

CHINA EDUCATION ALLIANCE INC.

Form 10-Q

November 14, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2013

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: **001-34386**

**CHINA EDUCATION ALLIANCE, INC.**

(Exact name of registrant as specified in its charter)

**North Carolina**

(State or other jurisdiction of incorporation or organization)

**56-2012361**

(I.R.S. Employer Identification No.)

**58 Heng Shan Road, Kun Lun Shopping Mall**

**Harbin, People's Republic of China**

**150090**

(Address of principal executive offices)

(Zip Code)

**86-451-8233-5794**

(Registrant's telephone number,

including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  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 November 13, 2013, there were 10,582,530 shares of \$0.001 par value common stock issued and outstanding.

FORM 10-Q

CHINA EDUCATION ALLIANCE, INC.

INDEX

|   | Page |
|---|------|
| PART I.   |      |
| Financial Information   | 3    |
| Item 1. Financial Statements (Unaudited).   | 3    |
| Item 2. Management's Discussion and Analysis of Financial Condition and results of Operation. | 18   |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk.                           | 28   |
| Item 4. Controls and Procedures.  | 29   |
| PART II.  |      |
| Other Information   | 29   |
| Item 1. Legal Proceedings.  | 29   |
| Item 1A. Risk Factors.  | 29   |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.                          | 29   |
| Item 3. Defaults Upon Senior Securities.  | 29   |
| Item 4. Mine Safety Disclosures.  | 29   |
| Item 5. Other Information.  | 30   |
| Item 6. Exhibits.   | 30   |
| Signatures  | 32   |

**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements****China Education Alliance, Inc. and Subsidiaries****Consolidated Balance Sheets**

|  | September<br>30,<br>2013<br>(Unaudited) | December<br>31,<br>2012 |
|--|---|-------------------------|
| <b>ASSETS</b>  |   |                         |
| Current Assets   |   |                         |
| Cash and cash equivalents  | \$62,251,843                            | \$64,172,917            |
| Other receivables  | 430,475                                 | 841,003                 |
| Prepaid expenses and other current assets  | 599,837                                 | 660,054                 |
| Total current assets   | 63,282,155                              | 65,673,974              |
| Non-current Assets   |   |                         |
| Note receivable  | -                                       | 7,935,122               |
| Property and equipment, net  | 9,294,255                               | 11,349,025              |
| Intangibles and capitalized software, net  | 7,630,135                               | 9,213,515               |
| Total non-current assets   | 16,924,390                              | 28,497,662              |
| Total Assets   | \$80,206,545                            | \$94,171,636            |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |   |                         |
| Current Liabilities  |   |                         |
| Accounts payable and accrued expenses  | \$243,373                               | \$420,434               |
| Deferred revenue   | 1,438,283                               | 1,332,620               |
| Income tax and other taxes payable   | 91,608                                  | 179,544                 |
| Total current liabilities  | 1,773,264                               | 1,932,598               |
| Commitments and Contingent Liabilities   | -                                       | -                       |
| Stockholders' Equity   |   |                         |
| Common stock (\$0.001 par value, 150,000,000 shares authorized, 10,582,530 and 10,582,530 issued as of September 30, 2013 and December 31, 2012, respectively; | 10,583                                  | 10,583                  |

Edgar Filing: CHINA EDUCATION ALLIANCE INC. - Form 10-Q

137,512 and 137,512 shares held in treasury, as of September 30, 2013 and December 31, 2012, respectively)

|  |              |              |
|--|--------------|--------------|
| Additional paid-in capital                   | 40,942,009   | 40,941,215   |
| Statutory reserve                            | 3,792,161    | 3,792,161    |
| Retained earnings                            | 20,896,700   | 36,186,436   |
| Accumulated other comprehensive income       | 12,437,792   | 10,322,490   |
| Less: Treasury stock                         | (977,072 )   | (977,072 )   |
| Stockholders' equity - CEAI and Subsidiaries | 77,102,173   | 90,275,813   |
| Noncontrolling interests in subsidiaries     | 1,331,108    | 1,963,225    |
| Total stockholders' equity                   | 78,433,281   | 92,239,038   |
| <br>   |              |              |
| Total Liabilities and Stockholders' Equity   | \$80,206,545 | \$94,171,636 |

The accompanying notes are an integral part of these consolidated financial statements.

## China Education Alliance, Inc. and Subsidiaries

## Consolidated Statements of Operations and Comprehensive Income

(Unaudited)

|  | Three months ended September 30, |              | Nine months ended September 30, |               |
|--|----------------------------------|--------------|---------------------------------|---------------|
|  | 2013                             | 2012         | 2013                            | 2012          |
| Revenue                                    |                                  |              |                                 |               |
| Online education revenue                   | \$ 506,725                       | \$ 608,080   | \$ 1,901,324                    | \$ 3,919,487  |
| Training center revenue                    | 1,120,760                        | 1,458,946    | 4,079,340                       | 6,028,033     |
| Total revenue                              | 1,627,485                        | 2,067,026    | 5,980,664                       | 9,947,520     |
| Cost of Revenue                            |                                  |              |                                 |               |
| Online education costs                     | 1,356,547                        | 2,052,518    | 4,120,051                       | 5,487,283     |
| Training center costs                      | 667,079                          | 828,969      | 1,954,031                       | 2,407,085     |
| Total cost of revenue                      | 2,023,626                        | 2,881,487    | 6,074,082                       | 7,894,368     |
| Gross Profit/(Loss)                        |                                  |              |                                 |               |
| Online education gross profit/(loss)       | (849,822 )                       | (1,444,438 ) | (2,218,727 )                    | (1,567,796 )  |
| Training center gross profit               | 453,681                          | 629,977      | 2,125,309                       | 3,620,948     |
| Total gross profit/(loss)                  | (396,141 )                       | (814,461 )   | (93,418 )                       | 2,053,152     |
| Operating Expenses                         |                                  |              |                                 |               |
| Selling expenses                           | 3,697,071                        | 2,610,144    | 6,033,210                       | 4,888,530     |
| Administrative expenses                    | 3,089,854                        | 2,833,040    | 6,586,752                       | 5,225,653     |
| Depreciation and amortization              | 839,763                          | 735,966      | 2,433,982                       | 2,395,556     |
| Total operating expenses                   | 7,626,688                        | 6,179,150    | 15,053,944                      | 12,509,739    |
| Loss from operations                       | (8,022,829 )                     | (6,993,611 ) | (15,147,362 )                   | (10,456,587 ) |
| Other Income (Expense)                     |                                  |              |                                 |               |
| Other expenses, net                        | (7,593 )                         | 500          | (10,400 )                       | (4,189 )      |
| Loss on disposal of property and equipment | (4,324 )                         | (83,309 )    | (14,456 )                       | (99,127 )     |
| Impairment loss on intangible assets       | -                                | -            | (606,032 )                      | (1,446,003 )  |
| Interest income                            | 56,546                           | 453,472      | 166,940                         | 1,416,117     |
| Total other income/(Expense), net          | 44,629                           | 370,663      | (463,948 )                      | (133,202 )    |
| Net Loss Before Provision for Income Tax   | (7,978,200 )                     | (6,622,948 ) | (15,611,310 )                   | (10,589,789 ) |
| Income taxes:                              |                                  |              |                                 |               |
| Current                                    | -                                | -            | -                               | (32 )         |
| Deferred                                   | -                                | -            | -                               | (318,997 )    |
| Net Loss                                   | (7,978,200 )                     | (6,622,948 ) | (15,611,310 )                   | (10,908,818 ) |
|  | (131,331 )                       | (50,263 )    | (321,574 )                      | (242,239 )    |

Edgar Filing: CHINA EDUCATION ALLIANCE INC. - Form 10-Q

|   |                 |                 |                  |                  |
|---|-----------------|-----------------|------------------|------------------|
| Net Loss attributable to the noncontrolling interests |                 |                 |                  |                  |
| Net Loss - attributable to CEAI and Subsidiaries      | \$ (7,846,869 ) | \$ (6,572,685 ) | \$ (15,289,736 ) | \$ (10,666,579 ) |
| Net Loss per common stock-basic and diluted           | \$ (0.74 )      | \$ (0.62 )      | \$ (1.44 )       | \$ (1.01 )       |
| Weighted Average Shares Outstanding-basic and diluted | 10,582,530      | 10,582,530      | 10,582,530       | 10,582,530       |
| The Components of Other Comprehensive Income          |                 |                 |                  |                  |
| Net Loss  | \$ (7,846,869 ) | \$ (6,572,685 ) | \$ (15,289,736 ) | \$ (10,666,579 ) |
| Foreign currency translation adjustment               | 326,018         | 71,828          | 2,115,302        | 805,384          |
| Comprehensive Loss                                    | \$ (7,520,851 ) | \$ (6,500,857 ) | \$ (13,174,434 ) | \$ (9,861,195 )  |

The accompanying notes are an integral part of these consolidated financial statements.



**China Education Alliance, Inc. and Subsidiaries****Consolidated Statements of Cash Flows**

(Unaudited)

|  | Nine Months ended September 30, |                  |
|--|---------------------------------|------------------|
|  | 2013                            | 2012             |
| Cash flows from operating activities                                       |                                 |                  |
| Net loss   | \$ (15,611,310 )                | \$ (10,908,818 ) |
| Adjustments to reconcile net loss to net cash used in operating activities |                                 |                  |
| Depreciation and amortization - operating expenses                         | 2,433,982                       | 2,395,556        |
| Depreciation and amortization - cost of revenue                            | 2,079,770                       | 2,131,445        |
| Loss on disposal of fixed assets   | 14,456                          | 99,127           |
| Bad debt written off on other receivables                                  | -                               | 18,953           |
| Impairment loss on intangible assets                                       | 606,032                         | 1,446,003        |
| Stock based compensation   | 794                             | 4,514            |
| Accounts receivable  | -                               | (111,754 )       |
| Prepaid expenses and other receivables                                     | 503,944                         | 303,523          |
| Deferred tax assets  | -                               | 318,996          |
| Accounts payable and accrued liabilities                                   | (183,261 )                      | (1,058,601 )     |
| Income tax and other taxes payable   | (87,936 )                       | (408,861 )       |
| Deferred revenue   | 69,772                          | (828,987 )       |
| Net cash used in operating activities                                      | (10,173,757 )                   | (6,598,904 )     |
| Cash flows from investing activities                                       |                                 |                  |
| Purchases of property and equipment  | (983,654 )                      | (1,421,353 )     |
| Loan received back from NIT  | 8,047,383                       | -                |
| Proceeds from disposal of property and equipment                           | 14,456                          | 20,466           |
| Net cash (used in) provided by investing activities                        | 7,078,185                       | (1,400,887 )     |
| Cash flows from financing activities                                       |                                 |                  |
| Advance to a stockholder   | -                               | 99,903           |
| Dividend paid to noncontrolling shareholders                               | (354,085 )                      | (158,514 )       |
| Net cash used in financing activities                                      | (354,085 )                      | (58,611 )        |
| Effect of exchange rate changes on cash                                    | 1,528,583                       | 422,989          |
| Net increase (decrease) in cash and cash equivalents                       | (1,921,074 )                    | (7,635,413 )     |
| Cash and cash equivalents at beginning of period                           | 64,172,917                      | 73,597,159       |
| Cash and cash equivalents at end of period                                 | \$ 62,251,843                   | \$ 65,961,746    |
| Supplemental disclosure of cash flow information                           |                                 |                  |

Edgar Filing: CHINA EDUCATION ALLIANCE INC. - Form 10-Q

|                 |           |           |
|-----------------|-----------|-----------|
| Income tax paid | \$ 93,858 | \$ 92,832 |
|-----------------|-----------|-----------|

The accompanying notes are an integral part of these consolidated financial statements.

