ION GEOPHYSICAL CORP
Form 10-Q
November 06, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2014
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
COMMISSION FILE NUMBER: 1-12691
ION GEOPHYSICAL CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| DELAWARE | 22-2286646 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 2105 CityWest Blvd. Suite 400 Houston, Texas | 77042-2839 |
| (Address of principal executive offices) | (Zip Code) |

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (281) 933-3339

Indicate by check mark whether the registrant (1) has filed all 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 ý 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý 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. (Check one):

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No ý
At October 24, 2014, there were 164,203,639 shares of common stock, par value $0.01 per share, outstanding.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2014

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| | September 30, 2014 | December 31, 2013 |
|---|---|---|
| | ( In thousands, except share data) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 129,847 | $ 148,056 |
| Accounts receivable, net | 86,738 | 149,448 |
| Unbilled receivables | 57,477 | 49,468 |
| Inventories | 55,376 | 57,173 |
| Prepaid expenses and other current assets | 26,453 | 24,772 |
| Total current assets | 355,891 | 428,917 |
| Deferred income tax asset | 14,340 | 14,650 |
| Property, plant, equipment and seismic rental equipment, net | 60,365 | 46,684 |
| Multi-client data library, net | 243,917 | 238,784 |
| Equity method investments | 40,174 | 53,865 |
| Goodwill | 50,385 | 55,876 |
| Intangible assets, net | 9,191 | 11,247 |
| Other assets | 19,482 | 14,648 |
| Total assets | $ 793,745 | $ 864,671 |
| LIABILITIES AND EQUITY | | |
| Current liabilities: | | |
| Current maturities of long-term debt | $ 5,901 | $ 5,906 |
| Accounts payable | 30,666 | 22,654 |
| Accrued expenses | 75,608 | 84,358 |
| Accrued multi-client data library royalties | 24,416 | 46,460 |
| Deferred revenue | 16,495 | 20,682 |
| Total current liabilities | 153,086 | 180,060 |
| Long-term debt, net of current maturities | 179,583 | 214,246 |
| Other long-term liabilities | 142,776 | 210,602 |
| Total liabilities | 475,445 | 604,908 |
| Redeemable noncontrolling interests | 2,086 | 1,878 |
| Equity: | | |
| Common stock, $0.01 par value; authorized 200,000,000 shares; outstanding 164,203,639 and 163,737,757 shares at September 30, 2014 and December 31, 2013, respectively, net of treasury stock | 1,642 | 1,637 |
| Additional paid-in capital | 886,170 | 879,969 |
| Accumulated deficit | (553,531) | (606,157) |
| Accumulated other comprehensive loss | (11,720) | (11,138) |
| Treasury stock, at cost, 849,539 shares at both September 30, 2014 and December 31, 2013 | (6,565) | (6,565) |
| Total stockholders’ equity | 315,996 | 257,746 |
| Noncontrolling interests | 218 | 139 |
| Total equity | 316,214 | 257,885 |

| | | |
|---|---|---|
| Total liabilities and equity | $ 793,745 | $ 864,671 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands, except per share data) | | | |
| Service revenues | $71,923 | $44,679 | $272,386 | $224,231 |
| Product revenues | 34,617 | 35,159 | 100,332 | 106,259 |
| Total net revenues | 106,540 | 79,838 | 372,718 | 330,490 |
| Cost of services | 60,285 | 52,256 | 200,697 | 188,494 |
| Cost of products | 17,032 | 42,686 | 47,716 | 85,525 |
| Gross profit (loss) | 29,223 | (15,104) | 124,305 | 56,471 |
| Operating expenses: | | | | |
| Research, development and engineering | 10,910 | 10,288 | 30,254 | 28,665 |
| Marketing and sales | 8,480 | 8,416 | 27,610 | 25,364 |
| General, administrative and other operating expenses | 15,182 | 22,720 | 48,334 | 50,277 |
| Total operating expenses | 34,572 | 41,424 | 106,198 | 104,306 |
| Income (loss) from operations | (5,349) | (56,528) | 18,107 | (47,835) |
| Interest expense, net | (5,048) | (4,281) | (14,779) | (8,103) |
| Equity in losses of investments | (5,558) | (5,192) | (9,027) | (10,414) |
| Other income (expense), net | (622) | (74,301) | 73,970 | (180,392) |
| Income (loss) before income taxes | (16,577) | (140,302) | 68,271 | (246,744) |
| Income tax expense | 8,345 | 56,954 | 14,261 | 19,450 |
| Net income (loss) | (24,922) | (197,256) | 54,010 | (266,194) |
| Net (income) loss attributable to noncontrolling interests | 381 | 498 | (1,384) | 515 |
| Net income (loss) attributable to ION | (24,541) | (196,758) | 52,626 | (265,679) |
| Preferred stock dividends | — | 338 | — | 1,014 |
| Conversion payment of preferred stock | — | 5,000 | — | 5,000 |
| Net income (loss) applicable to common shares | $(24,541) | $(202,096) | $52,626 | $(271,693) |
| Net income (loss) per share: | | | | |
| Basic | $(0.15) | $(1.29) | $0.32 | $(1.73) |
| Diluted | $(0.15) | $(1.29) | $0.32 | $(1.73) |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 164,149 | 157,143 | 164,021 | 156,842 |
| Diluted | 164,149 | 157,143 | 164,326 | 156,842 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| | (In thousands) | | | |
| Net income (loss) | $(24,922) | $(197,256) | $54,010 | $(266,194) |
| Other comprehensive income (loss), net of taxes, as appropriate: | | | | |
| Foreign currency translation adjustments | (2,632) | 2,513 | 489 | (530) |
| Equity interest in investees' other comprehensive income (loss) | 738 | (716) | (1,125) | (1,265) |
| Other changes in other comprehensive income | 28 | 27 | 54 | 381 |
| Total other comprehensive income (loss), net of taxes | (1,866) | 1,824 | (582) | (1,414) |
| Comprehensive net income (loss) | (26,788) | (195,432) | 53,428 | (267,608) |
| Comprehensive (income) loss attributable to noncontrolling interest | 381 | 498 | (1,384) | 515 |
| Comprehensive net income (loss) attributable to ION | $(26,407) | $(194,934) | $52,044 | $(267,093) |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| | (In thousands) | |
| Cash flows from operating activities: | | |
| Net income (loss) | $54,010 | $(266,194) |
| Adjustments to reconcile net income (loss) to cash provided by operating activities: | | |
| Depreciation and amortization (other than multi-client data library) | 20,989 | 13,146 |
| Amortization of multi-client data library | 46,014 | 50,892 |
| Stock-based compensation expense | 7,058 | 5,707 |
| Equity in losses of investments | 9,027 | 10,414 |
| Accrual for (reduction of) loss contingency related to legal proceedings | (69,557) | 181,776 |
| Gain on sale of Source product line | (6,522) | — |
| Gain on sale of cost-method investment | — | (3,591) |
| Write-down of multi-client data library | — | 5,461 |
| Write-down of receivables from OceanGeo | — | 9,157 |
| Write-down of excess and obsolete inventory | — | 21,197 |
| Deferred income taxes | (1,536) | 7,768 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 71,540 | 57,481 |
| Unbilled receivables | (8,036) | 6,890 |
| Inventories | (4,272) | (13,157) |
| Accounts payable, accrued expenses and accrued royalties | (31,324) | (6,179) |
| Deferred revenue | (4,153) | (6,527) |
| Other assets and liabilities | 3,738 | 4,274 |
| Net cash provided by operating activities | 86,976 | 78,515 |
| Cash flows from investing activities: | | |
| Cash invested in multi-client data library | (57,340) | (86,346) |
| Purchase of property, plant, equipment and seismic rental assets | (6,842) | (13,539) |
| Repayment of (advances to) INOVA Geophysical | 1,000 | (8,000) |
| Investment in and advances to OceanGeo B.V. | (3,683) | (9,500) |
| Cash of OceanGeo B.V. upon acquiring a controlling interest | 609 | — |
| Net proceeds from sale of Source product line | 14,394 | — |
| Proceeds from sale of a cost-method investment | — | 4,150 |
| Investment in convertible note | — | (2,000) |
| Other investing activities | 928 | 76 |
| Net cash used in investing activities | (50,934) | (115,159) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of notes | — | 175,000 |
| Borrowings under revolving line of credit | 15,000 | — |
| Payments under revolving line of credit | (50,000) | (97,250) |
| Payments on notes payable and long-term debt | (11,737) | (3,296) |
| Costs associated with issuance of debt | (2,126) | (6,731) |
| Acquisition of non-controlling interest | (6,000) | — |
| Payment of preferred dividends | — | (1,014) |
| Conversion payment of preferred stock | — | (5,000) |

| | | |
|---|---|---|
| Proceeds from employee stock purchases and exercise of stock options | 577 | 2,367 |
| Other financing activities | (154) | 790 |
| Net cash (used in) provided by financing activities | (54,440) | 64,866 |
| Effect of change in foreign currency exchange rates on cash and cash equivalents | 189 | (608) |
| Net (decrease) increase in cash and cash equivalents | (18,209) | 27,614 |
| Cash and cash equivalents at beginning of period | 148,056 | 60,971 |
| Cash and cash equivalents at end of period | $129,847 | $88,585 |

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

ION GEOPHYSICAL CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed consolidated balance sheet of ION Geophysical Corporation and its subsidiaries (collectively referred to as the “Company” or “ION,” unless the context otherwise requires) at December 31, 2013 has been derived from the Company’s audited consolidated financial statements at that date. The condensed consolidated balance sheet at September 30, 2014, and the condensed consolidated statements of operations and comprehensive income (loss) for the three and nine months ended September 30, 2014 and 2013 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2014 and 2013, are unaudited. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the operating results for a full year or of future operations.

These condensed consolidated financial statements have been prepared using accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the Securities and Exchange Commission (the “SEC”). Certain information and footnote disclosures normally included in annual financial statements presented in accordance with accounting principles generally accepted in the United States have been omitted. The accompanying condensed consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2013 and Amendment No. 1 thereto on Form 10-K/A, which was filed on March 28, 2014 and contains the separate consolidated financial statements of INOVA Geophysical Equipment Limited (“INOVA Geophysical”) for its fiscal year ended December 31, 2013.

(2) Acquisition of OceanGeo

In February 2013, the Company acquired 30% of OceanGeo B.V. (“OceanGeo”). OceanGeo specializes in seismic acquisition operations using ocean bottom cables deployed from vessels leased by OceanGeo. In October 2013, the Company reached agreement with its joint venture partner in OceanGeo, Georadar Levantamentos Geofisicos S/A (“Georadar”), for the Company to have the option to increase its ownership percentage in OceanGeo from 30% to 70%, subject to certain conditions.

To further assist OceanGeo in acquiring backlog, in October 2013, the Company also agreed to loan OceanGeo additional funds for working capital, as necessary, up to a maximum of $25.0 million. Prior to obtaining a controlling interest in OceanGeo, the Company advanced a total of $18.9 million to OceanGeo.

In January 2014, the Company acquired an additional 40% interest in OceanGeo, through the conversion of certain outstanding amounts loaned to OceanGeo by the Company into additional equity interests of OceanGeo, bringing the Company’s total equity interest in OceanGeo to 70% and giving the Company control over OceanGeo. The Company has included in its results of operations, the results of OceanGeo from the date of the Company’s acquisition of a controlling interest.

In July 2014, the Company paid $6.0 million to Georadar for the remaining 30% of OceanGeo, increasing its equity interest in OceanGeo to 100%. In addition to the $6.0 million cash purchase price, the Company agreed to pay Georadar up to an additional $5.0 million, contingent upon the occurrence of certain future events, including the award of a future material project in 2014 and a minimal amount of vessel downtime. The Company does not believe that it will have to pay the contingent amount and, therefore, has not accrued this amount as of September 30, 2014. Since the initial investment in early 2013, the Company has invested or contributed assets totaling approximately $46.5 million to OceanGeo.

The Company acquired OceanGeo as part of its strategy to expand the range of service offerings it can provide to oil and gas exploration and production customers and to put its Calypso® seabed acquisition technology to work in a service model to meet the growing demand for seabed seismic services.

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The acquisition of OceanGeo was accounted for by the acquisition method, whereby the assets acquired and liabilities assumed were recorded at their fair values as of the acquisition date based on an income approach. The estimated fair value of the assets acquired and liabilities assumed approximated the purchase price and therefore no goodwill or bargain purchase was recognized. During the three months ended September 30, 2014, management adjusted its purchase accounting valuation estimates and, as a result, retrospectively adjusted the valuations of assets with a corresponding increase to property, plant, and equipment as of the acquisition date. The retrospective adjustments amounted to approximately $3.9 million and primarily related to revisions of estimates of recoverability of the multi-client data library. In connection with the acquisition, the Company incurred $1.3 million in acquisition-related transaction costs related to professional services and fees. These costs were expensed as incurred and were included in other income (expense), net in the Company's condensed consolidated statement of operations for the nine months ended September 30, 2014. As a result of consolidating OceanGeo's results into the Company's consolidated results of operations for the period from the acquisition date at the end of January 2014 to September 30, 2014, the Company's results of operations include $25.0 million of OceanGeo revenues and $1.7 million of income from OceanGeo's operations for the three months ended September 30, 2014, and $71.5 million of OceanGeo revenues and $12.3 million of income from OceanGeo's operations for the nine months ended September 30, 2014. The following table summarizes the fair value assigned to the assets acquired and liabilities assumed, as well as the noncontrolling interest, at the acquisition date (in thousands):

| Estimated Fair Value of Assets Acquired and Liabilities Assumed: | |
|---|---|
| Cash and cash equivalents | $609 |
| Accounts receivable | 9,247 |
| Prepaid expenses and other current assets | 1,433 |
| Property, plant, equipment and seismic rental equipment, net | 18,474 |
| Other assets | 2,227 |
| Total identifiable assets | 31,990 |
| Accounts payable and accrued liabilities | (13,464) |
| Bank loans | (6,135) |
| Other liabilities | (1,026) |
| Net assets | 11,365 |
| Noncontrolling interest | (3,410) |
| Total consideration | $7,955 |

The following summarized unaudited pro forma consolidated income statement information for the nine months ended September 30, 2014 and 2013 and for the three months ended September 30, 2013, assumes that the OceanGeo acquisition had occurred as of the beginning of the periods presented. The Company has prepared these unaudited pro forma financial results for comparative purposes only. These unaudited pro forma financial results may not be indicative of the results that would have occurred if ION had completed the acquisition as of the beginning of the periods presented or the results that may be attained in the future. Amounts presented below are in thousands, except for the per share amounts:

| Pro forma Consolidated ION Income Statement Information | Three Months Ended September 30, 2013 | Nine Months Ended September 30, 2014 | Nine Months Ended September 30, 2013 |
|---|---|---|---|
| Net revenues | $79,838 | $381,902 | $362,157 |
| Income (loss) from operations | $(72,757) | $22,492 | $(66,997) |
| Net income (loss) | $(214,305) | $55,838 | $(277,612) |
| Net income (loss) attributable to ION | $(213,807) | $53,684 | $(277,097) |
| Basic net income (loss) per common share | $(1.40) | $0.33 | $(1.81) |
| Diluted net income (loss) per common share | $(1.40) | $0.33 | $(1.81) |

(3) Segment Information

The Company operates through four business segments – Solutions, Systems, Software and Ocean Bottom Services (the segment name for OceanGeo) – as well as through its INOVA Geophysical joint venture. See Note 4 “Equity Method Investments” for the summarized financial information for INOVA Geophysical. The Company measures segment operating results based on income from operations.

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A summary of segment information is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net revenues: | | | | |
| Solutions: | | | | |
| New Venture | $18,446 | $11,945 | $76,499 | $93,630 |
| Data Library | 3,262 | 5,184 | 30,104 | 36,153 |
| Total multi-client revenues | 21,708 | 17,129 | 106,603 | 129,783 |
| Data Processing | 24,151 | 26,318 | 91,131 | 91,453 |
| Total | $45,859 | $43,447 | $197,734 | $221,236 |
| Systems: | | | | |
| Towed Streamer | $13,666 | $15,342 | $35,782 | $41,461 |
| Ocean Bottom Equipment | — | 159 | — | 7,307 |
| Other | 11,029 | 10,766 | 36,166 | 33,194 |
| Total | $24,695 | $26,267 | $71,948 | $81,962 |
| Software: | | | | |
| Software Systems | $9,922 | $8,892 | $28,384 | $24,297 |
| Services | 1,088 | 1,232 | 3,198 | 2,995 |
| Total | $11,010 | $10,124 | $31,582 | $27,292 |
| Ocean Bottom Services | $24,976 | $— | $71,454 | $— |
| Total | $106,540 | $79,838 | $372,718 | $330,490 |
| Gross profit (loss): | | | | |
| Solutions | $5,927 | $(8,487) | $51,207 | $33,600 |
| Systems | 10,123 | (13,987) | 31,288 | 3,195 |
| Software | 8,326 | 7,370 | 23,388 | 19,676 |
| Ocean Bottom Services | 4,847 | — | 18,422 | — |
| Total | $29,223 | $(15,104) | $124,305 | $56,471 |
| Gross margin: | | | | |
| Solutions | 13% | (20)% | 26% | 15% |
| Systems | 41% | (53)% | 43% | 4% |
| Software | 76% | 73% | 74% | 72% |
| Ocean Bottom Services | 19% | —% | 26% | —% |
| Total | 27% | (19)% | 33% | 17% |
| Income (loss) from operations: | | | | |
| Solutions | $(5,960) | $(18,163) | $11,733 | $215 |
| Systems | 2,917 | (23,610) | 9,835 | (21,172) |
| Software | 6,227 | 6,280 | 16,985 | 16,396 |
| Ocean Bottom Services | 1,677 | — | 12,333 | — |
| Corporate and other | (10,210) | (21,035) | (32,779) | (43,274) |
| Income (loss) from operations | (5,349) | (56,528) | 18,107 | (47,835) |
| Interest expense, net | (5,048) | (4,281) | (14,779) | (8,103) |
| Equity in losses of investments | (5,558) | (5,192) | (9,027) | (10,414) |
| Other income (expense), net | (622) | (74,301) | 73,970 | (180,392) |
| Income (loss) before income taxes | $(16,577) | $(140,302) | $68,271 | $(246,744) |

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(4) Equity Method Investments

The following table reflects the change in the Company's equity method investments during the nine months ended September 30, 2014 (in thousands):

| | INOVA Geophysical | OceanGeo | Total |
|---|---|---|---|
| Investments at December 31, 2013 | $51,065 | $2,800 | $53,865 |
| Equity in earnings (losses) of investments | (9,765) | 738 | (9,027) |
| Advances to OceanGeo (prior to consolidation) | — | 3,683 | 3,683 |
| Acquisition of controlling interest (consolidation) of OceanGeo | — | (7,221) | (7,221) |
| Equity interest in investees' other comprehensive loss | (1,126) | — | (1,126) |
| Investments at September 30, 2014 | $40,174 | $— | $40,174 |

INOVA Geophysical — The Company accounts for its 49% interest in INOVA Geophysical as an equity method investment and records its share of earnings and losses of INOVA Geophysical on a one fiscal quarter lag basis. For the three and nine months ended September 30, 2014, the Company recorded its share of losses from INOVA Geophysical of $5.6 million and $9.8 million, respectively, compared to its share of losses for the corresponding periods in 2013, of $0.2 million and $3.0 million, respectively. The following table reflects the summarized financial information for INOVA Geophysical for the three months ended June 30, 2014 and 2013 and the nine-month periods from October 1, 2013 and 2012 to June 30, 2014 and 2013, respectively (in thousands):

| | Three Months Ended June 30, | | Nine-Month Periods from October 1 through June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net revenues | $11,092 | $61,241 | $77,774 | $142,947 |
| Gross profit (loss) | $(2,164) | $12,243 | $8,020 | $26,378 |
| Income (loss) from operations | $(9,851) | $1,658 | $(16,094) | $(7,103) |
| Net loss | $(11,425) | $(488) | $(20,010) | $(6,518) |

Related Party Transactions

For information regarding transactions between the Company and its equity method investees, see Note 14 "Related Party Transactions."

