosed in Note 5. Other financial assets and liabilities do not have material interest rate risk.

*Foreign currency risk*

Most of the transactions of the Company were settled in Renminbi. In the opinion of the directors, the Company does not have significant foreign currency risk exposure.

*Company's operations are substantially in foreign countries*

Substantially all of the Company's services are provided in China. The Company's operations are subject to various political, economic, and other risks and uncertainties inherent in China. Among other risks, the Company's operations are subject to the risks of restrictions on transfer of funds; export duties, quotas, and embargoes; domestic and international customs and tariffs; changing taxation policies; foreign exchange restrictions; and political conditions and governmental regulations.

The Chinese government began tightening its regulation of internet cafes in 2001. In particular, a large number of unlicensed internet cafes have been closed. In addition, the Chinese government has imposed higher capital (RMB 10,000,000 is required for a regional internet café chain and RMB 50,000,000 is required for a national internet café chain) and facility requirements for the establishment of internet cafes. Furthermore, the Chinese government's policy, which encourages the development of a limited number of national and regional internet cafe chains and discourages the establishment of independent internet cafes, may slow down the growth of internet cafes. Recently, the Ministry of Culture, together with other government authorities, issued a joint notice suspending the issuance of new internet cafe chain licenses. Any intensified government regulation of internet cafes could restrict our ability to maintain and expand our internet cafes.

Currently, the Company uses only one internet service provider. However, there are other internet service providers available to the Company. The management of the Company believes that the risk of loss of internet services is not that high because other service providers are available to the Company.

**15. Earnings (loss) per Share**

Basic earnings(loss) per share is computed by dividing net income(loss) attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings(loss) per share reflects the potential dilution of securities by including other potential common stock, including convertible preferred stock, stock options and warrants, in the weighted average number of common shares outstanding for the period, if dilutive. The numerators and denominators used in the computations of basic and dilutive earnings (loss) per share are presented in the following table:

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	For The Three Months Ended September 30, 2014		For The Nine Months Ended September 30, 2014	
	2013		2013	
<b>BASIC</b>				
Numerator for basic earnings (loss) per share attributable to the Company's common stockholders:				
Net income (loss)	\$ (3,962,297)	\$ 2,117,834	\$ (4,115,476)	\$ 6,778,933
Dividend on preferred stock	-	(113,836 )	-	(113,836 )
Net income (loss) used in computing basic earnings per share	\$ (3,962,297)	\$ 2,003,998	\$ (4,115,476)	\$ 6,665,097
Basic weighted average shares outstanding	5,494,524	5,137,905	5,258,148	4,975,653
Basic earnings per share	\$ (0.72 )	\$ 0.39	\$ (0.78 )	\$ 1.34

	For The Three Months Ended September 30, 2014		For The Nine Months Ended , September 30, 2014	
<b>DILUTED</b>				
Numerator for diluted earnings (loss) per share attributable to the Company's common stockholders:				
Net income (loss)	\$(3,962,297)	\$2,003,998	\$(4,115,476)	\$6,665,097
Dividend on preferred stock	-	113,836	-	113,836
Net income (loss) used in computing diluted earnings per share	\$(3,962,297)	\$2,117,834	\$(4,115,476)	\$6,778,933
Weighted average outstanding shares of common stock	5,494,524	5,137,905	5,258,148	4,975,653
Weighted average preferred stock	-	-	-	162,252
Diluted weighted average shares outstanding	5,494,524	5,137,905	5,258,148	5,137,905
Diluted earnings (loss) per share	\$(0.72	) \$0.39	\$(0.78	) \$1.32
Potential common shares outstanding as of September 30:				
Warrants	-	499,665	-	499,665

# The earnings (loss) per share and weighted average number of common shares for September 30, 2013 were retroactively restated to reflect the one-for-five reverse stock split effective on June 16, 2014.

## 16. Segment Information

The Company applies the provisions of ASC 280, "Disclosures about Segments of an Enterprise and Related Information". The Company views its operations and manages its business as one segment: the operation of internet cafe chains. Factors used to identify the Company's single operating segment include the organizational structure of the Company and the financial information available for evaluation by the chief operating decision-maker in making decisions about how to allocate resources and assess performance. The Company operates in one geographical area, the PRC.

