China Internet Cafe Holdings Group, Inc.
Form 10-Q
May 15, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended March 31, 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 incorporation or organization)	(I.R.S. Employer Identification No.)

#1707, Block A, Genzon Times Square, Longcheng Blvd, Centre City, Longgang District, Shenzhen, Guangdong Province, People's Republic of China 518048

(Address of principal executive offices) (Zip Code)

Issuer's telephone Number: **011-86-755-8989-6008**

#2009-2010, 4 th Building, ZhuoYue Century Center, FuHua Third Road, FuTian District, Shenzhen, Guangdong Province, People's Republic of China 518048

(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 x 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 x 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 ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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

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 May 15, 2012, there are 21,308,247 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).

The unaudited condensed consolidated financial statements of registrant for the three months ended March 31, 2012 and 2011 follow. The condensed consolidated financial statements reflect all adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the interim periods presented. All such adjustments are of a normal and recurring nature.

CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2012

CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2012 Unaudited	December 31, 2011
ASSETS		
Current assets:		
Cash	$21,988,739	$19,629,680
Rental deposit	81,089	86,580
Equipment deposit	1,001,052	994,732
Inventory	116,426	212,607
Deferred tax assets	71,323	69,405
Total current assets	23,258,629	20,993,004
Property, plant and equipment, net	12,174,366	13,000,745
Intangible assets, net	152,593	161,083
Rental deposit-long term portion	322,756	314,736
Total assets	$35,908,344	$34,469,568
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$148,564	$100,480
Registration penalties payable	641,200	448,844
Deferred revenue	2,057,586	2,084,086
Payroll and payroll related liabilities	364,083	323,286
Income and other taxes payable	1,041,810	1,316,209
Accrued expenses	361,814	365,696
Amount due to a shareholder	2,245,464	2,135,218
Dividend payable on preferred stock	71,938	72,729
Derivative financial instrument - preferred stock	579,882	147,704
Derivative financial instrument - warrants	435,775	129,496
Total current liabilities	7,948,116	7,123,748
Commitments and contingencies (Note 17)		
Preferred stock as of March 31, 2012 and December 31, 2011 ($0.00001 par value, 100,000,000 shares authorized, 4,274,703 shares issued and outstanding as of March 31, 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, 21,254,377 shares issued and outstanding as of March 31, 2012 and December 31, 2011)	212	212
Additional paid in capital	1,906,455	1,728,726
Statutory surplus reserves	718,744	718,744
Retained earnings	20,016,910	19,760,289
Accumulated other comprehensive income	1,635,434	1,455,376
Total stockholders' equity	24,277,755	23,663,347

Total liabilities and stockholders’ equity	$35,908,344	$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 Three Month Ended March 31, 2012	2011 Restated
Revenue	$ 7,134,204	$ 6,489,581
Cost of revenue	5,005,431	3,995,342
Gross profit	2,128,773	2,494,239
Operating Expenses		
General and administrative expenses	569,894	444,467
Total operating expenses	569,894	444,467
Income from operations	1,558,879	2,049,772
Non-operating income (expenses)		
Change in fair value of derivative financial instrument - preferred stock	(432,178)	(1,439,326)
Change in fair value of derivative financial instrument - warrants	(306,279)	(762,643)
Interest income	3,730	1,994
Interest expenses	-	(2,531)
Other expenses	(143)	-
Total non-operating income (expenses)	(734,870)	(2,202,506)
Income(Loss) before income taxes	824,009	(152,734)
Income taxes	495,450	559,689
Net income(loss)	328,559	(712,423)
Dividend on preferred stock	(71,938)	(33,202)
Net income(loss) attributable to China Internet Cafe Holdings Group, Inc. common stockholders	$ 256,621	$ (745,625)
Other comprehensive income		
Net income	$ 328,559	$ (712,423)
Foreign currency translation	180,058	55,373
Total comprehensive income	$ 508,617	$ (657,050)
Earnings per share		
- Basic	$ 0.01	$ (0.04)
- Diluted	$ 0.01	$ (0.04)
Weighted average common stock outstanding		
- Basic	21,254,377	20,580,542

