

China Internet Cafe Holdings Group, Inc.  
Form 10-Q  
August 14, 2012

**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 June 30, 2012**

**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: **011-86-755-8989-6008**

**Not applicable**

(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)

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

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY**

**PROCEEDINGS DURING THE PRECEDING FIVE YEARS**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

As of August 13, 2012, there were 21,414,821 shares of \$0.00001 par value common stock (the "Common Stock") issued and outstanding.

FORM 10-Q

CHINA INTERNET CAFE HOLDINGS GROUP, INC.

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**PART I - FINANCIAL INFORMATION**

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

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

**CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

Consolidated Balance Sheets at June 30, 2012 (unaudited) and December 31, 2011	F-2
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**CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS**

	June 30, 2012 Unaudited	December 31, 2011
<b>ASSETS</b>		
Current assets:		
Cash	\$22,324,039	\$19,629,680
Rental deposit	48,696	86,580
Equipment deposit	768,607	994,732
Inventory	52,520	212,607
Deferred tax assets	72,208	69,405
Total current assets	23,266,070	20,993,004
Property, plant and equipment, net	12,871,089	13,000,745
Intangible assets, net	143,156	161,083
Rental deposit-long term portion	425,088	314,736
Total assets	\$36,705,403	\$34,469,568
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Short term loan	\$158,506	\$-
Accounts payable	149,120	100,480
Registration penalties payable	641,200	448,844
Deferred revenue	1,921,114	2,084,086
Payroll and payroll related liabilities	342,177	323,286
Income and other taxes payable	862,345	1,316,209
Accrued expenses	365,374	365,696
Amount due to a shareholder	2,388,597	2,135,218
Dividend payable on preferred stock	71,938	72,729
Derivative financial instrument - preferred stock	271,405	147,704
Derivative financial instrument - warrants	352,666	129,496
Total current liabilities	7,524,442	7,123,748
Commitments and contingencies (Note 13)		
Preferred stock (\$0.00001 par value, 100,000,000 shares authorized, 4,274,703 shares issued and outstanding as of June 30, 2012 and December 31, 2011; preference in liquidation - \$5,770,849)	3,682,473	3,682,473
Stockholders' Equity:		
Common stock (\$0.00001 par value, 100,000,000 shares authorized, 21,361,534 and 21,254,377 shares issued and outstanding as of June 30, 2012 and December 31, 2011)	214	212
Additional paid in capital	1,978,390	1,728,726
Statutory surplus reserves	718,744	718,744
Retained earnings	21,173,582	19,760,289

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Accumulated other comprehensive income	1,627,558	1,455,376
Total stockholders' equity	25,498,488	23,663,347
Total liabilities and stockholders' equity	\$36,705,403	\$34,469,568

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

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

	For The Six Month Ended June 30,		For The Three Months Ended June 30,	
	2012	2011 Restated	2012	2011 Restated
Revenue	\$14,010,113	\$15,114,661	\$6,875,909	\$8,625,080
Cost of revenue	9,943,536	9,067,523	4,938,105	5,072,181
Gross profit	4,066,577	6,047,138	1,937,804	3,552,899
Operating Expenses				
General and administrative expenses	810,687	992,604	240,793	548,137
Loss on disposal of fixed assets	533,213	-	533,213	-
Total operating expenses	1,343,900	992,604	774,006	548,137
Income from operations	2,722,677	5,054,534	1,163,798	3,004,762
Non-operating income (expenses)				
Change in fair value of derivative financial instrument - preferred stock	(123,701 )	677,403	308,477	2,116,729
Change in fair value of derivative financial instrument - warrants	(223,170 )	357,812	83,109	1,120,455
Interest income	9,925	5,102	6,195	5,102
Interest expenses	(4,450 )	(5,164 )	(4,450 )	(2,633 )
Other expenses	(12,470 )	(472 )	(12,327 )	(2,466 )
Total non-operating income (expenses)	(353,866 )	1,034,681	381,004	3,237,187
Income before income taxes	2,368,811	6,089,215	1,544,802	6,241,949
Income taxes	811,642	1,372,386	316,192	812,697
Net income	1,557,169	4,716,829	\$1,228,610	\$5,429,252
Dividend on preferred stock	(143,876 )	(101,978 )	(71,938 )	(68,776 )
Net income attributable to China Internet Cafe Holdings Group, Inc. common stockholders	\$1,413,293	\$4,614,851	1,156,672	5,360,476
Other comprehensive income				
Net income	\$1,557,169	\$4,716,829	1,228,610	5,429,252
Foreign currency translation	172,182	415,111	(7,876 )	359,738
Total comprehensive income	\$1,729,351	\$5,131,940	\$1,220,734	\$5,788,990
Earnings per share				
- Basic	\$0.07	\$0.25	0.05	0.25
- Diluted	\$0.06	\$0.21	0.05	0.21
Weighted average common stock outstanding				



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- Basic	21,308,691	20,854,258	21,335,769	21,124,967
- Diluted	25,583,394	23,877,252	25,610,472	25,399,670

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

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

	For The Six Months Ended	
	June 30,	
	2012	2011
		Restated
Cash flows from operating activities		
Net income	\$1,557,169	\$4,716,829
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Change in fair value of derivative financial instrument - preferred stock	123,701	(677,403 )
Change in fair value of derivative financial instrument- warrants	223,170	(357,812 )
Stock based compensation	105,000	-
Advisory fee	-	292,192
Depreciation	1,331,182	1,305,607
Amortization	19,054	18,386
Loss on disposal of fixed assets	533,213	-
Deferred tax assets	(2,328 )	(64,556 )
Changes in operating assets and liabilities:		
Prepayment	-	(15,616 )
Rental deposit	(69,798 )	(64,595 )
Inventory	161,708	(76,246 )
Accounts payable	47,995	24,275
Deferred revenue	(177,483 )	1,357,008
Payroll and payroll related liabilities	16,683	92,779
Income and other taxes payable	(463,373 )	670,417
Accrued expenses and penalties payable	190,009	241,006
Amount due to a shareholder	243,588	1,414,776
Net cash provided by operating activities	3,839,490	8,877,045
Cash flows from investing activities		
(Increase)/Decrease of property, plant and equipment	(1,645,091 )	(4,626,368 )
Receipt of loan receivable due to termination of an investment agreement	-	2,449,629
Deposits paid for property, plant and equipment	233,198	-
Net cash used in investing activities	(1,411,893 )	(2,176,739 )
Cash flows from financing activities		
Net proceeds from issuance of preferred stock and warrants	-	5,675,614
Increase/(Decrease) from short term loan	158,662	-
Net cash flows provided by financing activities:	158,662	5,675,614
Effect of foreign currency translation on cash	108,100	211,398
Net increase in cash	2,694,359	12,587,318
Cash - beginning of period	19,629,680	3,836,824
Cash - end of period	\$22,324,039	\$16,424,142

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Cash paid during the period for:

Interest paid	\$ 153	\$5,164
Income taxes paid	\$1,093,327	\$942,480
Transfer of equipment deposits paid in property and equipment	\$-	\$1,235,497
Dividend payable on preferred stock	71,938	101,978
Registration penalties	\$192,356	-
Advisory fee	\$-	\$292,192

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

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

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

**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.) (“the Company”, “we”, “us”, “our” or “China Internet Cafe”) was incorporated in the State of Nevada on March 14, 2006. The Company was a development company from incorporation to 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.

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, China Internet Cafe completed a reverse acquisition transaction through a share exchange with Classic Bond Development Limited, a British Virgin Islands corporation (“Classic Bond”) and its shareholders, whereby we acquired 100% of the issued and outstanding capital stock of Classic Bond, in exchange for 19,000,000 shares of our common stock, which shares constituted 94% of our issued and outstanding shares on a fully-diluted basis, as of and immediately after the consummation of the reverse acquisition. As a result of the reverse acquisition, Classic Bond became our wholly owned subsidiary and the former shareholders of Classic Bond, became our controlling shareholders. The business, assets and liabilities did not change as a result of the reverse acquisition.

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 20,200,000 common shares, as of July 2, 2010. Each share of Classic Bond is restated to 10.10 shares of China Internet Cafe common stock.

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 fees of \$129,033 and interest expenses of \$6,053 related to the short-term loan for the payment of restructuring expenses. All of these expenses amounting to a total of \$435,086, which was recorded as reorganizational expenses in the 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 stock with no par value. On November 2, 2009, 50,000 shares of common stock at \$0.129 (HK\$1) each were issued for cash at \$6,452 (HK\$50,000) to several shareholders including Mr. Guo Dishan, the 65% equity interest shareholder and the sole director of the Company.

On June 23, 2010, the Company further issued 1,950,000 shares of common stock to 42 individuals to raise \$84,093 (HK\$651,721) for 651,721 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 the existing shareholders of Junlong Culture Communication Co., Ltd., a company controlled by China Internet Cafe (as explained herein) and the total amount was \$251,612. At December 31, 2010 and December 31, 2009, the issued and outstanding of common stock were 2,000,000 and 50,000 shares.