(5) Long-term Debt

| Obligations (in thousands) | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Senior secured second-priority notes | $175,000 | $175,000 |
| Revolving line of credit | — | 35,000 |
| Equipment capital leases | 9,693 | 8,651 |
| Facility capital lease obligation | 791 | 1,501 |
| Total | 185,484 | 220,152 |
| Current portion of long-term debt and lease obligations | (5,901) | (5,906) |
| Non-current portion of long-term debt and lease obligations | $179,583 | $214,246 |

New Credit Facility, including Revolving Line of Credit

In August 2014, ION and its subsidiaries, ION Exploration Products (U.S.A.), Inc., I/O Marine Systems, Inc. and GX Technology Corporation (collectively, the "Subsidiary Borrowers" and together with ION, the "Borrowers"), entered into a new credit facility (the "New Credit Facility").

The terms of the New Credit Facility are set forth in a revolving credit and security agreement dated as of August 22, 2014, among the Borrowers, the lenders party thereto and PNC Bank, National Association ("PNC"), as agent for the lenders.

The New Credit Facility replaced the Company's prior syndicated credit facility under a credit agreement dated as of March 25, 2010, as amended, by and among ION, the subsidiary guarantors that were parties thereto and China Merchants Bank Co., Ltd., New York Branch ("CMB"), as administrative agent and lender (the "Prior Credit Facility").

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The revolving credit and security agreement contemplates maximum credit facilities of up to $175.0 million in the aggregate, consisting of (i) a revolving facility of up to $125.0 million, to which the lenders have committed $80.0 million and up to an additional $45.0 million of which is subject to the implementation of certain accordion provisions (with availability under such revolving facility subject at all times to a borrowing base and other conditions to borrowing) and (ii) an uncommitted term facility in an aggregate amount of up to $50.0 million on terms to be mutually agreed at a later date and subject to receiving commitments of lenders to such term facility.

The borrowing base for revolving credit borrowings under the New Credit Facility is calculated using a formula based on certain eligible receivables, eligible inventory and other amounts. In addition, the New Credit Facility includes a $15.0 million sublimit for the issuance of documentary and standby letters of credit. As of September 30, 2014, no amounts were drawn under the New Credit Facility. The Company expects that any amounts drawn under the New Credit Facility sooner than one year prior to the maturity of the New Credit Facility (as described below) will be classified as long-term debt.

The New Credit Facility is available for revolving credit borrowings to be used to pay fees and expenses related to the entry into the New Credit Facility and to provide for the Company's general corporate needs, including the Company's working capital requirements, capital expenditures, surety deposits and acquisition financing.

The interest rate on revolving credit borrowings under the New Credit Facility will be, at the Company's option, (i) an alternate base rate equal to the highest of (a) the prime rate of PNC, (b) a federal funds effective rate plus 0.50% or (c) a LIBOR-based rate plus 1.0%, plus an applicable interest margin, or (ii) a LIBOR-based rate, plus an applicable interest margin. The revolving credit indebtedness under the New Credit Facility is scheduled to mature on the earlier of (x) August 22, 2019 or (y) the date which is 90 days prior to the maturity date of the Notes (as defined below) (or such later due date if the Notes have been refinanced).

The obligations of the Borrowers under the New Credit Facility are secured by a first-priority security interest in 100% of the stock of the Subsidiary Borrowers and 65% of the equity interests in ION International Holdings L.P. and by substantially all other assets of the Borrowers.

The revolving credit and security agreement contains covenants that, among other things, restrict the Company, subject to certain exceptions, from incurring additional indebtedness (including capital lease obligations), repurchasing equity, paying dividends or distributions, granting or incurring additional liens on the Company's properties, pledging shares of the Company's subsidiaries, entering into certain merger or other change-in-control transactions, entering into transactions with the Company's affiliates, making certain sales or other dispositions of the Company's assets, making certain investments, acquiring other businesses and entering into sale-leaseback transactions with respect to the Company's property.

The revolving credit and security agreement requires compliance with certain financial covenants, including requirements related to ION and the Subsidiary Borrowers, measured on a rolling four quarter basis, (i) maintaining a minimum fixed charge coverage ratio of 1.1 to 1 as of the end of each fiscal quarter during the existence of a covenant testing trigger event, and (ii) not exceeding a maximum senior secured leverage ratio of 3.0 to 1 as of the end of each fiscal quarter.

The fixed charge coverage ratio is defined as the ratio of (i) ION's EBITDA, minus unfunded capital expenditures made during the relevant period, minus distributions (including tax distributions) and dividends made during the relevant period, minus cash taxes paid during the relevant period, to (ii) certain debt payments made during the relevant period. The senior secured leverage ratio is defined as the ratio of (x) total senior funded debt to (y) ION's EBITDA (excluding expenditures related directly to the Company's multi-client data library). As of September 30, 2014, the Company was in compliance with these financial covenants.

The revolving credit and security agreement contains customary event of default provisions (including a "change of control" event affecting ION), the occurrence of which could lead to an acceleration of the Company's obligations under the revolving credit and security agreement.

In connection with entering into the New Credit Facility, PNC replaced CMB as administrative agent, first lien representative for the first lien secured parties and collateral agent for the first lien secured parties under the Intercreditor Agreement (as defined below). The Company incurred $1.9 million of costs related to entering into the New Credit Facility, which are being amortized over 3.5 years. As a part of the cancellation of the Prior Credit

Facility, the Company wrote-off to interest expense $0.3 million of unamortized debt issuance costs.
Senior Secured Second-Priority Notes
In May 2013, the Company sold $175.0 million aggregate principal amount of 8.125% Senior Secured Second-Priority Notes due 2018 ("Notes") in a private offering pursuant to an Indenture dated as of May 13, 2013. The Notes are senior secured second-priority obligations of the Company, are guaranteed by certain of the Company's U.S. subsidiaries, and mature on May 15, 2018. Interest on the Notes accrues at the rate of 8.125% per annum and will be payable semiannually in arrears on May 15 and November 15 of each year during their term. In May 2014, the holders of the Notes exchanged their Notes for a like principal amount of registered Notes with the same terms.

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On or after May 15, 2015, the Company may on one or more occasions redeem all or a part of the Notes at the redemption prices set forth below, plus accrued and unpaid interest and special interest, if any, on the Notes redeemed during the 12-month period beginning on May 15th of the years indicated below:

| Date | Percentage |
|---|---|
| 2015 | 104.063% |
| 2016 | 102.031% |
| 2017 and thereafter | 100.000% |

The Notes are initially jointly and severally guaranteed on a senior secured basis by each of the Company's current material U.S. subsidiaries: GX Technology Corporation, ION Exploration Products (U.S.A.), Inc. and I/O Marine Systems, Inc. (the "Notes Guarantors"). The Notes and the guarantees are secured, subject to certain exceptions and permitted liens, by second-priority liens on substantially all of the assets that secure the indebtedness under the New Credit Facility (see "— New Credit Facility, including Revolving Line of Credit" above). The indebtedness under the Notes is effectively junior to the Company's obligations under the New Credit Facility to the extent of the value of the collateral securing the New Credit Facility, and to any other indebtedness secured on a first-priority basis to the extent of the value of the Company's assets subject to those first-priority security interests.

The Notes contain certain covenants that, among other things, limit the Company's ability and the ability of its restricted subsidiaries to take certain actions or permit certain conditions to exist during the term of the Notes. These limits apply to making certain investments, incurring additional indebtedness, selling assets, paying dividends, issuing preferred stock, carrying out mergers or consolidations, and certain other transactions. These and other restrictive covenants contained in the Indenture are subject to important exceptions and qualifications. All of the Company's subsidiaries are currently restricted subsidiaries. As of September 30, 2014, the Company was in compliance with these covenants.

In connection with the issuance of the Notes, the Company and the Notes Guarantors entered into a second lien intercreditor agreement dated as of May 13, 2013 (the "Intercreditor Agreement") with, among others, CMB, as administrative agent, first lien representative for the first lien secured parties and collateral agent for the first lien secured parties, the trustee under the Indenture and the collateral agent for the second lien secured parties.

OceanGeo Brazil Bank Debt

In connection with the Company's acquisition of a controlling interest in OceanGeo in the first quarter of 2014, OceanGeo's existing debt was consolidated into the Company's accounts. During the three months ended September 30, 2014, OceanGeo repaid this debt in full.

(6) Net Income (Loss) per Share

Basic net income (loss) per common share is computed by dividing net income (loss) applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted net income per common share is determined based on the assumption that dilutive restricted stock and restricted stock unit awards have vested and outstanding dilutive stock options have been exercised and the aggregate proceeds were used to reacquire common stock using the average price of such common stock for the period. The total number of shares issued or reserved for future issuance under outstanding stock options at September 30, 2014 and 2013 was 9,111,725 and 7,081,950, respectively, and the total number of shares of restricted stock and shares reserved for restricted stock units outstanding at September 30, 2014 and 2013 was 1,144,432 and 763,559, respectively. All outstanding stock awards for the three months ended September 30, 2014 and the three and nine months ended September 30, 2013 were anti-dilutive.

Prior to September 30, 2013, there were 27,000 shares outstanding of the Company's Series D Cumulative Convertible Preferred Stock ("Series D Preferred Stock"). In September 2013, the holder converted all of the outstanding shares of Series D Preferred Stock into 6,065,075 shares of common stock. The then-outstanding shares of Series D Preferred Stock were anti-dilutive for the three and nine months ended September 30, 2013.

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The following table summarizes the computation of basic and diluted net income (loss) per common share (in thousands, except per share amounts):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net income (loss) applicable to common shares | $(24,541) | $(202,096) | $52,626 | $(271,693) |
| Weighted average number of common shares outstanding | 164,149 | 157,143 | 164,021 | 156,842 |
| Effect of dilutive stock awards | — | — | 305 | — |
| Weighted average number of diluted common shares outstanding | 164,149 | 157,143 | 164,326 | 156,842 |
| Basic net income (loss) per share | $(0.15) | $(1.29) | $0.32 | $(1.73) |
| Diluted net income (loss) per share | $(0.15) | $(1.29) | $0.32 | $(1.73) |

(7) Income Taxes

The Company maintains a valuation allowance for substantially all of its deferred tax assets. The valuation allowance is calculated in accordance with the provisions of the Financial Accounting Standards Board's ("FASB") Accounting Standard Codification Topic 740 "Income Taxes," which requires that a valuation allowance be established or maintained when it is "more likely than not" that all or a portion of deferred tax assets will not be realized. In the event the Company's expectations of future operating results change, the valuation allowance may need to be adjusted upward or downward. As of September 30, 2014, the Company's unreserved net U.S. deferred tax assets totaled $3.9 million. These existing unreserved deferred tax assets are currently considered to be "more likely than not" realized.

The Company's effective tax rates for the three months ended September 30, 2014 and 2013 were (50.3)% and (40.6)%, respectively, and for the nine months ended September 30, 2014 and 2013 were 20.9% and (7.9)%, respectively. The Company's effective tax rate for the nine months ended September 30, 2014 was positively impacted by the change in valuation allowance related to the reduction of the legal contingency reserve. The Company's income tax expense for the three and nine months ended September 30, 2014 relates to income from the Company's non-U.S. businesses, including OceanGeo. This foreign tax expense has not been offset by the tax benefits on losses within the U.S. and other jurisdictions, from which the Company cannot currently benefit.

The Company has approximately $2.2 million of unrecognized tax benefits and does not expect to recognize significant increases in unrecognized tax benefits during the next 12-month period. Interest and penalties, if any, related to unrecognized tax benefits are recorded in income tax expense.

As of September 30, 2014, the Company's U.S. federal tax returns for 2007 and subsequent years remain subject to examination by tax authorities. The Company is no longer subject to U.S. Internal Revenue Service ("IRS") examination for periods prior to 2007, although carryforward attributes that were generated prior to 2007 may still be adjusted upon examination by the IRS if they either have been or will be used in an open year. In the Company's foreign tax jurisdictions, tax returns for 2010 and subsequent years generally remain open to examination.

(8) Litigation

WesternGeco

In June 2009, WesternGeco L.L.C. ("WesternGeco") filed a lawsuit against the Company in the United States District Court for the Southern District of Texas, Houston Division. In the lawsuit, styled WesternGeco L.L.C. v. ION Geophysical Corporation, WesternGeco alleged that the Company had infringed several method and apparatus claims contained in four of its United States patents regarding marine seismic streamer steering devices.

The trial began in July 2012. A verdict was returned by the jury in August 2012, finding that the Company infringed the claims contained in the four patents by supplying its DigiFIN® lateral streamer control units and the related software from the United States and awarded WesternGeco the sum of $105.9 million in damages, consisting of $12.5 million in reasonable royalty and $93.4 million in lost profits.

In June 2013, the presiding judge entered a Memorandum and Order, ruling that WesternGeco is entitled to be awarded supplemental damages for the additional DigiFIN units that were supplied from the United States before and after trial that were not included in the jury verdict due to the timing of the trial. In October 2013, the judge entered another Memorandum and Order, ruling on the number of DigiFIN units that are subject to supplemental damages and also ruling that the supplemental damages applicable to the additional units should be calculated by adding together the jury's previous reasonable royalty and lost profits damages awards per unit, resulting in supplemental damages of $73.1 million.

In April 2014, the judge entered another Order, ruling that lost profits should not have been included in the calculation of supplemental damages in the October 2013 Memorandum and Order and reducing the supplemental damages award in the case from $73.1 million to $9.4 million. In the Order, the judge also further reduced the damages award in the case by $3.0 million to reflect a settlement and license that WesternGeco entered into with a customer of the Company that had purchased and used DigiFIN units that were also included in the damages amounts awarded against the Company.

In May 2014, the judge signed and entered a Final Judgment in the amount of $123.8 million. Also, the Final Judgment included an injunction that enjoins the Company, its servants, agents and anyone acting in concert with it, from supplying in or from the United States the DigiFIN product or any parts unique to the DigiFIN product, or any instrumentality no more than colorably different from any of these products or parts, for combination outside of the United States. The Company has conducted its business in compliance with the Court's orders in the case, and the Company has reorganized its operations such that it no longer supplies the DigiFIN product or any parts unique to the DigiFIN product in or from the United States.

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As previously disclosed, the Company has taken a loss contingency accrual of $123.8 million related to this case. Post-judgment interest will continue to accrue until this legal matter is fully resolved. The Company's assessment of its potential loss contingency may change in the future due to developments in the case and other events, such as changes in applicable law, and such reassessment could lead to the determination that no loss contingency is probable or that a greater or lesser loss contingency is probable. Any such reassessment could have a material effect on the Company's financial condition or results of operations.

The Company and WesternGeco have each appealed the Final Judgment to the United States Court of Appeals for the Federal Circuit. The Company filed its appeal brief on September 4, 2014. WesternGeco's appeal brief was filed on October 21, 2014. Oral arguments have not been scheduled as of the date of this Quarterly Report on Form 10-Q.

In order to stay the judgment during the appeal, the Company arranged with sureties to post an appeal bond with the trial court on the Company's behalf in the amount of $120.0 million. The terms of the appeal bond arrangements provide the sureties the contractual right for as long as the bond is outstanding to require the Company to post cash collateral for up to the full amount of the bond; however, the sureties did not require cash collateral upon the posting of the appeal bond. If the sureties exercise their right to require collateral while the appeal bond is outstanding, the Company would intend to utilize a combination of cash on hand and undrawn balances available under the Company's New Credit Facility. If the Company is required to collateralize the full amount of the bond, the Company might also seek additional debt and/or equity financing. The collateralization of the full amount of the bond could have an adverse effect on the Company's liquidity. Any requirements that the Company collateralize the appeal bond will reduce its liquidity and may reduce the amount otherwise available to be borrowed under its New Credit Facility. No assurances can be made whether the Company's efforts to raise additional cash would be successful and, if so, on what terms and conditions, and at what cost the Company might be able to secure any such financing. The Company will incur fees of approximately $2.0 million per year to maintain the appeal bond until such time as the appeal bond is no longer required.

Other

The Company has been named in various other lawsuits or threatened actions that are incidental to its ordinary business. Litigation is inherently unpredictable. Any claims against the Company, whether meritorious or not, could be time-consuming, cause the Company to incur costs and expenses, require significant amounts of management time and result in the diversion of significant operational resources. The results of these lawsuits and actions cannot be predicted with certainty. Management currently believes that the ultimate resolution of these matters will not have a material adverse impact on the financial condition, results of operations or liquidity of the Company.

(9) Other Income (Expense), Net

A summary of other income (expense), net is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Reduction of (accrual for) loss contingency related to legal proceedings (Note 8) | $— | $(71,776) | $69,557 | $(181,776) |
| Gain on sale of product line[1] | — | — | 6,522 | — |
| Gain on sale of a cost-method investment | — | — | — | 3,591 |
| Other expense, net | (622) | (2,525) | (2,109) | (2,207) |
| Total other income (expense), net | $(622) | $(74,301) | $73,970 | $(180,392) |

(1) In May 2014, the Company sold its Source product line for approximately $14.4 million, net of transaction fees, recording a gain of approximately $6.5 million before taxes. As a part of this transaction, the Company reduced Goodwill on the Marine reporting unit by $5.1 million. The historical results of this product line have not been material to the Company's results of operations.