- Diluted	25,529,080	22,527,907

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

CHINA INTERNET CAFE HOLDINGS GROUP, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	For The Three Months Ended March 31, 2012	2011 Restated
Cash flows from operating activities		
Net income(loss)	$ 328,559	$ (712,423)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Change in fair value of derivative financial instrument - preferred stock	432,178	1,439,326
Change in fair value of derivative financial instrument- warrants	306,279	762,643
Stock based compensation	105,000	-
Advisory fee	-	192,466
Depreciation	911,076	621,998
Amortization	9,535	9,112
Deferred tax assets	(1,481)	(55,532)
Changes in operating assets and liabilities:		
Prepayment	-	(73,592)
Rental deposit	-	(23,398)
Inventory	97,757	6,642
Accounts payable	47,556	37,676
Deferred revenue	(39,832)	351,300
Payroll and payroll related liabilities	38,833	9,840
Income and other taxes payable	(283,416)	188,166
Accrued expenses and penalties payable	186,610	201,752
Amount due to a shareholder	101,281	928,585
Net cash provided by operating activities	2,239,937	3,884,561
Cash flows from investing activities		
Receipt of loan receivable due to termination of an investment agreement	-	2,428,142
Assets acquisition of cafes	-	(590,787)
Net cash provided by investing activities	-	1,837,355
Cash flows from financing activities		
Net proceeds from issuance of preferred stock and warrants	-	5,675,614
Net cash flows provided by financing activities:	-	5,675,614
Effect of foreign currency translation on cash	119,123	3,556
Net increase in cash	2,359,060	11,401,086
Cash - beginning of period	19,629,680	3,836,824
Cash - end of period	$ 21,988,739	$ 15,237,910
Cash paid during the period for:		

Interest paid	$ -	$ 2,531
Income taxes paid	$ 600,199	$ 484,648
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVTIES:		
Summary of Assets Acquired from Acquisitions:		
Net property and equipment	-	503,492
Other current assets	-	15,792
Intangible assets	-	209,582
Net assets acquired	-	728,866
Transfer of equipment deposits paid in property and equipment	$ -	$ 1,224,660
Dividend payable on preferred stock	71,938	33,202
Registration penalties	$ 192,356	-
Advisory fee	$ -	$ 192,466

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

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CHINA INTERNT CAFÉ HOLDINGS, GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 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 and 15 internet cafes in 2011. In total, we own 59 internet cafes within Shenzhen of China.

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 months ended March 31, 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 three months ended March 31, 2012 and 2011, the commission income was $71,963 and $51,740, respectively, less than 1% 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 20% 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.

(l) *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 of 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 $2,057,586 and $2,084,086 as of March 31, 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 March 31, 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:

	March 31, 2012	December 31, 2011
Current assets and Long term rental deposit	$23,558,288	$21,256,846
Property, plant and equipment	12,174,366	13,000,745
Intangible assets	152,594	161,083
Total assets	35,885,248	34,418,674
Total liabilities	(10,900,195)	(11,064,894)
Net assets	$24,985,053	$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):

	March 31, 2012	March 31, 2011
Quarter ended RMB : USD exchange rate (closing buying rate)	6.3122	6.5701
Three months average RMB : USD exchange rate (average ask rate)	6.2976	6.5894

	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 March 31, 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:

March 31, 2012	December 31, 2011
$1,001,052	$994,732

As of March 31, 2012 and December 31, 2011, equipment deposit $1,001,052 (RMB 6,318,839) and $994,732 (RMB 6,318,839) for purchase computers for three new internet cafes. One internet cafe will be opened in June 2012 and another two internet cafes will be opened in the third quarter..

4. Inventory

Inventory consists of:

	March 31, 2012	December 31, 2011
Purchased IC cards	$116,426	$212,607

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

5. Income and Other Taxes Payable

Income and other tax payables consist of the following:

	March 31, 2012	December 31, 2011
Business tax payable	$459,268	$605,274
Income tax	483,076	582,406
Withhold individual income tax payable	2,968	1,300
Other tax payable	96,498	127,229
Total	$1,041,810	$1,316,209

6. Amount Due To a Shareholder (Related party loan)

	March 31, 2012	December 31, 2011
Mr. Guo Di Shan, a shareholder of the Company	$2,245,464	$2,135,218

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

7. Income Tax

The Company's subsidiary incorporated in PRC is subject to PRC enterprises income tax at the applicable tax rates on the taxable income as reported in their Chinese statutory accounts in accordance with the relevant enterprises income tax laws. Junlong was charged a tax rate of 24% of its taxable income in 2011 and 25% in 2012. As approved by the relevant tax authority in the PRC, Junlong's income tax rates will be 25% for 2012 and thereafter.