#### **Classic Bond Development Limited (“Classic Bond”)**

Classic Bond is in the business of operating internet cafes throughout the Longgang District of Shenzhen in Guangdong Province in the People's Republic of China (“PRC”). The Company conducts its operations through the following subsidiaries: (a) Shenzhen Zhonghefangda Network Technology Co., Ltd. (“Zhonghefangda”), a wholly-owned subsidiary of the Company located in the PRC, and (b) Shenzhen Junlong Culture Communication Co., Ltd. (“Junlong”), an entity located in the PRC, 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 was incorporated in the PRC on June 10, 2010 with registered capital of \$129,032 (HK\$1 million). Zhonghefangda is engaged in the provision of management and consulting services.

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 was able to consolidate the assets, liabilities, and results of operations and cash flows of Junlong in the financial statements. Because the legal representatives and ultimate major stockholder of Zhonghefangda and Junlong is the same person, Mr. Gou Dishan, Zhonghefangda and Junlong were deemed, until June 11, 2010, to be under the 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 Junlong's business. The agreement provides that Junlong will compensate Zhonghefangda in consideration for its right to receive the aggregate net profit of Junlong for a period of twenty (20) years and for succeeding periods of the same duration until terminated by both parties under agreed to 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 is

deemed to control Junlong as a VIE and should be consolidated in the accompanying financial statements.

**Shenzhen Junlong Culture Communication Co., Ltd.**

Junlong is a Chinese enterprise organized in the PRC on December 26, 2003 in accordance with the Laws of the People's Republic of China with registered capital of \$0.136 million (Renminbi ("RMB") 1 million). In 2001, the Chinese government imposed higher capital and facility requirements for the establishment of internet cafes (RMB 10 million for regional internet cafe chains and RMB 50 million for national internet cafe chains). 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). Its capital verification process has been completed.

In 2005, Junlong obtained licenses to operate internet cafe chains from the Ministry of Culture, and opened their first internet cafe in April, 2006. We continued to open a total of 7 internet cafes in 2006, 5 internet cafes in 2007, 11 internet cafes in 2008, 5 internet cafes in 2009, 16 internet cafes in 2010, 15 internet cafes in 2011, and 1 internet cafe in 2012. In total, we own 60 internet cafes within Shenzhen of China.

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## 2. Summary of Significant Accounting Policies

### (a) Basis of presentation

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. The functional currency is the Chinese Renminbi, however the accompanying condensed consolidated financial statements have been translated and presented in United States Dollars (\$).

It is management's opinion that the unaudited condensed consolidated financial statements include all adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows of the Company for the periods presented. All adjustments are of a normal recurring nature. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of operating results expected for the full year or future interim periods. These unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, filed on March 30, 2012 (the "Annual Report").

Results of operations for the interim periods are not indicative of annual results.

### (b) Principle of consolidation

The condensed consolidated financial statements include the accounts of China Internet Cafe, Classic Bond, Zhonghefangda and the Junlong. All significant intercompany balances and transactions have been eliminated in the consolidation. The condensed 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 US GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reported periods. Actual results could differ from those estimates.

## Significant Estimates

These financial statements include some amounts that are based on management's best estimates and judgments. The most significant estimates relate to depreciation of property, plant and equipment, deferred revenue, impairment testing of long-lived assets and various contingent liabilities. It is reasonably possible that the above-mentioned estimates and others may be adjusted as more current information becomes available, and any adjustment could be



significant in future reporting periods.

(d) Revenue recognition

Internet cafe members' purchase prepaid IC cards which include stored value that will be deducted based on time usage of computer at the internet cafe. Revenues derived from the prepaid IC cards at the internet cafe 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 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 amounted 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 six months ended June 30, 2012 and 2011, the commission income was \$151,743 and \$111,640, respectively, 1.08% 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, business taxes and surcharges. Our internet surfing business tax is 25% on gross revenue generated from our internet cafes. Our other surcharges are an education surcharge of 3%, city development surcharge of 1%, a culture development surcharge of 3%, and a snacks and drinks business tax of 5%. All surcharges are calculated on the basis of business tax amount.

(f) Credit risk

The Company may be exposed to credit risk from its cash at bank. 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 purchase 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.

(i) Fair Value of Financial Instruments

The Financial Accounting Standards Board ("FASB") accounting standards require disclosing fair value to the extent practicable for financial instruments that are recognized or unrecognized in the balance sheet. The fair value of the financial instruments disclosed herein is not necessarily representative of the amount that could be realized or settled, nor does the fair value amount consider the tax consequences of realization or settlement.

For certain financial instruments, including cash, accounts payable, short-term loans, accruals and other payables, it was assumed that the carrying amounts approximate fair value because of the near term maturities of such obligations.

(j) Stock-Based Compensation

Our advisor assists the Company with ongoing corporate compliance and developments are accounted for under ASC 505-50. ASC 505-50-30-11 (previously EITF 96-18) which provides that an issuer shall 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 the equipment deposits to the computer suppliers for purchase of computer and equipment for new internet cafes.

(1) Property and equipment

Property and equipment, comprising computer equipment and hardware, leasehold improvement, office furniture and vehicles and 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
Cafe computer equipment and hardware	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 expenses. All our lease contracts state lease 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 by 5 years. We calculate amortization of the definite-lived intangible assets on a straight-line basis over the useful lives of the related intangible assets.

Development cost of internal-use software is insignificant and has been recorded as expense in the period such cost occurs.

(n) Deferred Revenue

Deferred revenue represents unused balances of the prepaid amounts from the IC cards that are unused balance. The Outstanding customer balances are \$1,921,114 and \$2,084,086 as of June 30, 2012 and December 31, 2011, 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 June 30, 2012.

(o) Comprehensive income

The Company follows the FASB's accounting standard. 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.

(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. 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 quarter-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.

(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 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 100% ownership of Zhonghefangda. Classic Bond, as mentioned above, will absorb a majority of the economic risks and rewards of the VIEs being consolidated in the accompanying financial statements.

The carrying amount of the VIEs' assets and liabilities are as follows:

	June 30, 2012	December 31, 2011
Current assets and Long term rental deposit	\$23,682,962	\$21,256,846
Property, plant and equipment	12,871,090	13,000,745
Intangible assets	143,156	161,083
Total assets	36,697,208	34,418,674
Total liabilities	(10,750,241)	(11,064,894)
Net assets	\$25,946,967	\$23,353,780

(r) Foreign currency translation

Assets and liabilities of the Company with a functional currency of RMB is 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 (source: www.onanda.com):

	June 30, 2012	June 30,, 2011
Quarter ended RMB : USD exchange rate (closing buying rate)	6.3089	6.4630
Three months average RMB : USD exchange rate (average ask rate)	6.3027	6.5316
	December 31, 2011	
Year ended RMB : USD exchange rate (closing buying rate)	6.3523	
Average yearly RMB : USD exchange rate (average ask rate)	6.4544	

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 provides any other post-retirement or post-employment benefits.

(t) Earnings per share (EPS)

Earnings per share ("EPS") 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 reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

There is a dilution factor related to dividend on preferred stock occurred during the year. See related details in note 16.

(u) Statutory surplus reserves (Appropriated retained earnings)

In accordance with the relevant laws and regulations of the PRC and the articles of associations of the Company, Junlong is required to allocate 10% of their 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 subsidiaries, any further allocation is optional.

As of June 30, 2012, the statutory surplus reserves of the subsidiary already reached 50% of the registered capital of the subsidiary and the Company did not have any further allocation requirement.

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.

(v) Recent Accounting Pronouncements

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs, which is a new accounting guidance to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. The guidance changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. This guidance is effective for the Company's fiscal year beginning January 1, 2012. The Company adoption of this guide did not have material effect on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, which is a new guidance on the presentation of comprehensive income that will require a company to present components of net income and other comprehensive income in one continuous statement or in two separate, but consecutive statements. There are no changes to the components that are recognized in net income or other comprehensive income under current GAAP. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011, with early adoption permitted. It is applicable to the Company's fiscal year beginning January 1, 2012. The adoption of ASU 2011-05 did not have material impact on the Company's consolidated financial statements.

ASU 2011-05 was modified by the issuance of ASU 2011-12 - Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 in December 2011, which indefinitely deferred certain provisions of ASU 2011-05, including the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. This amendment is effective for both annual and interim financial statements beginning after December 15, 2011. The adoption of ASU 2011-12 did not have any material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11 - *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*, which requires entities to disclose both gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. The objective of the disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of U.S. GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards ("IFRS"). This ASU is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective presentation for all comparative periods presented is required. Its adoption of ASU 2011-11 is not expected to have material impact on its consolidated financial statements.