## China Education Alliance, Inc. and Subsidiaries

### Notes to Unaudited Consolidated Financial Statements

#### 1. Description of Business

**Nature of organization** - China Education Alliance, Inc. (the “Company”), formerly known as ABC Realty Co., was organized under the laws of the State of North Carolina on December 2, 1996. ABC Realty Co.’s primary purpose was to act as a broker or agent in residential real estate transactions. On September 15, 2004, ABC Realty Co., pursuant to a Plan of Exchange, acquired Harbin Zhong He Li Da Education Technology, Inc. (“ZHLD”), a corporation formed on August 9, 2004 in the City of Harbin in the Heilongjiang Province, People’s Republic of China (the “PRC”), with an authorized capital of \$60,386 (Renminbi (“RMB”) 500,000).

On September 15, 2004, ABC Realty Co. entered into a Plan of Exchange with ZHLD and Duane C. Bennett, the former Chairman of ABC Realty Co., pursuant to which the shareholders of ZHLD exchanged all of their registered capital of \$60,386 for 18,333,334 shares of common stock of the Company, or approximately 95% of the Company’s common stock. On November 17, 2004, ABC Realty Co. changed its name to China Education Alliance, Inc. On December 13, 2004, China Education Alliance, Inc. consummated the Plan of Exchange with ZHLD and ZHLD’s shareholders. As a result of the Plan of Exchange, the transaction was treated for accounting purposes as a recapitalization of ZHLD.

ZHLD is a technology company engaged in the online education industry in the PRC. Its mission is to promote online exam preparation services in the PRC, to improve the efficiency and effectiveness of elementary education, secondary education, vocational education, skill education, continuing education, and professional training programs, and to integrate with the international education system.

ZHLD’s subsidiary, Heilongjiang Zhonghe Education Training Center (“ZHTEC”) was registered in the PRC on July 8, 2005 with a registered capital of \$60,386 and is accounted for as a wholly owned subsidiary of ZHLD. ZHLD owns 99% of ZHTEC with 1% held in trust by Mr. Xiqun Yu, the Company’s CEO, for the benefit of ZHLD.

ZHLD also owns 70% of Beijing Hua Yu Hui Zhong Technology Development Co., Ltd. (“BHYHZ”). BHYHZ was formed on September 30, 2006 in the PRC. At the time of its organization, we transferred a 30% interest in this subsidiary to the National Vocational Education Association of China, a non-profit, quasi-government entity, for no consideration to enable us to work with the Association’s network to expand our business.

On April 18, 2008, ZHLD entered into an agreement and supplementary agreement with Harbin Daily Newspaper Group (“Newspaper Group”) to invest in a joint venture company, Harbin New Discovery Media Co., Ltd. (“New Discovery”). ZHLD contributed RMB3,000,000 (approximately \$430,000) and Newspaper Group contributed RMB3,120,000 (approximately \$445,000) towards the registered capital of New Discovery. In return for their respective contributions, ZHLD owns 49.02% equity interest and Newspaper Group owns 50.98% equity interest in New Discovery. The parties are prohibited, for the duration of the joint venture from retiring or transferring their equity interests. As the Company did not foresee that the investment cost is recoverable from this joint venture in the near future, the Company provided fully impairment on the investment by the year ended December 31, 2011.

On January 4, 2009, ZHLD entered into an agreement with Mr. Guang Li to jointly incorporate and invest in a joint venture company, Zhong He Li Da (Beijing) Management Consultant Co., Ltd. (“ZHLDBJ”). ZHLD contributed RMB425,000 (approximately \$62,107), and Mr. Guang Li contributed RMB 75,000 (approximately \$10,960) towards the registered capital of ZHLDBJ, amounting to a total registered capital of RMB500,000 (approximately \$73,067). In return for their respective contributions, ZHLD owns an 85% equity interest, and Mr. Guang Li owns a 15% equity interest in ZHLDBJ. ZHLD has entrusted Mr. Xiqun Yu to hold 20% of its equity interest of ZHLDBJ on its behalf. ZHLDBJ will be involved in the vocational training business which includes IT engineering and accounting training.

In February 2010, the Company, through ZHLD, incorporated a new company in the PRC, Beijing New Shifan Education & Technology Co., Ltd. ("New Shifan") with a registered capital of RMB1.95 million (approximately \$291,132). ZHLD owned a 65% equity interest in New Shifan and the other equity holders together owned a 35% equity interest in New Shifan. New Shifan was created to continue the operations of Beijing Shifan Culture Communication Co., Ltd. ("Beijing Shifan"). The Company paid the original owner of Beijing Shifan RMB7 million (approximately \$1,056,970) to acquire their expertise, in (i) science and math education at the secondary education level, (ii) the rights to continue publishing the magazine "Senior High School Students Mathematics, Physics, and Chemistry" and (iii) the rights to a nationwide contest for middle school and high school students. In September 2011, New Shifan changed its name to Beijing Hua Yu Pin Xue Education Technology Co., Ltd ("HYPX"). In October 2011, ZHLD took over the 35% equity interest from the other equity holders of HYPX without any consideration, and entrusted Mr. Xiqun Yu to hold the 35% equity interest on behalf of ZHLD. In November 2011, HYPX increased its share capital to RMB2 million (approximately \$298,567). In January 2012, due to changes in government regulations, the Company authorized Mr. Yu to hold the 100% equity interest on behalf of ZHLD. HYPX is focusing on expanding our training centers in Beijing, and developing extensive marketing strategy to establish new markets in other main cities.

On March 4, 2011, the Company entered into a management agreement with Nanchang Institute of Technology ("NIT"), a vocational training institution based in Nanchang, PRC. Pursuant to the agreement, the Company would assist in managing the daily operations of NIT for ten years for an annual management fee of RMB 10 million (approximately \$1,461,347). The management fee was payable on a quarterly basis and in the event of late payment, a late fee would be imposed. Additionally, a liquidated damage of RMB 50 million (approximately \$7,935,122) would be paid by any party that defaulted on the agreement.

In connection with the management agreement, the Company entered in to a loan agreement, pursuant to which the Company agreed to loan NIT RMB 50 million (approximately \$7,935,122) to build training facilities and NIT would repay the RMB 50 million (approximately \$7,935,112) in ten years from the date NIT received the principal. The loan had an annual interest rate of 20% and the interest would be waived by the Company if NIT made all payments under the management agreement in a timely manner. We received 20% annual interest income due each quarter, therefore, the management fee was waived. The loan was secured by the assets of certain guarantors. On March 29, 2013, NIT repaid the loan principal of RMB50 million and accrued interests and the loan agreement was terminated. On the same day, the management agreement with NIT was also terminated.

On February 25, 2011, the Company entered into a share transfer agreement with the shareholder of Harbin Tianlang Culture and Education School ("Tianlang"), a tutoring school with 5,000 students, based in Harbin, PRC. Pursuant to the share transfer agreement, the Company purchased 60% of the equity interests of Tianlang for RMB 35 million (approximately \$5.3 million). The shareholder and the Company also provided RMB 2 million (approximately \$0.3 million) and RMB 3 million (approximately \$0.5 million) as working capital for Tianlang, respectively. Tianlang had established a new board of directors with five directors, of which three directors were appointed by the Company and two directors were appointed by the shareholder. The acquisition of Tianlang was completed in April 2011. We are currently co-managing Tianlang with the previous majority owner. The Company and the previous majority owner will be entitled to 60% and 40%, respectively, of the profits of Tianlang.

On May 31, 2011, the Company entered into share transfer agreements with the shareholders (the “Shareholders”) of Changchun City Chaoyang District Nuoya Foreign Languages School (“Changchun Nuoya”) and Harbin City Nangang District Nuoya Foreign Languages School (“Harbin Nuoya”), two foreign language schools based in the PRC.

Pursuant to the agreements, the Company purchased 100% of the two schools for an aggregate of RMB 16 million (approximately \$2.5 million), and all consideration had been paid up. The Shareholders’ obligations under the agreements are guaranteed by a guarantor who will be jointly and severally liable in the event of a breach by the Shareholders. The acquisition of Changchun Nuoya and Harbin Nuoya was completed by the end of May 2011 and their financial statements had been consolidated with the Company’s financial statements since May 2011. The Company did not foresee that the investment cost in Harbin Nuoya and Changchun Nuoya is recoverable in the near future. As a result, the Company fully impaired its investment in the two schools. As there is little demand for non-English classes at the time being, the Company has suspended the operation of Changchun Nuoya.

In June 2012, the Company, through ZHLD, incorporated a new company in the PRC, Harbin Zhong He Li Da Information Technology Co., Ltd. (“ZHLDT”) with a registered capital of RMB2 million. Mr. Yu has been entrusted to hold the 100% equity interest on behalf of ZHLD. ZHLDT was established to initiate and design a platform for online education programs, and provide this effective and efficient communication service to all the teachers and students.

## 2. Basis of Preparation of Financial Statements

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (“GAAP”). The consolidated financial statements include the financial statements of the Company and its subsidiaries. All significant inter-company transactions and balances have been eliminated in consolidation. The portion of the income applicable to noncontrolling interests in subsidiaries undertakings is reflected in the consolidated statements of operations.

## 3. Summary of Significant Accounting Policies

**Use of estimates** - The preparation of these financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of net sales and expenses during the reported periods.