Deferred tax assets and liabilities are recognized for the expected future tax consequences of differences between the carrying amounts of assets and liabilities and their respective tax bases using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred taxes are comprised of the following:

	March 31, 2012 US$	December 31, 2011 US$
DTA:		
Deferred assets - accrued expenses	71,323	69,405
Deferred assets - NOL of US shell company	262,803	-
Total Deferred assets	334,126	69,405
DTL:		-
US shell company	-	(26,645)
Total Gross DTA (DTL)	334,126	42,759
Valuation allowance	(262,803)	26,645
Net WW deferred assets(laities)	71,323	69,405

The Company applied the provisions of ASC 740.10.50, "Accounting for Uncertainty in Income Taxes", which provides clarification related to the process associated with accounting for uncertain tax positions recognized in our financial statements. The Company classified all interest and penalties related to unrecognized tax benefits, if any, as a component of income tax provisions. The Company performed self-assessment and the Company's liability for income taxes includes the liability for unrecognized tax benefits, interest and penalties which relate to tax years still subject to review by taxing authorities. Audit periods remain open for review until the statute of limitations has passed. The completion of review or the expiration of the statute of limitations for a given audit period could result in an adjustment to the Company's liability for income taxes. Any such adjustment could be material to the Company's results of operations for any given quarterly or annual period based, in part, upon the results of operations for the given period. As of March 31, 2012 and through the financial statements issue date, the management considered that the Company had no uncertain tax positions affecting its consolidated financial position and results of operations or cash flows, and will continue to evaluate for the uncertain position in future. Our policy for recording interest and penalties associated with tax audits is to record such items as a component of income tax expense. There are no estimated interest costs and penalties provided in the Company's consolidated financial statements for the three months ended March 31, 2012 and 2011, respectively.

The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities and the major one is the China Tax Authority. The open tax year for examination in PRC is 3 years.

All of the Group's income before income taxes is from PRC sources. Actual income tax expense reported in the consolidated statements of operations and comprehensive income differ from the amounts computed by applying the PRC statutory income tax rate of 25% and 24% to income before income taxes for the three months ended March 31, 2012 and 2011 for the followings reasons:

	2012	2011
Income before income taxes	$824,009	$(152,734)

Computed "expected" income tax expense at 25% and 24% in 2012 and 2011	$206,002	$-
Tax effect of net taxable timing differences	71,323	55,695
Effect of cumulative tax (gains)/losses	218,125	503,994
	$495,450	$559,689

Our policy for recording interest and penalties associated with audits is to record such items as a component of income tax expense. There were no interest and penalties recorded for the three months ended March 31, 2012 and 2011.

8. 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 related to this plan is calculated at a range of 8% of the average monthly salary. The pension expense was $3,452 and $2,826 for the three months ended March 31, 2012 and 2011, respectively.

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

10. Sale of Common Stock, Series A Preferred Stock and Warrants

<u>Securities Purchase Agreement</u>

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

Because certain of the instruments issued in the Offering are derivative instruments which will be initially and continuously carried at fair value, we believe the aggregate proceeds received should be allocated following the principles implicit in the guidance at ASC 815-15-30-2. The proceeds are first allocated to those derivative instruments that will initially and continuously be carried at fair value. The remaining proceeds, if any, are then allocated between the non-derivative host contract and other non-derivative instruments on a relative fair value basis. The Company reviewed the features of the Series A Preferred Stock, other than the conversion feature, and concluded that, on balance, the terms and features of the host contract should be considered to be more akin to a debt instrument. Accordingly, the embedded conversion option may be required to be bifurcated and accounted for as a derivative instrument unless it meets the exemption provided by ASC 815-10-15-74a.

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

Warrants

The Series A and Series B Warrants are exercisable at any time and from time to time at an exercise price of $2.00 and $3.00 per share, respectively, and 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.

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 March 31, 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 March 31, 2012, the Warrants, the Placement Agent Warrants and the embedded derivative instrument related to the Series A Preferred Stock were re-valued at $318,324, $117,451 and $579,882, respectively, using a binomial model, based on the quoted market price of $0.40, a term equal to the remaining life of the instruments, an expected dividend yield of 0%, risk-free interest rates of 0.18% to 0.32% based on constant maturity rates published by the U.S. Federal Reserve applicable to the remaining life of the instruments and estimated volatility of 155% to 175%. The aggregate change in the fair value of the derivative liabilities between December 31, 2011 and March 31, 2012 of $738,457 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 March 31, 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 year ended March 31, 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	432,178	306,279	738,457
Ending balance, March 31, 2012	$579,882	$435,775	$1,015,657

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.