### 3. Equipment Deposit

Equipment deposit consists of:

June 30,	December
2012	31,
	2011
\$768,607	\$994,732

As of June 30, 2012, equipment deposit \$768,607 (RMB 4,849,063) for computers and equipment purchase for two new internet cafes and leased hold improvements for new and relocated cafes. As of December 31, 2011, \$994,732 (RMB 6,318,839) for computers purchase for three new internet cafes. One new cafe was opened in June 2012 and



other two new cafes were opened in July 2012.

#### 4. Inventory

Inventory consists of:

June	December
30,	31,
2010	2011

Purchased IC cards \$52,520 \$212,607

There was no allowance made for obsolete or slow moving inventory as of June 30, 2012 and December 31, 2011.

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**5. Short Term Loan**

The short-term loans due within one year as of June 30, 2012 and December 31, 2011 consist of the following:

Bank	Loan Period	Interest rate	June 30, 2012	December 31, 2011
China Construction Bank	April 1, 2012 to March 26, 2013	12.46 %	\$158,506	\$ -

On March 27, 2012, the Company entered into a loan agreement with China Construction Bank for \$158,506 (RMB 1,000,000), which was secured by director's guarantee. The annual interest rate is approximately 12.46% and is due on March 26, 2013.

**6. Income and Other Taxes Payable**

Income and other tax payables consist of the following:

	June 30, 2012	December 31, 2011
Business tax payable	\$456,309	\$605,274
Income tax	307,329	582,406
Withhold individual income tax payable	2,885	1,300
Other tax payable	95,822	127,229
Total	\$862,345	\$1,316,209

**7. Due To a Shareholder (Related party loan)**

June 30, 2012	December 31, 2011
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Mr. Guo Di Shan, a shareholder of the Company \$2,388,597 \$2,135,218

The amount due to Mr. Guo Di Shan is unsecured with no stated interest and payable on demand.

**8. Disposal of fixed assets**

The Company has relocated 13 existing internet cafes during the second quarter of 2012 and incurred loss on disposal of lease hold improvements approximately \$0.53 million. At the end of 2011, Shenzhen China government redesigned industry districts. Some factories have moved following the new policy. The Company relocated those cafes to the new districts in order to keep its customers.

## **9. Income Tax**

The Company is subject to U.S. federal income tax, and the Company's subsidiaries incorporated in the People's Republic of China (the "PRC") are subject to enterprise income taxes in the PRC.

During the three months ended June 30, 2012 and 2011, the Company recorded an income tax expense of approximately \$0.32 million and \$0.81 million, respectively. During the six months ended June 30, 2012 and 2011, the Company recorded an income tax expense of approximately \$0.81 million and \$1.37 million, respectively. The decrease of approximately in the Company's income tax expense was primarily due to the decrease in profits of its PRC subsidiaries.

The effective tax rate increased by 7% from a 13% effective rate for the three months ended June 30, 2011 to a 20% effective rate for the three months ended June 30, 2012. The effective tax rate increased by 11% from a 23% effective rate for the six months ended June 30, 2011 to a 34% effective rate for the six months ended June 30, 2012. The increase in tax rate was mainly due to the change of unrealized gain or loss of derivative instruments.

For the three months ended June 30, 2012 and 2011, the Company recorded uncertain tax benefits of approximately \$0 and \$0, respectively. For the six months ended June 30, 2012 and 2011, the Company recorded uncertain tax benefits of approximately \$0 and \$0, respectively.

Aggregate undistributed earnings of approximately \$24 million as of June 30, 2012 of the Group's PRC subsidiaries 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 with respect to its employees in PRC. The pension expense was \$ 6,507 and \$6,299 for the six months ended June 30, 2012 and 2011, respectively. The pension expense was \$3,055 and \$3,473 for the three months ended June 30, 2012 and 2011, respectively.

## **11. Stockholders' Equity**

### **Common Stock**

On July 2, 2010, the China Internet Cafe Holdings Group, Inc. ("China Internet Cafe"), 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 19,000,000 newly issued shares of the Company's common stock, which represented approximately 94% of the 20,200,000 issued and outstanding shares of common stock after the transaction and after the coincident cancellation of 4,973,600 shares of common stock held by the Company's former majority stockholder which have a net effect of increase of 1,200,000 shares. The business, assets and liabilities did not change as a result of the reverse acquisition.

As of June 30, 2012 and December 31, 2011, there are 21,361,534 and 21,254,377 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 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"), as an amendment to its Articles of Incorporation.

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.

Upon liquidation of the Company, holders of Series A Preferred Stock are entitled to be paid, prior to any distribution to any holders of common stock, or any other class or series of stock issued hereafter or junior to the Series A Preferred Stock, an amount equal to \$1.35 per share plus the amount of any accrued but unpaid dividends thereon, as of the date of liquidation (the "Series A Liquidation Preference"). Until conversion, the Series A Preferred Stock has no voting rights other than with respect to matters that may adversely affect the rights of the holders of the Series A Preferred Stock.

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 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 is \$1.35 per share. The conversion price is subject to adjustment for standard anti-dilution events, including stock splits or similar adjustments. In addition, for a period of 12 months following the effective date of the Registration Statement required to be filed under the Registration Rights Agreement discussed below, in the event the Company issues or sells any additional shares of Common Stock or any securities convertible into or exchangeable for, directly or indirectly, Common Stock at a price per share less than the then-applicable Conversion Price or without consideration, then the Conversion Price upon each such issuance will be reduced to the price determined by multiplying the Conversion Price by a fraction: (1) the numerator of which is equal to the sum of (i) the number of shares of outstanding Common Stock immediately prior to the issuance of such additional shares of Common Stock plus (ii) the number of shares of Common Stock which the aggregate consideration for the total number of such additional shares of Common Stock so issued would purchase at a price per share equal to the outstanding Conversion Price in effect immediately prior to such issuance; and (2) the denominator of which is equal to the number of shares of outstanding Common Stock immediately after the issuance of such additional shares of Common Stock.

The Series A Preferred Stock is not subject to mandatory redemption (except on liquidation) but is redeemable in certain circumstances:

If, upon the Company's receipt of a Conversion Notice, the Company cannot issue shares of Common Stock registered for resale under the Registration Statement for any reason, including, without limitation, because the Company (i) does not have a sufficient number of shares of Common Stock authorized and available, (ii) is otherwise prohibited by applicable law or by the rules or regulations of any stock exchange, interdealer quotation system or other self-regulatory organization with jurisdiction over the Company or its securities from issuing all of the Common Stock which is to be issued to a holder of Series A Preferred Stock pursuant to a Conversion Notice or (iii) subsequent to the effective date of the Registration Statement, fails to have a sufficient number of shares of Common Stock registered for resale under the Registration Statement, then the Company shall issue as many shares of Common Stock as it is able to issue in accordance with such holder's Conversion Notice and with respect to the unconverted Series A Preferred Stock, the holder, solely at such holder's option, can require the Company to redeem the shares that cannot be converted at their Series A Liquidation Preference of \$1.35 per share.

If an "Organic Change" occurs (defined as (i) a capital reorganization of the Company (other than by way of a stock split or combination of shares or stock dividends or distributions or similar events, or (ii) a merger or consolidation of the Company with or into another corporation where the holders of the Company's outstanding voting securities prior to such merger or consolidation do not own over 50% of the outstanding voting securities of the merged or consolidated entity, immediately after such merger or consolidation, or (iii) the sale of all or substantially all of the Company's properties or assets to any other person, the holders of the Series A Preferred Stock may request redemption at 110% of the Series A Liquidation Preference of \$1.35 per share. Because of the possible redemption conditions, the Series A Preferred Stock is classified as mezzanine equity.

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 will automatically convert into shares of Common Stock (subject to a restriction that the holder may not convert if it would result in them holding in excess of 9.99% of the then issued and outstanding shares of Common Stock, unless they waive such restriction in writing at least 61 days prior) at the earlier to occur of (i) the 24 month anniversary of the Closing Date, 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.

As of June 30, 2012 and December 31, 2011, there were 4,274,703 shares of Series A Preferred Stock outstanding, which were issued on February 22, 2011.

## 12. Sale of Common Stock, Series A Preferred Stock and Warrants

### 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”).

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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 expire 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 75,000 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.

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### 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 June 30, 2012, 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 expense 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 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) 427,740 Warrants - \$1.35 per share (ii) 85,494 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 427,740 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 they directly or indirectly own (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.

At June 30, 2012, the Warrants, the Placement Agent Warrants and the embedded derivative instrument related to the Series A Preferred Stock were re-valued at \$258,407, \$94,259 and \$271,405, respectively, using a binomial model, based on the quoted market price of \$0.31, a term equal to the remaining life of the instruments, an expected dividend yield of 0%, risk-free interest rates of 0.17% to 0.29% based on constant maturity rates published by the U.S. Federal Reserve applicable to the remaining life of the instruments and estimated volatility of 179%. The aggregate change in the fair value of the derivative liabilities between December 31, 2011 and June 30, 2012 of \$346,871 has been debited to income.

*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 4,274,703 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 400,000 shares of Common Stock, with 200,000 shares to be released following the completion of a Transaction, 100,000 shares to be released six months after the completion of a Transaction and 100,000 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. During the year ended December 31, 2011, the expense has been fully recognized.