## 17. Subsequent Events

As of the date of this report, the Company has evaluated subsequent events for potential recognition and disclosure through the date of the financial statement issuance.

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

*The following discussion and analysis of our financial condition and result of operations contains forward-looking statements and involves numerous risks and uncertainties, including, but not limited to, those described in the "Risk Factors" section of the other reports we file with the Securities and Exchange Commission. Actual results may differ materially from those contained in any forward-looking statements.*

### Overview

Prior to the consummation of the share exchange transaction described below, we were a shell company with nominal operations and nominal assets. Currently, through our wholly-owned subsidiary, Junlong Culture Communication Co. Ltd. ("Junlong"), we operate what we believe is the largest Internet Café chain in Shenzhen city, People's Republic of China ("PRC"), consisting of 57 internet cafes in high traffic areas. Our focus is on providing top quality internet café facilities that offer a one-stop entertainment and media venue for customers, typically mature students and migrant workers, at reasonable prices. Although our cafes do sell snacks, drinks, and game access cards, more than 97% of our revenue comes directly from selling internet access time to our computers.

From the second quarter to third quarter of 2014, our business environment has become very challenging; we start to show the trend of losing our members; the major causes are as that the 4G is getting popular; more public space provide the free Wi-Fi services; the smart phones and mobile games are both getting popular.

We, therefore focused on upgrading our café computers and renovating our existing cafes for a more enjoyable service. We expect our future growth to be driven by a number of factors and trends including:

1. Our ability to improve our service to our customers by providing an enjoyable entertainment environment.
2. Our ability to optimize our current 57 internet cafes
3. Our ability to identify and acquire target companies for joint ventures in the coming years
4. Develop the business opportunities in other business field.

For the three months ended September 30, 2014, our revenue was approximately \$1.4 million and our net loss was approximately \$4.0 million, representing decreases of 80% and 287%, respectively, from the revenue of approximately \$7.0 million and net income of approximately \$2.1 million for the three months ended September 30,

2013.

The discussion below of our performance is based upon our unaudited financial statements for the three and nine months ended September 30, 2014 and 2013, which are included in this report.

We believe that the following factors will continue to affect our financial performance:

**Improved Disposable Income.** We believe as the Shenzhen municipal government increases the minimum wage, migrant workers, who are our major customers, will have more disposable income. We are expecting the inflow of migrant workers to continue to contribute to our revenue growth.

**Continued Internet Café Use.** Our business may be adversely affected by an increase in the availability of the 4G network. We believe, however, that people prefer to play videos and games on a computer's screen than on the small screen of a cell phone. In addition, young people in the PRC prefer internet cafes since it is a social place for them. We expect the preference will continue and provide sustainable business.

**Customer Loyalty.** As we continue to expand our operations, developing and maintaining customer loyalty will be critical to continued revenue growth.

**Expansion into South Western Provinces.** The Company currently holds a regional internet café chain license. In order to meet the basic requirements of a national internet chain license, the Company's will seek to acquire and open at least 20 internet cafes in two provinces other than Guangdong province. The Company has conducted research in provinces and cities in southwestern China, including Chongqing, Sichuan, Guizhou and Yunnan, and is targeting internet cafes in these areas for acquisition. The Company believes a national license is imperative for the development of a national market.

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## Results of Operations

The following tables set forth key components of our results of operations for the periods indicated, in dollars and as a percentage of revenue.

### CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES

#### CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	For Three Months Ended September 30, 2014		2013		Amount change	%	
		As percentage of revenue		As percentage of revenue			
Revenue	\$1,423,831	100	% \$6,959,619	100	% (5,535,788)	-80 %	
Cost of revenue	4,776,535	335	% 3,980,038	57	% 796,497	20 %	
Gross profit (loss)	(3,352,704)	-235	% 2,979,581	43	% (6,332,285)	-213 %	
Operating Expenses							
General and administrative expenses	630,916	44	% 145,746	2	% 485,170	333 %	
Total operating expenses	630,916	44	% 145,746	2	% 485,170	333 %	
Income (Loss) from operations	(3,983,620)	-280	% 2,833,835	41	% (6,817,455)	-241 %	
Non-operating income (expenses)							
Change in fair value of derivative financial instrument - warrants	-	-	2,123	0	% (2,123 )	-100 %	
Interest income	21,314	1	% 4,596	0	% 16,718	364 %	
Interest expenses	-	0	% (3,724 )	0	% 3,724	-100 %	
Other expenses	9	0	% (42 )	0	% 51	-121 %	
Total non-operating income (expenses)	21,323	1	% 2,953	0	% 18,370	622 %	
Net income (loss) before income taxes	(3,962,297)	-278	% 2,836,788	41	% (6,799,085)	-240 %	
Income taxes	-	-	718,954	10	% (718,954 )	-100 %	
Net income (loss) attributable to China Internet Cafe Holdings Group, Inc.	(3,962,297)	-278	% 2,117,834	30	% (6,080,131)	-287 %	