11. 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 March 31, 2012, the Company was obligated under operating leases requiring minimum rentals as follows:

Fiscal year	
Remainder of 2012	$1,707,086
2013	1,895,786
2014	1,365,516
2015	1,271,876
2016	415,396
2017	11,592
	$7,186,519

During the three months ended March 31, 2012 and 2011, rent expenses amounted to $556,099 and $423,588, respectively, of which $523,410 and $389,144 were recorded as cost of sales, respectively.

12. Concentrations

The Company did not have any customer constituting greater than 10% of net sales for the three months ended March 31, 2012 and 2011.

At March 31, 2012 and December 2011, there was one supplier of consignment snacks and drinks in the amount of $148,564 and $100,480, respectively, which accounted for 100% and 100% of the Company’s accounts payable.

13. 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.

14. 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:

	For The Three Months Ended March 31,

	2012	2011
BASIC		
Numerator for basic earnings per share attributable to the Company's common stockholders:		
Net income	$ 328,559	$ (712,423)
Dividend on preferred stock	(71,938)	(33,202)
Net income used in computing basic earnings per share	$ 256,621	$ (745,625)
Basic weighted average shares outstanding	21,254,377	20,580,542
Basic earnings per share	$ 0.01	$ (0.04)

	For The Three Months Ended March 31, 2012	2011
DILUTED		
Numerator for diluted earnings per share attributable to the Company's common stockholders:		
Net income	$ 256,621	$ (745,625)
Dividend on preferred stock	71,938	33,202
Net income used in computing diluted earnings per share	$ 328,559	$ (712,423)
Weighted average outstanding shares of common stock	21,254,377	20,580,542
Weighted average preferred stock	4,274,703	1,947,365
Diluted weighted average shares outstanding	25,529,080	22,527,907
Diluted earnings per share	$ 0.01	$ (0.04)
Potential common shares outstanding as of March 31:		
Series A preferred stock	4,274,703	4,274,703
Warrants	2,498,326	2,498,326
	6,773,029	6,773,029

During the three months ended March 31, 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.

15. 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.

16. Subsequent Event

As of March 31, 2012, the Company has evaluated subsequent events for potential recognition and disclosure through the date of the financial statement issuance.

17. Restatement of previously issued unaudited quarterly financial information (unaudited)

The unaudited quarterly financial statements for the three months ended March 31, 2011 have been restated to correct the errors in the valuation of derivative instruments. The quoted market prices to value the derivatives 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 March 31, 2011, the consolidated statement of income and comprehensive income and the consolidated statement of cash flows for the three months ended March 31, 2011 are presented below.

The following restatements impact the quarterly financial statements:

- Decreased advisory fees expenses $223,260 and derivative financial instruments – day one loss approximately $1.12 million.
- Increased loss of derivative financial instrument in preferred stock and warrants approximately $1.53 million and $0.82 million, respectively
- Increased net loss of approximately $1.0 million
- Basic and diluted earnings per shares decreased from earning $0.01 per share to loss $0..04 per share
- Fair market value of financial instruments in preferred stock and warrants decreased approximately $2.26 million and $1.20 million, respectively
- Additional paid in capital decreased approximately $0.48 million and retained earnings decreased approximately $1.01 million
- Preferred stock increased approximately $3.68 million from $-0-