In addition to the above fees, the Company issued 50,000 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 \$1.00 per share (determined as described above) were expensed during the year ended December 31, 2011.

*Consulting services and compensation*

On January 1, 2012, the Company issued 300,000 common stock options exercisable at \$0.64 per share vesting on January 1, 2012 to Potomac Investments, LLC for its service rendered. The options are exercisable until November 15, 2014. The company records the expense of the stock options over the related vesting period. The options were valued using the Binomial Model at the date of grant. The total fair market value at grant date is \$108,000 based on the following assumptions: dividend yield: 0%; volatility: 164.33%, risk free rate: 0.36%, expected term: 3 years. All options remain outstanding at June 30, 2012.

*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.

The following represents a reconciliation of the changes in fair value of financial instruments measured at fair value using Level 3 inputs during the six months ended June 30, 2012:

	Preferred – Embedded Derivative	Warrants	Total
Beginning balance, December 31, 2010	\$-	\$-	\$-
Issued – February 22, 2011	1,604,794	912,786	2,517,580
Fair value adjustments	(1,457,090)	(783,290)	(2,240,380)
Ending balance, December 31, 2011	\$147,704	\$129,496	\$277,200
Fair value adjustments	123,701	223,170	346,871
Ending balance, June 30, 2012	\$271,405	\$352,666	\$624,071

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.

### 13. Commitments and Contingencies

#### *Operating Leases*

In the normal course of business, the Company leases office space and internet cafes under operating lease agreements, which expire through 2017. The Company rents internet cafes 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 June 30, 2012, the Company was obligated under operating leases requiring minimum rentals as follows:

Fiscal year	
Remainder of 2012	\$1,265,582
2013	2,505,706
2014	2,437,865
2015	1,538,787
2016	401,021



2017	11,571
	\$8,160,532

During the three and six months ended June 30, 2012, rent expenses amounted to \$655,011 and \$1,121,110, respectively, of which \$235,781 and \$442,480 was recorded as cost of sales, respectively.

During the three and six months ended June 30, 2011, rent expenses amounted to \$515,522 and \$939,110, respectively, of which \$473,378 and \$862,552 was recorded as cost of sales, respectively.

#### **14. Concentrations**

The Company did not have any customer constituting greater than 10% of net sales for the six months ended June 30, 2012 and 2011.

At June 30, 2012 and December 2011, there was one supplier of consignment snacks and drinks in the amount of \$149,120 and \$100,480, respectively, which accounted for 100% and 100% of the Company's accounts payable.

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## 15. Operating Risk and Uncertainties

### *Foreign currency risk*

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

### *Company's operations are substantially in a foreign country*

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 the 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 and facility requirements for the establishment of internet cafes (RMB 10,000,000 for regional internet cafe chains and RMB 50,000,000 for national internet cafe chains). 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 operations.

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 of other service providers available to the Company.

## 16. Earnings per Share

Basic earnings per share is computed by dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings 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 per share are presented in the following table:

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	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2012	2011	2012	2011
<b>BASIC</b>				
Numerator for basic earnings per share attributable to the Company's common stockholders:				
Net income	\$ 1,228,610	\$ 5,429,252	\$ 1,557,169	\$ 4,716,829
Dividend on preferred stock	(71,938 )	(68,776 )	(143,876 )	(101,978 )
Net income used in computing basic earnings per share	\$ 1,156,672	\$ 5,360,476	\$ 1,413,293	\$ 4,614,851
Basic weighted average shares outstanding	21,335,769	21,124,967	21,308,691	20,854,258
Basic earnings per share	\$ 0.05	\$ 0.25	\$ 0.07	\$ 0.22

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2012	2011	2012	2011
<b>DILUTED</b>				
Numerator for diluted earnings per share attributable to the Company's common stockholders:				
Net income	\$ 1,156,672	\$ 5,360,476	\$ 1,413,293	\$ 4,614,851
Dividend on preferred stock	71,938	68,776	143,876	101,978
Net income used in computing diluted earnings per share	\$ 1,228,610	\$ 5,360,476	\$ 1,557,169	\$ 4,716,829
Weighted average outstanding shares of common stock	21,335,769	21,124,967	21,335,769	20,854,258
Weighted average preferred stock	4,274,703	4,274,703	4,274,703	3,022,994
Diluted weighted average shares outstanding	25,610,472	25,399,670	25,610,472	23,877,252
Diluted earnings per share	\$ 0.05	\$ 0.21	\$ 0.06	\$ 0.20
Potential common shares outstanding as of June 30:				
Series A preferred stock	4,274,703	4,274,703	4,274,703	4,274,703
Warrants	2,498,326	2,498,326	2,498,326	2,498,326
	6,773,029	6,773,029	6,773,029	6,773,029

During the three and six months ended June 30, 2012 and 2011, the average market price of the common stock during the period was less than the exercise price of the Warrants. Accordingly, the Warrants were anti-dilutive and have not been included in the calculation of diluted earnings per share.

## **17. 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.

## **18. Restatement of previously issued unaudited quarterly financial information**

The unaudited quarterly financial statements for the six months ended June 30, 2011 have been restated to correct the errors in the valuation of derivative instruments. The quoted market prices to value the derivative instruments were used to replace an enterprise value approach even though the limited trading of the Company's stock.

The effect of restatements to correct the errors referred impact on the quarterly consolidated balance sheets as of June 30, 2011, the consolidated statement of income and comprehensive income and the consolidated statement of cash flows for the six months ended June 30, 2011 are presented below.

The following restatements impact the quarterly financial statements:

- Decreased advisory fees expenses \$338,942 and \$115,683 for the six and three months ended June 30, 2011, respectively, and derivative financial instruments – day one loss approximately \$1.12 million
- Increased gain of derivative financial instrument in preferred stock and warrants approximately \$0.39 million and \$0.18 million, respectively, for the six months ended June 30, 2011
- Increased gain of derivative financial instrument in preferred stock and warrants approximately \$1.92 million and \$1.00 million, respectively, for the three months ended June 30, 2011
- Increased net income of approximately \$2.0 million and \$3.0 million for the six and three months ended June 30, 2011
- Basic and diluted earnings per shares increased \$0.10 and \$0.04 per share for the six months ended June 30, 2011
- Basic and diluted earnings per shares increased \$0.14 and \$0.12 per share for the three months ended June 30, 2011
- Fair market value of financial instruments in preferred stock and warrants decreased approximately \$4.18 million and \$2.75 million, respectively
- Additional paid in capital increased approximately \$0.48 million and retained earnings increased

Preferred stock increased approximately \$3.68 million from \$0

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

	June 30, 2011 As restated	June 30, 2011 As previously reported	Changes
<b>ASSETS</b>			
Current assets:			
Cash	\$ 16,424,142	\$ 16,424,142	\$-
Restricted cash	967,043	967,043	-
Rental deposit	68,614	68,614	-
Prepayment	15,782	15,782	-
Inventory	261,794	261,794	-
Deferred advisory fee	157,808	340,866	(183,058 )
Deferred tax assets	65,241	65,241	-
Total current assets	17,960,424	18,143,482	(183,058 )
Property, plant and equipment, net	11,692,619	11,692,619	-
Intangible assets, net	176,905	176,905	-
Rental deposit-long term portion	294,312	294,312	-
Total assets	\$ 30,124,260	\$ 30,307,318	\$(183,058 )
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Current liabilities:			
Short term loan	\$ 154,727	\$ 154,727	\$-
Accounts payable	93,611	93,611	-
Deferred revenue	1,964,584	1,964,584	-
Payroll and payroll related liabilities	297,906	297,906	-
Income and other taxes payable	1,687,455	1,687,455	-
Accrued expenses	348,307	348,307	-
Amount due to a shareholder	1,896,569	1,896,569	-
Dividend payable on preferred stock	101,978	101,978	-
Derivative financial instrument - preferred stock	927,391	5,109,335	(4,181,944)
Derivative financial instrument - warrants	554,974	2,748,158	(2,193,184)
Total current liabilities	8,027,502	14,402,630	(6,375,128)
Commitments and contingencies (Note 17)			
Preferred stock (\$0.00001 par value, 100,000,000 shares authorized, 4,274,703 and 0 shares issued and outstanding; preference in liquidation - \$5,770,849 and \$0)	3,682,473	-	3,682,473
Stockholders' Equity:			
Common stock (\$0.00001 par value, 100,000,000 shares authorized, 21,124,967 and 20,200,000 shares issued and outstanding as of June 30, 2011 and December 31, 2010, respectively)	212	212	-
Additional paid in capital	1,553,969	1,069,049	484,920
Statutory surplus reserves	718,744	718,744	-
Retained earnings	15,114,305	13,089,628	2,024,677
Accumulated other comprehensive income	1,027,055	1,027,055	-