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Dividend on preferred stock	-	-	(113,836 )	-2	%	113,836	100	%
Net income (loss) attributable to China Internet Cafe Holdings Group, Inc. Common stockholders	\$(3,962,297)	-278	% \$2,003,998	29	%	(5,966,295)	-298	%
Other comprehensive income (loss)								
Net income (loss)	\$(3,962,297)	-278	% 2,117,834	30	%	(6,080,131)	-287	%
Foreign currency translation	17,746	1	% 237,854	3	%	(220,108 )	-93	%
Net Comprehensive income (loss)	\$(3,944,551)	-277	% \$2,355,688	34	%	(6,300,239)	-267	%

**Comparison of Three Months Ended September 30, 2014 and 2013**

**Revenue**

Our revenue is primarily generated from sales of prepaid IC cards and SIM cards which include stored value that will be deducted based on time usage of computers at our internet cafes. Our revenue decreased approximately \$5.5 million, or 80%, from approximately \$6.9 million for the three months ended September 30, 2013 to \$1.4 million for the three months ended September 30, 2014. The decrease in revenue was due to our decreased business hours in the third quarter of 2014 compared with the same period of 2013. We fully closed 5 existing internet cafes located in areas with many new internet cafes in April, temporarily closed 17 existing internet cafes for renovation during the second quarter in order to provide good entertainment environments to our customers, and temporarily closed 20 existing internet cafes in order to strengthen internet cafes' fire safety management required by Shenzhen government during the third quarter. We will expect a recover in revenue when we reopen our 37 temporarily closed internet cafes as soon as they pass the fire safety inspections performed by Shenzhen Government.

### **Cost of Revenue**

Cost of revenue is primarily composed of depreciation and amortization, salary, rent, utility, value added tax and surcharge. Among the components of cost of revenue, depreciation and amortization, salary and rent are fixed costs while utility and value added tax and surcharge are variable costs, which change in proportion to the change in revenue.

Our cost of sales for the three months ended September 30, 2014 increased approximately \$0.8 million from approximately \$4.8 million compared with the same period of 2013 approximately \$4.0 million. The increase was mainly generated from an increase in depreciation expenses of our new installed café computers. We installed 12,659 new café computers and disposed all café computers installed before 2012 in the second quarter. Due to the prompt development of computer technology, we changed our depreciation period for new café computers from 5 years to 2 years. We expect the increase in our cost of sales will continue in the future as we expect increased depreciation expenses in our new café computers.

### **Gross Profit (Loss)**

Gross profit (loss) is the difference between revenue and cost of revenue. Our gross profit decreased by approximately \$6.3 million, or 213%, to a loss approximately \$3.3 million for the three months ended September 30, 2014 from a profit approximately \$3.0 million for the same period in 2013. Gross loss as a percentage of sales was 235% for the fiscal year ended September 30, 2014, as compared to gross profit 43% for the fiscal year of 2013. The decrease in our gross profit margin was mainly attributable to the decrease in revenue and increase in cost of revenue.

### **Operating Expenses**

Operating expenses are composed of general and administrative expenses. General and administrative expenses mainly consist of the overhead of our headquarters in Shenzhen and fees paid to legal counsel, auditors, and consultants. Our operating expenses increased by approximately \$0.5 million, or 333%, to approximately \$0.6 million for the three months ended September 30, 2014 from approximately \$0.1 million for the same period in 2013. The increase was primarily due to an increase of approximately \$0.5 million in advisory fee paid to a consultant company in July of 2014. We expect that our operating expenses will be stable in the future.