Significant estimates include values, classification, useful lives assigned to and impairment of acquired intangible assets, the useful lives and impairment of property and equipment, collectability of accounts receivable, reserves for allowances and stock option valuation. Actual results may differ from these estimates.

**Cash and cash equivalents** - The Company considers all highly liquid debt instruments purchased with a maturity period of three months or less to be cash or cash equivalents. The carrying amounts reported in the accompanying unaudited condensed consolidated balance sheets for cash and cash equivalents approximate their fair value. All of the Company’s cash that is held in bank accounts in the PRC is not protected by Federal Deposit Insurance Corporation (“FDIC”) insurance or any other similar insurance in the PRC. The cash that the Company maintains in US banks is insured up to \$250,000 at each bank as of September 30, 2013 and December 31, 2012. The Company’s cash at their US banks is in excess of statutorily insured limits at \$3,388,110 and \$4,525,820, as of September 30, 2013 and December 31, 2012, respectively.

**Property and equipment** - Property and equipment is stated at the historical cost, less accumulated depreciation and impairments. Depreciation on property and equipment is provided using the straight-line method over the estimated

useful lives of the assets as follows:

|                         |                            |
|-------------------------|----------------------------|
| Buildings               | 20 years                   |
| Communication equipment | 10 years                   |
| Transportation vehicles | 5 years                    |
| Furniture and fixtures  | 5 years                    |
| Leasehold improvements  | over unexpired lease terms |

Expenditures for renewals and betterments are capitalized while repairs and maintenance costs are normally charged to the statement of operations in the period/year in which they are incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the asset, the expenditure is capitalized as an additional cost of the asset.

Upon sale or disposal of an asset, the historical cost and related accumulated depreciation and impairment of such asset are removed from their respective accounts and any gain or loss is recorded in the statements of operations.

The Company reviews the carrying value of property and equipment for impairment whenever events and circumstances indicate that the carrying value of an asset may not be recoverable from the estimated future cash flows expected to result from its use and eventual disposition. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment loss is recognized equal to an amount by which the carrying value exceeds the fair value of assets. The factors considered by management in performing this assessment include current operating results, trends and prospects, the manner in which the property and equipment are used, and the effects of obsolescence, demand, competition, and other economic factors.



**Intangibles** - Intangibles consist of franchise rights on educational products, software, teacher list, student list, domain/brand name, course materials, goodwill, magazine rights and contest operation rights. Most intangible assets are amortized over the lives of the rights agreements, or their respective operational useful lives.

The Company evaluates the carrying value of intangible assets during the second quarter of each year and between annual evaluations if events occur, or circumstances change, that would more likely than not reduce the fair value of the intangible asset below its carrying amount. For the three months and nine months ended September 30, 2013 and 2012, the Company recorded \$0 and \$0, \$606,032 and \$1,446,003, respectively, as impairment loss.

In April 2011, the Company purchased 60% equity interest of Tianlang for RMB 35 million (approximately \$5.3 million) and 100% ownership of Changchun Nuoya and Harbin Nuoya. These three schools' net assets included identifiable intangible assets such as domain name/brand name, cost of materials, student list, course materials and teacher lists. The economic useful life for domain name/brand name is estimated to be 10 years and the others are estimated to be 3 years.

**Long-lived assets** - The Company reviews its long-lived assets for impairments when changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Long-lived assets under certain circumstances are reported at the lower of carrying amount or fair value. Assets to be disposed of and assets not expected to provide any future service potential to the Company are recorded at the lower of carrying amount or fair value less cost to sell. To the extent carrying values exceed fair values; an impairment loss is recognized in operating results.

**Foreign Currency** - The Company's principal country of operations is the PRC. The financial position and results of operations of the Company are recorded in USD as the functional currency, and the financial position and results of operations of the Company's PRC subsidiaries are recorded in RMB as the functional currency. The results of operations denominated in foreign currency are translated at the average rate of exchange during the respective reporting period.

Assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the market rate of exchange at that date. The registered equity capital denominated in the functional currency is translated at the historical rate of exchange at the time of capital contribution. All translation adjustments resulting from the translation of the financial statements into the reporting currency ("U.S. Dollars" or "US\$") are recorded in accumulated other comprehensive income, a separate component within shareholders' equity. The accompanying consolidated financial statements are presented in US\$. The functional currency of the Company is RMB. The consolidated financial statements are translated into US\$ from RMB at year-end exchange rates as to assets and liabilities and average exchange rates as to revenues and expenses. Capital accounts are translated at their historical exchange rates when the capital transactions occurred. The resulting translation adjustments are recorded as a component of shareholders' equity included in other comprehensive income. Gains and losses from foreign currency transactions are included in profit or loss. There were no gains and losses from foreign currency transactions during the quarter ended September

30, 2013 and 2012.

|                         | As of<br>September<br>30,<br>2013 | December<br>31, 2012 |
|-------------------------|-----------------------------------|----------------------|
| RMB: US\$ exchange rate | 6.1396                            | 6.3011               |

|                                 | Nine months<br>ended September<br>30, |        |
|---------------------------------|---------------------------------------|--------|
|                                 | 2013                                  | 2012   |
| Average RMB: US\$ exchange rate | 6.2132                                | 6.3085 |

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 US\$ at the rates used in translation.

**Noncontrolling interest** - Noncontrolling interest in the Company's subsidiaries are recorded in accordance with the provisions of Financial Accounting Standard Board ("FASB") Codification 810 Consolidation ("ASC 810") and are reported as a component of equity, separate from the parent's equity. Purchase or sales of equity interests that do not result in a change of control are accounted for as equity transactions. Results of operations attributable to the noncontrolling interest are included in our consolidated results of operations and, upon loss of control, the interest sold, as well as interest retained, if any, will be reported at fair value with any gain or loss recognized in earnings.

**Revenue recognition** - Revenue is recognized when the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) the service has been rendered; (3) the selling price is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. The Company believes that these criteria are satisfied when customers download prepaid study materials.

Prepaid debit cards allow the Company's subscribers to purchase a predetermined monetary amount of download materials downloadable from its website. The Company tracks usage of the debit card and records revenue when the debit card is used.

At the time that the prepaid debit card is purchased, the receipt of cash is recorded as deferred revenue. Revenues are recognized in the month when card is used. Unused value relating to debit cards is recognized as revenues when the prepaid debit card expires.

Tuition from courses is recognized ratably over the period that fees are earned, typically the life of the course. The Company offers credits to students if they should withdraw, or are unable to complete their courses. Historically the issuances of credits have not been high with regards to tuition fees. The Company offers cash refunds on a limited basis based on individual circumstances.

The Company engages an advertisement agency to manage its on-line advertisement revenue. Pursuant to the contract with this agency, upon posting of an on-line advertisement on the Company's website, the Company is entitled to share with the agency 50% of the amount charged to the on-line advertiser.

The Company recognizes advertising revenue monthly on receipt of the confirmation from the agent. The agency is responsible for collection of all ad revenue from advertisers. The agency is required to make their remittance for on-line advertising six months after on-line ads are posted on the Company's website.

Deferred revenue reflects the unearned portion of debit cards sold and tuition payments received. Tuition is recognized as revenue ratably over the periods in which it is earned, generally the term of the program or as the debit card is used.

**Deferred revenue** - Deferred revenue reflects the unearned portion of debit cards sold and tuition payments received. Deferred revenue as of September 30, 2013 and December 31, 2012 was \$1,438,283 and \$1,332,620, respectively.

**Advertising** - The Company expenses advertising costs at the time they are published on the newspaper and for all other advertising the first time the respective advertising takes place. These costs are included in selling and administrative expenses. The total advertising expenses incurred for the three and nine months ended September 30, 2013 and 2012 were \$2,832,246 and \$868,907, \$3,748,182 and \$1,021,891, respectively.

**Taxation** - Taxation on profits earned in the PRC are calculated on the estimated assessable profits for the year at the rates of taxation prevailing in the PRC after taking into effect the benefits from any special tax credits or "tax holidays" allowed in the PRC.

The Company does not accrue United States income tax on unremitted earnings from foreign operations, as it is the Company's intention to invest these earnings in foreign operations for the foreseeable future. All of the Company's revenues are generated in the PRC. The Company's US operations provide corporate and administrative functions for the entire Company. The Company's tax provisions for the three and nine months ended September 30, 2013 and 2012 are related to the Company's PRC operations.

If the Company should have an uncertainty in accounting for income taxes, the Company evaluates a tax position in a two-step process. The first step is to determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including the resolution of any related appeals or litigation based on the technical merits of the position. The second step is to measure the tax position that meets the more-likely-than-not threshold to determine the amount of provision or benefit to be recognized in the financial statements. A tax position is measured at the largest amount of provision or benefit where there is a greater than 50% likelihood of being realized upon ultimate settlement.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent period in which the threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not criteria should be de-recognized in the first subsequent reporting period in which the threshold is no longer met.

### **Income Tax**

Private schools or colleges operated for reasonable returns, such as our subsidiary Tianlang, are subject to income taxes at 25% after January 1, 2008, but were sometimes subject to deemed amounts or preferential tax arrangement of income tax to be determined by the relevant tax authorities. Our subsidiary Tianlang had not yet been charged income taxes under current regulation. The Company is unable to accurately estimate the chance of having the Tianlang's tax position being challenged by PRC tax authorities; therefore the Company did not record any tax liabilities in respect of Tianlang's profits.

Based on all known facts and circumstances and current tax law, the Company believes that the total amount of unrecognized tax provisions or benefits as of September 30, 2013, is not material to its results of operations, financial condition or cash flows. The Company also believes that the total amount of unrecognized tax provisions or benefits as of September 30, 2013, if recognized, would not have a material effect on its effective tax rate. The Company further believes that there are no tax positions for which it is reasonably possible, based on current PRC tax laws and policies, that the unrecognized tax provisions or benefits will significantly increase or decrease over the next 12 months producing, individually or in the aggregate, a material effect on the Company's results of operations, financial condition or cash flows.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets, including tax loss and credit carry forwards, and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

The effect of deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred income tax expense represents the change during the period in the deferred tax assets and deferred tax liabilities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The Company had no deferred tax assets as of September 30, 2013 and December 31, 2012.

### Value added tax

The Provisional Regulations of the People's Republic of China Concerning Value Added Tax ("VAT") promulgated by the State Council came into effect on January 1, 1994. Under these regulations and the Implementing Rules of the Provisional Regulations of the PRC Concerning VAT is imposed on goods sold in or imported into the PRC and on processing, repair and replacement services provided within the PRC.