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Total stockholders' equity	22,096,758	15,904,688	6,192,070
Total liabilities and stockholders' equity	\$ 30,124,260	\$ 30,307,318	\$(183,058 )

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

	For The Six Months Ended June 30, 2011			For The three Months Ended June 30, 2011		
	As restated	As previously reported	Changes	As restated	As previously reported	Changes
Revenue	\$ 15,114,661	\$ 15,114,661	\$-	\$ 8,625,080	\$ 8,625,080	\$-
Cost of revenue	9,067,523	9,067,523	-	5,072,181	5,072,181	-
Gross profit	6,047,138	6,047,138	-	3,552,899	3,552,899	-
Operating Expenses						
General and administrative expenses	992,604	1,331,546	(338,942 )	548,137	663,820	(115,683 )
Total operating expenses	992,604	1,331,546	(338,942 )	548,137	663,820	(115,683 )
Income from operations	5,054,534	4,715,592	338,942	3,004,762	2,889,079	115,683
Non-operating income (expenses)						
Derivative financial instruments - day-one loss	-	(1,120,072 )	1,120,072	-	-	-
Change in fair value of derivative financial instrument - preferred stock	677,403	289,148	388,255	2,116,729	194,841	1,921,888
Change in fair value of derivative financial instrument - warrants	357,812	180,404	177,408	1,120,455	123,365	997,090
Interest income	5,102	5,102	-	5,102	5,102	-
Interest expenses	(5,164 )	(5,164 )	-	(2,633 )	(2,633 )	-
Other expenses	(472 )	(472 )	-	(2,466 )	(2,466 )	-
Total non-operating income (expenses)	1,034,681	(651,054 )	1,685,735	3,237,187	318,210	2,918,977
Net income before income taxes	6,089,215	4,064,538	2,024,677	6,241,949	3,207,289	3,034,660
Income taxes	1,372,386	1,372,386		812,697	812,697	-
Net income attributable to China Internet Cafe Holdings Group, Inc.	4,716,829	\$ 2,692,152	\$ 2,024,677	5,429,252	\$ 2,394,592	\$ 3,034,660
Dividend on preferred stock	(101,978 )	(101,978 )	-	(68,776 )	(68,776 )	-
	4,614,851	2,692,152	1,922,699	5,360,476	2,325,816	3,034,660

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

Other comprehensive income						-
Net income	\$4,716,829	2,692,152	2,024,677	\$5,429,252	2,394,592	3,034,660
Foreign currency translation	415,111	415,111	-	359,738	359,738	-
Net Comprehensive income	\$5,131,940	\$3,107,263	\$2,024,677	\$5,788,990	\$2,754,330	\$3,034,660
						-
Earnings per share						-
- Basic	0.22	0.12	0.10	0.25	0.11	0.14
- Diluted	0.2	0.12	0.08	0.21	0.10	0.12
Weighted average common stock outstanding						
- Basic	20,854,258	20,854,258	-	21,124,967	21,124,967	-
- Diluted	23,877,252	20,854,258	3,022,994	25,399,670	21,124,967	4,274,703

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

	For The Six Months Ended June 30,2011		
	As restated	As previously reported	Changes
Cash flows from operating activities			
Net income	\$4,716,829	\$2,692,152	\$2,024,677
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Derivative financial instruments - day-one loss	-	1,120,072	(1,120,072)
Change in fair value of derivative financial instrument - preferred stock	(677,403 )	(289,148 )	(388,255 )
Change in fair value of derivative financial instrument- warrants	(357,812 )	(180,404 )	(177,408 )
Advisory fee	292,192	631,134	(338,942 )
Depreciation	1,305,607	1,305,607	-
Amortization	18,386	18,386	-
Deferred tax assets	(64,556 )	(64,556 )	-
Changes in operating assets and liabilities:			
Prepayment	(15,616 )	(15,616 )	-
Rental deposit	(64,595 )	(64,595 )	-
Inventory	(76,246 )	(76,246 )	-
Accounts payable	24,275	24,275	-
Deferred revenue	1,357,008	1,357,008	-
Payroll and payroll related liabilities	92,779	92,779	-
Income and other taxes payable	670,417	670,417	-
Accrued expenses	241,006	241,006	-
Amount due to a shareholder	1,414,776	1,414,776	-
Net cash provided by operating activities	8,877,045	8,877,045	-
Cash flows from investing activities			
Acquisition of property, plant and equipment	(4,626,368 )	(4,626,368 )	-
Receipt of loan receivable due to termination of an investment agreement	2,449,629	2,449,629	-
Net cash used in investing activities	(2,176,739 )	(2,176,739 )	-
Cash flows from financing activities			
Net proceeds from issuance of preferred stock and warrants	5,675,614	5,675,614	-
Net cash flows provided by financing activities:	5,675,614	5,675,614	-
Effect of foreign currency translation on cash	211,398	211,398	-
Net increase in cash	12,587,318	12,587,318	-
Cash - beginning of period	3,836,824	3,836,824	-

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Cash - end of period	\$ 16,424,142	\$ 16,424,142	\$-
Cash paid during the period for:			
Interest paid	\$ 5,164	\$ 5,164	\$-
Income taxes paid	\$ 942,480	\$ 942,480	\$-
<b>SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:</b>			
Transfer of equipment deposits paid in property and equipment	\$ 1,235,497	\$ 1,235,497	\$-
Dividend payable on preferred stock	\$ 101,978	\$ 101,978	\$-
Advisory fee	\$ 292,192	\$ 631,134	\$(338,942 )

**19. Subsequent Event**

As of June 30, 2012, 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, in our belief, the largest internet café chain in Shenzhen city, People's Republic of China ("PRC"), consisting of 62 internet cafes in high traffic areas as of the date of this report. We focus on providing top quality internet café facilities that offer a one-stop entertainment and media venue for customers, typically adult students and migrant workers, at reasonable prices. Although our cafes sell snacks, drinks, and game access cards, more than 95% of our revenue comes directly from selling internet access time to our computers.

During the quarter ended June 30, 2012, we focused on integrating and relocating our existing cafes and establishing new cafes in Shenzhen. We expect our future growth to be driven by a number of factors including:

1. Our ability to expand our client base through promotion of our services
2. Our ability to integrate cafes we acquired in the previous years
3. Our ability to identify and integrate joint venture target companies in the coming years

For the quarter ended June 30, 2012, our revenue was approximately \$6.88 million and our net profit was approximately \$1.23 million, representing a decrease of 20% and 77%, respectively, from revenue of approximately \$8.63 million and net income of approximately \$5.43 million for the quarter ended June 30, 2011. As of June 30, 2012, we had 643 employees.

The below discussion of our performance is based upon the unaudited financial statements of China Internet Café Holdings Group, Inc. for the three and six months ended June 30, 2012 and 2011, 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 increased home computer and home game console ownership. We believe, however, the home computer and game console penetration rate is relatively low in the PRC as compared to that of the United States and Europe. In addition, young people in the PRC prefer internet cafes to home computers 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 continuous revenue growth.

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

## Recent Developments and Reorganizations

On July 2, 2010, we completed a reverse acquisition transaction (“Reverse Acquisition”) through a share exchange with Classic Bond Development Limited, a BVI company, (“Classic Bond”) and its shareholders, whereby we acquired 100% of the issued and outstanding capital stock of Classic Bond, in exchange for 19,000,000 shares of our common stock, \$0.00001 par value (the “Common Stock”), which constituted 94% of our issued and outstanding shares on a fully-diluted basis as of and immediately after the consummation of the Reverse Acquisition. As a result of the Reverse Acquisition, Classic Bond became our wholly-owned subsidiary and the former shareholders of Classic Bond became our controlling stockholders.

Upon the closing of the Reverse Acquisition, Xuezheng Yuan, our sole director and officer, submitted a resignation letter pursuant to which he resigned from all offices that he held with immediate effect and from his position as our sole director, effective August 13, 2010. Also upon the closing of the Reverse Acquisition, our Board of Directors increased its size from one to five members and Dishan Guo, Zhenquan Guo, Lei Li, Wenbin An and Lizong Wang were appointed to fill the vacancies created by the resignation of Xuezheng Yuan. Mr. Dishan Guo's appointment became effective upon closing of the Reverse Acquisition, while the remaining appointments became effective on August 13, 2010. In addition, upon the closing of the Reverse Acquisition, our executive officers were replaced by the Classic Bond executive officers.

For accounting purposes, the share exchange transaction was treated as a reverse acquisition, with Classic Bond as the acquirer and China Internet Café Holdings Group, Inc. as the acquired party.

On January 20, 2011, we filed with the Nevada Secretary of a Certificate of Amendment to Articles of Incorporation to give effect to a name change from “China Unitech Group, Inc.” to “China Internet Café Holdings Group, Inc.” The Certificate of Amendment was approved by our Board of Directors on July 30, 2010 and was approved by a stockholder holding 59.45% of our outstanding Common Stock by written consent on July 30, 2010.