### **Non-operating Income**

Our non-operating income increased by approximately \$0.018 million, or 622%, to approximately \$0.021 million for the three months ended September 30, 2014 from approximately \$0.003 million for the same period in 2013. The increase in income was due to an increase in interest income of approximately \$0.017 million.

### **Income (loss) before Income Taxes**

Income before income taxes decreased by approximately \$6.8 million, or 240%, to an approximately \$4.0 million loss for the three months ended September 30, 2014 from approximately \$2.8 million income for the same period in 2013. The decrease in income before income tax was mainly attributable to decrease in revenue.

### **Income Taxes**

Our income taxes decreased by approximately \$0.7 million to approximately \$-0- million for the three months ended September 30, 2014 from approximately \$0.7 million for the same period in 2013. The primary reason for the decrease in income taxes was the loss before income tax as a result of 37 temporarily closed internet cafes.

### **Net Income (Loss)**

Our net income decreased by approximately \$6.1 million, or 287%, to approximately \$4.0 million loss for the three months ended September 30, 2014 from approximately \$2.1 million income for the same period in 2013 as a result of the factors described above. We expect (but cannot guarantee) our net profit will return to historical levels when we reopen 37 temporarily closed internet cafes as soon as they pass the fire safety inspections performed by Shenzhen Government.

**Results of Operations for the Nine Months Ended September 30, 2014 and 2013**

The following tables set forth key components of our results of operations for the periods indicated, in dollars and as a percentage of revenue.

	For Nine Months Ended September 30		2013		Amount change	%	%	%	
	2014	As percentage of revenue		As percentage of revenue					
Revenue	\$13,788,938	100	%	\$21,166,465	100	%	(7,377,527 )	-35	%
Cost of revenue	13,148,341	95	%	12,045,782	57	%	1,102,559	9	%
Gross profit	640,597	5	%	9,120,683	43	%	(8,480,086 )	-93	%
<b>Operating Expenses</b>									
General and administrative expenses	880,916	6	%	512,795	2	%	368,121	72	%
Loss on disposal of equipment	2,930,003	21	%	-	-		2,930,003	10	%
Total operating expenses	3,810,919	28	%	512,795	2	%	3,298,124	643	%
Income (loss) from operations	(3,170,322 )	-23	%	8,607,888	41	%	(11,778,210)	-137	%
<b>Non-operating income</b>									
Change in fair value of derivative financial instrument - preferred stock	-	-		64,280	0	%	(64,280 )	-100	%
Change in fair value of derivative financial instrument - warrants	-	-		310,173	1	%	(310,173 )	-100	%
Interest income	90,194	1	%	13,630	-		76,564	562	%
Interest expenses	(7,037 )	0	%	(9,116 )	-		2,079	-23	%
Other expenses	(46,842 )	0	%	(232 )	-		(46,610 )	20091	%
Total non-operating income	36,315	0	%	378,735	2	%	(342,420 )	-90	%
Net income (loss) before income taxes	(3,134,007 )	-23	%	8,986,623	42	%	(12,120,630)	-135	%
Income taxes	981,469	7	%	2,207,690	10	%	(1,226,221 )	-56	%
Net income (Loss) attributable to China Internet Cafe Holdings Group, Inc.	(4,115,476 )	-30	%	6,778,933	32	%	(10,894,409)	-161	%
Dividend on preferred stock	-	-		(113,836 )	-1	%	-	100	%
	\$ (4,115,476 )	-30	%	\$6,665,097	31	%	(10,780,573)	-162	%

Net income (Loss) attributable to  
China Internet Cafe Holdings  
Group, Inc. Common stockholders

Other comprehensive income  
(loss)

Net income (loss)	\$(4,115,476 )	-30	%	6,778,933	32	%	(10,894,409 )	-161	%
Foreign currency translation	(304,909 )	-2	%	978,856	-		(1,283,765 )	-131	%
Net Comprehensive income (loss)	\$(4,420,385 )	-32	%	\$7,757,789	37	%	(12,178,174)	-157	%