VAT payable in the PRC is charged on an aggregated basis at a rate of 13% or 17% (depending on the type of goods involved) on the full price collected for the goods sold or, in the case of taxable services provided, at a rate of 17% on the charges for the taxable services provided, but excluding, in respect of both goods and services, any amount paid in respect of VAT included in the price or charges, less any deductible VAT already paid by the taxpayer on purchases of goods and services. The Company records all revenues net of VAT.

**Stock-based compensation** - The Company records compensation expense associated with stock-based awards and other forms of equity compensation. Such compensation would include the recording of cost resulting from all stock-based payment transactions including shares issued under its stock option plans. The Company records expense over the vesting period in connection with stock options granted. The compensation expense for stock-based awards includes an estimate for forfeitures and is recognized over the expected term of the award on a straight-line basis.

The Company recorded stock-based compensation expenses of \$0 and \$595, respectively, for the three months ended September 30, 2013 and 2012. The Company also recorded stock-based compensation expenses of \$794 and \$4,514 for the nine months ended September 30, 2013 and 2012, respectively.

**Fair value of financial instruments** - The Company has adopted newly issued generally accepted accounting principles with regards to fair value measurement for assets and liabilities that establishes a common definition for fair value to be applied to existing generally accepted accounting principles that require the use of fair value measurements, establishes a framework for measuring fair value and expands disclosure about such fair value measurements. The adoption of these principles did not have an impact on the Company's financial position or operating results, but did expand certain disclosures.

Fair value is defined fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Additionally, current standards require the use of valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. These inputs are prioritized below:

- Level 1: Observable inputs such as quoted market prices in active markets for identical assets or liabilities
- Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data
- Level 3: Unobservable inputs for which there is little or no market data, which require the use of the reporting entity's own assumptions.

The Company did not have any assets or liabilities valued using Level 2 or Level 3 inputs as of September 30, 2013 and December 31, 2012, respectively.

**Treasury stock** - We account for treasury stock under the cost method and include treasury stock as a component of stockholders' equity. When retired, the excess of the cost of treasury stock over its par value is allocated between retained earnings and additional paid-in capital.

**Recent accounting pronouncements** - Management does not believe that any recently issued, but not yet effective, accounting standards or pronouncements, if currently adopted, would have a material effect on the Company's consolidated financial statements.

#### **4. Concentrations of business and credit risk**

The majority of the Company's bank accounts are with banks located in the PRC that are not covered by any type of protection similar to that provided by the FDIC on funds held in U.S. banks.

The Company is operating in the PRC, which may give rise to significant foreign currency risks from fluctuations and the degree of volatility of foreign exchange rates between the US\$ and the RMB.

Financial instruments that potentially subject the Company to concentration of credit risk consist principally of cash and accounts receivable, the balances of which are stated on the balance sheet. The Company places its cash in high credit quality financial institutions; however, such funds are not insured in the PRC. As of September 30, 2013 and December 31, 2012, the Company maintains cash in the US, in a financial institution insured by the FDIC that has approximately \$3,388,110 and \$4,525,820, respectively, in funds in excess of FDIC insured amounts.



For the three and nine months ended September 30, 2013 and 2012, no sales to a single customer accounted for 10% or more of our revenue.

Our subsidiaries ZHTC, Changchun Nuoya and Harbin Nuoya are private schools not operated for reasonable returns; therefore, are not allowed to distribute dividends. As of September 30, 2013 and December 31, 2012, the total un-distributable net assets of ZHTC, Changchun Nuoya and Harbin Nuoya amounted to \$34,111,899 and \$33,169,873, respectively.

**5. Cash and cash equivalents**

Cash and cash equivalents consist of the following:

|                     | September 30, 2013<br>(Unaudited) | December 31, 2012 |
|---------------------|-----------------------------------|-------------------|
| Cash on Hand -China | \$ 460,695                        | \$ 38,522         |
| Bank Deposits-China | 58,067,920                        | 59,273,602        |
| Bank Deposits-US    | 3,723,228                         | 4,860,793         |
|                     | \$ 62,251,843                     | \$ 64,172,917     |

**6. Prepaid expenses and other current assets**

Prepaid expenses consist of the following:

|  | September 30, 2013<br>(Unaudited) | December 31, 2012 |
|--|-----------------------------------|-------------------|
| Prepaid rent                           | \$ 407,606                        | \$ 313,981        |
| Prepaid teachers and online material   | 166,660                           | 213,174           |
| Prepaid services and professional fees | 12,240                            | -                 |
| Prepaid advertising                    | -                                 | 104,746           |
| Other prepaid expenses                 | 13,331                            | 28,153            |
|  | \$ 599,837                        | \$ 660,054        |

**7. Property and equipment, net**

Property and equipment consist of the following:

|                                | September 30, 2013 | December 31, 2012 |
|--------------------------------|--------------------|-------------------|
|                                | (Unaudited)        |                   |
| Buildings                      | \$ 1,447,654       | \$ 1,410,550      |
| Transportation vehicles        | 107,067            | 112,258           |
| Communication equipment        | 10,491,283         | 12,949,181        |
| Furniture and fixtures         | 5,566,197          | 2,956,701         |
| Leasehold improvement          | 3,988,225          | 2,955,891         |
|                                | 21,600,426         | 20,384,581        |
| Less: Accumulated Depreciation | (12,306,171 )      | (9,035,556 )      |
| Property and Equipment, net    | \$ 9,294,255       | \$ 11,349,025     |

For the three and nine months ended September 30, 2013 and 2012, depreciation expenses totaled \$1,241,271 and \$1,026,989, \$3,292,800 and \$3,115,180, respectively. For the three and nine months ended September 30, 2013 and 2012, loss on disposal of fixed assets was \$4,324 and \$83,309, \$14,456 and \$99,127, respectively.

## **8. Intangibles and capitalized software, net**

Intangibles of the Company consisted of franchise rights on educational products, software, magazine rights, contest operation rights, domain name/brand name, course materials, student list and teacher list, and goodwill.

### Franchise rights

The franchise rights owned by the Company consist of the following:

- The ACCP training course is an authority for training software engineers under training procedures with textbooks;
- The BENET training course is an authority for training internet engineers under training procedures with textbooks.

### Capitalized software

The capitalized software of the Company consists of all the Company's software, among which two main ones are the following:

- The usage rights for job seekers is software to help university students to search jobs, post their resumes, and communicate with potential employers;
- The usage right for learners is software to help elementary and secondary students to do assignments, test papers, and get instructions from teachers.

### Intangible assets on acquisitions

In March 2011, the Company acquired a 60% controlling interest in Tianlang for a purchase price of RMB 35 million (approximately \$5.3 million). The school had insignificant tangible assets or liabilities at the acquisition date. The entire estimated fair value of approximately \$8.9 million has been allocated to the net identifiable assets of Tianlang; the intangible assets recorded are all subject to amortization.

In May 2011, the Company acquired a 100% ownership in Changchun Nuoya and Harbin Nuoya. The aggregate purchase price for the two schools was RMB 16 million (approximately \$2.5 million). The schools had insignificant tangible assets or liabilities at the acquisition date. The entire estimated fair value of approximately \$2.5 million has been allocated to the net identifiable assets of Changchun Nuoya and Harbin Nuoya; the intangible assets recorded are all subject to amortization.

The Company did not foresee that the investment cost in Harbin Nuoya is recoverable in the near future, and concluded for the group reporting that certain triggering events had occurred which could result in it being more likely than not that the fair value of each reporting unit would be less than its carrying value. As a result, the Company conducted the impairment test for intangible assets which resulted in impairments for the three and nine months ended September 30, 2013 of \$0 and \$606,032, respectively, for Harbin Nuoya.

Intangibles and capitalized software consist of the following:

|  | September 30, 2013<br>(Unaudited) | December 31, 2012 |
|--|-----------------------------------|-------------------|
| ACCP training course                     | \$ 820,900                        | \$ 799,859        |
| BENET training course                    | 57,496                            | 56,023            |
| Usage rights- Job Seekers                | 488,631                           | 476,107           |
| Usage rights- Learners                   | 325,754                           | 317,405           |
| Others                                   | 2,508,635                         | 2,470,238         |
| Domain names                             | 9,642,721                         | 9,446,515         |
| Course materials                         | 545,635                           | 534,040           |
| Student list                             | 806,781                           | 790,083           |
| Teacher list                             | 1,062,825                         | 1,041,949         |
|  | 16,259,378                        | 15,932,219        |
| Less: Impairments                        | (1,986,433                        | ) (1,447,703      |
| Less: accumulated amortization           | (6,642,810                        | ) (5,271,001      |
| Intangible and Capitalized Software, net | \$ 7,630,135                      | \$ 9,213,515      |

For the three and nine months ended September 30, 2013 and 2012, amortization expenses were \$400,924 and \$418,746, \$1,220,952 and \$1,411,821, respectively.

For the three and nine months ended September 30, 2013 and 2012, impairment loss was \$0 and \$0, \$606,032 and \$1,446,003, respectively.

Amortization of intangibles and capitalized software over the next five years is as follows:

|                           |             |
|---------------------------|-------------|
| Years ending December 31, |             |
| 2013                      | \$402,339   |
| 2014                      | 1,146,662   |
| 2015                      | 956,346     |
| 2016                      | 860,836     |
| 2017                      | 765,522     |
|                           | \$4,131,705 |

### 9. Accounts payable and accrued expenses

Accounts payable and accrued expenses consist of the following:

|                  | September 30, 2013<br>(Unaudited) | December 31, 2012 |
|------------------|-----------------------------------|-------------------|
| Accounts payable | \$ -                              | \$ 3,968          |
| Accrued payroll  | 109,758                           | 195,880           |
| Accrued expenses | 23,170                            | 148,561           |
| Other payables   | 110,445                           | 72,025            |
|                  | \$ 243,373                        | \$ 420,434        |

### 10. Deferred revenue

Deferred revenues include subscriber prepayments and education fee prepayments. Subscriber prepayments represent deferred revenue for the purchase of debit cards used to pay for the online downloading of education materials. The Company recognizes revenue when the card is used to download material. During the period between the purchase and use of debit cards, the unused portion of the debit card is treated as deferred revenue to the Company. Education fee prepayments represent payments for tuition for the Company's training schools, which are amortized over the term of the course. As of September 30, 2013 and December 31, 2012, the Company had deferred revenue of \$1,438,283

and \$1,332,620, respectively.

## 11. Stockholders' Equity

The Company had no significant equity transactions during the quarter ended September 30, 2013.

## 12. Warrants and options

### Stock Options

During the three and nine months ended September 30, 2013 and 2012, the Company did not issue any stock options. The total stock based compensation was \$0 and \$595, \$794 and \$4,514 respectively, related to the vesting of previously granted options.