On February 22, 2011, in connection with a security purchase agreement between the Company and certain investors (the “Investors”), we closed a private placement (the “Offering”) of approximately \$6.4 million from offering a total of 474,967 units at a purchase price of \$13.50 per unit, each consisting of: (i) nine shares of the Company’s Preferred Shares, 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, 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, each exercisable for the purchase of one share of Common Stock at an exercise price of \$3.00 per share. As a condition to the Offering, we agreed to grant certain registration rights to the Investors pursuant to a Registration Rights Agreement dated February 22, 2011.

In 2011, we opened 15 internet cafés. In the second quarter of 2012, we opened one internet cafe and relocated 13 existing cafes. In July of 2012, we opened another two internet cafes and are currently in the process of relocating another ten existing cafes to better business areas. As of the date of this report, we own 62 internet cafés within the city of Shenzhen in Guangdong province, PRC.



## Results of Operations

The following table sets forth key components of our results of operations for the periods indicated, in dollars and as a percentage of revenue:

	For The Three Months Ended					
	June 30, 2012		2011 Restated		Amount	%
		As percentage		As percentage	Change	change
Revenue	\$6,875,909	100 %	\$8,625,080	100 %	\$(1,749,172)	-20 %
Cost of revenue	4,938,105	72 %	5,072,181	59 %	(134,077 )	-3 %
Gross profit	1,937,804	28 %	3,552,899	41 %	(1,615,095)	-45 %
<b>Operating Expenses</b>						
General and administrative expenses	240,793	4 %	548,137	6 %	(307,344 )	-56 %
Loss on disposal of fixed assets	533,213	8 %	-	0 %	533,213	100 %
Total operating expenses	774,006	11 %	548,137	6 %	225,869	41 %
Income from operations	1,163,798	17 %	3,004,762	35 %	(1,840,964)	-61 %
<b>Non-operating income (expenses)</b>						
Derivative financial instruments - day-one loss	-					
Change in fair value of derivative financial instrument - preferred stock	308,477	4 %	2,116,729	-	(1,808,252)	-85 %
Change in fair value of derivative financial instrument - warrants	83,109	1 %	1,120,455	-	(1,037,346)	-93 %
Interest income	6,195	0 %	5,102	0 %	1,093	21 %
Interest expenses	(4,450 )	0 %	(2,633 )	0 %	(1,817 )	69 %
Other expenses	(12,327 )	0 %	(2,466 )	0 %	(9,861 )	400 %
Total non-operating income (expenses)	381,004	6 %	3,237,187	38 %	(2,856,183)	-88 %
Net income before income taxes	1,544,802	22 %	6,241,949	72 %	(4,697,147)	-75 %
Income taxes	316,192	5 %	812,697	9 %	(496,505 )	-61 %
Net income attributable to China Internet Cafe Holdings Group, Inc.	\$1,228,610	18 %	\$5,429,252	63 %	\$(4,200,642)	-77 %
Dividend on preferred stock	(71,938 )	-1 %	(68,776 )	-	(3,162 )	-5 %
Net income attributable to China Internet Cafe Holdings Group, Inc. Common stockholders	1,156,672	17 %	5,360,476	62 %	(4,203,804)	-78 %
Other comprehensive income						

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Net income	1,228,610	18	%	5,429,252	63	%	(4,200,642)	-77	%
Foreign currency translation	(7,876 )	0	%	359,738	4	%	(367,614 )	-102	%
Net Comprehensive income	\$1,220,734	18	%	\$5,788,990	67	%	\$(4,568,256)	-79	%

**Comparison of the Quarters Ended June 30, 2012 and 2011**

**Revenue**

Our revenue is primarily generated from the sales of prepaid IC cards with stored value that is deducted based on time usage of computers at our internet cafes. Revenue decreased approximately \$1.75 million, or 20%, from approximately \$8.63 million for the quarter ended June 30, 2011 to approximately \$6.88 million for the quarter ended June 30, 2012. The decrease in revenue was mainly attributable to decrease in time usage of our computers in the internet cafes as a result of the relocation of 13 of our internet cafes in the quarter ended June 30, 2012. Starting from 2012, the Shenzhen local government has ordered certain factories to be relocated to new districts. In order to maintain our current customer base (primarily consisting of factory workers), we relocated 13 internet cafes to the districts where the factories are moved. Currently we are in the process of relocating another ten internet cafes and we expect our revenue will recover after the completion of relocation in the third quarter of 2012. We will continue to focus on growth within Shenzhen while simultaneously pursuing options for expansion through establishment and acquisition in other cities and provinces.

### **Cost of Revenue**

Cost of revenue is primarily composed of depreciation and amortization, salary, rent, utility, business tax and surcharge. Among the components of cost of revenue, depreciation and amortization, salary and rent are fixed costs while utility and business tax and surcharge are variable costs, which change in proportion to the change in revenue. Our cost of revenue decreased by approximately \$0.13 million, or 3%, to approximately \$4.94 million for the quarter ended June 30, 2012 from approximately \$5.07 million for the same period in 2011. As our fixed costs remained stable for the quarter ended June 30, 2012, the decrease was mainly attributable to decrease in business tax and surcharge due to the decrease in revenue in the quarter ended June 30, 2012 as compared to the same period in 2011.

### **Gross Profit**

Gross profit is the difference between sales revenue and cost of revenue. Our gross profit decreased by approximately \$1.62 million, or 45%, to approximately \$1.94 million for the quarter ended June 30, 2012 from approximately \$3.55 million for the same period in 2011. Gross profit as a percentage of sales was 28% for the quarter ended June 30, 2012, as compared to 41% for the same period in 2011. The decrease in our gross profit margin was mainly attributable to the increase in salary and benefits, rent, utilities, depreciation, and other costs as compared to the same period in 2011 as well as the decrease in revenue resulting from the relocation of our 13 internet cafes. The increase in salary and benefits, rent, depreciation, and other costs was mainly in connection with the opening of a new internet cafe in the quarter ended June 30, 2012. In addition, for the quarter ended June 30, 2012, we incurred more salary and benefits, rent, depreciation and other costs because we operated eight more internet cafes in the quarter ended June 30, 2012 as compared to the same period in 2011.

### **Operating Expenses**

Operating expenses are composed of general and administrative expenses and loss on disposal of fixed assets. General and administrative expenses mainly consist of overheads of our headquarters in Shenzhen and fees paid to legal counsel, auditor, and consultants. Our general and administrative expenses decreased by approximately \$0.31 million, or 56% to approximately \$0.24 million as compared to approximately \$0.55 million for the quarter ended June 30, 2011. In the quarter ended June 30, 2011, we paid stock based compensation to our consultants in consideration of their services in connection with our private placement transaction in 2011 while in the quarter ended June 30, 2012, we did not incur such expenses. However, in the quarter ended June 30, 2012, we incurred loss of approximately \$0.53 million resulting from disposal of lease hold improvement due to the relocation of 13 internet cafes as compared to \$0 loss for the same period in 2011. The decrease in general and administrative expenses was offset by the loss on disposal of leasehold improvement and led to an increase in operating expenses of approximately \$0.23 million, or 41%, to approximately \$0.77 million for the quarter ended June 30, 2012 from approximately \$0.55 million for the same period in 2011. We expect that our operating expenses will continue to increase in the third quarter due to our relocation of another ten internet cafes and will decrease after the completion of relocation of our internet cafes.

**Non-Operating Income/Expenses**

Other income decreased by approximately \$2.86 million, or 88%, from approximately \$3.24 million non-operating income, to approximately \$0.38 million non-operating income for the quarter ended June 30, 2012 as compared to the same period in 2011. The decrease was primarily due to the lower unrealized gain of our derivative instruments for the quarter ended June 30, 2012 as compared to the same period in 2011.

**Income before Income Taxes**

Income before income taxes decreased by approximately \$4.70 million, or 75%, to approximately \$1.54 million for the quarter ended June 30, 2012 from approximately \$6.24 million for the same period in 2011. The decrease in income before income taxes was mainly attributable to the decrease in revenue as a result of the relocation of the 13 internet cafes and a lower unrealized gain of our derivative instruments for the quarter ended June 30, 2012 as compared to the same period in 2011.

**Income Taxes**

Our income taxes decreased by approximately \$0.50 million, or 61%, during the quarter ended June 30, 2012 to approximately \$0.32 million from approximately \$0.81 million during the same period in 2011. The primary reason for the decrease in income taxes was the decrease in income before income tax for the quarter ended June 30, 2012 as compared to the same period in 2011.

**Net Income**

Our net income decreased by approximately \$4.20 million, or 77%, to approximately \$1.23 million for the quarter ended June 30, 2012 from approximately \$5.43 million during the same period in 2011 as a result of the factors described above. We expect to generate higher net profit after the completion of relocation of the internet cafes in the third quarter of 2012.