### **Comparison of Nine Months Ended September 30, 2014 and 2013**

#### **Revenue**

Our revenue is primarily generated from sales of prepaid IC cards and SIM cards which include stored value that will be deducted based on time usage of computers at the internet cafe. Sales revenue decreased approximately \$7.4 million, or 35%, from approximately \$21.2 million for the nine months ended September 30, 2013 to approximately \$13.8 million for the same period ended September 30, 2014. The decrease in revenue was mainly due to our decreased business hours in the second and third quarter of 2014 compared with the same period of 2013. We fully closed 5 existing internet cafes located in areas with many new internet cafes in April, temporarily closed 17 existing internet cafes for renovation during the second quarter in order to provide good entertainment environments to our customers, and temporarily closed 20 existing internet cafes in the third quarter in order to strengthen our fire safety system required by Shenzhen government. We expect revenues to return to prior levels when we reopen our 37 temporarily closed internet cafes as soon as they pass fire safety inspections performed by Shenzhen government.

### **Cost of Revenue**

Cost of revenue is primarily composed of depreciation and amortization, salary, rent, utility, value added tax and surcharge. Among the components of cost of revenue, depreciation and amortization, salary and rent are fixed costs while utility and value added tax and surcharge are variable costs, which change in proportion to the change in revenue.

Our cost of sales increased by approximately \$1.1 million, or 9%, to approximately \$13.1 million for the nine months ended September 30, 2014 from approximately \$12.0 million for the same period in 2013. The increase was primarily a result of an increase in depreciation expenses of our new installed café computers. In 2014, we installed 12,659 new café computers and disposed of all café computers installed before 2012. Due to the prompt development of computer technology, we changed our depreciation period for new café computers from 5 years to 2 years. We expect the increase in our cost of sales will continue in the future as we expect increased depreciation expenses in our new café computers.

### **Gross Profit**

Gross profit decreased by approximately \$8.5 million, or 93%, to approximately \$0.6 million for the nine months ended September 30, 2014 from approximately \$9.1 million for the same period in 2013. Gross profit as a percentage of sales was 5% for the nine months ended September 30, 2014, as compared to 43% for the same period in 2013. The decrease in our gross profit margin was mainly attributable to decrease in revenue and increase in cost of revenue.

### **Operating Expenses**

Operating expenses are composed of general and administrative expenses. General and administrative expenses mainly consist of the overhead of our headquarters in Shenzhen and fees paid to legal counsel, auditors, and consultants. Our operating expenses increased by approximately \$3.3 million, or 643%, to approximately \$3.8 million for the nine months ended September 30, 2014 from approximately \$0.5 million for the same period in 2013. The increase was primarily due to an increase of approximately \$2.93 million in loss on disposal of equipment. In 2014, we installed 12,659 new café computers and disposed of all café computers installed before 2012. The proceeds from disposal of café computers were RMB 200 each and approximately \$0.46 million in total. We expect that our operating expenses will be stable in the future.

### **Non-operating Income/Expenses**

Our other income decreased by approximately \$0.34 million, or 90%, to approximately \$0.04 million or the nine months ended September 30, 2014 from approximately \$0.38 million for the same period in 2013. The decrease in non-operating income was due to a decrease in income of approximately \$0.37 million in the fair value of derivative instruments from income of approximately \$0.37 million for the nine months ended September 30, 2013 to \$-0- for the same period of 2014 as a result of the expiration of all derivative instruments – Warrants in February 2014 .

**Income (Loss) before Income Taxes**

Income before income taxes decreased by approximately \$12.1 million, or 135%, to approximately \$3.1 million loss before income taxes for the nine months ended September 30, 2014 from approximately \$9.0 million income before income taxes for the same period in 2013. The decrease in income before income tax was mainly attributable to the decrease in revenue, increase in cost of revenue, and loss on disposal of café computers.



**Income Taxes**

We are subject to U.S. federal income tax, and our subsidiaries incorporated in the PRC are subject to enterprise income taxes in the PRC. Our income taxes decreased by approximately \$1.2 million or 56% to approximately \$1.0 million for the nine months ended September 30, 2014 from approximately \$2.2 million for the same period in 2013. The primary reason for the decrease in income taxes was the decrease in income before income tax.

**Net Income (loss)**

Our net income decreased by approximately \$10.9 million, or 161%, to a loss of approximately \$4.1 million for the nine months ended September 30, 2014 from an income of approximately \$6.8 million for the same period in 2013 as a result of the factors described above. We expect our net profit will recover when we reopen 37 temporarily closed internet cafes as soon as they can pass fire safety inspections performed by Shenzhen government.