The Company measures the fair value of options at the end of each reporting period until options are exercised, cancelled or expire unexercised. As of September 30, 2013, there were options to acquire 52,667 shares of common stock with a weighted average exercise price of \$2.67 and a weighted average remaining life of 0.60 years, which remain outstanding and continue to be remeasured at the intrinsic value over their remaining vesting period of 0.60 years. Compensation expense in any given period is calculated as the difference between total earned compensation at the end of the period, less total earned compensation at the beginning of the period. Compensation earned is calculated on a straight line basis over the requisite service period for any given option award. As of September 30, 2013, there was no unrecognized compensation expense related to stock options. The intrinsic value for exercisable options as of September 30, 2013 is \$0 because the market price is lower than exercise price.

Stock option activity for the three months ended September 30, 2013 is summarized as follows:

|   | Shares<br>underlying<br>options | Weighted<br>average<br>exercise<br>price |
|---|---------------------------------|--|
| Outstanding as of December 31, 2012             | 52,667                          | \$ 2.67                                  |
| Granted   | -                               | -  |
| Exercised                                       | -                               | -  |
| Expired / cancelled / forfeited                 | -                               | -  |
| Outstanding as of September 30, 2013            | 52,667                          | \$ 2.67                                  |
| Exercisable and vested as of September 30, 2013 | 52,667                          | \$ 2.67                                  |

The following table summarizes the Company's stock options outstanding at September 30, 2013.

| Weighted average exercise price | Outstanding<br>September 30, 2013 | Weighted average<br>remaining life in years | Number<br>exercisable |
|---------------------------------|-----------------------------------|---|-----------------------|
| \$ 2.67                         | 52,667                            | 0.60  | 52,667                |
|                                 | 52,667                            |   | 52,667                |

**13.**

**Earnings per share**

Per GAAP the Company reconciles the numerator and denominator of the basic and diluted earnings per share (EPS) computations.

For the three and nine months ended September 30, 2013 and 2012, dilutive shares include shares attributable to exercisable options only if such inclusion would be dilutive.



The following reconciles the components of the EPS computation:

|   | Nine months ended<br>September 30, |                 |
|---|------------------------------------|-----------------|
|   | 2013                               | 2012            |
|   | (Unaudited)                        | (Unaudited)     |
| Net loss to common shareholders               | \$ (15,289,736)                    | \$ (10,666,579) |
| Weighted average shares outstanding - basic   | 10,582,530                         | 10,582,530      |
| Weighted average shares outstanding - diluted | 10,582,530                         | 10,582,530      |
| Loss per share – basic and diluted            | \$ (1.44 )                         | \$ (1.01 )      |

|   | Three Months Ended<br><b>September 30,</b> |                 |
|---|--|-----------------|
|   | 2013                                       | 2012            |
|   | (Unaudited)                                | (Unaudited)     |
| Net loss to common shareholders               | \$ (7,846,869 )                            | \$ (6,572,685 ) |
| Weighted average shares outstanding - basic   | 10,582,530                                 | 10,582,530      |
| Weighted average shares outstanding - diluted | 10,582,530                                 | 10,582,530      |
| Loss per share – basic and diluted            | \$ (0.74 )                                 | \$ (0.62 )      |

During the three and nine months ended September 30, 2013 and 2012, options to purchase 52,667 and 52,667 shares of common stock with exercise prices greater than the average fair market value of the Company's stock were not included in the calculation because the effect is anti-dilutive.

#### 14. Commitments and contingencies

##### *Employee Benefits*

The full time employees of subsidiaries based in the PRC are entitled to employee benefits including medical care, welfare subsidies, unemployment insurance and pension benefits through a Chinese government mandated multi-employer defined contribution plan. The Company is required to accrue for those benefits based on certain percentages of the employees' salaries and make contributions to the plans out of the amounts accrued for medical and pension benefits. The total provision and contributions made for such employee benefits for the three and nine months ended September 30, 2013 and 2012 were \$28,431 and \$16,130, \$73,397 and \$52,149, respectively. The Chinese government is responsible for the medical benefits and the pension liability to be paid to these employees.

*Minimum Lease Commitments*

The Company has thirty office leases and training center leases which expire at various dates from October 2013 through June 2018. The Company recorded an aggregate of \$447,687 and \$380,771, \$1,182,387 and \$988,508 as rent expenses for the three and nine months ended September 30, 2013 and 2012, respectively. Rental commitments as of September 30, 2013 are as follows:

|                           |             |
|---------------------------|-------------|
| Years ending December 31, |             |
| 2013                      | \$401,870   |
| 2014                      | 1,166,368   |
| 2015                      | 890,716     |
| 2016                      | 354,838     |
| 2017                      | 102,451     |
|                           | \$2,916,243 |

**15.**

**Operating Risk**

(a)

Country risk

Currently, the Company's revenue is mainly derived from sale of educational products and services in the PRC. The Company hopes to expand its operations in the PRC, however, there are no assurances that the Company will be able to achieve such an expansion successfully. Therefore, a downturn or stagnation in the economic environment of the PRC could have a material adverse effect on the Company's financial condition.

(b)

Products risk

The Company competes with larger companies, who have greater funds available for expansion, marketing, research and development and the ability to attract more qualified personnel. There can be no assurance that the Company will remain competitive with larger competitors.

(c) Exchange rate risk

The Company cannot guarantee that the current exchange rate will remain steady, therefore there is a possibility that the Company could post the same amount of profit for two comparable periods and because of a fluctuating exchange rate actually post higher or lower profit depending on exchange rate of RMB converted to US\$ on that date. The exchange rate could fluctuate depending on changes in the political and economic environments without notice.

(d) Political risk

Currently, the PRC is in a period of growth and is openly promoting business development in order to bring more business into the PRC. Additionally, the PRC allows for certain Chinese corporation to be owned by a United States corporation. If the PRC government changes the laws or regulations, the Company's ability to operate in the PRC could be affected.

(e) Key personnel risk

The Company's future success depends on the continued services of executive management in the PRC. The loss of any of their services would be detrimental to the Company and could have an adverse effect on business development. The Company does not currently maintain key-man insurance on their lives. Future success is also dependent on the ability to identify, hire, train and retain other qualified managerial and other employees. Competition for these individuals is intense and increasing.

(f) Non-compliance with financing requirements

The Company might need to obtain future financing that require timely filing of registration statements, and have declared effective those registration statements, to register the shares being offered by the selling stockholders in future financing. The Company might be subject to liquidated damages and other penalties if they continue to obtain future financing requiring registration statements, and not having those registration statements filed and declared effective in a prompt manner.

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

The following discussion of the results of our operations and financial condition should be read in conjunction with our consolidated financial statements and the related notes thereto, which appear elsewhere in this quarterly report.

Except for the historical information contained herein, the following discussion, as well as other information in this report, contain "forward-looking statements," within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and are subject to the "safe harbor" created by those sections. Forward-looking statements include, but are not limited to, statements that express our intentions, beliefs, expectations, strategies, predictions or any other statements relating to our future activities or other future events or conditions. These statements are based on current expectations, estimates and projections about our business based, in part, on assumptions made by management. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. Therefore, actual outcomes and results may, and are likely to, differ materially from what is expressed or forecasted in the forward-looking statements due to numerous factors, including those discussed from time to time in this report, as well as and any risks described in the "risk factors" section of our filings we make with the SEC. In addition, such statements could be affected by risks and uncertainties related to the ability to conduct business in the People's Republic of China, demand, including demand for our products resulting from change in the educational curriculum or in educational policies, our ability to raise any financing which we may require for our operations, competition, government regulations and requirements, pricing and development difficulties, our ability to make acquisitions and successfully integrate those acquisitions with our business, as well as general industry and market conditions and growth rates, and general economic conditions. Any forward-looking statements speak only as of the date on which they are made, should not be relied upon as representing our views as of any subsequent date and we do not undertake any obligation to update any forward-looking statement to reflect events or circumstances after the date of this report.



Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. On an on-going basis, we evaluate these estimates, including those related to useful lives of property and equipment, bad debts, impairment, net intangibles, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. There can be no assurance that actual results will not differ from those estimates.

## Overview

We are engaged in the business of distribution of educational resources through the Internet. Our website, [www.edu-chn.com](http://www.edu-chn.com), is a comprehensive education network platform which is based on network video technology and large data sources of education resources. We have a database comprising such resources as test papers for secondary education courses as well as video on demand. Our database includes more than 500,000 exams, test papers and courseware for secondary and elementary schools. We generate revenue through our website by selling prepaid debit cards to our subscribers and sales of advertisement on our website.

We also provide on-site teaching and training services and have training facilities in Heilongjiang and Beijing, which can accommodate approximately 8,000 students. The courses cover primarily the compulsory education curriculum of junior, middle and high school. We also provide vocational training services and language training services. We charge tuition fees for these classes and services.

We have also introduced another online service aimed at students who want to attend vocational school. These students include high school students who do not intend to continue their education at universities and university graduates who are looking for employment. The core business for our vocation education will be in three main areas: vocation training, vocational certification, and career development for college graduates. We have collaborated with the National Vocational Education Association of China in setting up [www.360ve.com](http://www.360ve.com), which provides information regarding vocation training schools and vocation training both on-line and on-site at our training centers. We will also be involved in a project called the “Zhong He Win-Win Program”, which is designed to fit the needs of Chinese entrepreneurs and to improve their leadership, management and marketing skills. Our comprehensive business training initiatives integrate research-based, proprietary content with processes that are specifically connected to the critical business issues that most private Chinese companies are facing.

Beginning 2012, we started to design and build a web-based information platform for our online education program - “China Education Cloud Platform” to provide a stable long distance education network including video/audio courses, cloud based network service for teachers, students, and parents and online educational administration services system.

This platform is also intended to serve as a comprehensive cloud based resource/space for educational institutions and individual teachers to store and share resources, market and sell their courses and services among themselves, including course management, video releases, examination system, courseware, study cards management system, etc. We will charge fees for the cloud storage and receive commissions for the courses/services the educational institutions or the teachers sell through our platform. This platform is in the final testing phase. We expect to launch this platform by the end of this year and are currently in discussions with several potential business partners/customers to optimize the functionality of the platform, as well as negotiations with advertisement companies to design a comprehensive marketing campaign to promote this platform.