**Results of Operations for the Six Months Ended June 30, 2012 and 2011**

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

	For The Six Months Ended June 30, 2012		2011		Amount change	%	%		
		As percentage		As percentage					
Revenue	\$14,010,113	100	%	\$15,114,661	100	%	\$(1,104,548)	-7	%
Cost of revenue	9,943,536	71	%	9,067,523	60	%	876,013	10	%
Gross profit	4,066,577	29	%	6,047,138	40	%	(1,980,561)	-33	%
Operating Expenses									
General and administrative expenses	810,687	6	%	992,604	7	%	(181,917 )	-18	%
Loss on disposal of fixed assets	533,213	4	%	-	0	%	533,213	100	%
Total operating expenses	1,343,900	10	%	992,604	7	%	351,296	35	%
Income from operations	2,722,677	19	%	5,054,534	33	%	(2,331,857)	-46	%
Non-operating income (expenses)									
Change in fair value of derivative financial instrument - preferred stock	(123,701 )	-1	%	677,403	-		(801,104 )	-118	%
Change in fair value of derivative financial instrument - warrants	(223,170 )	-2	%	357,812	-		(580,982 )	-162	%
Interest income	9,925	0	%	5,102	0	%	4,823	95	%
Interest expenses	(4,450 )			(5,164 )	0	%	714	-14	%
Other expenses	(12,470 )	0	%	(472 )			(11,998 )	2,542	%
Total non-operating income (expenses)	(353,866 )	-3	%	1,034,681	7	%	(1,388,547)	-134	%
Net income before income taxes	2,368,811	17	%	6,089,215	40	%	(3,720,404)	61	%

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Income taxes	811,642	6	%	1,372,386	9	%	(560,744 )	-41	%
Net income attributable to China Internet Cafe Holdings Group, Inc.	1,557,169	11	%	4,716,829	31	%	(3,159,660)	67	%
Dividend on preferred stock	(143,876 )	-1	%	(101,978 )	-		(41,898 )	41	%
Net income attributable to China Internet Cafe Holdings Group, Inc. Common stockholders	\$1,413,293	10	%	\$4,614,851	31	%	\$(3,201,558)	-69	%
Other comprehensive income									
Net income	\$1,557,169	11	%	4,716,829	31	%	\$(3,159,660)	-67	%
Foreign currency translation	172,182	1	%	415,111	3	%	(242,929 )	-59	%
Net Comprehensive income	\$1,729,351	12	%	\$5,131,940	34	%	\$(3,402,589)	-66	%

## **Comparison of Six Months Ended June 30, 2012 and 2011**

### **Revenue**

Revenue decreased by approximately \$1.10 million, or 7%, to approximately \$14.01 million for the six months ended June 30, 2012 from \$15.11 million for the same period in 2011. The decrease in revenue was mainly attributable to decrease in time usage of our computers in the internet cafes. Starting from 2012, the Shenzhen local government has ordered certain factories to be relocated to new districts. In order to maintain our current customer base, we relocated 13 internet cafes to the districts where the factories are moved. We are currently in the process of relocating another ten internet cafes and we expect our revenue will recover after the completion of relocation in the third quarter of 2012. We will continue to focus on growth within Shenzhen while simultaneously pursuing options for expansion through establishment and acquisition in other cities and provinces.

### **Cost of Revenue**

Cost of revenue is primarily composed of depreciation and amortization, salary, rent, utility business tax and surcharge. Our cost of revenue increased by approximately \$0.88 million, or 10%, to approximately \$9.94 million for the six months ended June 30, 2012 from approximately \$9.07 million for the same period in 2011. The increase for the six months ended June 30, 2012 was mainly attributable to increase in depreciation, rent, utilities, and labor cost associated with the newly opened internet cafes in the third and fourth quarter of 2011, which we did not incur these expenses for the same period of 2011.

### **Gross Profit**

Gross profit is the difference between sales revenue and cost of sales. Our gross profit decreased by approximately \$1.98 million, or 33%, to approximately \$4.07 million for the six months ended June 30, 2012 from approximately \$6.05 million for the same period in 2011. Gross profit as a percentage of sales was 29% for the six months ended June 30, 2012, as compared to 40% for the same period in 2011. The decrease in our gross profit margin was mainly attributable to (1) the increase in salary, depreciation, and other costs as compared to the same period in 2011, (2) costs incurred from the opening of one new internet cafe in the quarter ended June 30, 2012 and the operations of eight cafes we opened in late 2011 and (3) decrease in revenue because of the relocation of our 13 cafes. Our management expects the gross profit margin to improve after the completion of the relocation by the end of the third quarter of 2012.

### **Operating Expenses**

Operating expenses are composed of general and administrative expenses and loss on disposal of fixed assets. General and administrative expenses mainly consist of overheads of our headquarters in Shenzhen and fees paid to legal counsel, auditor, and consultants. Operating expenses increased by approximately \$0.35 million, or 35%, to approximately \$1.34 million for the six months ended June 30, 2012 from approximately \$0.99 million for the same period in 2011. The increase was mainly attributable to the loss resulting from disposal of lease hold improvement due to the relocation of 13 cafes in the quarter ended June 30, 2012. We expect that our operating expenses will increase as we are currently relocating another ten internet cafes and thus will incur more loss in the third quarter of 2012 due to disposal of lease hold improvement.

### **Non-Operating Income/Expenses**

Other income decreased by approximately \$1.39 million, or 134%, to expense of approximately \$0.35 million for the six months ended June 30, 2012 from income of approximately \$1.03 million for the same period in 2011. The significant decrease was due to the decrease of approximately \$1.38 million in the fair value of derivative instruments from a gain of approximately \$1.03 million for the six months ended June 30, 2011 to a loss of approximately \$0.35 million for the same period in 2012.



### **Income before Income Taxes**

Income before income taxes decreased by approximately \$3.72 million, or 61%, to approximately \$2.37 million for the six months ended June 30, 2012 from approximately \$6.09 million for the same period in 2011. The decrease in income before income tax was mainly attributable to the increase in cost of revenue incurred from the newly opened internet cafes, a loss incurred from the disposal of fixed assets, and the decrease in fair value of our derivative instruments.

### **Income Taxes**

Our income taxes decreased by approximately \$0.56 million, or 41%, during the six months ended June 30, 2012 to approximately \$0.81 million from approximately \$1.37 million during the same period in 2011. The primary reasons for the decrease in income taxes were the decrease in income before income tax as a result of decrease in revenue and increase in cost of revenue.

### **Net Income**

Our net income decreased by approximately \$3.16 million, or 67%, to approximately \$1.56 million for the six months ended June 30, 2012 from approximately \$4.72 million for the same period in 2011 as a result of the factors described above. We expect to generate higher net profit after the completion of the relocation of our internet cafes by the end of the third quarter of 2012.

### **Liquidity and Capital Resources**

As of June 30, 2012, we had cash and cash equivalents of approximately \$22.32 million. The following table provides detailed information about our net cash flow for each financial statement period presented in this report:

#### **Cash Flow**

Six Months Ended	
June 30,	
2012	2011

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Net cash provided by operating activities	\$3,839,490	\$8,877,045
Net cash used in investing activities	(1,411,893)	(2,176,739)
Net cash provided by financing activities	158,662	5,675,614
Effect of foreign currency translation on cash and cash equivalents	108,100	211,398
Net cash flows	2,694,359	12,587,318

***Operating Activities***

Net cash provided by operating activities was approximately \$3.84 million for the six months ended June 30, 2012, as compared to approximately \$8.88 million for the same period in 2011. The variance in cash provided by operating activities for the six months ended June 30, 2012 was mainly attributable to (1) a decrease in net income of approximately \$3.16 million and deferred revenue of approximately \$1.53 million as compared to the same period in 2011 due to the relocation of 13 cafes; (2) a decrease in tax payable of approximately \$0.46 million due to decrease in net income; and (3) an increase in accrued expenses of approximately \$0.19 million as a result of a penalty for delay in effectively registering securities sold in our private placement in February 2011.

***Investing Activities***

Net cash used in investing activities was approximately \$1.41 million for the six months ended June 30, 2012, as compared to approximately \$2.18 million for the same period in 2011. For the six months ended June 30, 2012, we spent approximately \$1.41 million on acquisition of computers and equipment and lease hold improvements for the new cafe and the relocated 13 cafes. For the same period in 2011, we spent approximately \$4.63 million on acquisition of computers and lease hold improvements for 13 newly opened cafes. In addition, we terminated an acquisition agreement in the six months ended June 30, 2011 and the deposit in connection with the acquisition of approximately \$2.45 million was returned to the Company.

### ***Financing Activities***

Net cash provided by financing activities was approximately \$0.16 million for the six months ended June 30, 2012, as compared to approximately \$5.68 million for the same period in 2011. The Company conducted a securities offering in February 2011 and received the proceeds of approximately \$5.68 million while in the six months ended June 30, 2012, the Company took out a short-term loan of approximately \$0.16 million (RMB 1,000,000) from China Construction Bank.