**Liquidity and Capital Resources**

As of September 30, 2014, we had cash and cash equivalents of approximately \$23.4 million. The following table provides detailed information about our cash flow for each financial statement period presented in this report.

**Cash Flow**

	Nine Months Ended September 30,	
	2014	2013
Net cash provided by operating activities	\$1,238,718	\$10,843,065
Net cash used in investing activities	(17,705,485)	(72,056 )
Net cash used in financing activities	(162,715 )	-
Effect of foreign currency translation on cash and cash equivalents	(260,286 )	791,421
Net cash flows	(16,889,768)	11,562,430

***Operating Activities***

Net cash provided by operating activities was approximately \$1.2 million for the nine months ended September 30, 2014 compared with approximately \$10.8 million for the same period of 2013. The decrease in cash provided by operating activities was mainly attributable to a decrease in gross profit approximately \$8.5 million, loss on disposal of café computers approximately \$2.9 million, and higher depreciation expenses for our new café computers. We changed our depreciation period for our new café computers from 5 years to 2 years and had higher depreciation expenses compared to the same period of 2013.

### ***Investing Activities***

Net cash used in investing activities was approximately \$17.7 million for the nine months ended September 30, 2014 compared with approximately \$0.07 million for the same period of 2013. During the second and third quarter of 2014, we purchased 12,659 new café computers for approximately \$16.9 million and renovated 17 our existing internet cafes for approximately \$1.3 million.

### ***Financing Activities***

Net cash used in financing activities was \$0.16 million for the nine months ended September 30, 2014 compared with \$-0- for the same period of 2013. In June of 2014, we paid off our short-term loan of approximately \$0.16 million (RMB 1,000,000) on its due date. In June of 2013, we took out a new short-term loan of approximately \$0.16 million (RMB 1,000,000) after we paid off a short-term loan of approximately \$0.16 million on its due date.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires our management to make assumptions, estimates and judgments that affect the amounts reported, including the notes thereto, and related disclosures of commitments and contingencies, if any. We have identified certain accounting policies that are significant to the preparation of our financial statements. These accounting policies are important for an understanding of our financial condition and results of operations. Critical accounting policies are those that are most important to the portrayal of our financial conditions and results of operations and require management's difficult, subjective, or complex judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Certain accounting estimates are particularly sensitive because of their significance to financial statements and because of the possibility that future events affecting the estimate may differ significantly from management's current judgments. We believe the following critical accounting policies involve the most significant estimates and judgments used in the preparation of our financial statements.

### ***Revenue recognition***

Internet café members purchase prepaid IC cards/SIM cards, which include stored value that will be deducted based on time usage of computers at the internet café. Revenues derived from the prepaid IC cards/SIM cards at the internet café are recognized when services are provided. This is based upon usage of computer time at the internet café. Outstanding customer balances in the IC cards/SIM cards are included in deferred revenue on the balance sheets. The Company does not charge any service fees that cause a decrement to customer balances. There is no expiration date for IC cards.

The Company also records revenue from commission received from the sale of third parties on-line gaming cards, snacks and drinks. Commission revenue amounting to 17% of the value of the on-line gaming cards, snacks and drinks is recognized at the time the items are sold to customers.

### ***Cost of goods sold***

Cost of revenue consists primarily of depreciation of each internet café's computer equipment and hardware and overhead associated with the internet cafes including rental payments, utilities, value added taxes, and surcharges. Our value added taxes is 3% on gross revenue generated from selling time for internet surfing in our internet cafes. Our other surcharges are an education surcharge of 3% of value added tax amount, city development surcharge of 7% of value added tax amount, a culture development surcharge of 3% of gross revenue, and a snacks and drinks business tax of 5% of gross revenue.

### ***Property, plant and equipment***

Property and equipment, comprising computer equipment and hardware, leasehold improvements, office furniture and vehicles are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives listed below.

	Estimated Useful Lives
Leasehold improvement	5 years
Café computer equipment and hardware	2-5 years
Café furniture and fixtures	5 years
Office furniture, fixtures and equipment	5 years
Motor vehicles	5 years

Leasehold improvements mainly result from decoration expenses. All of our lease contracts state that lease terms are for 5 years and leasehold improvements are amortized over 5 years, which represents the shorter of useful life and lease term.