(10) Details of Selected Balance Sheet Accounts

Inventories

A summary of inventories is as follows (in thousands):

| | September 30, 2014 | December 31, 2013 |
|---|---|---|

| | | |
|---|---|---|
| Raw materials and subassemblies | $40,970 | $54,168 |
| Work-in-process | 11,879 | 2,297 |
| Finished goods | 26,977 | 33,263 |
| Reserve for excess and obsolete inventories | (24,450) | (32,555) |
| Total | $55,376 | $57,173 |

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Other Long-term Liabilities

| A summary of other long-term liabilities is as follows (in thousands): | September 30, 2014 | December 31, 2013 |
|---|---|---|
| Accrual for loss contingency related to legal proceedings (Note 8) | $123,770 | $193,327 |
| Deferred rents | 12,277 | 8,822 |
| Facility abandonment restructuring accrual | 4,211 | 4,837 |
| Other long-term liabilities | 2,518 | 3,616 |
| Total | $142,776 | $210,602 |

(11) Accumulated Other Comprehensive Income (Loss)

A summary of changes in accumulated other comprehensive loss by component is as follows (in thousands):

| | Foreign currency translation adjustments | Equity interest in investees' other comprehensive income (loss) | Other changes in other comprehensive income (loss) | Total |
|---|---|---|---|---|
| Accumulated other comprehensive loss at December 31, 2013 | $(11,923) | $841 | $(56) | $(11,138) |
| Net current-period other comprehensive income (loss) | 489 | (1,125) | 54 | (582) |
| Accumulated other comprehensive loss at September 30, 2014 | $(11,434) | $(284) | $(2) | $(11,720) |

(12) Supplemental Cash Flow Information and Non-cash Activity

A summary of non-cash items from investing and financing activities is as follows (in thousands):

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2014 | 2013 |
| Cash paid during the period for: | | |
| Interest | $9,087 | $2,042 |
| Income taxes | $12,008 | $13,778 |
| Non-cash items from investing and financing activities: | | |
| Purchases of computer equipment financed through capital leases | $5,768 | $5,962 |
| Leasehold improvement paid by landlord | $— | $5,000 |
| Conversion of investment in a convertible note to equity | $3,151 | $6,765 |
| Transfer of inventory to property, plant, equipment and seismic rental equipment | $3,039 | $1,471 |
| Investment in multi-client data library financed through trade payables | $1,298 | $— |
| Purchases of property, plant, and equipment and seismic rental equipment financed through accounts payable | $— | $835 |

(13) Fair Value of Financial Instruments

Authoritative guidance on fair value measurements defines fair value, establishes a framework for measuring fair value and stipulates the related disclosure requirements. The Company follows a three-level hierarchy, prioritizing and defining the types of inputs used to measure fair value.

Investment in Convertible Note. In March 2012, the Company and a privately owned U.S.-based technology company entered into an agreement for the Company to make available to the technology company a credit facility in an amount of up to $4.0 million. The credit facility has since been amended such that the current maturity date is March 2015, the annual interest rate is 0.25%, and the conversion provision allows for conversion of any or all of the outstanding balance of the promissory note under the credit facility into an amount of common shares of the technology company up to 19.5% of the total outstanding shares of the company.

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In September 2014, the Company converted $3.2 million of the balance of the note into 688,000 common shares of the investee, which resulted in a post-conversion equity ownership percentage interest in the investee of 19.5%. This investment continues to be accounted for as a cost method investment and is included in Other assets. Prior to conversion, the note and accrued interest had a fair value that approximated its book value resulting in no realized gain or loss on this conversion. The Company performed a fair value analysis with respect to its investment in the convertible note and interest using Level 3 inputs. These inputs included a market approach, including terms and likelihood of an investment event.

As of September 30, 2014, $1.1 million of principal and accrued interest remains outstanding under this credit arrangement and the fair value of this investment approximated its book value, including the accrued interest.

Fair Value of Other Financial Instruments. Due to their highly liquid nature, the amount of the Company's other financial instruments, including cash and cash equivalents, accounts and unbilled receivables, notes receivable, accounts payable, and accrued multi-client data library royalties, represent their approximate fair value.

The carrying amounts of the Company's long-term debt as of September 30, 2014 and December 31, 2013 were $185.5 million and $220.2 million, respectively, compared to its fair values of $176.7 million and $190.4 million as of September 30, 2014 and December 31, 2013, respectively. The fair value of the long-term debt was calculated using Level 1 inputs, including an active market price.

The Company's cost method investment for which quoted market prices are not available are recorded at cost and reviewed periodically if there are events or changes in circumstances that may have a significant adverse effect on the fair value of the investments.

(14) Related Party Transactions

BGP Inc. ("BGP") owned approximately 14.5% of the Company's outstanding common stock as of September 30, 2014. For the nine months ended September 30, 2014 and 2013, the Company recorded revenues from BGP of $5.1 million and $5.3 million, respectively. Total receivables due from BGP were $1.0 million at September 30, 2014.

In July 2013, the Company agreed to lend up to $10.0 million to INOVA Geophysical, and received a promissory note issued by INOVA Geophysical to the order of the Company, which was originally scheduled to mature on September 30, 2013. The maturity date of the promissory note has since been extended to December 31, 2014. The loan was made by the Company to support certain short-term working capital needs of INOVA Geophysical. The indebtedness under the note accrues interest at an annual rate equal to the London Interbank Offered Rate plus 650 basis points. In 2013, the Company advanced the full principal amount of $10.0 million to INOVA Geophysical under the promissory note. INOVA Geophysical has repaid a total of $6.0 million, of which $4.0 million remains outstanding at September 30, 2014. This balance is included in Prepaid expenses and other current assets.

With the Prior Credit Facility being replaced by the New Credit Facility in August 2014, INOVA no longer provides a bank stand-by letter of credit as credit support for the Company's obligations under the New Credit Facility. For further information regarding our New Credit Facility, see Note 5 "Long-term Debt."

(15) Polarcus Alliance

In June 2013, the Company entered into an alliance (the "Polarcus Alliance") with Polarcus MC Ltd., a Cayman Islands limited liability company, ("Polarcus") in order to collaborate on 3D multi-client data library projects. The premise of the Polarcus Alliance is for towed-streamer seismic services and other related services to be provided by Polarcus and data processing and reservoir services to be provided by the Company. Under the Polarcus Alliance, each party can identify and propose potential project opportunities to the other party, which the other party then has the option to propose amendments to the potential project and accept or reject participation in the proposed project.

Under the Polarcus Alliance, the Company is currently participating in one project, offshore Ireland, that was proposed by Polarcus and accepted by the Company. Acquisition started and completed in the third quarter of 2014. This project is currently in the data processing phase. The transactions related to this project are included within the Company's consolidated results of operations, financial position and cash flows and are immaterial.

The activities of each project under the Polarcus Alliance are accounted for consistent with our accounting policies related to the Company's multi-client data library, except that the Company only records revenue at the Company's agreed sharing ratio of each project and capitalizes its agreed share of the direct project costs. When the current project is complete, the Company will have increased its multi-client data library by its share of the total direct project

costs.
The Company periodically settles any differences between actual payments for direct project costs made by each company and the agreed sharing ratio on a specific project through cash payments between the companies. As a result, the Company may build up a payable and/or receivable balance with Polarcus to be settled at a later date.

(16) Recent Accounting Pronouncements

Revenue Recognition — In May 2014, the FASB and the International Accounting Standards Board ("IASB") jointly issued new accounting guidance for recognition of revenue. This new guidance replaces virtually all existing U.S. GAAP and IFRS guidance on revenue recognition. The new guidance is effective for fiscal years beginning after December 15, 2016. This new guidance applies to all periods presented. Therefore, when the Company issues its financial statements on Forms 10-Q and 10-K for periods included in its year ended December 31, 2017, its comparative periods that are presented from the years ended December 31, 2015 and 2016, must be retrospectively presented in compliance with this new guidance. Early adoption is not allowed for U.S. GAAP. The new guidance requires companies to make more estimates and use more judgment than under current accounting guidance. The Company is currently evaluating (i) the two allowed adoption methods to determine which method it plans to use for retrospective presentation of comparative periods and (ii) whether the implementation of this new guidance will have a material impact on the Company's consolidated financial position or results of operations for the periods presented.

Reporting Discontinued Operations — In April 2014, the FASB issued amendments to guidance for reporting discontinued operations and disposals of components of an entity. The amended guidance requires that a disposal representing a strategic shift that has (or will have) a major effect on an entity's financial results or a business activity classified as held for sale should be reported as discontinued operations. The amendments also expand the disclosure requirements for discontinued operations and add new disclosures for individually significant dispositions that do not qualify as discontinued operations. The amendments are effective prospectively for fiscal years, and interim reporting periods within those years, beginning after December 15, 2014 (early adoption is permitted only for disposals that have not been previously reported). The implementation of the amended guidance is not expected to have a material impact on the Company's consolidated financial position or results of operations.

(17) Condensed Consolidating Financial Information

In 2013, the Company sold $175.0 million aggregate principal amount of its 8.125% Senior Secured Second-Priority Notes due 2018. The Notes were issued by ION Geophysical Corporation and are guaranteed by the Company's current material U.S. subsidiaries: GX Technology Corporation, ION Exploration Products (U.S.A.), Inc. and I/O Marine Systems, Inc. ("the Guarantors"), which are 100-percent-owned subsidiaries. The Guarantors have fully and unconditionally guaranteed the payment obligations of ION Geophysical Corporation with respect to these debt securities. The following condensed consolidating financial information presents the results of operations, financial position and cash flows for:

- ION Geophysical Corporation and the Guarantors (in each case, reflecting investments in subsidiaries utilizing the equity method of accounting).
- All other subsidiaries of ION Geophysical Corporation that are not Guarantors.
- The consolidating adjustments necessary to present ION Geophysical Corporation's results on a consolidated basis.

This condensed consolidating financial information should be read in conjunction with the accompanying consolidated financial statements and notes.

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| Balance Sheet | September 30, 2014<br>ION Geophysical Corporation<br>(In thousands) | The Guarantors | All Other Subsidiaries | Consolidating Adjustments | Total Consolidated |
|---|---|---|---|---|---|
| ASSETS | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $84,294 | $— | $45,553 | $— | $129,847 |
| Accounts receivable, net | 1,529 | 36,502 | 48,707 | — | 86,738 |
| Unbilled receivables | — | 42,059 | 15,418 | — | 57,477 |
| Inventories | — | 3,151 | 52,225 | — | 55,376 |
| Prepaid expenses and other current assets | 11,585 | 3,500 | 13,138 | (1,770 ) | 26,453 |
| Total current assets | 97,408 | 85,212 | 175,041 | (1,770 ) | 355,891 |
| Deferred income tax asset | 6,499 | 6,675 | 760 | 406 | 14,340 |
| Property, plant, equipment and seismic rental equipment, net | 6,547 | 28,832 | 24,986 | — | 60,365 |
| Multi-client data library, net | — | 219,251 | 24,666 | — | 243,917 |
| Equity method investments | 40,174 | — | — | — | 40,174 |
| Investment in subsidiaries | 796,608 | 280,302 | — | (1,076,910 ) | — |
| Goodwill | — | 21,884 | 28,501 | — | 50,385 |
| Intangible assets, net | — | 6,752 | 2,439 | — | 9,191 |
| Intercompany receivables | 35,192 | — | — | (35,192 ) | — |
| Other assets | 17,624 | 197 | 1,661 | — | 19,482 |
| Total assets | $1,000,052 | $649,105 | $258,054 | $(1,113,466) | $793,745 |
| LIABILITIES AND EQUITY | | | | | |
| Current liabilities: | | | | | |
| Current maturities of long-term debt | $— | $4,901 | $1,000 | $— | $5,901 |
| Accounts payable | 1,886 | 12,443 | 16,337 | — | 30,666 |
| Accrued expenses | 14,214 | 42,489 | 19,988 | (1,083 ) | 75,608 |
| Accrued multi-client data library royalties | — | 23,800 | 616 | — | 24,416 |
| Deferred revenue | — | 13,707 | 2,788 | — | 16,495 |
| Total current liabilities | 16,100 | 97,340 | 40,729 | (1,083 ) | 153,086 |
| Long-term debt, net of current maturities | 175,000 | 4,444 | 139 | — | 179,583 |
| Intercompany payables | 490,127 | 34,963 | 229 | (525,319 ) | — |
| Other long-term liabilities | 2,829 | 130,775 | 9,455 | (283 ) | 142,776 |
| Total liabilities | 684,056 | 267,522 | 50,552 | (526,685 ) | 475,445 |
| Redeemable noncontrolling interests | — | — | 2,086 | — | 2,086 |
| Equity: | | | | | |
| Common stock | 1,642 | 290,460 | 5,787 | (296,247 ) | 1,642 |
| Additional paid-in capital | 886,170 | 175,005 | 247,585 | (422,590 ) | 886,170 |
| Accumulated earnings (deficit) | (553,531 ) | 334,625 | | | |
| Current-PRC | 373 | 125 | | | |
| Deferred-PRC | (191 ) | (18 ) | | | |
| | 182 | 107 | | | |

The Company’s deferred tax liabilities at September 30, 2012 and changes for the nine months then ended were as follows:

| | Amount |
|---|---|

| | US$('000) |
|---|---|
| Balance as of December 31, 2011 (audited) | 1,893 |
| Reversal during the period | (164 ) |
| Exchange translation adjustment | 10 |
| Balance as of September 30, 2012 (unaudited) | 1,739 |

Deferred tax liabilities arose on the recognition of the identifiable intangible assets acquired from acquisition transactions consummated in 2011. Reversal for the nine and three months ended September 30, 2012 of approximately US$164,000 and US$55,000, respectively, was due to the amortization of these acquired intangible assets.

The Company's deferred tax assets at September 30, 2012 and December 31, 2011 were as follows:

| | September 30, 2012 US$('000) (Unaudited) | December 31, 2011 US$('000) |
|---|---|---|
| Tax effect of net operating losses carried forward | 2,762 | 1,975 |
| Bad debts provision | 793 | 651 |
| Valuation allowance | (2,878 ) | (2,534 ) |
| | 677 | 92 |

| | September 30, 2012 US$('000) (Unaudited) | December 31, 2011 US$('000) |
|---|---|---|
| Deferred tax assets reclassified as current asset | 95 | - |
| Deferred tax assets reclassified as non-current asset | 582 | 92 |
| | 677 | 92 |

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The net operating losses carried forward incurred by the Company (excluding its PRC operating subsidiary and VIEs) were approximately US$5,957,000 and US$5,381,000 at September 30, 2012 and December 31, 2011, respectively, which loss carry forwards gradually expire over time, the last of which expires in 2032. A full valuation allowance has been recorded because it is considered more likely than not that the deferred tax assets will not be realized through sufficient future earnings of the entity to which the operating losses relate.

The net operating losses carried forward incurred by the Company’s PRC subsidiary and VIEs were approximately US$3,835,000 and US$361,000 at September 30, 2012 and December 31, 2011, respectively, which loss carry forwards gradually expire over time, the last of which expires in 2017. The related deferred tax assets was calculated based on the respective net operating losses incurred by each of the PRC subsidiary and VIEs and the respective corresponding enacted tax rate that will be in effect in the period in which the differences are expected to reverse. No valuation allowance has been recorded because it is considered more likely than not that the deferred tax assets will be realized through sufficient future earnings of the entities to which the operating losses relate.

The bad debts provision recorded by the Company’s PRC subsidiary and VIEs were approximately US$3,200,000. A full valuation allowance has been recorded because it is considered more likely than not that the deferred tax assets will not be realized through bad debts verification by the local tax authorities where the PRC subsidiary and VIEs operate.

The Company’s non-current portion of deferred tax assets and deferred tax liabilities were attributable to different tax-paying components of the entity, which were under different tax jurisdictions. Therefore, in accordance with ASC Topic 740 “Income taxes”, the non-current portion of deferred tax assets and deferred tax liabilities were presented separately in the Company’s balance sheets.

19. Dividend payable

| | September 30, 2012 US$(’000) (Unaudited) | December 31, 2011 US$(’000) |
|---|---|---|
| Dividend payable to Series A convertible stock holders | - | 5 |

Dividend to Series A convertible preferred stockholders was accrued at the per annum rate of 10% and calculated based on US$2.5 per share liquidation preference and the actual number of days of each share of the Series A convertible preferred stock outstanding for each of the reporting periods. On August 21, 2011, all of the Company’s outstanding Series A convertible preferred stock, which had not been voluntarily converted into the Company’s common shares, were fully converted into the Company’s common shares under the mandatory conversion clause entered into by and between the Company and its Series A convertible preferred stockholders. For the nine months ended September 30, 2012 and 2011, the Company paid dividends of approximately US$5,000 and US$374,000 to its Series A convertible preferred stockholders, respectively. For the three months ended September 30, 2012 and 2011, the Company paid US$nil and approximately US$91,000 to its Series A convertible preferred stockholders, respectively.

20. Long-term borrowing from director

| | September 30, 2012 US$('000) (Unaudited) | December 31, 2011 US$('000) |
|---|---|---|
| Long-term borrowing from director | 138 | 137 |

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Long-term borrowing from director is a non-interest bearing loan from a director of the Company relating to the original paid-in capital contribution in the Company's wholly-owned subsidiary Rise King WFOE.

## 21. Warrants

The Company issued warrants in its August 2009 Financing. Warrants issued and outstanding at September 30, 2012 and changes during the nine months then ended are as follows:

| | Warrants Outstanding | | | Warrants Exercisable | | |
|---|---|---|---|---|---|---|
| | Number of underlying shares | Weighted Average Exercise Price | Average Remaining Contractual Life (years) | Number of underlying shares | Weighted Average Exercise Price | Average Remaining Contractual Life (years) |
| Balance, December 31, 2011 (audited) | 3,005,456 | $3.41 | 2.21 | 3,005,456 | $3.41 | 2.21 |
| Granted / Vested | - | | | - | | |
| Forfeited | - | | | - | | |
| Exercised | - | | | - | | |
| Expired | (642,000) | | | (642,000) | | |
| Balance, September 30, 2012 (unaudited) | 2,363,456 | $3.52 | 1.88 | 2,363,456 | $3.52 | 1.88 |

On August 21, 2012, 642,000 Series A warrants to purchase common stock of the Company issued on August 21, 2009 expired. An aggregate of 2,363,456 Series B warrants and placement agent warrants to purchase common stock of the Company will expire on August 21, 2014.

## 22. Restricted Net Assets

As most of the Company's operations are conducted through its PRC subsidiary and VIEs, the Company's ability to pay dividends is primarily dependent on receiving distributions of funds from its PRC subsidiary and VIEs. Relevant PRC statutory laws and regulations permit payments of dividends by its PRC subsidiary and VIEs only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations and after it has met the PRC requirements for appropriation to statutory reserves. Paid in capital of the PRC subsidiary and VIEs included in the Company's consolidated net assets are also non-distributable for dividend purposes.

In accordance with the PRC regulations on Enterprises with Foreign Investment, a WFOE established in the PRC is required to provide certain statutory reserves, namely general reserve fund, the enterprise expansion fund and staff welfare and bonus fund which are appropriated from net profit as reported in the enterprise's PRC statutory accounts. A WFOE is required to allocate at least 10% of its annual after-tax profit to the general reserve until such reserve has reached 50% of its registered capital based on the enterprise's PRC statutory accounts. Appropriations to the enterprise expansion fund and staff welfare and bonus fund are at the discretion of the board of directors. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. Rise King WFOE is subject to the above mandated restrictions on distributable profits. Additionally, in accordance with the Company Law of the PRC, a domestic enterprise is required to provide a statutory common reserve of at least 10% of its annual after-tax profit until such reserve has reached 50% of its registered capital based on the enterprise's PRC statutory accounts. A domestic enterprise is also required to provide for a discretionary surplus reserve, at the discretion of the board of directors. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. All of the Company's PRC VIEs are subject to the above mandated restrictions on distributable profits.