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

	March 31, 2011 As restated	**March 31, 2011 As previously reported**	**Changes**
ASSETS			
Current assets:			
Cash	$15,237,910	$15,237,910	$-
Restricted cash	951,278	951,278	-
Rental deposit	27,534	27,534	-
Prepayment	73,808	73,808	-
Inventory	175,066	175,066	-
Deferred advisory fee	257,534	556,274	(298,740)
Deferred tax assets	55,695	55,695	-
Total current assets	16,778,825	17,077,565	(298,740)
			-
Property, plant and equipment, net	8,169,399	8,169,399	-
Intangible assets, net	183,160	183,160	-
Rental deposit-long term portion	288,780	288,780	-
Total assets	$25,420,164	$25,718,904	$(298,740)
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Short term loan	$152,204	$152,204	$-
Accounts payable	105,742	105,742	-
Deferred revenue	935,833	935,833	-
Payroll and payroll related liabilities	210,684	210,684	-
Income and other taxes payable	1,182,176	1,182,175	-
Accrued expenses	306,455	306,455	-
Amount due to a shareholder	1,397,776	1,397,776	-
Dividend payable on preferred stock	33,202	33,202	-
Derivative financial instrument - preferred stock	3,044,120	5,304,176	(2,260,056)
Derivative financial instrument - warrants	1,675,429	2,871,523	(1,196,094)
Total current liabilities	9,043,621	12,499,770	(3,456,149)
Commitments and contingencies			
Preferred stock ($0.00001 par value, 100,000,000 shares authorized, 4,274,703 shares issued and outstanding as of March 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, 21,124,967 and 20,200,000 shares issued and outstanding as of March 31, 2011)	211	211	-
Additional paid in capital	1,553,969	1,069,050	484,919
Statutory surplus reserves	718,744	718,744	-
Retained earnings	9,753,829	10,763,812	(1,009,983)
Accumulated other comprehensive income	667,317	667,317	-
Total stockholders' equity	12,694,070	13,219,134	(525,064)
			-
Total liabilities and stockholders' equity	$25,420,164	$25,718,904	$(298,740)

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

	For The Three Months Ended March 31, 2011		
	As restated	As previously reported	Changes
Revenue	$6,489,581	$6,489,581	$-
Cost of revenue	3,995,342	3,995,342	-
Gross profit	2,494,239	2,494,239	-
Operating Expenses			
General and administrative expenses	444,467	667,727	(223,260)
Total operating expenses	444,467	667,727	(223,260)
Income from operations	2,049,772	1,826,512	223,260
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	(1,439,326)	94,307	(1,533,633)
Change in fair value of derivative financial instrument - warrants	(762,643)	57,039	(819,682)
Interest expenses	(2,531)	(2,531)	-
Other income	1,994	1,994	-
Total other income (expenses)	(2,202,506)	(969,263)	(1,233,243)
			-
Net income before income taxes	(152,734)	857,249	(1,009,983)
Income taxes	559,689	559,689	-
			-
Net income attributable to China Internet Cafe Holdings Group, Inc.	(712,423)	$297,560	$(1,009,983)
			-
Dvidend on preferred stock	(33,202)	(33,202)	-
Net income attributable to China Internet Cafe Holdings Group, Inc. Common Stockholders	(745,625)	264,358	(1,009,983)
			-
Other comprehensive income			-
Net income	$(712,423)	$297,560	$(1,009,983)
Foreign currency translation	55,373	55,373	-
Net Comprehensive income	$(657,050)	$352,933	$(1,009,983)
Earnings per share			
- Basic	$(0.04)	$0.01	$(0.05)

- Diluted	$(0.04)	$0.01	$(0.05)
Weighted average common stock outstanding			
- Basic	20,580,542	20,580,542	-
- Diluted	22,527,907	20,580,542	1,947,365

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

	For The Three Months Ended March 31		
	2011	**2011**	
	As restated	As previously reported	Changes
Cash flows from operating activities			
Net income	$(712,423)	$297,560	(1,009,983)
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	1,439,326	(94,307)	1,533,633
Change in fair value of derivative financial instrument - warrants	762,643	(57,039)	819,682
Advisory fee	192,466	415,726	(223,260)
Depreciation	621,998	621,998	-
Amortization	9,112	9,112	-
Deferred tax assets	(55,532)	(55,532)	-
Changes in operating assets and liabilities:			
Prepayment	(73,592)	(73,592)	-
Rental deposit	(23,398)	(23,398)	-
Inventory	6,642	6,642	-
Accounts payable	37,676	37,676	-
Deferred revenue	351,300	351,300	-
Payroll and payroll related liabilities	9,840	9,840	-
Income and other taxes payable	188,166	188,166	-
Accrued expenses	201,752	201,752	-
Amount due to a shareholder	928,585	928,585	-
Net cash provided by (used in) operating activities	3,884,561	3,884,561	-
Cash flows from investing activities			
Acquisition of property, plant and equipment	(590,787)	(590,787)	-
Receipt of loan receivable due to termination of an investment agreement	2,428,142	2,428,142	-
Net cash used in investing activities	1,837,355	1,837,355	-
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	3,556	3,556	-
Net increase in cash	11,401,086	11,401,086	-
Cash - beginning of period	3,836,824	3,836,824	-
Cash - end of period	$15,237,910	$15,237,910	-
Cash paid during the period for:			
Interest paid	$2,531	$2,531	