Our current activities are primarily conducted in the northern part of the PRC. PRC has about 150 million students aged 6 -18, who are the target of our education services. There are about 10 million students in the 6-18 age group in the northeastern provinces of the PRC. Because we serve approximately 500,000 – 600,000 students, only 5% of the students in our primary market, we believe that we have great potential to grow. Our growth will depend on how we penetrate and expand our market. Our expansion may take the form of organic growth and/or acquisitions and the key to our growth will be increased student enrollment.

### **Significant Accounting Estimates and Policies**

The discussion and analysis of our financial condition and results of operations is based upon our financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities. On an on-going basis, we evaluate our estimates including the allowance for doubtful accounts, the salability and recoverability of our products, income taxes and contingencies. We base our estimates on historical experience and on other assumptions that we believe to be reasonable under the circumstances, the results of which form our basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Property and equipment are evaluated for impairment whenever indicators of impairment exist. Accounting standards require that if an impairment indicator is present, we must assess whether the carrying amount of the asset is unrecoverable by estimating the sum of the future cash flows expected to result from the asset, undiscounted and without interest charges. If the recoverable amount is less than the carrying amount, an impairment charge must be recognized based on the fair value of the asset.

Intangible assets and capitalized software, which we acquired from third parties, are amortized over the lives of the rights agreements, which are two to five years. We evaluate the carrying value of the franchise rights during the fourth quarter of each year and between annual evaluations if events occur or circumstances change that would more likely than not reduce the fair value of the intangible asset below its carrying amount.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes. This process involves estimating our current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Our deferred tax assets are from US corporate parent and have been fully reserved. Our US parent provides corporate and administrative functions for the entire consolidated Company. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income, and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent that we establish a valuation allowance or increase this allowance in a period, we must include a tax provision or reduce our tax benefit in the statements of operations. We use our judgment to determine our provision or benefit for income taxes, deferred tax assets and



liabilities and any valuation allowance recorded against our net deferred tax assets. We believe, based on a number of factors including historical operating losses, which we will not realize the future benefits of a significant portion of our net deferred tax assets and we have accordingly provided a full valuation allowance against our deferred tax assets. However, various factors may cause those assumptions to change in the near term.

We cannot predict what future laws and regulations might be passed that could have a material effect on our results of operations. We assess the impact of significant changes in laws and regulations on a regular basis and update the assumptions and estimates used to prepare our financial statements when we deem it necessary.

We have determined the significant principles by consulting accounting policies that involve the most complex and subjective decisions or assessments. Our most significant accounting policies are those related to revenue recognition and deferred revenue.

Revenue is recognized when the following criteria are met: (1) persuasive evidence of an arrangement exists; (2) the service has been rendered; (3) the selling price is fixed or determinable; and (4) collection of the resulting receivable is reasonably assured. We believe that these criteria are satisfied upon customers' download of prepaid study materials. Prepaid debit cards allow our subscribers to purchase a predetermined monetary amount of download materials posted on our website. Prepaid service contracts are amortized to income on a straight-line basis over the length of the service contract. These service contracts allow the user to obtain materials for a designated period of time. At the time that the prepaid debit card is purchased, the receipt of cash is recorded as deferred revenue.

Revenue is recognized in the month when services are actually rendered. Unused value relating to debit cards is recognized as revenue when the prepaid debit card has expired. Revenue from advertising on our website is recognized when the advertisement is run. Since advertising customers are billed monthly, there is no unearned advertising revenue.

The Company engages an advertisement agency to manage its on-line advertisement revenue. Per the contract with this agency, upon posting of an on-line advertisement on the Company's website, the Company is entitled to share with the agency 50% of the amount charged to the on-line advertiser. The Company recognizes revenue upon posting of an advertisement on their web-site. The agency is responsible for collection of all ad revenue from advertisers. The agency is required to make their remittance for on-line advertising within six months after on-line ads are posted on our website.

Prepaid expenses are primarily comprised of advance payments made for services to teachers for on-line materials and video, outdoor advertising and prepaid rent.

Deferred revenue includes subscriber prepayments and education fee prepayments. Subscriber prepayments represents deferred revenue for the purchase of debit cards used to pay for the on-line downloading of education materials, including testing booklets, supplemental materials and teaching video clips. We value the sales based on the actual occurrence of customer download. Therefore, the spare time between the purchase of debit cards and actual download is recorded under advances on accounts as deferred or unearned revenue. Once the download takes place, the amount is then transferred from advances on accounts to sales. Education fee prepayments represent tuition payments and payments for service contracts which are amortized over their respective terms.

We have granted options under the 2011 Incentive Stock Plan to our officers, directors or key employees to purchase 52,667 shares of common stock of the Company. To the extent that we do adopt such plans in the future, such grants will be valued at the grant date and expensed over the applicable vesting period.

## **Recent Accounting Pronouncements**

Management does not believe that any recently issued, but not yet effective, accounting standards or pronouncements, if currently adopted, would have a material effect on the Company's consolidated financial statements.

## Results of Operations

### Comparison of the Three Months Ended September 30, 2013 and 2012

The following table sets forth information from our statements of operations for the quarters ended September 30, 2013 and 2012:

|   | <b>Three months ended September 30,</b> |           |                    |           |
|---|---|-----------|--------------------|-----------|
|   | <b>2013</b>                             |           | <b>2012</b>        |           |
|   | <b>(Unaudited)</b>                      |           | <b>(Unaudited)</b> |           |
| Revenue   | \$ 1,627,485                            | 100.00 %  | \$ 2,067,026       | 100.00 %  |
| Cost of revenue   | 2,023,626                               | 124.34 %  | 2,881,487          | 139.40 %  |
| Gross Profit  | (396,141 )                              | -24.34 %  | (814,461 )         | -39.40 %  |
| Other income  | 44,629                                  | 2.74 %    | 370,663            | 17.93 %   |
| Income(loss) from operations                              | (8,022,829)                             | -492.96%  | (6,993,611)        | -338.34 % |
| Net Income(loss) before provision for income tax          | (7,978,200)                             | -490.22 % | (6,622,948)        | -320.41 % |
| Provision for income taxes                                | -                                       | 0.00 %    | -                  | 0.00 %    |
| Net income (loss) - attributable to CEAI and Subsidiaries | (7,846,869)                             | -482.15 % | (6,572,685)        | -317.98 % |
| Net income (loss)   | (7,978,200)                             | -490.22 % | (6,622,948)        | -320.41 % |

## Revenue

Revenue for the three months ended September 30, 2013 (the “September 30, 2013 Quarter”) decreased by \$439,541, or 21%, to \$1,627,485 from \$2,067,026 for the three months ended September 30, 2012 (the “September 30, 2012 Quarter”).

Revenue from the online education division includes revenue generated from online examination orientated material downloads, tutorial exercise downloads, and advertisement income. Revenue generated by the online education division decreased by \$101,355, or 17%, to \$506,725 for the September 30, 2013 Quarter from \$608,080 for the September 30, 2012 Quarter.

Revenue from the training center division is comprised of tuition from examination-orientated after school training classes, language training classes, vocational training classes etc. Revenue generated by the training center division decreased by \$338,186, or 23% to \$1,120,760 for the September 30, 2013 Quarter from \$1,458,946 for the September 30, 2012 Quarter.

The decline in revenue for the September 30, 2013 Quarter was a result of decline in revenue across all of our business. We believe revenue was affected by external factors including slowdown in economic growth within the PRC, untruthful allegations about our businesses, and increased competition. These factors contributed to the continuous decline in interest of existing and new students, which resulted in decrease in student enrollments and led to a decline in revenue as compared to the September 30, 2012 Quarter. We expect to improve the performance of our online education division in the future by providing students with more competitive, up-to-date study materials and easy access. We have contracted technology companies and hired our own professional IT technicians to design and build a new web-based platform, which aiming to provide the long-distance teaching services encompassing online community system and online teaching management system, etc. Additionally, we have successfully established more than ten new training centers this year in Beijing, and these new centers have started operations during the quarter. We have also established a new strategic business development plan for the next year, with the main target to optimize the operation of existing training centers while seeking good opportunities to expand our market share. As such, we predict that our revenue will gradually recover after we launch the new web-based platform and set up more training centers.

## Cost of Revenue

Our overall cost of revenue decreased by \$857,861 or 30% to \$2,023,626 for the September 30, 2013 Quarter, from \$2,881,487 for the September 30, 2012 Quarter.

Cost of revenue for the online education business comprises cost of obtaining new materials to offer students, depreciation related to computer equipment and software and direct labor cost. Direct labor cost in connection with the maintenance and operation of our websites are fixed costs whereas the costs for purchase of materials and depreciation of equipment and software are variable costs. While the direct labor cost usually stays stable, the costs for purchase of materials and depreciation of equipment and software vary as we purchase new materials, equipment and software. The cost of revenue for the purchase of new materials, equipment and software does not directly correlate with revenue. We constantly have to invest in and update our content to be competitive and current in spite of falling revenue in the online education business.

The cost of revenue for the online education division decreased by \$695,971 or 34% to \$1,356,547 for the September 30, 2013 Quarter, from \$2,052,518 for the September 30, 2012 Quarter primarily in tandem with the decrease in revenue. Considering the revenue for the online education division was not improving and in order to cut down the costs of the online education division, we started to temporarily reduce our expenditure on purchase of new study materials in the second quarter of 2013. As a result, the cost of revenue for the September 30, 2013 Quarter decreased more than the decrease in revenue. To effectively control cost of revenue for the online education division, we will continue to closely monitor the variable costs while maintaining fixed costs at a stable level.

The principal components of cost of revenue at our training centers are rentals, direct labor costs and the depreciation expense. While the rental expenses are fixed and depreciation usually remains stable, the costs for direct labor (i.e. teachers' salary) vary. Cost of revenue for the training center division decreased by \$161,890 or 20% to \$667,079 for the September 30, 2013 Quarter from \$828,969 for the September 30, 2012 Quarter. The decrease in cost of revenue was mainly due to a decrease in teachers' salary as our teachers are paid by the number of classes they teach and there was a decrease in classes we offered during the September 30, 2013 Quarter as compared to the September 30, 2012 Quarter.