As a result of these PRC laws and regulations, the Company's PRC subsidiary and VIEs are restricted in their ability to transfer a portion of their net assets to the Company.  As of September 30, 2012 and December 31, 2011, net assets restricted in the aggregate, which include paid-in capital and statutory reserve funds of the Company's PRC subsidiary and VIEs that are included in the Company's consolidated net assets, was approximately US$5.3 million and US$4.7 million, respectively.

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The New PRC Enterprise Income Tax ("EIT") Law, which was effected on January 1, 2008, also imposed a 10% withholding income tax for dividends distributed by a foreign invested enterprise to its immediate holding company outside China, which were exempted under the previous EIT law. A lower withholding tax rate will be applied if there is a tax treaty arrangement between mainland China and the jurisdiction of the foreign holding company. Holding companies in Hong Kong, for example, will be subject to a 5% rate. Rise King WFOE is invested by its immediate holding company in Hong Kong and will be entitled to the 5% preferential withholding tax rate upon distribution of the dividends to its immediate holding company.

The ability of the Company's PRC subsidiary and VIEs to make dividends and other payments to the Company may also be restricted by changes in applicable foreign exchange and other laws and regulations.

Foreign currency exchange regulation in China is primarily governed by the following rules:

- Foreign Exchange Administration Rules (1996), as amended in August 2008, or the Exchange Rules;
- Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules.

Currently, under the Administration Rules, Renminbi is freely convertible for current account items, including the distribution of dividends, interest payments, trade and service related foreign exchange transactions, but not for capital account items, such as direct investments, loans, repatriation of investments and investments in securities outside of China, unless the prior approval of the State Administration of Foerign Exchange (the "SAFE") is obtained and prior registration with the SAFE is made. Foreign-invested enterprises like Rise King WFOE that need foreign exchange for the distribution of profits to its shareholders may effect payment from their foreign exchange accounts or purchase and pay foreign exchange rates at the designated foreign exchange banks to their foreign shareholders by producing board resolutions for such profit distribution. Based on their needs, foreign-invested enterprises are permitted to open foreign exchange settlement accounts for current account receipts and payments of foreign exchange along with specialized accounts for capital account receipts and payments of foreign exchange at certain designated foreign exchange banks.

Although the current Exchange Rules allow the convertibility of Chinese Renminbi into foreign currency for current account items, conversion of Chinese Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or securities, requires the approval of SAFE, which is under the authority of the People's Bank of China. These approvals, however, do not guarantee the availability of foreign currency conversion. The Company cannot be sure that it will be able to obtain all required conversion approvals for its operations or the Chinese regulatory authorities will not impose greater restrictions on the convertibility of Chinese Renminbi in the future. Currently, most of the Company's retained earnings are generated in Renminbi. Any future restrictions on currency exchanges may limit the Company's ability to use its retained earnings generated in Renminbi to make dividends or other payments in U.S. dollars or fund possible business activities outside China.

As of September 30, 2012 and December 31, 2011, there was approximately US$36.5 million and US$34.0 million in retained earnings in the aggregate, respectively, which was generated by the Company's PRC subsidiary and VIEs in Renminbi included in the Company's consolidated net assets, aside from US$2.3 million and US$2.2 million statutory reserve funds as of September 30, 2012 and December 31, 2011, respectively, that may be affected by increased restrictions on currency exchanges in the future and accordingly may further limit the Company's PRC subsidiary' and VIEs' ability to make dividends or other payments in U.S. dollars to the Company, in addition to the approximately US$5.3 million and US$4.7 million of restricted net assets as of September 30, 2012 and December 31, 2011, respectively, as discussed above.

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23. Related party transactions

Revenue from related parties:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 US$('000) (Unaudited) | 2011 US$('000) (Unaudited) |
| -Beijing Saimeiwei Food Equipment Technology Co., Ltd, | 73 | 66 |
| -Beijing Fengshangyinli Technology Co., Ltd. | 2 | 269 |
| -Beijing Telijie Century Environmental Technology Co., Ltd. | 42 | 212 |
| | 117 | 547 |

| | Three Months Ended September 30, | |
|---|---|---|
| | 2012 US$('000) (Unaudited) | 2011 US$('000) (Unaudited) |
| -Beijing Saimeiwei Food Equipment Technology Co., Ltd, | 18 | 7 |
| -Beijing Fengshangyinli Technology Co., Ltd. | 1 | 37 |
| -Beijing Telijie Century Environmental Technology Co., Ltd. | 32 | 45 |
| | 51 | 89 |

24. Employee defined contribution plan

Full time employees of the Company in the PRC participate in a government mandated defined contribution plan, pursuant to which certain pension benefits, medical care, employee housing fund and other welfare benefits are provided to employees. Chinese labor regulations require that the PRC subsidiaries of the Company make contributions to the government for these benefits based on certain percentages of the employees' salaries. The employee benefits were expensed as incurred. The Company has no legal obligation for the benefits beyond the contributions made. The total amounts for such employee benefits were approximately US$288,000 and US$280,000 for the nine months ended September 30, 2012 and 2011, respectively. The total amounts for such employee benefits were approximately US$93,000 and US$123,000 for the three months ended September 30, 2012 and 2011, respectively.

25. Concentration of risk

Credit risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash and cash equivalents, accounts receivable, other receivables and prepayments and deposits to suppliers. As of September 30, 2012 and December 31, 2011, substantially all of the Company's cash and cash equivalents were held by major financial institutions located in the PRC and Hong Kong, which management believes are of high credit quality.

Risk arising from operations in foreign countries

All of the Company's operations are conducted within the PRC. The Company's operations in the PRC are subject to various political, economic, and other risks and uncertainties inherent in the PRC. Among other risks, the Company's operations in the PRC are subject to the risks of restrictions on transfer of funds, changing taxation policies, foreign exchange restrictions; and political conditions and governmental regulations.

Currency convertibility risk

Significant part of the Company's businesses is transacted in RMB, which is not freely convertible into foreign currencies. All foreign exchange transactions take place either through the People's Bank of China or other banks authorized to buy and sell foreign currencies at the exchange rates quoted by the People's Bank of China. Approval of foreign currency payments by the People's Bank of China or other regulatory institutions requires submitting a payment application form together with suppliers' invoices and signed contracts. These exchange control measures imposed by the PRC government authorities may restrict the ability of the Company's PRC subsidiary and VIEs to transfer its net assets, which to the Company through loans, advances or cash dividends.

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Concentration of customers

For the nine months ended September 30, 2012, one customer accounted for 12% of the Company’s sales. For the nine months ended September 30, 2011, one customer accounted for 11% of the Company’s sales. Except for the aforementioned customer, there was no other single customer who accounted for more than 10% of the Company’s sales for the nine months ended September 30, 2012 and 2011, respectively.

For the three months ended September 30, 2011, one customer accounted for 16% of the Company’s sales. Except for the aforementioned customer, there was no other single customer who accounted for more than 10% of the Company’s sales for the three months ended September 30, 2012 and 2011, respectively.

As of September 30, 2012, one customer accounted for 16% of the Company’s accounts receivables. As of December 31, 2011, one customer accounted for 21% of the Company’s accounts receivables. Except for the aforementioned customer, there was no other single customer who accounted for more than 10% of the Company’s accounts receivable as of September 30, 2012 and December 31, 2011, respectively.

Concentration of suppliers

For the nine months ended September 30, 2012, two suppliers accounted for 58% and 11% of the Company’s cost of sales, respectively. For the nine months ended September 30, 2011, two suppliers accounted for 33% and 23% of the Company’s cost of sales, respectively. Except for the aforementioned suppliers, there was no other single supplier who accounted for more than 10% of the Company’s cost of sales for the nine months ended September 30, 2012 and 2011, respectively.

For the three months ended September 30, 2012, one supplier accounted for 45% of the Company’s cost of sales. For the three months ended September 30, 2011, two suppliers accounted for 46% and 26% of the Company’s cost of sales, respectively. Except for the aforementioned suppliers, there was no other single supplier who accounted for more than 10% of the Company’s cost of sales for the three months ended September 30, 2012 and 2011, respectively.

## 26. Commitments

The following table sets forth the Company’s contractual obligations as of September 30, 2012:

| | Office Rental US$(’000) (Unaudited) | Purchase of TV advertisement time US$(’000) (Unaudited) | Server hosting and board-band Leasing US$(’000) (Unaudited) | Total US$(’000) (Unaudited) |
|---|---|---|---|---|
| Three months ending December 31, | | | | |
| -2012 | 73 | 3,772 | 54 | 3,899 |
| Year ending December 31, | | | | |
| -2013 | 293 | - | 115 | 408 |
| -2014 | 293 | - | - | 293 |
| -2015 | 293 | - | - | 293 |

| | | | | |
|---|---|---|---|---|
| -2016 | 73 | - | - | 73 |
| Total | 1,025 | 3,772 | 169 | 4,966 |

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27. Segment reporting

The Company follows ASC Topic 280 “Segment Reporting”, which requires that companies disclose segment data based on how management makes decisions about allocating resources to segments and evaluating their performance. Reportable operating segments include components of an entity about which separate financial information is available and which operating results are regularly reviewed by the chief operating decision maker (“CODM”) to make decisions about resources to be allocated to the segment and assess each operating segment’s performance.

Nine Months Ended September 30, 2012 (Unaudited)

| | Internet Ad. US$ (‘000) | TV Ad. US$ (‘000) | Bank kiosk US$ (‘000) | Brand management and sales channel building US$ (‘000) | Others US$ (‘000) | Inter-segment and reconciling item US$ (‘000) | Total US$ (‘000) |
|---|---|---|---|---|---|---|---|
| Revenue | 15,393 | 19,751 | 214 | 3,031 | - | (40) | 38,349 |
| Cost of sales | 7,447 | 19,519 | 19 | 1,080 | - | - | 28,065 |
| Total operating expenses | 4,666 | 675 | 155 | 813 | 1,165 * | - | 7,474 |
| Depreciation and amortization expense included in total operating expenses | 782 | 51 | 155 | 161 | 74 | - | 1,223 |
| Operating income (loss) | 3,280 | (443) | 40 | 1,138 | (1,165) | (40) | 2,810 |
| Share of losses in equity investment affiliates | - | - | - | (274) | (120) | - | (394) |
| Expenditure for long-term assets | 179 | 6 | - | - | - | - | 185 |
| Net income (loss) | 3,208 | (417) | 40 | 579 | (1,175) | (40) | 2,195 |
| Total assets - September 30,2012 | 41,547 | 15,607 | 649 | 8,207 | 15,012 | (22,570) | 58,452 |

*Including approximate US$38,000 share-based compensation expenses.

Three Months Ended September 30, 2012 (Unaudited)

| | Internet Ad. US$ (‘000) | TV Ad. US$ (‘000) | Bank kiosk US$ (‘000) | Brand management and sales channel building US$ (‘000) | Others US$ (‘000) | Inter-segment and reconciling item US$ (‘000) | Total US$ (‘000) |
|---|---|---|---|---|---|---|---|

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Revenue | 5,690 | 3,238 | 72 | 1,327 | - | (40) | 10,287 |
| Cost of sales | 2,522 | 3,162 | 7 | 472 | - | - | 6,163 |
| Total operating expenses | 1,313 | 208 | 52 | 339 | 344 * | - | 2,256 |
| Depreciation and amortization expense included in total operating expenses | 261 | 16 | 52 | 54 | 22 | - | 405 |
| Operating income (loss) | 1,855 | (132) | 13 | 516 | (344) | (40) | 1,868 |
| | | | | | | | |
| Share of losses in equity investment affiliates | - | - | - | (70) | (27) | - | (97) |
| Expenditure for long-term assets | 133 | 6 | - | - | - | - | 139 |
| Net income (loss) | 1,622 | (124) | 13 | 317 | (345) | (40) | 1,443 |
| Total assets - September 30,2012 | 41,547 | 15,607 | 649 | 8,207 | 15,012 | (22,570) | 58,452 |

*Including approximate US$11,000 share-based compensation expenses.

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Nine Months Ended September 30, 2011 (Unaudited)

| | Internet Ad. US$ (‘000) | TV Ad. US$ (‘000) | Bank kiosk US$ (‘000) | Brand management and sales channel building US$ (‘000) | Others US$ (‘000) | Inter-segment and reconciling item US$ (‘000) | Total US$ (‘000) |
|---|---|---|---|---|---|---|---|
| Revenue | 16,434 | 4,756 | 415 | 943 | - | (14) | 22,534 |
| Cost of sales | 4,711 | 3,847 | 36 | 288 | - | (14) | 8,868 |
| Total operating expenses | 3,645 | 394 | 155 | 523 | 1,307 * | - | 6,024 |
| Depreciation and amortization expense included in total operating expenses | 183 | 75 | 120 | 275 | 74 | - | 727 |
| Operating income (loss) | 8,078 | 515 | 224 | 132 | (1,307) | - | 7,642 |
| | | | | | | | |
| Gain on deconsolidation of subsidiaries | - | - | - | - | 232 | - | 232 |
| Share of earnings (losses) in equity investment affiliates | - | 26 | - | - | (206) | - | (180) |
| Expenditure for long-term assets | 1,477 | 1 | 185 | 7 | 13 | - | 1,683 |
| Net income (loss) | 7,291 | 502 | 224 | 106 | (1,276) | - | 6,847 |
| Total assets - September 30,2011 | 49,474 | 3,681 | 866 | 4,916 | 20,941 | (30,210) | 49,668 |

*Including approximate US$237,000 share-based compensation expenses.

Three Months Ended September 30, 2011 (Unaudited)

| | Internet Ad. US$ (‘000) | TV Ad. US$ (‘000) | Bank kiosk US$ (‘000) | Brand management and sales channel building US$ (‘000) | Others US$ (‘000) | Inter-segment and reconciling item US$ (‘000) | Total US$ (‘000) |
|---|---|---|---|---|---|---|---|
| Revenue | 3,860 | 1,972 | 140 | 446 | - | - | 6,418 |
| Cost of sales | 1,605 | 1,669 | 12 | 132 | - | - | 3,418 |
| Total operating expenses | 1,102 | 76 | 24 | 234 | 376 * | - | 1,812 |
| Depreciation and amortization expense included in total operating expenses | 91 | 37 | 24 | 80 | 25 | - | 257 |
| Operating income (loss) | 1,153 | 227 | 104 | 80 | (376) | - | 1,188 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Gain on deconsolidation of subsidiaries | - | - | - | - | - | - | - |
| Share of earnings (losses) in equity investment affiliates | - | (4) | - | - | (71) | - | (75) |
| Expenditure for long-term assets | 13 | 1 | 74 | 4 | 1 | - | 93 |
| Net income (loss) | 1,119 | 191 | 105 | 42 | (446) | - | 1,011 |
| Total assets - September 30,2011 | 49,474 | 3,681 | 866 | 4,916 | 20,941 | (30,210) | 49,668 |

*Including approximate US$65,000 share-based compensation expenses.

28. Earnings per share

Basic and diluted earnings per share for each of the periods presented are calculated as follows (All amounts, except number of shares and per share data, are presented in thousands of US dollars):

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| | Nine months ended September 30, | | Three months ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| | US$('000) | US$('000) | US$('000) | US$('000) |
| | (Unaudited) | | (Unaudited) | |
| | (Amount in thousands except for the number of shares and per share data) | | (Amount in thousands except for the number of shares and per share data) | |
| Net income attributable to ChinaNet Online Holdings, Inc. | $1,749 | $6,943 | $1,220 | $1,111 |
| Less: Dividend for Series A convertible preferred stock | - | 407 | - | 85 |
| Net income attributable to common shareholders of ChinaNet Online Holdings, Inc. (numerator for basic earnings per share) | $ 1,749 | 6,536 | $ 1,220 | 1,026 |
| Add: Dividend for Series A convertible preferred stock | - | 407 | - | - |
| Net income attributable to common shareholders of ChinaNet Online Holdings, Inc. (numerator for diluted earnings per share) | $ 1,749 | $ 6,943 | $ 1,220 | $ 1,026 |
| | | | | |
| Weighted average number of common shares outstanding - Basic | 22,185,226 | 17,806,818 | 22,186,540 | 18,632,103 |
| Effect of diluted securities: | | | | |
| Series A Convertible preferred stock | - | 2,173,322 | - | - |
| Warrants | - | 285,624 | - | - |
| Weighted average number of common shares outstanding -Diluted | 22,185,226 | 20,265,764 | 22,186,540 | 18,632,103 |
| | | | | |
| Earnings per share-Basic | $0.08 | $0.37 | $0.05 | $0.06 |
| Earnings per share-Diluted | $0.08 | $0.34 | $0.05 | $0.06 |

For the nine months ended September 30, 2012, the diluted earnings per share calculation did not include the warrants and options to purchase up to 2,909,390 and 939,440 shares of common stock, respectively, because their effect was anti-dilutive.

For the three months ended September 30, 2012, the diluted earnings per share calculation did not include the warrants and options to purchase up to 2,719,347 and 939,440 shares of common stock, respectively, because their effect was anti-dilutive.

For the nine months ended September 30, 2011, the diluted earnings per share calculation did not include the warrants and options to purchase up to 3,094,974 and 54,000 shares of common stock, respectively, because their effect was anti-dilutive.

For the three months ended September 30, 2011, the diluted earnings per share calculation did not include the effect of the 1,348,469 incremental shares resulted from assumed conversion of the convertible preferred stock and the warrants and options to purchase up to 4,781,056 and 54,000 shares of common stock, respectively, because their effect was anti-dilutive.

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29. Share-based compensation expenses

On July 12, 2010, the Company renewed its investor relations service contract with Hayden Communications International, Inc. (“HCI”) for an18-month period commencing on July 12, 2010. As additional compensation, the Company issued HCI 60,000 restricted shares of the Company’s common stock. These shares were valued at $3.80 per share, the closing bid price of the Company’s common stock on the date of grant. The related compensation expenses were amortized over the 18-month service period. Total compensation expenses recognized for the nine months ended September 30, 2012 and 2011 was U$$6,333 and US$114,000 respectively. Total compensation expenses recognized for the three months ended September 30, 2012 and 2011 was US$nil and US$38,000, respectively.

As a result of the merger of HCI and MZ Group, the Company terminated the service contract with HCI and engaged MZHCI, LLP (“MZ-HCI”) to provide investor relations services for a 24-month period commencing on January 1, 2012. As additional compensation, the Company granted 80,000 restricted shares of the Company’s common stock. These shares were valued at $1.05 per share, the closing bid price of the Company’s common stock on the date of grant. The related compensation expenses were amortized over the requisite service period. Total compensation expenses recognized for the nine months ended September 30, 2012 and 2011 was US$31,500 and US$nil, respectively. Total compensation expenses recognized for the three months ended September 30, 2012 and 2011 was US$10,500 and US$nil, respectively.

On November 30, 2009, the Company granted 5-year options to each of its three independent directors, Mr. Douglas MacLellan, Mr. Mototaka Watanabe and Mr. Zhiqing Chen, to purchase in the aggregate 54,000 shares of the Company’s common stock at an exercise price of US$5.00 per share, in consideration of their services to the Company. These options vest quarterly at the end of each 3-month period, in equal installments over the 24-month period from the date of grant. The Company utilized Black-Scholes option pricing model to gauge the grant date fair value of these options of US$4.05 per option. The related compensation expenses were amortized over its vesting period. Total compensation expenses recognized for these options for the nine months ended September 30, 2012 and 2011 was US$nil and US$123,260, respectively. Total compensation expenses recognized for these options for the three months ended September 30, 2012 and 2011 was US$nil and US$27,340, respectively.