### **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, 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 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 are included in deferred revenue on the balance sheets. The Company does not charge any service fees that will cause a decrement to customer balances. There is no expiration date for our 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 20% 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 goods sold consists primarily of depreciation of each internet café's computer equipment and hardware and overhead associated with the internet cafés including rental payments, utilities, business taxes and surcharges. Our internet surfing business tax is 25% on gross revenue generated from our internet cafés. Other surcharges are an education surcharge of 3%, a city development surcharge of 1%, a culture development surcharge of 3%, and a snacks and drinks business tax of 5%. All surcharges are calculated on the basis of business tax amount.

***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	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 the IC cards. The outstanding customer balances were \$1,921,114 and \$2,084,086 as at June 30, 2012 and December 31, 2011, respectively, and were included in deferred revenue on the balance sheets. Our management has evaluated the deferred revenue balance and has determined any potential revenue from the unused balance to be immaterial as of June 30, 2012.

### ***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 purpose 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 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.

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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:

	June 30, 2012	June 30, 2011
Quarter ended RMB : USD exchange rate (closing buying rate)	6.3089	6.4630
Six months average RMB : USD exchange rate (average ask rate)	6.3027	6.5316

	December 31, 2011
Year ended RMB : USD exchange rate (closing buying rate)	6.3523
Average yearly RMB : USD exchange rate (average ask rate)	6.4544

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

### *Accounting Standards Codification*

In May 2011, the FASB issued ASU 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs, which is a new accounting guidance to provide a consistent definition of fair value and ensure that the fair value measurement and disclosure requirements are similar between U.S. GAAP and International Financial Reporting Standards. The guidance changes certain fair value measurement principles and enhances the disclosure requirements particularly for Level 3 fair value measurements. This guidance is effective for the Company's fiscal year beginning January 1, 2012. The Company adoption of this guide did not have material effect on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income, which is a new guidance on the presentation of comprehensive income that will require a company to present components of net income and other comprehensive income in one continuous statement or in two separate, but consecutive statements. There are no changes to the components that are recognized in net income or other comprehensive income under current GAAP. This guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011, with early adoption permitted. It is applicable to the Company's fiscal year beginning January 1, 2012. The adoption of ASU 2011-05 did not have material impact on the Company's consolidated financial statements.

ASU 2011-05 was modified by the issuance of ASU 2011-12 - Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 in December 2011, which indefinitely deferred certain provisions of ASU 2011-05, including the requirement to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement in which net income is presented and the statement in which other comprehensive income is presented. This amendment is effective for both annual and interim financial statements beginning after December 15, 2011. The adoption of ASU 2011-12 did not have any material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU 2011-11 - Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities, which requires entities to disclose both gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting agreement. The objective of the disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of U.S. GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards ("IFRS"). This ASU is effective for fiscal years, and interim periods within those years, beginning on or after January 1, 2013. Retrospective presentation for all comparative periods presented is required. Its adoption of ASU 2011-11 is not expected to have material impact

on its consolidated financial statements.

### **Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition 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, 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) for the quarter ended June 30, 2012. Based upon that evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were not effective for the quarter ended June 30, 2012 as a result of the material weaknesses identified in our internal control over financial reporting.

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 for the quarter ended June 30, 2012, 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 our complexity and 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.

As a result of the material weakness identified above, our internal control over financial reporting was not effective for the quarter ended June 30, 2012.

***2012 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 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 the 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.**

Not applicable.

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

On July 18, 2012, the Company issued an aggregate of 53,287 shares of unregistered common stock to holders of its Series A Convertible Preferred Stock ("Preferred Stock").

The Preferred Stock was issued in a private placement on February 22, 2011. Pursuant to the Certificate of Designation, Preferences and Rights for the Preferred Stock, the Company must pay a quarterly dividend at an annual rate of 5% for each outstanding share of Preferred Stock either in cash or by issuing to the holders of Preferred Stock such number of additional shares of Common Stock which when multiplied by \$1.35, would equal the amount of such quarterly dividend not paid in cash. The board of directors of the Company has decided to pay the dividends by

issuing restricted Common Stock to the holders of Preferred Stock.

The sales of the unregistered securities were made in accordance with and in reliance upon the exemption from securities registration afforded by Section 4(2) of the Securities Act of 1933, as amended and/or Regulation D or Regulation S promulgated thereunder.

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

None.

**Item 4. Mine Safety Disclosures.**

Not applicable.

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

Copies of the following documents are included as exhibits to this report pursuant to Item 601 of Regulation S-K.

Exhibit No. Description

- 2.1(1) Form of Share Exchange Agreement, dated July 2, 2010, among the Company, Classic Bond Development Limited and its shareholders.
- 3.1(2) Articles of Incorporation of the Company
- 3.2(2) Bylaws of the Company
- 3.3(3) Amended and Restated Bylaws, adopted on July 30, 2010
- 3.4(6) Certificate of Designations Preferences and Rights of the 5% Series A Convertible Preferred Stock of China Internet Café Holdings Group, Inc.
- 4.1(1) Form of Cancellation Agreement, dated July 2, 2010, among the Company and certain shareholders.
- 4.2(2) Specimen Stock Certificate
- 10.1(1) Management Consulting Service Agreement, dated June 11, 2010, among Zhonghefangda, Junlong and Junlong's shareholders.
- 10.2(1) Equity Pledge Agreement, dated June 11, 2010, among Zhonghefangda, Junlong and Junlong's shareholders.
- 10.3(1) Option Agreement, dated June 11, 2010, among Zhonghefangda, Junlong and Junlong's shareholders.
- 10.4(1) Proxy Agreement, dated June 11, 2010, among Zhonghefangda, Junlong and Junlong's shareholders.
- 10.5(1) English Translation of Employment Agreement, dated April 1, 2009, between Junlong and Tu Fan.
- 10.6(1) English Translation of Form of Non-disclosure and Non-competition Agreement, dated March 11, 2010, between Junlong and its employees.
- 10.7(1) English Summary of Loan Agreement, dated October 23, 2009, between Junlong and Shenzhen Branch of China Construction Bank.
- 10.8(1) English Summary of Guaranty Contract of Maximum Amount, dated October 23, 2009, between Dishan Guo and Shenzhen Branch of China Construction Bank.
- 10.9(1) English Summary of Purchase Agreement, dated June 7, 2010, between Junlong and Shenzhen SEG Industrial Investment Co., Ltd.
- 10.10(1) English Summary of Lease Contract, dated September 1, 2006, between Junlong and Zou Zhiwei.
- 10.11(1) English Summary of Lease Contract, dated December 15, 2009, between Junlong and Hao Changsheng
- 10.12(5) Lease contract re: No. 1 Xinxin Garden, Fangjicun, Xudong Road, Wuchang, Wuhan, Hubei Province, China 430062 between the Company and Xuezheng Yuan.

- 10.13(6) Securities Purchase Agreement, dated February 22, 2011, by and among China Internet Café Holdings Group, Inc. and Investors identified therein
- 10.14(6) Registration Rights Agreement, dated February 22, 2011
- 10.15(6) Securities Escrow Agreement, dated February 22, 2011

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- 10.16(6) Lock-up Agreement, dated February 22, 2011
  - 10.17(6) Form of Series A Warrant
  - 10.18(6) Form of Series B Warrant
  - 31.1 Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32.1(7) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
  - 101.INS (8) XBRL Instance Document
  - 101.SCH(8) XBRL Taxonomy Extension Schema Document
  - 101.PRE(8) XBRL Taxonomy Extension Presentation Linkbase Document
  - 101.CAL(8) XBRL Taxonomy Extension Calculation Linkbase Document
  - 101.LAB(8) XBRL Taxonomy Extension Label Linkbase Document
  - 101.DEF(8) XBRL Taxonomy Extension Definition Linkbase Document
- (1) Incorporated by reference to our Current Report on Form 8-K filed with the SEC on July 9, 2010.
- (2) Incorporated by reference to our Registration Statement on Form SB-2 filed on August 30, 2006.
- (3) Incorporated by reference to our Current Report on Form 8-K filed with the SEC on August 3, 2010.
- (4) Incorporated by reference to our Annual Report on Form 10-K filed with the SEC on June 30, 2008.
- (5) Incorporated by reference to our Annual Report on Form 10-K filed with the SEC on September 28, 2010.
- (6) Incorporated by reference to our Current Report on Form 8-K filed with the SEC on February 23, 2011.

(7) The Exhibits attached to this Form 10-Q shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934 (the "Exchange Act") or otherwise subject to liability under that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act, except as expressly set forth by specific reference in such filing.

(8) Pursuant to Rule 405(a)(2) of Regulation S-T, the Company is relying upon the applicable 30-day grace period for the initial filing of its Interactive Data File required to contain detail-tagged footnotes or schedules. The Company intends to file the required detail-tagged footnotes or schedules by the filing of an amendment to this Quarterly Report on Form 10-Q with the 30-day period.



**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: August 14, 2012

/s/ Dishan Guo  
Dishan Guo  
Chief Executive Officer, President (Principal Executive  
Officer) and Chief Financial Officer (Principal Financial  
and Accounting Officer)