### Gross Profit (Loss)

The following table sets forth information as to the gross profit (loss) and gross margin for our two lines of business for the quarters ended September 30, 2013 and 2012:

|                         | <b>Three months ended September 30,</b> |   |                  |   |
|-------------------------|---|---|------------------|---|
|                         | 2013                                    |   | 2012 (Unaudited) |   |
|                         | (Unaudited)                             |   |                  |   |
|                         | \$                                      |   | \$               |   |
| Online Education        |   |   |                  |   |
| Revenue                 | 506,725                                 |   | 608,080          |   |
| Cost of revenue         | 1,356,547                               |   | 2,052,518        |   |
| Gross profit            | -849,822                                |   | -1,444,438       |   |
| Gross margin            | -168                                    | % | -238             | % |
| Training Center Revenue |   |   |                  |   |
| Revenue                 | 1,120,760                               |   | 1,458,946        |   |
| Cost of revenue         | 667,079                                 |   | 828,969          |   |
| Gross profit            | 453,681                                 |   | 629,977          |   |
| Gross margin            | 40                                      | % | 43               | % |

The gross margin for online education division is negative 168% for the September 30, 2013 Quarter as compared with negative 238% for the September 30, 2012 Quarter. This is mainly due to the decrease in depreciation and amortization expenses component in cost of revenue during the period. We expect gross margin for online education division to gradually improve after we introduce the web-based platform to the market.

The gross margin for our training center division decreased to 40% for the September 30, 2013 Quarter from 43% for the September 30, 2012 Quarter because cost of revenue did not decrease as much as revenue. As part of our growth strategy, we plan to expand our onsite training network in Beijing and other major cities in order to increase our brand awareness and reputation. With the launch of our new training centers, we expect gross margin for our training center division to continue to decrease as the newly established centers may not generate sufficient revenue during the early stage.

## **Selling Expenses**

Selling expenses include advertising expense, consulting fees, sales commissions, and other expenses. Selling expenses increased by \$1,086,927 or 42% to \$3,697,071 for the September 30, 2013 Quarter, from \$2,610,144 for the September 30, 2012 Quarter. The increase in selling expenses was mainly due to the increase in advertising and marketing expenses. We incurred advertising and marketing expenses of \$2,832,246, an increase of \$1,963,339 or 69%, due to increased marketing and sales promoting activities to rebuild our brand name and reputation. Such activities include advertising through media, online and onsite promotion, handouts, brochures, etc.

## **Administrative Expenses**

Administrative expenses increased by \$256,814 or 9%, to \$3,089,854 for the September 30, 2013 Quarter, from \$2,833,040 for the September 30, 2012 Quarter. This was mainly due to the increase in research and development expenses relating to the development of the web-based platform, the office expenses, and labor costs throughout the period. In the future we expect the administrative expenses to continue to increase because: 1) we will incur maintenance expenses for the web-based platform after it being successfully launched; 2) we will incur expenses associated with the expansion of our onsite training centers for purposes of gaining more market shares. The office and administrative expenses associated with the newly opened onsite training centers also contributed to the increase in administrative expenses.

## **Other Income (Expense)**

Other income was \$44,629 for the September 30, 2013 Quarter, a decrease of \$326,034, or 88% as compared to \$370,663 for the September 30, 2012 Quarter. The difference was mainly due to the decrease in interest income due to the repayment of the loan by NIT

## **Income Taxes**

The provision for income tax was nil for both the September 30, 2013 Quarter and September 30, 2012 Quarter. In 2013, the applicable income tax rate is 15% for ZHLD, as ZHLD had been approved by the local government as being involved in a high technology industry. Otherwise, the regular PRC statutory tax rate is 25%. ZHTC, Tianlang, Changchun Nuoya, Harbin Nuoya and Beijing Xicheng District Hua Yu Pin Xue Training School are currently exempt from PRC taxation, as they operate as a business enterprise engaged in educational opportunities. The Company's other subsidiaries: BHYHZ, ZHLDBJ, HYPX, ZHLDIT and Beijing Shifanxuezhitang Information



Science Institute are taxed at the PRC regular statutory rate (25%), and have not accrued taxes since inception due to recurring losses or not having generated income since inception.

**Net Income/Loss**

As a result of the foregoing, we had net loss attributable to the Company and its subsidiaries of \$7,846,869, or negative return of \$0.74 per share basic and diluted, for the September 30, 2013 Quarter, as compared to net loss of \$6,572,685 or negative return of \$0.62 per share basic and diluted, for the September 30, 2012 Quarter.

**Comparison of the Nine Months Ended September 30, 2013 and 2012**

The following table sets forth information from our statements of operations for the nine months ended September 30, 2013 and 2012:

|   | <b>Nine Months Ended September 30</b> |           |                    |           |
|---|---------------------------------------|-----------|--------------------|-----------|
|   | <b>2013</b>                           |           | <b>2012</b>        |           |
|   | <b>(Unaudited)</b>                    |           | <b>(Unaudited)</b> |           |
| Revenue   | \$5,980,664                           | 100.00 %  | \$9,947,520        | 100.00 %  |
| Cost of revenue   | 6,074,082                             | 101.56 %  | 7,894,368          | 79.36 %   |
| Gross Profit  | -93,418                               | -1.56 %   | 2,053,152          | 20.64 %   |
| Other income  | (463,948 )                            | -7.76 %   | (133,202 )         | -1.34 %   |
| Income(loss) from operations                              | (15,147,362)                          | -253.27 % | (10,456,587)       | -105.12 % |
| Net Income(loss) before provision for income tax          | (15,611,310)                          | -261.03 % | (10,589,789)       | -106.46 % |
| Provision for income taxes                                | -                                     | 0.00 %    | 319,029            | 3.21 %    |
| Net income (loss) - attributable to CEAI and Subsidiaries | (15,289,736)                          | -255.65 % | (10,666,579)       | -107.23 % |
| Net income (loss)   | (15,611,310)                          | -261.03 % | (10,908,818)       | -109.66 % |

**Revenue**

Revenue for the nine months ended September 30, 2013 decreased by \$3,966,856, or 40%, to \$5,980,664 as compared to \$9,947,520 for the nine months ended September 30, 2012.

Revenue from the online education division decreased by \$2,018,163, or 51%, to \$1,901,324 for the nine months ended September 30, 2013 from \$3,919,487 for the same period in 2012.

Revenue from the training center division decreased by \$1,948,693, or 32%, to \$4,079,340 for the nine months ended September 30, 2013 as compared to \$6,028,033 for the nine months ended September 30, 2012.

The decline in revenue for the nine months ended September 30, 2013 was a result of decline in revenue across all of our business. We believe revenue was affected by external factors including slowdown in the PRC economic growth, untruthful allegations about our businesses, and increased competition. These factors contributed to the continuous decrease in student enrollments and led to the decline in revenue as compared to the same period in 2012.

We expect to improve the performance of our online education division in the future by providing students with more competitive, up-to-date study materials and easy access. We have contracted technology companies and hired our own professional IT technicians to design and build a new web-based platform, which aiming to provide the long-distance teaching services which encompass online community system and online teaching management system, etc. Additionally, we have successfully established more than ten new training centers this year in Beijing. These new centers have started operations during the quarter. We have also established a new strategic business development plan for next year, with the main target to optimize the operation of existing training centers while seeking good opportunities to expand our market share. As such, we predict that our revenue will gradually recover after we launch the new web-based platform and set up more training centers.

### **Cost of revenue**

Our overall cost of revenue decreased by \$1,820,286 or 23% to \$6,074,082 for the nine months ended September 30, 2013 as compared to \$7,894,368 for the nine months ended September 30, 2012.

Cost of revenue for the online education business comprises cost of obtaining new materials to offer students, depreciation related to computer equipment and software and direct labor cost. Direct labor cost in connection with the maintenance and operation of our websites are fixed costs whereas the costs for purchase of materials and depreciation of equipment and software are variable costs. While the direct labor cost usually stays stable, the costs for purchase of materials and depreciation of equipment and software vary as we purchase new materials, equipment and software. We constantly have to invest in and update our content to be competitive and current in spite of falling revenue in the online education business.

The cost of revenue for the online education division decreased by \$1,367,232 or 25% to \$4,120,051 for the nine months ended September 30, 2013 as compared to \$5,487,283 for the nine months ended September 30, 2012 primarily in tandem with the decrease in revenue. However, cost of revenue did not drop in direct proportion with the decline in revenue as we had to purchase new study materials to maintain competitive. We also incurred certain fixed costs to maintain the accuracy and competitiveness of our online materials. To efficiently control cost of revenue for the online education division, we will continue to closely monitor the variable costs while maintaining fixed costs at a stable level.

The principal components of cost of revenue at our training centers are rentals, direct labor costs and the depreciation expense. While the rental expenses are fixed and depreciation usually remains stable, the costs for direct labor (i.e. teachers' salary) vary. Cost of revenue for the training center division decreased by \$453,054 or 19% to \$1,954,031 for the nine months ended September 30, 2013 as compared to \$2,407,085 for the nine months ended September 30, 2012. As the rental expenses and depreciation remained stable, decrease in cost of revenue was mainly attributable to decrease in teachers' salary as our teachers are paid by the number of classes they teach and there was a decrease in classes we offered in the nine months ended September 30, 2013 as compared to the nine months ended September 30, 2012.

The following table sets forth information as to the gross margin for our two lines of business for the nine months ended September 30, 2013 and 2012:

|                  | <b>Nine Months Ended</b> |                    |
|------------------|--------------------------|--------------------|
|                  | <b>September 30</b>      |                    |
|                  | 2013                     | 2012               |
|                  | <b>(Unaudited)</b>       | <b>(Unaudited)</b> |
| Online Education | \$                       | \$                 |
| Revenue          | 1,901,324                | 3,919,487          |
| Cost of revenue  | 4,120,051                | 5,487,283          |
| Gross profit     | -2,218,727               | -1,567,796         |
| Gross margin     | -117                     | -40                |
|                  | %                        | %                  |

Training Center Revenue

|                 |           |   |           |   |
|-----------------|-----------|---|-----------|---|
| Revenue         | 4,079,340 |   | 6,028,033 |   |
| Cost of revenue | 1,954,031 |   | 2,407,085 |   |
| Gross profit    | 2,125,309 |   | 3,620,948 |   |
| Gross margin    | 52        | % | 60        | % |

The gross margin of the online education division decreased to negative 117% for the nine months ended September 30, 2013, from negative 40% for the nine months ended September 30, 2012 due to the significant decrease in online education revenue and the relatively moderate decrease in cost of revenue. We expect gross margin for online education division to gradually improve after we introduce the new web-based platform.

The gross margin of the training center division decreased to 52% for the nine months ended September 30, 2013 from 60% for the nine months ended September 30, 2012. The decrease was mainly due to the significant decrease in training center revenue and the relatively slight decrease in cost of revenue. Together with our new training centers, we expect gross margin for our training center division to continue to decrease as the newly established centers may not generate sufficient revenue during the early stage.