On November 30, 2011, under the Company’s 2011 Omnibus Securities and Incentive Plan, the Company issued its management, employees and directors in the aggregate of 885,440 options to purchase up the same number of the company’s common stock at an exercise price of US$1.20 per share. These options were fully vested and exercisable upon issuance and subject to forfeiture upon an employee's cessation of employment at the discretion of the Company.

Options issued and outstanding at September 30, 2012 and their movements during the nine months then ended are as follows:

| | Option Outstanding | | | Option Exercisable | | |
|---|---|---|---|---|---|---|
| | Number of underlying shares | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number of underlying shares | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price |
| Balance, December 31, 2011 (audited) | 939,440 | 9.51 | $ 1.42 | 939,440 | 9.51 | $ 1.42 |
| Granted/Vested | - | | | - | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Forfeited | - | | | - | | |
| Exercised | - | | | - | | |
| Balance, September 30, 2012 (unaudited) | 939,440 | 8.76 | $ 1.42 | 939,440 | 8.76 | $ 1.42 |

The aggregate unrecognized share-based compensation expenses as of September 30, 2012 and 2011 is approximately US$53,000 and US$63,000, respectively.

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

### Forward-Looking Statements

You should read the following discussion and analysis of our financial condition and results of operations in conjunction with our consolidated financial statements and the related notes included elsewhere in this interim report. Our consolidated financial statements have been prepared in accordance with U.S. GAAP. The following discussion and analysis contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, beliefs, intentions or future strategies that are signified by the words "expect," "anticipate," "intend," "believe," or similar language. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. Our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information set forth under the heading "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. Readers are cautioned not to place undue reliance on these forward-looking statements.

### Overview

Our company (formerly known as Emazing Interactive, Inc.) was incorporated in the State of Texas in April 2006 and re-domiciled to become a Nevada corporation in October 2006. From the date of our company's incorporation until June 26, 2009, when our company consummated the Share Exchange (as defined below), our company's activities were primarily concentrated in web server access and company branding in hosting web based e-games.

On June 26, 2009, our company entered into a Share Exchange Agreement (the "Exchange Agreement"), with (i) China Net Online Media Group Limited, a company organized under the laws of British Virgin Islands ("China Net BVI"), (ii) China Net BVI's shareholders, Allglad Limited, a British Virgin Islands company ("Allglad"), Growgain Limited, a British Virgin Islands company ("Growgain"), Rise King Investments Limited, a British Virgin Islands company ("Rise King BVI"), Star (China) Holdings Limited, a British Virgin Islands company ("Star"), Surplus Elegant Investment Limited, a British Virgin Islands company ("Surplus"), Clear Jolly Holdings Limited, a British Virgin Islands company ("Clear" and together with Allglad, Growgain, Rise King BVI, Star and Surplus, the "China Net BVI Shareholders"), who together owned shares constituting 100% of the issued and outstanding ordinary shares of China Net BVI (the "China Net BVI Shares") and (iii) G. Edward Hancock, our principal stockholder at such time. Pursuant to the terms of the Exchange Agreement, the China Net BVI Shareholders transferred to us all of the China Net BVI Shares in exchange for the issuance of 13,790,800 shares (the "Exchange Shares") in the aggregate of our common stock (the "Share Exchange"). As a result of the Share Exchange, China Net BVI became our wholly owned subsidiary and we are now a holding company which, through certain contractual arrangements with operating companies in the People's Republic of China (the "PRC"), is engaged in providing advertising, marketing, communication and brand management and sales channel building services to small and medium companies in China.

Our wholly owned subsidiary, China Net BVI, was incorporated in the British Virgin Islands on August 13, 2007. On April 11, 2008, China Net BVI became the parent holding company of a group of companies comprised of CNET Online Technology Limited, a Hong Kong company ("China Net HK"), which established, and is the parent company of, Rise King Century Technology Development (Beijing) Co., Ltd., a wholly foreign-owned enterprise ("WFOE") established in the PRC ("Rise King WFOE"). We refer to the transactions that resulted in China Net BVI becoming an indirect parent company of Rise King WFOE as the "Offshore Restructuring."

PRC regulations prohibit direct foreign ownership of business entities providing internet content, or ICP services in the PRC, and restrict foreign ownership of business entities engaging in the advertising business. In October 2008, a series of contractual arrangements (the "Contractual Agreements" or the "VIE Agreements) were entered between Rise

King WFOE and Business Opportunity Online (Beijing) Network Technology Co., Ltd. ("Business Opportunity Online"), Beijing CNET Online Advertising Co., Ltd. ("Beijing CNET Online") (collectively the "PRC Operating Entities") and its common individual owners (the "PRC Shareholders" or the "Control Group"). The Contractual Agreements allowed China Net BVI through Rise King WFOE to, among other things, secure significant rights to influence the PRC Operating Entities' business operations, policies and management, approve all matters requiring shareholder approval, and receive 100% of the income earned by the PRC Operating Entities.  In return, Rise King WFOE provides consulting services to the PRC Operating Entities.  In addition, to ensure that the PRC Operating Entities and the PRC Shareholders perform their obligations under the Contractual Arrangements, the PRC Shareholders have pledged all of their equity interests in the PRC Operating Entities to Rise King WFOE. They have also entered into an option agreement with Rise King WFOE which provides that at such time as when the current restrictions under PRC law on foreign ownership of Chinese companies engaging in the Internet content, information services or advertising business in China are lifted, Rise King WFOE may exercise its option to purchase the equity interests in the PRC Operating Entities directly.

Pursuant to the Contractual Agreements, all of the equity owners' rights and obligations of the VIEs were assigned to Rise King WFOE, which resulted in the equity owners lacking the ability to make decisions that have a significant effect on the VIEs, Rise King WFOE's ability to extract the profits from the operation of the VIEs and assume the residual benefits of the VIEs. Due to the fact that Rise King WFOE and its indirect parent are the sole interest holders of the VIEs, we included the assets, liabilities, revenues and expenses of the VIEs in our consolidated financial statements, which is consistent with the provisions of FASB Accounting Standards Codification ("ASC") Topic 810, "Consolidation" subtopic 10.

As a result of the Share Exchange on June 26, 2009, the former China Net BVI shareholders owned a majority of our common stock. The transaction was regarded as a reverse acquisition whereby China Net BVI was considered to be the accounting acquirer as its shareholders retained control of our company after the Share Exchange, although we are the legal parent company. The share exchange was treated as a recapitalization of our company. As such, China Net BVI (and its historical financial statements) is the continuing entity for financial reporting purposes. Following the Share Exchange, we changed our name from Emazing Interactive, Inc. to ChinaNet Online Holdings, Inc. The financial statements have been prepared as if China Net BVI had always been the reporting company and then on the share exchange date, had changed its name and reorganized its capital stock.

As of the date of the Share Exchange, through a series of contractual agreements, we operate our business in China primarily through Business Opportunity Online and Beijing CNET Online. Beijing CNET Online owns 51% of Shanghai Borongdingsi Computer Technology Co., Ltd. ("Shanghai Borongdingsi"). Business Opportunity Online, Beijing CNET Online and Shanghai Borongdingsi, were incorporated on December 8, 2004, January 27, 2003 and August 3, 2005, respectively.

On June 24, 2010, one of our VIEs, Business Opportunity Online, together with three other individuals, who were not affiliated with the Company, formed a new company, Shenzhen City Mingshan Network Technology Co., Ltd. ("Shenzhen Mingshan"). Shenzhen Mingshan is 51% owned by Business Opportunity Online and 49% owned collectively by the other three individuals. Shenzhen Mingshan is primarily engaged in developing and designing internet based software, online games and the related operating websites and providing related internet and information technology services necessary to operate such games and websites. On January 6, 2011, as approved by the shareholders of Shenzhen Mingshan, an unaffiliated third party invested RMB15,000,000 (approximately US$2,368,172) into Shenzhen Mingshan in exchange for a 60% equity interest in Shenzhen Mingshan. As a result of this transaction, our share of the equity interest in Shenzhen Mingshan decreased from 51% to 20.4% and we ceased to have a controlling financial interest in ShenZhen Mingshan, but still retained an investment in, and significant influence over, Shenzhen Mingshan. Therefore, as of September 30, 2012, Shenzhen Mingshan was an equity investment affiliate of ours.

On December 6, 2010, through our wholly-owned subsidiary, Rise King WFOE, we entered into a series of exclusive contractual arrangements, which were similar to the Contractual Agreements discussed above, with Rise King (Shanghai) Advertisement Media Co., Ltd. ("Shanghai Jing Yang"), a company incorporated under PRC laws in December 2009. The contractual arrangements that we entered into with Shanghai Jing Yang allow us, through Rise King WFOE, to, among other things, secure significant rights to influence Shanghai Jing Yang's business operations, policies and management, approve all matters requiring shareholder approval, and receive 100% of the income earned by Shanghai Jing Yang. From the date of incorporation until December 6, 2010, Shanghai Jing Yang did not conduct any business activities. Therefore, Shanghai Jing Yang's accounts were included in our consolidated financial statements with no goodwill recognized in accordance with ASC Topic 810 “Consolidation”.

On December 8, 2010, Shanghai Jing Yang acquired a 49% interest in a newly established company, Beijing Yang Guang Media Investment Co., Ltd. (“Beijing Yang Guang”). In August 2011, Shanghai Jing Yang sold back its 49% equity interest in Beijing Yang Guang to the majority shareholder of Beijing Yang Guang.

We, through one of our VIEs, Beijing CNET Online, acquired a 100% equity interest in Quanzhou Zhi Yuan Marketing Planning Co., Ltd. (“Quanzhou Zhi Yuan”) and a 51% equity interest in Quanzhou Tian Xi Shun He Advertisement Co., Ltd. (“Quanzhou Tian Xi Shun He”) on January 4, 2011 and February 23, 2011, respectively. Quanzhou Zhi Yuan and Quanzhou Tian Xi Shun He are both independent advertising companies based in Fujian province of the PRC, which provide comprehensive branding and marketing services to over fifty SMEs focused primarily in the sportswear and clothing industry. In June 2011, Beijing CNET Online acquired the remaining 49% equity interest of Quanzhou Tian Xi Shun He. Quanzhou Tian Xi Shun He became a wholly owned subsidiary of Beijing CNET Online.

On January 28, 2011, one of our VIEs, Business Opportunity Online, formed a new wholly owned subsidiary, Business Opportunity Online (Hubei) Network Technology Co., Ltd. ("Business Opportunity Online Hubei"). Business Opportunity Online Hubei is primarily engaged in internet advertisement design, production and promulgation.

On March 1, 2011, one of our VIEs, Business Opportunity Online, together with an individual, who was not affiliated with us, formed a new company, Beijing Chuang Fu Tian Xia Network Technology Co., Ltd. ("Beijing Chuang Fu Tian Xia"). Business Opportunity Online and the co-founding individual owned 51% and 49% of the equity interests of Beijing Chuang Fu Tian Xia, respectively. In addition to capital investment, the co-founding individual is required to provide the controlled domain names, www.liansuo.com and www.chuangye.com to be registered under the established company. Beijing Chuang Fu Tian Xia is primarily engaged in providing and operating internet advertising, marketing and communication services to SMEs through the websites associated the above mentioned domain names.

On April 18, 2011, Business Opportunity Online Hubei formed a new wholly owned company, Hubei CNET Advertising Media Co., Ltd. ("Hubei CNET"). Hubei CNET is primarily engaged in advertisement design, production, promulgation and providing the related advertising and marketing consultancy services.

On April 18, 2011, Business Opportunity Online Hubei, together with an individual, who was not affiliated with us, formed a new company, Zhao Shang Ke Network Technology (Hubei) Co., Ltd. ("Zhao Shang Ke Hubei"). Business Opportunity Online Hubei and the co-founding individual owned 51% and 49% of the equity interests of Zhao Shang Ke Hubei, respectively. Zhao Shang Ke Hubei is primarily engaged in providing advertisement design, production, promulgation and sales channels building services. On December 29, 2011, as approved by the shareholders of Zhao Shang Ke Hubei, two unaffiliated third party investors invested RMB10,000,000 (approximately US$1,578,781) into Zhao Shang Ke Hubei in exchange for an aggregate 50% equity interests in Zhao Shang Ke Hubei. As a result of this transaction, our share of the equity interests in Zhao Shang Ke Hubei decreased from 51% to 25.5% and we ceased to have a controlling financial interest in Zhao Shang Ke Hubei, but still retained an investment in, and significant influence over, Zhao Shang Ke Hubei. Therefore, as of September 30, 2012, Zhao Shang Ke Hubei was an equity investment affiliate of ours.

On July 1, 2011, Quanzhou Zhi Yuan formed a new wholly owned company, Xin Qi Yuan Advertisement Planning (Hubei) Co., Ltd. ("Xin Qi Yuan Hubei"). Xin Qi Yuan Hubei is primarily engaged in advertisement design, production, promulgation and providing the related advertising and marketing consultancy services.

On July 1, 2011, Quanzhou Tian Xi Shun He formed a new wholly owned company, Mu Lin Sen Advertisement (Hubei) Co., Ltd. ("Mu Lin Sen Hubei"). Mu Lin Sen Hubei is primarily engaged in advertisement design, production, promulgation and providing the related advertising and marketing consultancy services.

On July 1, 2011, Business Opportunity Online Hubei, together with an individual who is not affiliated with us, formed a new company, Sheng Tian Network Technology (Hubei) Co., Ltd. ("Sheng Tian Hubei"). Business Opportunity Online Hubei and the co-founding individual owned 51% and 49% of the equity interests of Sheng Tian Hubei, respectively. Sheng Tian Hubei is primarily engaged in computer system design, development and promotion, software development and promotion, and providing the related technical consultancy services.

On September 5, 2011, Business Opportunity Online Hubei formed a new wholly owned company, Chongqing Business Opportunity Online Technology Co., Ltd. ("Business Opportunity Online Chongqing"). Business Opportunity Online Chongqing is primarily engaged in internet advertisement design, production and promulgation. In September 2012, the Company sold all of its equity interest in Business Opportunity Online Chongqing to two unaffiliated parties. Business Opportunity Online Chongqing was dormant from the time of its incorporation through the date the Company disposed of its equity interest to two unaffiliated parties. No gain or loss was incurred in connection with this transaction, as we recovered all of its net assets, which are all cash and cash equivalents from the buyers.

On December 20, 2011, Business Opportunity Online Hubei acquired a 51% equity interest in Sou Yi Lian Mei. In September 2012, Business Opportunity Online Hubei acquired the remaining 49% equity interest in Sou Yi Lian Mei. Sou Yi Lian Mei became a wholly owned subsidiary of Business Opportunity Online Hubei accordingly. We accounted for this transaction in accordance with ASC Topic 810-10, “Changes in a parent’s ownership interest while the parent retains its controlling financial interest in its subsidiary”, which requires the transaction be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in our consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in our ownership interest in the subsidiary. The difference of approximately US$0.79 million between the fair value of the consideration payable and the amount by which the noncontrolling interest is adjusted was recognized in equity attributable to us as a deduction of our additional paid-in capital account. Sou Yi Lian Mei is primary engaged in providing online advertising and marketing services and operates its business primarily through its wholly-owned subsidiary, Jin Du Ya He (Beijing) Network Technology Co., Ltd ("Jin Du Ya He").

Through our PRC operating subsidiary and VIEs, we are one of China's leading B2B fully integrated internet service providers for expanding SMEs' sales networks in China and our services primarily include proprietary internet and advertising technologies which prepare and publish rich media enabled advertising and marketing campaigns for clients on the Internet, television and other valued added communication channels, host mini-sites with online messaging and consulting functionalities, generate effective sales leads and provide online management tools to help SMEs manage the expansion of their sales networks. Our goal is to strengthen our position as the leading diversified one-stop internet service provider to SMEs for their sales network expansion in China. Our multi-channel advertising and promotion platform consists of the websites www.28.com ("28.com"), www.liansuo.com ("liansuo.com"), www.chuangye.com ("chuangye.com") and www.sooe.cn ("sooe.cn"), our Internet advertising portals, ChinaNet TV, our TV production and advertising unit, our bank kiosk advertising unit, which is primarily used as an advertising platform for clients in the financial services industry and will be further utilized as an additional value-added communication channel for SME clients and our brand management and sales channel building services unit.

Basis of presentation, management estimates and critical accounting policies

Our unaudited interim consolidated financial statements have been prepared in accordance with U.S. GAAP for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as promulgated by the SEC, and include the accounts of our Company, and all of our subsidiaries and VIEs. We prepare financial statements in conformity with U.S. GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities on the date of the financial statements and the reported amounts of revenues and expenses during the financial reporting period. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. Some of our accounting policies require higher degrees of judgment than others in their application. In order to understand the significant accounting policies that we adopted for the preparation of our interim consolidated financial statements, you should refer to the information set forth in Note 3 "Summary of significant accounting policies" to our audited financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Recent Accounting Standards

In July 2012, the FASB issued ASU 2012-02, "Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment." This ASU simplifies how entities test indefinite-lived intangible assets for impairment which improve consistency in impairment testing requirements among long-lived asset categories. These amended standards permit an assessment of qualitative factors to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. For assets in which this assessment concludes it is more likely than not that the fair value is more than its carrying value, these amended standards eliminate the requirement to perform quantitative impairment testing as outlined in the previously issued standards. The guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial position and results of operations.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the Company's consolidated financial statements upon adoption.