### ***Deferred Revenue***

Deferred revenue represents unused balances of the prepaid amounts from our IC cards/SIM cards. The outstanding customer balances are \$1,481,292 and \$2,293,794 at September 30, 2014 and December 31, 2013, respectively, and are included in deferred revenue on the balance sheets. Management has evaluated the deferred revenue balance and has determined any potential revenue from the unused balance to be immaterial as of the nine months ended September 30, 2014.

### ***Comprehensive income***

The Company follows the FASB's accounting standards. Comprehensive income is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. For the Company, comprehensive income for the periods presented includes net income and foreign currency translation adjustments.

***Income taxes***

Income taxes are provided on an asset and liability approach for financial accounting and reporting of income taxes. Current tax is based on the profit or loss from ordinary activities adjusted for items that are non-assessable or disallowable for income tax purposes and is calculated using tax rates that have been enacted or substantively enacted at the balance sheet date. Deferred income tax liabilities or assets are recorded to reflect the tax consequences in future differences between the tax basis of assets and liabilities and the financial reporting amounts at each year-end. A valuation allowance is recognized if it is more likely than not that some portion, or all, of a deferred tax asset will not be realized.

***Foreign currency translation***

Assets and liabilities of a company with a functional currency other than US\$ are translated into US\$ using period end exchange rates. Income and expense items are translated at the average exchange rates in effect during the period. Foreign currency translation differences are included as a component of Accumulated Other Comprehensive Income in Stockholders' Equity.

The exchange rates used to translate amounts in RMB into USD for the purposes of preparing the consolidated financial statements were as follows:

	September 30, 2014	September 30, 2013	December 31, 2013
Period-end RMB : USD exchange rate	6.1534	-	6.1104
Nine months average RMB : USD exchange rate	6.1457	6.2132	-

The RMB is not freely convertible into foreign currency and all foreign exchange transactions must take place through authorized institutions. No representation is made that the RMB amounts could have been, or could be, converted into USD at the rates used in translation.

**Recently issued accounting pronouncements**

The FASB has issued Accounting Standards Update (ASU) No. 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements. The guidance addresses the consolidation of lessors in certain common control leasing arrangements and is based on a consensus reached by the Private Company Council (PCC).

Under current U.S. GAAP, a company is required to consolidate an entity in which it has a controlling financial interest. The assessment of controlling financial interest is performed under either: (a) a voting interest model; or (b) a variable interest entity model. In a variable interest entity model, the company has a controlling financial interest when it has: (a) the power to direct the activities that most significantly affect the economic performance of the entity; and (b) the obligation to absorb losses or the right to receive benefits of the entity that could be potentially significant to the entity.

To determine which model applies, a company preparing financial statements must first determine whether it has a variable interest in the entity being evaluated for consolidation and whether that entity is a variable interest entity.

The new guidance allows a private company to elect (when certain conditions exist) not to apply the variable interest entity guidance to a lessor under common control. Instead, the private company would make certain disclosures about the lessor and the leasing arrangement.

Under the amendments in this ASU, a private company lessee could elect an alternative not to apply variable interest entity guidance to a lessor when:

- (1) The private company lessee and the lessor are under common control;
- (2) The private company lessee has a leasing arrangement with the lessor;
- (3) Substantially all of the activity between the private company lessee and the lessor is related to the leasing activities (including supporting leasing activities) between those two companies, and
- (4) If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor related to the asset leased by the private company, then the principal amount of the obligation at inception does not exceed the value of the asset leased by the private company from the lessor.

If elected, the accounting alternative should be applied to all leasing arrangements meeting the above conditions. The alternative should be applied retrospectively to all periods presented, and is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted for all financial statements that have not yet been made available for issuance.

The adoption of ASU 2014-07 is not expected to have a material impact on the Company's financial position or results of operations.

The FASB has issued Accounting Standards Update (ASU) No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. The amendments in the ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. It also addresses sources of confusion and inconsistent application related to financial reporting of discontinued operations guidance in U.S. GAAP.

Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results. Examples include a disposal of a major geographic area, a major line of business, or a major equity method investment.

In addition, the new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations.

The new guidance also requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. This disclosure will provide users with information about the ongoing trends in a reporting organization's results from continuing operations.