### **Selling Expenses**

Selling expenses include advertising and marketing expenses, consulting fees and sales commissions. Selling expenses increased by \$1,144,680 or 23% to \$6,033,210 for the nine months ended September 30, 2013 from \$4,888,530 for the nine months ended September 30, 2012. The increase in selling expenses was mainly due to the increase in advertising and marketing expenses associated with promotion of our onsite training centers opened throughout the period. We incurred advertising and marketing expenses of \$3,748,182, an increase of \$2,726,291 or 73%, due to increased marketing and sales promoting activities, such as advertising through media, online and onsite promotion, handouts, brochures, etc.

### **Administrative expenses**

Administrative expenses increased by \$1,361,099 or 26%, to \$6,586,752 for the nine months ended September 30, 2013 as compared to \$5,225,653 for the nine months ended September 30, 2012. This increase was mainly due to the increase of approximately \$1 million in research and development expenses relating to the development of the web-based platform.

### **Other Income (Expense)**

Other expense was \$463,948 for the nine months ended September 30, 2013, an increase of \$330,746, or 248% as compared to \$133,202 for the nine months ended September 30, 2012. The difference was mainly due to the decrease in interest income due to the repayment of the loan to NIT and the impairment loss on certain intangible assets.

## **Income Taxes**

The provision for income tax is nil for the nine months ended September 30, 2013, as compared to the deferred tax benefits of \$319,029 for the nine months ended September 30, 2012. In 2013, the applicable income tax rate is 15% for ZHLD, as ZHLD had been approved by the local government as being involved in a high technology industry. Otherwise, the regular PRC statutory tax rate is 25%. ZHTC, Tianlang, Changchun Nuoya, Harbin Nuoya and Beijing Xicheng District Hua Yu Pin Xue Training School are currently exempt from PRC taxation, as they operate as a business enterprise engaged in educational opportunities. The Company's other subsidiaries: BHYHZ, ZHLDBJ, HYPX, ZHLDIT and Beijing Shifanxuezhitang Information Science Institute are taxed at the PRC regular statutory rate (25%), and have not accrued taxes since inception due to recurring losses or not having generated income since inception.

## **Net Income/Loss**

As a result of the foregoing, the Company had a net loss attributable to the Company and its subsidiaries of \$15,289,736, or negative return of \$1.44 per share basic and diluted, for the nine months ended September 30, 2013, as compared to net loss of \$10,666,579, or negative return of \$1.01 per share, basic and diluted, for the nine months ended September 30, 2012.

## **Liquidity and Capital Resources**

Our current assets primarily consist of cash, prepaid expenses, and other receivable. We do not have inventory. Because students who purchase our on-line programs purchase debit cards for the programs that they use and students who enroll in our training classes pay their tuition before starting classes, we do not have accounts receivable except some accounts receivable from our advertising business on our website. Our prepaid expenses are primarily advance payments made to teachers for on-line materials, prepaid advertisement expense, prepaid rent, and other prepayments.

As of September 30, 2013, we had working capital of \$61,508,891, a decrease of \$2,232,485, or 4% from working capital of \$63,741,376 as at December 31, 2012 due to loss generated from business. However, we still consider current working capital and borrowing capabilities adequate to cover our planned operating and capital requirements.

At September 30, 2013, we had cash and cash equivalents of \$62,251,843, a decrease of \$1,921,074 or 3%, from \$64,172,917 at December 31, 2012.

## **Cash Flow in Operating Activities**

Our net cash used in operating activities was \$10,173,757 for the nine months ended September 30, 2013, an increase of \$3,574,853 or 54% from \$6,598,904 for the nine months ended September 30, 2012. This increase was due to the increase in net loss from \$10,908,818 for the nine months ended September 30, 2012 to net loss of \$15,611,310 for the nine months ended September 30, 2013.

## **Cash Flow in Investing Activities**

Our cash provided by investing activities was \$7,078,185 for the nine months ended September 30, 2013, an increase of \$8,479,072 from cash of \$1,400,877 used in investing activities for the nine months ended September 30, 2012. The increase primarily resulted from the repayment of a loan from NIT, which resulted in cash inflow of approximately \$8,047,383.

## **Cash Flow in Financing Activities**



Our cash used in financing activities was \$354,085 for the nine months ended September 30, 2013, as compared to \$58,611 for the nine months ended September 30, 2012. Cash used in financing activities primarily consisted of dividends paid to noncontrolling stockholders offset by advance made by our officer, director and shareholder for general corporate expenses which will be subsequently reimbursed.

We believe that our working capital will be sufficient to enable us to meet our cash requirements for the next 12 months. However, we may incur additional expenses as we seek to expand our business to offer services in other parts of the PRC as well as to market and continue the development of our vocational training activities. We believe we have adequate working capital to fund future growth activities. Although we do not have any current plans to make any further acquisitions, it is possible that we may seek to acquire one or more businesses in the education field, and we may require financing for that purpose. We cannot assure you that funding will be available if and when we require funding.

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

As of September 30, 2013, we had no off-balance sheet arrangements.

### **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 Xiqun Yu, the Company's chief executive officer, and Cloris Li, the Company's chief financial officer, of the effectiveness of the Company's disclosure controls and procedures (as defined under Rule 13a-15(e) under the Exchange Act) as of the quarter ended September 30, 2013. Based upon that evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures were effective.

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

We regularly review our system of internal control over financial reporting and make changes to our processes and systems to improve controls and increase efficiency, while ensuring that we maintain an effective internal control environment. Changes may include such activities as implementing new, more efficient systems, consolidating activities, and migrating processes.

There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II - OTHER INFORMATION**

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

On June 26, 2013, the Company served Sherb & Co. LLP (“Sherb”), its former auditor, with process in the matter captioned, China Education Alliance, Inc. v. Sherb & Co., LLP, Case # 1:13-cv-4381-RA, which is pending before the United States District Court for the Southern District of New York (the “District Court Action”). In this action, the Company alleged causes of action for: breach of contract, breach of contract implied in fact, professional negligence, negligent misrepresentation, and unjust enrichment due to Sherb’s failure to perform accounting and auditing services in compliance with PCAOB standards. The Company seeks at least \$500,000 in damages, as well as interest, attorney’s fees, costs, and expenses and disbursements incurred in bringing this action. Sherb was required to respond to these allegations on or before August 15, 2013.

On August 15, 2013, Sherb filed a motion to compel arbitration, arguing that the matter should be arbitrated in accordance with the “Dispute Resolution Procedure” contained within the engagement letters executed by the parties. After reviewing the “Dispute Resolution Procedure” contained within each of the parties engagement letters, which contained an arbitration clause, we agreed that the proper forum for the matter was arbitration before the American Arbitration Association (“AAA”). Therefore, on August 28, 2013, the parties executed a Stipulation of Dismissal (without prejudice), dismissing the District Court Action. In addition, the parties agreed to try and mediate the matter before submitting the case to arbitration before the AAA. The mediation is scheduled to take place in December 2013, and if the mediation proves unsuccessful, the Company intends to file a suit against Sherb before the AAA and seek the same claims and damages as alleged in the prior District Court Action.

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

Not applicable.

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

None.

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

None.

#### **Item 4. Mine Safety Disclosures.**

Not applicable.

29

**Item 5. Other Information.**

Not applicable.

**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   |
|-------------|---|
| 3.1         | Articles of Incorporation filed December 2, 1996 in the State of North Carolina are incorporated herein by reference to Exhibit 3.1 to the Form SB-2 Registration Statement of China Education Alliance, Inc. (File No. 333-101167) filed on November 13, 2002.   |
| 3.2         | Articles of Amendment Business Corporation dated May 23, 2002 are incorporated herein by reference to Exhibit 3.2 to the Form SB-2 Registration Statement of China Education Alliance, Inc. (File No. 333-101167) filed on November 13, 2002.   |
| 3.3         | Articles of Amendment Business Corporation filed November 17, 2004, changing the name of the Company from ABC Realty Co. to China Education Alliance, Inc. is incorporated herein by reference to Exhibit 3.3 filed with the Company's Form 10-KSB annual report for its fiscal year ended December 31, 2005.   |
| 3.4         | Articles of Share Exchange of China Education Alliance, Inc. filed with the Department of The Secretary of State of the State of North Carolina on December 30, 2004 are incorporated herein by reference to Exhibit 3.1 filed with China Education Alliance, Inc.'s Form 10-QSB quarterly report for its quarter ended September 30, 2007 filed with the SEC on November 14, 2007. |
| 3.5         | Articles of Amendment to Articles of Incorporation filed with the Department of The Secretary of State of the State of North Carolina on October 4, 2007 are incorporated herein by reference to Exhibit 3.2 filed with China Education Alliance, Inc.'s Form 10-QSB quarterly report for its quarter ended September 30, 2007 filed with the SEC on November 14, 2007.             |
| 3.6         | Articles of Amendment to Articles of Incorporation filed with the Department of The Secretary of State of the State of North Carolina on September 26, 2011 is incorporated herein by reference to Exhibit 3.6 to the Form 10-K filed with the SEC on April 16, 2012.   |
| 3.7         | By Laws of China Education Alliance, Inc. are incorporated herein by reference to Exhibit 3.3 to the Form SB-2/A Registration Statement of China Education Alliance, Inc. filed on February 7, 2003 (File No. 333-101167).  |

- 4.1 China Education Alliance, Inc. 2009 Stock Incentive Plan is incorporated herein by reference to Exhibit 4.1 to the Post-Effective Amendment to Registration Statement on Form S-8 filed with the SEC on June 19, 2009.
- 4.2 China Education Alliance, Inc. 2011 Stock Incentive Plan is incorporated herein by reference to Exhibit 4.1 to Form S-8 filed with the SEC on July 1, 2011.
- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 32.1 Certification of the Principal Executive Officer pursuant to U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*\*
- 32.2 Certification of the Principal Financial Officer pursuant to U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*\*

30

101.INS XBRL Instance Document\*  
101.SCH XBRL Taxonomy Extension Schema Document\*  
101.CAL XBRL Taxonomy Calculation Linkbase Document\*  
101.DEF XBRL Taxonomy Extension Definition Linkbase Document\*  
101.LAB XBRL Taxonomy Label Linkbase Document\*  
101.PRE XBRL Taxonomy Presentation Linkbase Document\*

\*Filed herewith.

\*\*Furnished herewith.

**SIGNATURES**

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

**CHINA EDUCATION ALLIANCE,  
INC.**

Date: November 14, 2013 By: */s/ Xiqun Yu*  
Xiqun Yu  
Chief Executive Officer and Chairman  
(Principal Executive Officer)

Date: November 14, 2013 By: */s/ Cloris Li*  
Cloris Li  
Chief Financial Officer  
(Principal Financial Officer)