A. RESULTS OF OPERATIONS FOR THE NINE AND THREE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

The following table sets forth a summary, for the periods indicated, of our consolidated results of operations. Our historical results presented below are not necessarily indicative of the results that may be expected for any future period. All amounts, except number of shares and per share data, are presented in thousands of US dollars.

| | Nine Months Ended September 30, | | Three Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 US$ (Unaudited) | 2011 US$ (Unaudited) | 2012 US$ (Unaudited) | 2011 US$ (Unaudited) |
| Sales | | | | |
| From unrelated parties | $ 38,232 | $ 21,987 | $ 10,236 | $ 6,329 |
| From related parties | 117 | 547 | 51 | 89 |
| | 38,349 | 22,534 | 10,287 | 6,418 |
| Cost of sales | 28,065 | 8,868 | 6,163 | 3,418 |
| Gross margin | 10,284 | 13,666 | 4,124 | 3,000 |
| | | | | |
| Operating expenses | | | | |
| Selling expenses | 2,042 | 2,198 | 640 | 575 |
| General and administrative expenses | 4,320 | 2,726 | 1,260 | 861 |
| Research and development expenses | 1,112 | 1,100 | 356 | 376 |
| | 7,474 | 6,024 | 2,256 | 1,812 |
| | | | | |
| Income from operations | 2,810 | 7,642 | 1,868 | 1,188 |
| | | | | |
| Other income (expenses) | | | | |
| Interest income | 123 | 9 | 2 | 5 |
| Gain on deconsolidation of subsidiaries | - | 232 | - | - |
| Other (expenses)/income | (148) | 5 | (148) | - |
| | (25) | 246 | (146) | 5 |
| Income before income tax expense, equity method investments and noncontrolling interests | 2,785 | 7,888 | 1,722 | 1,193 |
| Income tax expense | 196 | 861 | 182 | 107 |
| Income before equity method investments and noncontrolling interests | 2,589 | 7,027 | 1,540 | 1,086 |
| Share of losses in equity investment affiliates | (394) | (180) | (97) | (75) |
| Net income | 2,195 | 6,847 | 1,443 | 1,011 |
| Net (income) / loss attributable to noncontrolling interests | (446) | 96 | (223) | 100 |
| Net income attributable to ChinaNet Online Holdings, Inc. | 1,749 | 6,943 | 1,220 | 1,111 |
| Dividend of Series A convertible preferred stock | - | (407) | - | (85) |
| Net income attributable to common stockholders of ChinaNet Online Holdings, Inc. | $ 1,749 | $ 6,536 | $ 1,220 | $ 1,026 |
| | | | | |
| Earnings per share | | | | |

| | | | | |
|---|---|---|---|---|
| Earnings per common share | | | | |
| Basic | $ 0.08 | $ 0.37 | $ 0.05 | $ 0.06 |
| Diluted | $ 0.08 | $ 0.34 | $ 0.05 | $ 0.06 |
| | | | | |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 22,185,226 | 17,806,818 | 22,186,540 | 18,632,103 |
| Diluted | 22,185,226 | 20,265,764 | 22,186,540 | 18,632,103 |

NON-GAAP MEASURES

To supplement the unaudited interim consolidated statement of income and comprehensive income presented in accordance with GAAP, we are also providing non-GAAP measures of income before income tax expenses, equity method investments and noncontrolling interests, net income, net income attributable to us, net income attributable to our common stockholders and basic and diluted earnings per share for the nine months ended September 30, 2011, which are adjusted from results based on GAAP to exclude the non-cash gain recognized on deconsolidation of a subsidiary incurred during the nine months ended September 30, 2011. For the nine months ended September 30, 2012 and for the three months ended September 30, 2012 and 2011, there is no non-cash income or expenses from nonrecurring transaction under non-GAAP measures. The non-GAAP financial measures are provided to enhance the investors' overall understanding of our current performance in on-going core operations as well as prospects for the future. These measures should be considered in addition to results prepared and presented in accordance with GAAP, but should not be considered a substitute for or superior to GAAP results. We use both GAAP and non-GAAP information in evaluating our operating business results internally and therefore deemed it important to provide all of this information to investors.

The following table presents reconciliations of our non-GAAP financial measures to the unaudited interim consolidated statements of income and comprehensive income for the nine months ended September 30, 2011 (all amounts, except number of shares and per share data, are presented in thousands of US dollars):

| | Nine Months Ended September 30, 2011 | |
|---|---|---|
| | GAAP US$ (Unaudited) | NON GAAP US$ (Unaudited) |
| Income from operations | $7,642 | $7,642 |
| Other income (expenses): | | |
| Interest income | 9 | 9 |
| Gain on deconsolidation of subsidiaries | 232 | - |
| Other income | 5 | 5 |
| | 246 | |
| | | 14 |
| Income before income tax expense, equity method investments and noncontrolling interests | 7,888 | |
| Adjusted income before income tax expense, equity method investments and noncontrolling interests | | 7,656 |
| Income tax expense | 861 | 861 |
| Income before equity method investments and noncontrolling interests | 7,027 | |
| Adjusted income before equity method investments and noncontrolling interests | | 6,795 |
| Share of losses in equity investment affiliates | (180) | (180) |
| Net income | 6,847 | |
| Adjusted net income | | 6,615 |
| Net loss attributable to noncontrolling interest | 96 | 96 |
| Net income attributable to ChinaNet Online Holdings, Inc. | 6,943 | |
| Adjusted net income attributable to ChinaNet Online Holdings, Inc. | | 6,711 |
| Dividend for series A convertible preferred stock | (407) | (407) |
| Net income attributable to common stockholders of ChinaNet Online | $6,536 | |
| Adjusted net income attributable to common stockholders of ChinaNet Online | | $6,304 |

| | | |
|---|---|---|
| | | |
| Earnings per common share-Basic | $0.37 | |
| Adjusted earnings per common share-Basic | | $0.35 |
| | $0.34 | |
| Earnings per common share-Diluted | | |
| Adjusted earnings per common share-Diluted | | $0.33 |
| | | |
| Weighted average number of common shares outstanding: | | |
| Basic | 17,806,818 | 17,806,818 |
| Diluted | 20,265,764 | 20,265,764 |

Revenue

The following tables set forth a breakdown of our total revenue, divided into five segments for the periods indicated, with inter-segment transactions eliminated:

| Revenue type | Nine Months Ended September 30, 2012 (Amounts expressed in thousands of US dollars, except percentages) | | | 2011 | | |
|---|---|---|---|---|---|---|
| Internet advertisement | $ 15,204 | 39.6 | % | $ 11,916 | 52.9 | % |
| Technical services | 149 | 0.4 | % | 4,518 | 20.0 | % |
| TV advertisement | 19,751 | 51.5 | % | 4,742 | 21.1 | % |
| Bank kiosks | 214 | 0.5 | % | 415 | 1.8 | % |
| Brand management and sales channel building | 3,031 | 8.0 | % | 943 | 4.2 | % |
| Total | $ 38,349 | 100 | % | $ 22,534 | 100 | % |

| Revenue type | Three Months Ended September 30, 2012 (Amounts expressed in thousands of US dollars, except percentages) | | | 2011 | | |
|---|---|---|---|---|---|---|
| Internet advertisement | $ 5,585 | 54.3 | % | $ 3,697 | 57.6 | % |
| Technical services | 65 | 0.6 | % | 163 | 2.5 | % |
| TV advertisement | 3,238 | 31.5 | % | 1,972 | 30.7 | % |
| Bank kiosks | 72 | 0.7 | % | 140 | 2.2 | % |
| Brand management and sales channel building | 1,327 | 12.9 | % | 446 | 7.0 | % |
| Total | $ 10,287 | 100 | % | $ 6,418 | 100 | % |

Total Revenues: Our total revenues increased to US$38.35 million for the nine months ended September 30, 2012 from US$22.53 million for nine months ended September 30, 2011, representing a 70% increase. For the three months ended September 30, 2012, our total revenue increased to US$10.29 million from US$6.42 million for the same period of 2011, representing a 60% increase. The increase in total revenues for the nine months ended September 30, 2012 was primarily due to the increase in our TV advertising revenues as compared to the same periods in 2011. For the three months ended September 30, 2012, revenues from internet advertising segment and brand management and sales channel building segment also contributed to the increase of total revenue achieved in the period.

We derive the majority of our advertising service revenues from the sale of internet advertising with sales leads, internet marketing and content management services on our portal. We also derive revenue from the sale of advertising time purchased from different TV programs and the provision of the related technical support to unrelated third parties and to certain related parties. Our advertising services to related parties were provided in the ordinary course of business on the same terms as those provided to our unrelated advertising clients. For the nine and three months ended September 30, 2012 and 2011, our service revenue from related parties in the aggregate was less than 3% of the total revenue we achieved for each respective reporting period.

Our advertising service revenues are recorded net of any sales discounts. Sales discounts include volume discounts and other customary incentives offered to our small and medium-sized franchise and merchant clients, including providing them with additional advertising time for their advertisements if we have unused space available on our websites and represent the difference between our official list price and the amount we actually charge our clients. We typically sign service contracts with our small and medium-sized business that require us to conduct internet advertising on our portal websites in specified locations on the sites and for agreed periods; and/or advertise onto our purchased advertisement time during specific TV programs for agreed periods. We recognize revenues as the advertisement airs over the contractual term based on the schedule agreed upon with our clients.

As a result of the research and development activities conducted and managed by Rise King WFOE, beginning in December 2009, our WFOE began providing a number of value added technical services and management systems to our internet advertising customers, which services enhance the quality and performance of the internet advertising services provided by Business Opportunity Online. These value added technical services are primarily online technical management systems and platforms. Customers use these technical services to analyze, monitor and manage their advertisements, their other traffic generating activities and their online marketing campaign activities on our key advertising portal, 28.com. Revenues generated by Rise King WFOE are from the provision of technical and management systems including tools, databases and services developed and managed by Rise King WFOE to analyze, monitor and manage a customer's advertisements, their traffic generating activities, and their online marketing campaign activities on our key advertising portal, 28.com. Most of these services are based on fixed price terms; revenues are then generated and recognized from the use of the online management system and tools on a periodic basis, together with the satisfaction of other applicable performance thresholds, if specified. Rise King WFOE's customers are similar to our internet advertising customers, with over 70% of the WFOE's customers also being customers of our internet advertisement services. The other remaining Rise King WFOE's customers do not directly advertise on our web portal but use Rise King WFOE's management systems and the internet information collected from our key advertising web portal to monitor and manage their traffic generating activities and online marketing campaign activities. These value added technical services, operated and managed by Rise King WFOE, are primarily developed and offered as additions to the internet advertisement services provided by Business Opportunity Online. The revenue generating activities conducted by Rise King WFOE are not prohibited under the known and existing PRC laws and regulations, as our WFOE is providing value-added technical services to our clients, and is not engaged in the internet advertising business or any other business that is subject to obtaining an Internet Content Provider License. For the internet advertisement services conducted by our VIE, Business Opportunity Online, customers place internet advertisements in different formats on our internet advertising portal, www. 28.com, for example, banners, links, logos, buttons, as well as mini-sites. Customers get internet visits and messages, often referred as sales leads, from their advertisements placed on our portal. For the value added technical services provided by our WFOE, customers primarily use the technical and management systems offered by it to analyze, monitor and manage their advertisements and traffic generating activities on our advertising portal. For example, Rise King WFOE's customers can use our management tools to obtain analysis of messages and sales leads received from their internet advertising.

The tables below summarize the revenues, cost of sales, gross margin and net loss/income generated from each of our VIEs and subsidiaries for the nine and three months ended September 30, 2012 and 2011, respectively.

For the nine months ended September 30, 2012:

| Name of subsidiary or VIE | Revenue from unrelated parties | Revenue from related parties | Revenue from inter-company | Total |
|---|---|---|---|---|
| | $ ('000) | $ ('000) | $ ('000) | $ ('000) |
| Rise King WFOE | 107 | 42 | 40 | 189 |
| Business Opportunity Online and subsidiaries | 31,800 | 75 | - | 31,875 |
| Beijing CNET Online and subsidiaries | 6,325 | - | - | 6,325 |
| Inter-co., elimination | - | - | (40 ) | (40 ) |
| Total revenue | 38,232 | 117 | - | 38,349 |

For the three months ended September 30, 2012:

| Revenue from | Revenue | Revenue | Total |
|---|---|---|---|

| Name of subsidiary or VIE | unrelated parties | from related parties | from inter-company | |
|---|---|---|---|---|
| | $ ('000) | $ ('000) | $ ('000) | $('000) |
| Rise King WFOE | 40 | 25 | 40 | 105 |
| Business Opportunity Online and subsidiaries | 8,387 | 26 | - | 8,413 |
| Beijing CNET Online and subsidiaries | 1,809 | - | - | 1,809 |
| Inter-co., elimination | - | - | (40 ) | (40 ) |
| Total revenue | 10,236 | 51 | - | 10,287 |

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For the nine months ended September 30, 2012:

| Name of subsidiary or VIE | Cost of Sales $ ('000) | Gross Margin $ ('000) |
|---|---|---|
| Rise King WFOE | 8 | 181 |
| Business Opportunity Online and subsidiaries | 23,795 | 8,080 |
| Beijing CNET Online and subsidiaries | 4,262 | 2,063 |
| Inter-co., elimination | - | (40) |
| Total | 28,065 | 10,284 |

For the three months ended September 30, 2012:

| Name of subsidiary or VIE | Cost of Sales $ ('000) | Gross Margin $ ('000) |
|---|---|---|
| Rise King WFOE | 3 | 102 |
| Business Opportunity Online and subsidiaries | 5,289 | 3,124 |
| Beijing CNET Online and subsidiaries | 877 | 932 |
| Shanghai Jing Yang | (6) | 6 |
| Inter-co., elimination | - | (40) |
| Total | 6,163 | 4,124 |

For the nine months ended September 30, 2012:

| Name of subsidiary or VIE | Net (Loss)/Income $ ('000) |
|---|---|
| Rise King WFOE | (1,172) |
| Business Opportunity Online and subsidiaries | 3,585 |
| Beijing CNET Online and subsidiaries | 367 |
| Shanghai Jing Yang | (9) |
| ChinaNet Online Holdings, Inc. | (576) |
| Total net income before allocation to the noncontrolling interest | 2,195 |

For the three months ended September 30, 2012:

| Name of subsidiary or VIE | Net (Loss)/Income $ ('000) |
|---|---|
| Rise King WFOE | (251) |
| Business Opportunity Online and subsidiaries | 1,514 |
| Beijing CNET Online and subsidiaries | 332 |

| | |
|---|---|
| Shanghai Jing Yang | (1 ) |
| ChinaNet Online Holdings, Inc. | (151 ) |
| Total net income before allocation to the noncontrolling interest | 1,443 |

For the nine months ended September 30, 2011:

| Name of subsidiary or VIE | Revenue from unrelated parties $ ('000) | Revenue from related parties $ ('000) | Revenue from inter-company $ ('000) | Total $('000) |
|---|---|---|---|---|
| Rise King WFOE | 4,347 | 171 | - | 4,518 |
| Business Opportunity Online and subsidiaries | 15,070 | 376 | - | 15,446 |
| Beijing CNET Online and subsidiaries | 2,567 | - | 14 | 2,581 |
| Shanghai Jing Yang | 3 | - | - | 3 |
| Inter-co., elimination | - | - | (14) | (14) |
| Total revenue | 21,987 | 547 | - | 22,534 |

For the three months ended September 30, 2011:

| Name of subsidiary or VIE | Revenue from unrelated parties $ ('000) | Revenue from related parties $ ('000) | Revenue from inter-company $ ('000) | Total $('000) |
|---|---|---|---|---|
| Rise King WFOE | 163 | - | - | 163 |
| Business Opportunity Online and subsidiaries | 5,338 | 89 | - | 5,427 |
| Beijing CNET Online and subsidiaries | 828 | - | - | 828 |
| Shanghai Jing Yang | - | - | - | - |
| Inter-co., elimination | - | - | - | - |
| Total revenue | 6,329 | 89 | | 6,418 |

For the nine months ended September 30, 2011:

| Name of subsidiary or VIE | Cost of Sales $ ('000) | Gross Margin $ ('000) |
|---|---|---|
| Rise King WFOE | 248 | 4,270 |
| Business Opportunity Online and subsidiaries | 6,992 | 8,454 |
| Beijing CNET Online and subsidiaries | 1,642 | 939 |
| Shanghai Jing Yang | - | 3 |
| Inter-co., elimination | (14) | - |
| Total | 8,868 | 13,666 |

For the three months ended September 30, 2011:

| Name of subsidiary or VIE | Cost of Sales $ ('000) | Gross Margin $ ('000) |
|---|---|---|

| | | |
|---|---|---|
| Rise King WFOE | 9 | 154 |
| Business Opportunity Online and subsidiaries | 2,965 | 2,462 |
| Beijing CNET Online and subsidiaries | 444 | 384 |
| Shanghai Jing Yang | - | - |
| Inter-co., elimination | - | - |
| Total | 3,418 | 3,000 |

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For the nine months ended September 30, 2011:

| Name of subsidiary or VIE | Net (Loss)/Income $ ('000) | |
|---|---|---|
| Rise King WFOE | 2,520 | |
| Business Opportunity Online and subsidiaries | 4,773 | |
| Beijing CNET Online and subsidiaries | 120 | |
| Shanghai Jing Yang | 28 | |
| ChinaNet Online Holdings, Inc. | (594 | ) |
| Total net income before allocation to the noncontrolling interest | 6,847 | |

For the three months ended September 30, 2011:

| Name of subsidiary or VIE | Net (Loss)/Income $ ('000) | |
|---|---|---|
| Rise King WFOE | (248 | ) |
| Business Opportunity Online and subsidiaries | 1,274 | |
| Beijing CNET Online and subsidiaries | 156 | |
| Shanghai Jing Yang | (4 | ) |
| ChinaNet Online Holdings, Inc. | (167 | ) |
| Total net income before allocation to the noncontrolling interest | 1,011 | |

Management considers revenues generated from internet advertising and the related technical services as one aggregate business operation and relies upon the consolidated results of all the operations in this business unit to make decisions about allocating resources and evaluating performance.

- Internet advertising revenues for the nine months ended September 30, 2012 were approximately US$15.20 million as compared to US$11.92 million for the same period in 2011, representing an increase of 28%. For the three months ended September 30, 2012 and 2011, internet advertising revenues were approximately US$5.59 million and US$3.70 million, respectively, representing an increase of 51%. The increase in internet advertising revenue for the nine months ended September 30, 2012 was due to the addition of the internet advertising revenue generated by Sou Yi Lian Mei of approximately US$5.01 million, resulting from the 51% equity interest acquisition in Sou Yi Lian Mei in late December 2011. The internet advertising revenue generated by the other operating VIEs of approximately US$10.19 million for the nine months ended September 30, 2012 decreased by approximately 15% as compared to US$11.92 million in internet advertising revenue generated in the same period of 2011. This decrease was primarily due to a decrease in the average advertising spending per customer caused by the general decline of China's economy in the second quarter of 2011, continued into the third quarter of 2012. For the three months ended September 30, 2012, the internet advertising revenue generated by Sou Yi Lian Mei was approximately US$1.75 million, and the internet advertising revenue generated by the other operating VIEs was approximately US$3.84 million for the three months ended September 30, 2012, representing a slight increase of approximately 4% as compared to US$3.70 million in internet advertising revenue generated in the same period of 2011, which is due to stabilization of the economic downturn in the overall economy during the period.

- Revenues generated from technical services offered by Rise King WFOE were US$0.15 million for the nine months ended September 30, 2012, as compared to US$4.5 million for the same period in 2011. For the three months ended

September 30, 2012 and 2011, revenues generated from technical services offered by Rise King WFOE were approximately US$0.07 million and US$0.16 million, respectively. Due to the Chinese government's monetary policy of increasing interest rates and tightening the money supply, economic difficulties began in the second quarter of 2011, which only slightly recovered, in the first nine months of 2012, with no significant improvement in the overall economy. In response to the overall economic downturn in China, and from the second half of 2011, the majority of our clients cancelled the subscription of these services and only continued their basic internet advertising service, which was recorded in as our internet advertising revenue discussed above and reduced their advertising spending significantly.