The amendments in this ASU enhance convergence between U.S. GAAP and International Financial Reporting Standards (IFRS). Part of the new definition of discontinued operation is based on elements of the definition of discontinued operations in IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations.

The amendments in the ASU are effective in the first quarter of 2015 for public organizations with calendar year ends. For most nonpublic organizations, it is effective for annual financial statements with fiscal years beginning on or after December 15, 2014. Early adoption is permitted.

The adoption of ASU 2014-08 is not expected to have a material impact on the Company's financial position or results of operations.



**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

Not applicable.

**Item 4. Controls and Procedures.**

*Evaluation of Disclosure Controls and Procedures*

The Company maintains a set of disclosure controls and procedures designed to ensure that information required to be disclosed by the Company in the reports filed under the Securities Exchange Act of 1934 as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms. Disclosure controls are also designed with the objective of ensuring that this information is accumulated and communicated to the Company's management, including the Company's chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Pursuant to Rule 13a-15(b) under the Exchange Act, the Company carried out an evaluation with the participation of the Company's management, including Dishan Guo, the Company's chief executive officer and chief financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined under Rule 13a-15(e) under the Exchange Act) as of September 30, 2014. Based upon that evaluation, the Company's management concluded that the Company's disclosure controls and procedures were not effective as of September 30, 2014 as a result of the material weakness identified in our internal control over financial reporting disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.

Specifically, our management identified certain matters involving internal control and our operations that it considered to be material weaknesses. As defined in the Exchange Act, a material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis. The material weakness identified by our management is described below:

We did not maintain sufficient personnel with an appropriate level of technical accounting knowledge, experience, and training in the application of GAAP commensurate with the complexity of our financial accounting and reporting requirements. This control deficiency is pervasive in nature. Further, there is a reasonable possibility that material misstatements of the financial statements including disclosures will not be prevented or detected on a timely basis as a result.

***2014 Planned Remediation***

We are committed to improving our financial organization. As part of this commitment, we will look to increase our personnel resources and technical accounting expertise within the accounting function by the end of fiscal year 2014 to resolve non-routine or complex accounting matters. We have in the past, and will continue to engage outside consultants in the future as necessary in order to ensure proper treatment of non-routine or complex accounting matters.

Management believes that hiring additional knowledgeable personnel with technical accounting expertise will remedy the material weakness of having insufficient personnel with an appropriate level of technical accounting knowledge, experience, and training in the application of GAAP commensurate with our complexity and our financial accounting and reporting requirements.

We will continue to monitor and evaluate the effectiveness of our disclosure controls and procedures and our internal controls over financial reporting on an ongoing basis and are committed to taking further action and implementing additional enhancements or improvements, as necessary and as funds allow.

### *Changes in Internal Control over Financial Reporting*

No changes in the Company's internal control over financial reporting have come to management's attention during the Company's last fiscal quarter that have materially affected, or are likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings.**

From time to time, we may become involved in various lawsuits and legal proceedings that 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 harm our business. We are currently not aware of any such legal proceedings or claims that we believe will have a material adverse effect on our business, financial condition or operating results.

### **Item 1A. Risk Factors.**

Reference is made to the risks and uncertainties disclosed in our Form 10-K for the year ended December 31, 2013 (the "2013 Form 10-K"), which are incorporated by reference into this report. Prospective investors are encouraged to consider the risks described in our 2013 Form 10-K, our Management's Discussion and Analysis of Financial Condition and Result of Operation contained in this report and other information publicly disclosed or contained in

documents we file with the Securities and Exchange Commission before purchasing our common stock.

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

On July 10, 2014, we issued 200,000 shares of our common stock to each of Yu Wang and Xiaoxu Liu, shareholders of Apex Market Holdings ("Apex"), for advisory services furnished by Apex pursuant to the exemption from the registration requirements of the Securities Act provided by Rule 903 of Regulation S.

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

**Exhibit No. Description**

31.1	Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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**SIGNATURES**

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

**CHINA INTERNET CAFE HOLDINGS GROUP, INC.**

Date: November 12, 2014

/s/ Dishan Guo

Dishan Guo

Chief Executive Officer, President (Principal Executive Officer) and Chief Financial Officer (Principal Financial and Accounting Officer)