- Our TV advertising revenue increased significantly to US$19.75 million for the nine months ended September 30, 2012 from US$4.74 million for the same period in 2011. For the three months ended September 30, 2012 and 2011, our TV advertising revenue was approximately US$3.24 million and US$1.97 million, respectively. We generated this US$19.75 million of TV advertising revenue for the nine months ended September 30, 2012 by selling approximately 17,950 minutes of advertising time purchased from different provincial TV stations as compared with approximately 4,700 minutes of advertising time that we sold in the same period of 2011. This increase in TV advertising time selling was due to enhanced cooperation with the TV station responsible for launching the entrepreneurial reality show, which is based on the same concept and premise as the hit TV game show “Shark Tank” in the U.S. This show is intended to get the general public to visit our website, Chuanye.com and create additional traffic on our two advertising portals, 28.com and Liansuo.com, and in return to monetize more branded larger size small and medium enterprises to use our services while securing our competitive advantage in the TV business segment against our competitors with more time purchased in 2012 as compared with 2011. The TV show is considered to be an alternative economic resource to obtain internet traffic to our web portals as the costs associated with our internet resources are increasing year over year and TV cost has a relatively lower rate of increase. However, due to the regular Chinese New Year holiday which takes place in the first quarter of each fiscal year and is always considered to be the slowest time of the year, and the continued economic downturn, we had to combine the time slots of the first quarter of 2012 at cost with other quarter’s available time slots sales in order to mitigate the deficiency in sales margin incurred during this time of the year. As a result of such combination, we achieved only 0.2% gross margin for this segment in the first quarter of 2012, this situation was improved in the second and third quarter of 2012 with our gross margin of this business segment improved to 2% for the three months ended June 30, 2012 and September 30, 2012 respectively, and the overall gross margin of this segment improved to 1% for the nine months ended September 30, 2012. For the nine and three months ended September 30, 2011, we limited TV time slots with affordable costs to the needed customers at an agreed profitable sales, which enabled us to achieve a 19% and 15% gross margin for each respective period.

- For the nine and three months ended September 30, 2012, we earned approximately US$0.21 million and US$0.07 million of revenue from the bank kiosk business segment, respectively, as compared to approximately US$0.42 million and US$0.14 million for the same period in 2011, respectively. The decrease in advertising revenue from the bank kiosk business was a result of the decline of the general economy in China, which caused a significant reduction in our customers’ overall advertising spending as discussed above. The bank kiosk advertising business is not intended to expand at the moment as management’s main focus is on expanding internet business. Therefore, it was not a significant contributor to revenue for either the nine and three months ended September 30, 2012 or 2011. Management currently maintains this business without any expansion plans and some of the technology used in this business unit will be fully integrated into the overall advertising and marketing platform.

- For the nine months ended September 30, 2012, we achieved approximately US$3.03 million service revenue from our brand management and sales channel building segment as compared to US$0.94 million service revenue generated in the same period of 2011. For the three months ended September 30, 2012, we achieved approximately US$1.33 million service revenue from our brand management and sales channel building segment as compared to US$0.45 million service revenue generated in the same period of 2011. The increase in the revenue from this business segment for the nine and three months ended September 30, 2012 was primarily due to the increase in the average brand advertising and marketing spending per customer from larger-sized and ex-exporting customers acquired for these periods, as a result of our further expansion of our client base in the fiscal year of 2012.

Cost of revenues

Our cost of revenues consisted of costs directly related to the offering of our advertising services, technical services, marketing services and brand management and sales channel building services. The following table sets forth our cost of revenues, divided into five segments, by amount and gross profit ratio for the periods indicated, with inter-segment transactions eliminated:

| | Nine Months Ended September 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2012 | | | 2011 | | |
| | (Amounts expressed in thousands of US dollars, except percentages) | | | | | |
| | Revenue | Cost | GP ratio | Revenue | Cost | GP ratio |
| Internet advertisement | $15,204 | $7,439 | 51% | $11,916 | $4,463 | 63% |
| Technical service | 149 | 8 | 95% | 4,518 | 248 | 95% |
| TV advertisement | 19,751 | 19,519 | 1% | 4,742 | 3,833 | 19% |
| Bank kiosk | 214 | 19 | 91% | 415 | 36 | 91% |
| Brand management and sales channel building | 3,031 | 1,080 | 64% | 943 | 288 | 69% |
| Total | $38,349 | $28,065 | 27% | $22,534 | $8,868 | 61% |

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| | Three Months Ended September 30, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | 2011 | | | |
| | (Amounts expressed in thousands of US dollars, except percentages) | | | | | | | |
| | Revenue | Cost | GP ratio | | Revenue | Cost | GP ratio | |
| Internet advertisement | $5,585 | $2,519 | 55 | % | $3,697 | $1,596 | 57 | % |
| Technical service | 65 | 3 | 95 | % | 163 | 9 | 94 | % |
| TV advertisement | 3,238 | 3,162 | 2 | % | 1,972 | 1,669 | 15 | % |
| Bank kiosk | 72 | 7 | 90 | % | 140 | 12 | 91 | % |
| Brand management and sales channel building | 1,327 | 472 | 64 | % | 446 | 132 | 70 | % |
| Total | $10,287 | $6,163 | 40 | % | $6,418 | $3,418 | 47 | % |

Cost of revenues: Our total cost of revenues increased to US$28.07 million for the nine months ended September 30, 2012 from US$8.87 million for the same period in 2011. For the three months ended September 30, 2012 and 2011, our total cost of revenues were approximately US$6.16 million and US$3.42 million, respectively. The increase in total cost of revenues for the nine and three months ended September 30, 2012 was primarily due to the significant increase in costs associated with our TV advertisement business segment, which was in line with the increase in our TV advertisement revenue for the nine and three months ended September 30, 2012, as discussed above. Our cost of revenues related to the offering of our advertising and marketing services primarily consists of internet resources purchased from other portal websites and technical services providers related to lead generation, sponsored search, TV advertisement time costs purchased from TV stations, direct labor cost associated with providing services and business taxes and surcharges.

- Cost associated with obtaining internet resources was the largest component of our cost of revenue for internet advertisement, accounting for approximately 80% of our total internet advertisement cost of sales. We purchased these internet resources from other well-known portal websites in China, for example, Baidu and Tecent (QQ). Our purchasing of these internet resources in large volumes allowed us to negotiate discounts with our suppliers. The majority of the resources purchased were used by the internet advertising unit to attract more internet traffic to our advertising portals, assist our internet advertisement clients to obtain more diversified exposure and to generate more visits to their advertisements and mini-sites placed on our portal websites, which result in potential sales leads. For the nine months ended September 30, 2012 and 2011, our total cost of sales for internet advertising revenue was US$7.44 million and US$4.46 million, respectively. For the three months ended September 30, 2012 and 2011, our total cost of sales for internet advertising was US$2.52 million and US$1.60 million, respectively. The increase in our cost of sales for internet advertising revenue was primarily due to the increase in the purchase price of these resources and the addition of the internet advertising cost of sales recorded by Sou Yi Lian Mei for the nine and three months ended September 30, 2012, which are approximately US$1.95 million and US$0.62 million, respectively. The internet cost of revenue incurred by the other operating VIEs of approximately US$5.49 million and US$1.90 million for the nine and three months ended September 30, 2012, respectively, increased by approximately 23% and 19%, respectively, as compared to US$4.46 million and US$1.60 million in internet advertising cost of revenue incurred in the same period of 2011, respectively. This increase was primarily due to the increase in the purchase price of such resources in 2012 as compared to 2011 and the increased demand of these resources to improve customer satisfaction. Given the foregoing, gross profit margin of internet advertising business segment furnished approximately 51% and 55% for the nine and three months ended September 30, 2012, respectively, as compared to 63% and 57% achieved in the same period in 2011, respectively.

- Beginning in December 2009, our WFOE began providing a number of value added technical services to our internet advertisement customers. The direct cost of sales for the WFOE's technical services revenue recognized by our WFOE was primarily the PRC business tax expenses, which was approximately 5% of the total technical service revenue recognized by Rise King WFOE. The decrease in the business tax expenses incurred by our WFOE for the nine and three months ended September 30, 2012 was in line with the decrease in the technical services revenue earned by our WFOE for the nine and three months ended September 30, 2012 as compared to the same periods in 2011.

- TV advertisement time cost is the largest component of the cost of the TV advertisement revenue. We purchase TV advertisement time from different provincial TV stations and resell it to our TV advertisement clients. Our TV advertisement time cost was approximately US$19.5 million and US$3.8 million for the nine months ended September 30, 2012 and 2011, respectively, and US$3.2 million and US$1.7 million for the three months ended September 30, 2012 and 2011, respectively. The significant increase in our total TV advertisement time cost was in line with the significant increase of TV advertising revenue for the nine and three months ended September 30, 2012 as compared to that in the same periods of 2011, as discussed above.

- Cost recognized for brand management and sales channel building business segment mainly consisted of director labor cost for providing these services to our customers and the related business tax and surcharges. The increase in cost of service in this segment was in line with the increase of revenue achieved by this segment for the nine and three months ended September 30, 2012 as compared to that in the same periods of 2011.

Gross Profit

As a result of the foregoing, our gross profit was US$10.3 million and US$4.1 million for the nine and three months ended September 30, 2012, respectively, as compared to US$13.67 million and US$3.0 million for the same period in 2011, respectively. Our overall gross margin decreased to 27% and 40% for the nine and three months ended September 30, 2012, respectively, as compared to 61% and 47% for the same period in 2011, respectively. For the nine months ended September 30, 2012, the decrease is a direct result of the significant increase of the low margin TV advertising revenue, which accounted for approximately 52% of the total revenue we achieved for the nine months ended September 30, 2012, as compared to 21% in the same period of 2011. For the three months ended September 30, 2012, the decrease in our overall gross margin is a result of (1) lower high margin internet advertising revenue achieved, which is 54% of the total revenue for the three months ended September 30, 2012, compared to 58% of the total revenue for the same period of last year; and (2) lower gross margin achieved from TV advertising segments, which contributed to 32% and 30% of the total revenue achieved for the three months ended September 30, 2012 and 2011, respectively, and achieved gross margin of 2% and 15%, respectively, for the three months ended September 30, 2012 and 2011.

Operating Expenses and Net Income

Our operating expenses consist of selling expenses, general and administrative expenses and research and development expenses. The following tables set forth our operating expenses, divided into their major categories by amount and as a percentage of our total revenues for the periods indicated.

| | Nine Months Ended September 30, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | | | | 2011 | | | |
| | (Amounts expressed in thousands of US dollars, except percentages) | | | | | | | |
| | | Amount | % of total revenue | | | Amount | % of total revenue | |
| Total Revenue | $ | 38,349 | 100 | % | $ | 22,534 | 100 | % |
| Gross Profit | | 10,284 | 27 | % | | 13,666 | 61 | % |
| Selling expenses | | 2,042 | 5 | % | | 2,198 | 10 | % |
| General and administrative expenses | | 4,320 | 11 | % | | 2,726 | 12 | % |
| Research and development expenses | | 1,112 | 3 | % | | 1,100 | 5 | % |
| Total operating expenses | $ | 7,474 | 19 | % | $ | 6,024 | 27 | % |

| | Three Months Ended September 30, | | | |
|---|---|---|---|---|
| | 2012 | | 2011 | |
| | (Amounts expressed in thousands of US dollars, except percentages) | | | |
| | Amount | % of total revenue | Amount | % of total revenue |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Total Revenue | $ | 10,287 | 100 | % | $ | 6,418 | 100 | % |
| Gross Profit | | 4,124 | 40 | % | | 3,000 | 47 | % |
| Selling expenses | | 640 | 6 | % | | 575 | 9 | % |
| General and administrative expenses | | 1,260 | 12 | % | | 861 | 13 | % |
| Research and development expenses | | 356 | 4 | % | | 376 | 6 | % |
| Total operating expenses | $ | 2,256 | 22 | % | $ | 1,812 | 28 | % |

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Operating Expenses: Our total operating expenses increased to US$7.47 million for the nine months ended September 30, 2012 from US$6.02 million for the same period of 2011. For the three months ended September 30, 2012, our total operating expenses increased to US$2.26 million as compared to US$1.81 million for the same period of 2011.

- Selling expenses: For the nine months ended September 30, 2012, our selling expenses decreased to US$2.04 million from US$2.20 million for the same period of 2011. For the three months ended September 30, 2012, our selling expenses increased to US$0.64 million as compared to US$0.58 million for the same period in 2011. Our selling expenses primarily consist of advertising expenses for brand development that we pay to TV stations and other media outlets for the promotion and marketing of our advertising web portals, other advertising and promotional expenses, website server hosting and broadband leasing expenses, staff salaries, staff benefits, performance bonuses, travelling expenses and communication expenses of our sales department. For the nine months ended September 30, 2012, the change in our selling expenses was primarily due to the following reasons: (1) the increase in staff salary, bonus, employee related benefit expenses and other general selling expenses, such as travelling expenses, business and entertainment expenses and communication expenses of approximately US$0.84 million, primarily due to the expansion of our sales department and inclusion of the selling expenses incurred by Sou Yi Lian Mei, the new VIE we acquired in December 2011; (2) increase in website server hosting and broadband leasing expense of approximately US$0.08 million due to the same reason as discussed above; (3) decrease in selling expenses of approximately US$0.11 million due to deconsolidation Zhao Shang Ke Hubei incurred in December 2011; and (4) our brand development advertising expenses for our advertising web portals decreased by approximately US$0.97 million. Due to the current economic downturn and overall cost reduction plan, we decided to slow down the brand-building activities until the recovery of the economy based on the factor that, our key advertising web portal, 28.com, has been already recognized as one of the most visiting Chinese internet portals providing internet advertising and marketing services with sales leads, and other value-added services to SMEs, particularly for small and medium-sized franchisors, in the PRC, by the investment we made in brand building over the last three years. For the three months ended September 30, 2012, the reasons for the change of selling expenses as compared to the same period of last year were similar to those discussed above for the nine months ended September 30, 2012. For the three months ended September 30, 2012, the decrease of our brand development advertising expenses was less than the amount of increased staff salary, bonus, employee related benefit expenses and other general selling expenses, due to inclusion of Sou Yi Liam Mei and other expansions of our sales department, there was slightly increase in our selling expenses for the period as compared with the same period of last year.

- General and administrative expenses: For the nine months ended September 30, 2012, our general and administrative expenses increased to US$4.32 million as compared to US$2.73 million for the same period in 2011. For the three months ended September 30, 2012, our general and administrative expenses increased to US$1.26 million as compared to US$0.86 million for the same period in 2011. Our general and administrative expenses primarily consist of salaries and benefits for management, accounting and administrative personnel, office rentals, depreciation and amortization expenses, professional service fees, maintenance, utilities and other office expenses. The change in our general and administrative expenses for the nine months ended September 30, 2012 was primarily due to the following reasons: (1) the increase in the amortization expenses related to the intangible assets identified in the acquisition transactions consummated in 2011 of approximately US$0.40 million, which was primarily due to the acquisition of Sou Yi Lian Mei was consummated in late December 2011 and the related amortization expenses was only included for the nine months ended September 30, 2012; (2) the increase in staff salary, bonus, employee related benefit expenses and other general selling expenses, such as entertainment expenses, travelling expenses and communication expenses of approximately US$0.71 million, primarily due to expansion of our general and administrative department of new VIEs incorporated in 2011 and inclusion of the general and administrative expenses incurred by Sou Yi Lian Mei, the new VIE we acquired in

December 2011; (3) the increase in allowance for doubtful accounts we provided for the nine months ended September 30, 2012 of approximately US$0.56 million; and (4) the decrease in general and administrative expenses of approximately US$0.07 million due to deconsolidation of Zhao Shang Ke Hubei incurred in December 2011. For the three months ended September 30, 2012, the reasons for the change in general and administrative expenses as compared to the same period of last year were similar to those for the nine months ended September 30, 2012, as discussed above.

- Research and development expenses: For the nine months ended September 30, 2012 and 2011, research and development expenses was US$1.11 million and US$1.10 million, respectively. For the three months ended September 30, 2012 and 2011, research and development expenses was US$0.36 million and US$0.38 million, respectively. Our research and development expenses primarily consist of salaries and benefits for the research and development staff, equipment depreciation expenses, and office utilities and supplies allocated to our research and development department. The change in our research and development expenses for the nine months ended September 30, 2012 was primarily due to the following reasons: (1) the amortization expenses of approximately US$0.09 million for the cloud-computing based software technologies, which we acquired in June 2011, thus nine and three months of amortization expenses was included for the nine months ended September 30, 2012 and 2011, respectively; and (2) the decrease in salary and staff benefit expenses in our research and development department of approximately US$0.10 million, due to internal transfer of the research and development staff to the operating department. For the three months ended September 30, 2012, the decrease in our research and development expenses was primarily due to the internal transfer of the research and development staff to the operating department as discussed above.

- Operating Profit: As a result of the foregoing, our operating profit decreased to US$2.81 million for the nine months ended September 30, 2012 from US$7.64 million for the same period in 2011. This was primarily due to the increasing cost and economic impact of the economic downturn on SMEs. For the three months ended September 30, 2012, our operating profit increased to US$1.87 million as compared to US$1.19 million for the same period in 2011.

- Interest income: Interest income for the nine months ended September 30, 2012 included an approximately US$0.11 million of interest income resulting from fixed deposit of approximately US$3.48 million.

- Gain on deconsolidation of subsidiaries: The deconsolidation of Shenzhen Mingshan that occurred on January 6, 2011, was accounted for in accordance with ASC Topic 810 "Consolidation". We recognized a gain of approximately US$0.23 million upon deconsolidation of Shenzhen Mingshan in our consolidated statements of income and comprehensive income for the nine months ended September 30, 2011, with a corresponding increase to the carrying value of the investment in Shenzhen Mingshan on our consolidated balance sheet. The deconsolidation gain represented the excess of the fair value of our retained equity interest in Shenzhen Mingshan over its carrying value as of the date of deconsolidation.

- Income before income tax expense, equity method investments and noncontrolling interests: As a result of the foregoing, our income before income tax expenses, equity method investment and noncontrolling interest decreased to US$2.79 million for the nine months ended September 30, 2012 from US$7.89 million for the same period in 2011. For the three months ended September 30, 2012, our income before income tax expenses, equity method investment and noncontrolling interest increased to US$1.72 million from US$1.19 million for the same period in 2011. Excluding the non-cash gain recognized for deconsolidation of Shenzhen Mingshan of approximately US$0.23 million, for the nine months ended September 30, 2011, our adjusted income before income tax expenses, equity method investments and noncontrolling interests was approximately US$7.66 million.

- Income Tax expenses: Our income tax expense was approximately US$0.20 million and US$0.86 million for the nine months ended September 30, 2012 and 2011, respectively. For the nine months ended September 30, 2012 and 2011, income tax expenses included: (1) current income tax expenses of approximately US$0.95 million and US$0.93 million, respectively; and (2) deferred income tax benefit of approximately US$0.75 million and US$ 0.07 million, respectively. For the three months ended September 30, 2012 and 2011, (1) our current income tax expense was approximately US$0.37 million and US$0.13 million, respectively; (2) deferred income tax benefit was approximately US$0.19 million and US$0.02 million, respectively. For the nine and three months ended September 30, 2012, the increase in current income tax expenses was mainly due to the increase in the overall effective income tax rate of the profitable PRC operating VIEs. For the nine months ended September 30, 2012 and 2011, deferred income tax benefit recognized in relation to the amortization of the intangible assets identified in the acquisition transactions consummated in 2011 was approximately US$0.16 million and US$0.07 million, respectively. For the nine months ended September 30, 2012, deferred income tax benefit recognized also include an approximately US$0.58 million deferred income tax benefit in relation to the net operating losses incurred by our PRC operating VIEs for the nine months ended September 30, 2012, which we consider likely to be able to be utilized with respect to future earnings of the entities to which the operating losses relate. For the three months ended September 30, 2012 and 2011, deferred income tax benefit recognized in relation to the amortization of the intangible assets identified in the acquisition transactions consummated in 2011 was approximately US$0.06 million and US$0.02 million, respectively. For the three months ended September 30, 2012, deferred income tax benefit recognized also included an approximately US$0.13 million deferred income tax benefit in relation to the net operating losses incurred by our PRC operating VIEs for the three months ended September 30, 2012, which we consider likely to be able to be utilized with respect to future earnings of the entities to which the operating losses relate.

- Income before equity method investments and noncontrolling interests: As a result of the foregoing, our income before equity method investments and noncontrolling interests decreased to approximately US$2.59 million for the nine months ended September 30, 2012 from US$7.03 million for the same period of 2011. For the three months ended September 30, 2012, our income before equity method investments and noncontrolling interest increased to US$1.54 million from US$1.09 million for the same period in 2011. Excluding the non-cash gain recognized for deconsolidation of Shenzhen Mingshan of approximately US$0.23 million, for the nine months ended September 30, 2011, our adjusted income before equity method investments and noncontrolling interests was US$6.80 million.

- Share of losses in equity investment affiliates: We acquired a 49% equity interest in Beijing Yang Guang in December 2010. In August 2011, we transferred our 49% equity interest in Beijing Yang Guang back to its majority shareholder. For the nine months ended September 30, 2011, our pro-rata share of earnings recognized in Beijing Yang Guang was approximately US$0.026 million. For the three months ended September 30, 2011, our pro-rata share of losses recognized in Beijing Yang Guang was approximately US$0.004 million. Shenzhen Mingshan used to be 51% owned by one of our operating VIEs and was consolidated by us from its date of incorporation through January 6, 2011. On January 6, 2011, an unaffiliated third party invested RMB15,000,000 (approximately US$2,368,172) to Shenzhen Mingshan in exchange for a 60% equity interest in Shenzhen Mingshan, and our percentage equity interest in Shenzhen Mingshan decreased from 51% to 20.4% accordingly. Shenzhen Mingshan then became an equity investment affiliate of ours. Accordingly, we recognized our pro-rata share of losses in Shenzhen Mingshan immediately after the deconsolidation, which was approximately US$0.12 million and US$0.21 million for the nine months ended September 30, 2012 and 2011, respectively. For the three months ended September 30, 2012 and 2011, we recognized our pro-rata share of losses in Shenzhen Mingshan of approximately US$0.03 million and US$0.07 million respectively. Zhao Shang Ke Hubei used to be 51% owned by one of our operating VIEs and was consolidated by us from its date of incorporation through December 29, 2011. On December 29, 2011, two unaffiliated third party investors invested RMB10,000,000 (approximately US$1,578,781) to Zhao Shang Ke Hubei in exchange for a 50% equity interest in Zhao Shang Ke Hubei, and our percentage equity interest in Zhao Shang Ke Hubei decreased from 51% to 25.5% accordingly. Zhao Shang Ke Hubei then became an equity investment affiliate of ours. Accordingly, we recognized our pro-rata share of losses in Zhao Shang Ke Hubei immediately after the deconsolidation, which was approximately US$0.27 million and US$0.07 million for the nine and three months ended September 30, 2012, respectively. Given the foregoing, net amount recognized as share of losses in equity investment affiliates was approximately US$0.39 million and US$0.18 million for the nine months ended September 30, 2012 and 2011, respectively. For the three months ended September 30, 2012 and 2011, net amount recognized as share of losses in equity investment affiliates was both approximately US$0.10 and US$0.07 million, respectively.

- Net income: As a result of the foregoing, our net income decreased to approximately US$2.20 million for the nine months ended September 30, 2012 as compared to approximately US$6.85 million for the same period of 2011. For the three months ended September 30, 2012, our net income increased to approximately US$1.44 million as compared to approximately US$1.01 million for the same period of 2011. Excluding the non-cash gain recognized for deconsolidation of Shenzhen Mingshan of approximately US$0.23 million, for the nine months ended September 30, 2011, our adjusted net income was approximately US$6.62 million.

- Income attributable to noncontrolling interest: Quanzhou Tian Xi Shun He was 51% owned by Beijing CNET Online upon acquisition before it became a wholly-owned subsidiary of Beijing CNET Online in June 2011. Zhao Shang Ke Hubei was 51% owned by Business Opportunity Online Hubei upon incorporation until it was deconsolidated from us in December 2011. Beijing Chuang Fu Tian Xia and Sheng Tian Hubei were 51% owned by Business Opportunity Online and Business Opportunity Online Hubei, respectively, upon incorporation. In December 2011, we, through one of our operating VIEs, acquired a 51% equity interest in Sou Yi Lian Mei and Sou Yi Lian Mei became a majority-owned VIE of ours, before we acquired the remaining 49% equity interest in Sou Yi Lian Mei in September 2012. Accordingly, net income or net loss incurred by these entities during the reporting periods when they were majority-owned subsidiaries of our PRC operating VIEs were allocated between their respective shareholders based on their respective percentage of the ownership in these entities. For the nine and three months ended September 30, 2012, the aggregate net losses allocated to the noncontrolling interest of Beijing Chuang Fu Tian Xia and Sheng Tian Hubei was approximately US$0.18 million and US$0.04 million, respectively; net income allocated to the noncontrolling interest of Sou Yi Lian Mei was approximately US$0.62 million and US$0.26 million, respectively. For the nine months ended September 30, 2011, the aggregate net losses allocated to the noncontrolling interest of Quanzhou Tian Xi Shun He and Beijing Chuang Fu Tian Xia was approximately US$0.12 million and net income allocated to the noncontrolling interest of Zhao Shang Ke Hubei was approximately US$0.024 million. For the three months ended September 30, 2011, the aggregate net losses allocated to the noncontrolling interest of Quanzhou Tian Xi Shun He, Beijing Chuang Fu Tian Xia and Zhao Shang Ke Hubei was approximately US$0.10 million. Given the foregoing, net amount recognized as net income attributable to noncontrolling interests for the nine and three months ended September 30, 2012 was approximately US$0.45 million and US$0.22 million, respectively. For the nine and three months ended September 30, 2011, net amount recognized as net losses attributable to noncontrolling interest was approximately US$0.096 million and US$0.10 million, respectively.

- Net income attributable to ChinaNet Online Holdings, Inc.: Total net income as adjusted by the net income attributable to the noncontrolling interest shareholders as discussed above yields the net income attributable to ChinaNet Online Holdings, Inc. Our net income attributable to ChinaNet Online Holdings, Inc. was approximately US$1.75 million and US$1.22 million for the nine and three months ended September 30, 2012, respectively, as compared to approximately US$6.94 million and US$1.11 million for the same period of 2011, respectively. Excluding the non-cash gain recognized for deconsolidation of Shenzhen Mingshan of approximately US$0.23 million, for the nine months ended September 30, 2011, our adjusted net income attributable to ChinaNet Online Holdings, Inc. was approximately US$6.71 million.

- Dividend for Series A convertible preferred stock: Cash dividend to Series A convertible stock holders was calculated at the per annum rate of 10% of the liquidation preference amount of the Series A preferred stock which was US$2.5 per share and the actual number of days each share outstanding within each of the reporting periods. As all of the outstanding Series A convertible preferred stock of us was automatically converted into our common stock on August 21, 2011, no preferred stock dividend was accrued for the nine and three months ended September 30, 2012. The cash dividends we accrued for the Series A convertible preferred stock was approximately US$0.41 million US$0.09 million for the nine and three months ended September 30, 2011, respectively.

- Net income attributable to ChinaNet's common stockholders: Net income attributable to ChinaNet's common stockholders represents the net income after allocation to noncontrolling interests minus the cash dividend accrued for Series A convertible preferred stock. Our net income attributable to ChinaNet's common stockholders was approximately US$1.75 million and US$1.22 million for the nine and three months ended September 30, 2012, respectively, as compared to approximately US$6.54 million and US$1.03 million for the same period of 2011, respectively. Excluding the non-cash gain recognized for deconsolidation of Shenzhen Mingshan of approximately US$0.23 million, for the nine months ended September 30, 2011, our adjusted net income attributable to ChinaNet's common stockholders was approximately US$6.30 million.

## B. LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents represent cash on hand and deposits held at call with banks. We consider all highly liquid investments with original maturities of three months or less at the time of purchase to be cash equivalents. As of September 30, 2012, we had cash and cash equivalents of approximately US$8.5 million.

Our liquidity needs primarily include (i) net cash used in operating activities that consists of (a) cash required to fund the initial build-out and continued expansion of our network and (b) our working capital needs, which include deposits and advance payment to TV advertising slots and internet resource providers, payment of our operating expenses and financing of our accounts receivable; and (ii) net cash used in investing activities that consist of the payment for acquisitions to further expand our business and client base, investment in software technologies and other general office equipment. To date, we have financed our liquidity needs primarily through proceeds from our operating activities generated in prior years. Our existing cash is adequate to fund operations for the next 12 months.

The following table provides detailed information about our net cash flow for the periods indicated:

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| | Amounts in thousands of US dollars | |

| | | |
|---|---|---|
| Net cash provided by operating activities | $ 2,467 | $ 8,443 |
| Net cash used in investing activities | (4,467 ) | (3,116 ) |
| Net cash (used in) provided by financing activities | (226 ) | 3 |
| Effect of exchange rate fluctuation on cash and cash equivalents | 44 | 360 |
| Net (decrease) increase in cash and cash equivalents | $ (2,182 ) | $ 5,690 |

Net cash provided by operating activities:

For the nine months ended September 30, 2012, our net cash provided by operating activities of approximate US$2.47 million was primarily attributable to:

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(1) net income excluding an approximately US$0.75 million net deferred income tax benefit, an approximately US$0.56 million of allowance for doubtful debts and a US$1.66 million non-cash expenses of depreciation, amortizations, share-based compensation and our share of losses in equity investment affiliates of approximately US$3.66 million;

(2) the receipt of cash from operations from changes in operating assets and liabilities such as:

- other receivables decreased by approximately US$0.20 million, which was primarily due to the collection of overdue contact deposit for TV advertising resources purchased;

- prepayment and deposit to suppliers decreased by approximately US$3.40 million, which was primarily due to the transferring of prepayment to suppliers to cost of sales when the related services had been provided by the suppliers;

- other current assets decreased by approximately US$0.03 million;

- advances from customers increased by approximately US$0.11 million;

- other payable increased by approximately $0.03 million; and

- taxes payable increased by approximately US$1.21 million.

(3) offset by the use from operations from changes in operating assets and liabilities such as:

- accounts receivable and due from related parties for the advertising services provided increased by approximately US$5.71 million;

- accounts payable and accruals decreased by approximately US$0.31 million; and

- due to related parties decreased by approximately US$0.16 million, due to returning the nominal shareholders of Shanghai Jing Yang for their original paid-in capital contribution.

For the nine months ended September 30, 2011, our net cash provided by operating activities of approximate US$8.44 million was primarily attributable to:

(1) net income excluding the US$0.23 million of non-cash gain recognized upon deconsolidation of a subsidiary and the US$1.08 million of non-cash expenses of depreciation, amortization, share-based compensation expenses and our share of losses in equity investment affiliates of approximately US$7.69 million;

(2) the receipt of cash from operations from changes in operating assets and liabilities such as:

- other receivables decreased by approximately US$3.79 million, which primarily due to the collection of temporary loans from third parties;

- other payables increased by approximately US$0.24 million; and

- taxes payable increased by approximately US$0.90 million.

(3) offset by the use from operations from changes in operating assets and liabilities such as:

-

accounts receivable and due from related parties for the advertising services provided increased by approximately US$1.79 million;

- advance from customers and due to related parties for the advertising services to be provided decreased by approximately US$1.46 million;

- other current assets increased by approximately US$0.13 million;

- other current liabilities decreased by approximately US$0.14 million; and

- we settled the amount due to a director and Control Group for approximately US$0.64 million for the cost and expenses paid by them on behalf of our company in previous years.

Net cash used in investing activities:

For the nine months ended September 30, 2012, our net cash used in investing activities included the following transactions: (1) we spent approximately US$0.19 million for purchasing of general office equipments; (2) we made an approximately US$2.45 million project development deposit to a third party project development and management company for the participation in the Xiaogan TMT Zone development and management. The Xiaogan TMT zone is intended to become the headquarters for SMEs, particularly those SMEs engaged in the small and medium sized franchising business. The deposit is refundable subject to upcoming planning and further evaluation of the development of the Xiaogan TMT Zone. If after evaluation, further involvement in the development is not economical or efficient for us and we decide to exit, the deposit will be refunded within the current calendar year; (3) the cash effect on disposal of Business Opportunity Online Chong Qing, which was approximately US$0.01 million, representing the cash and cash equivalent balance of Business Opportunity Online Chong Qing as of the date of disposal; and (4) we paid the remaining balance of consideration of approximately US$0.55 million for the 51% equity interest acquisition of Sou Yi Lian Mei consummated in December 2011 and paid approximately US$1.27 million for the remaining 49% equity interest acquisition of Sou Yi Lian Mei consummated in September 2012. In the aggregate, these transactions resulted in a net cash outflow from investing activities of approximately US$4.47 million for the nine months ended September 30, 2012.

For the nine months ended September 30, 2011, our net cash used in investing activities included the following transactions: (1) we spent approximately US$0.25 million for purchasing of computers, office equipment and settling the outstanding payment for bank kiosks purchased; (2) we also spent approximately US$1.44 million for the purchasing of software and the related technology from an individual not affiliated with us, with whom we incorporated a new majority-owned operating entity in July 2011; (3) we received approximately US$0.02 million cash from our acquisition of Quanzhou Zhi Yuan and Quanzhou Tian Xi Shun He, representing the total cash and cash equivalent balance of these two companies as of their respective acquisition dates; (4) the cash effect on deconsolidation of Shenzhen Mingshan which was approximately US$0.18 million, representing the cash and cash equivalent balance of Shenzhen Mingshan as of the date of deconsolidation; (5) in August 2011, we also made a capital injection of approximately US$0.17 million in cash to Shenzhen Mingshan for our proportion of the unpaid registered capital, which was required to be fully contributed within two years from the incorporation of Shenzhen Mingshan; (6) we also received approximately US$1.08 million cash consideration from the majority shareholder of Beijing Yang Guang, which resulted from the disposal of our 49% equity interest in Beijing Yang Guang to him in August 2011; and (7) we also spent approximately US$2.18 million for the acquisition of Quanzhou Zhi Yuan and Quanzhou Tian Xi Shun He. In the aggregate, these transactions resulted in a net cash outflow from investing activities of approximately US$3.12 million for the nine months ended September 30, 2011.

Net cash (used in) / provided by financing activities:

For the nine months ended September 30, 2012, our net cash used in financing activities was approximately US$0.23 million, which primarily consisted of the following transactions: (1) cash dividends paid to our preferred stockholders of approximately US$0.01 million; (2) one of our VIEs borrowed an approximately US$0.32 million working capital loan from Zhao Shang Ke Hubei, our equity investment affiliate during the three months ended March 31, 2012; and (3) our VIEs repaid all previously borrowed outstanding working capital loan of approximately US$0.54 million to Zhao Shang Ke Hubei during the three months ended June 30, 2012.

For the nine months ended September 30, 2011, our net cash provided by financing activities was approximately US$0.003 million which mainly consisted of the following transactions: (1) cash dividends paid to our preferred stockholders of approximately US$0.377 million; and (2) cash contributed by the noncontrolling interest shareholders of Beijing Chuang Fu Tian Xi, Zhao Shang Ke Hubei and Sheng Tian Hubei for approximately US$0.374 million in the aggregate, in connection with the incorporation of these companies.

Restricted Net Assets

As most of our operations are conducted through our PRC subsidiary and VIEs, our ability to pay dividends is primarily dependent on receiving distributions of funds from our PRC subsidiary and VIEs. Relevant PRC statutory laws and regulations permit payments of dividends by our PRC subsidiary and VIEs only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations and after it has met the PRC requirements for appropriation to statutory reserves. Paid in capital of the PRC subsidiary and VIEs included in our consolidated net assets are also not distributable for dividend purposes.

In accordance with the PRC regulations on Enterprises with Foreign Investment, a WFOE established in the PRC is required to provide certain statutory reserves, namely general reserve fund, the enterprise expansion fund and staff welfare and bonus fund which are appropriated from net profit as reported in the enterprise's PRC statutory accounts. A WFOE is required to allocate at least 10% of its annual after-tax profit to the general reserve until such reserve has reached 50% of its registered capital based on the enterprise's PRC statutory accounts. Appropriations to the enterprise expansion fund and staff welfare and bonus fund are at the discretion of the board of directors. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. Rise King WFOE is subject to the above mandated restrictions on distributable profits. Additionally, in accordance with the Company Law of the PRC, a domestic enterprise is required to provide a statutory common reserve of at least 10% of its annual after-tax profit until such reserve has reached 50% of its registered capital based on the enterprise's PRC statutory accounts. A domestic enterprise is also required to provide for a discretionary surplus reserve, at the discretion of the board of directors. The aforementioned reserves can only be used for specific purposes and are not distributable as cash dividends. All of the Company's PRC VIEs are subject to the above mandated restrictions on distributable profits.

As a result of these PRC laws and regulations, our PRC subsidiary and VIEs are restricted in their ability to transfer a portion of their net assets to us. As of September 30, 2012 and December 31, 2011, net assets restricted in the aggregate, which include paid-in capital and statutory reserve funds of our PRC subsidiary and VIEs that are included in our consolidated net assets, was approximately US$5.3 million and US$4.7 million, respectively.

The New PRC Enterprise Income Tax ("EIT") Law, which was effected on January 1, 2008, also imposed a 10% withholding income tax for dividends distributed by a foreign invested enterprise to its immediate holding company outside China, which were exempted under the previous EIT law. A lower withholding tax rate will be applied if there is a tax treaty arrangement between mainland China and the jurisdiction of the foreign holding company. Holding companies in Hong Kong, for example, will be subject to a 5% rate. Rise King WFOE is invested by its immediate holding company in Hong Kong and will be entitled to the 5% preferential withholding tax rate upon distribution of the dividends to its immediate holding company.

The ability of our PRC subsidiaries to make dividends and other payments to us may also be restricted by changes in applicable foreign exchange and other laws and regulations.

Foreign currency exchange regulation in China is primarily governed by the following rules:

- Foreign Exchange Administration Rules (1996), as amended in August 2008, or the Exchange Rules;

- Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules.

Currently, under the Administration Rules, Renminbi is freely convertible for current account items, including the distribution of dividends, interest payments, trade and service related foreign exchange transactions, but not for capital account items, such as direct investments, loans, repatriation of investments and investments in securities outside of China, unless the prior approval of the State Administration of Foreign Exchange (the "SAFE") is obtained and prior registration with the SAFE is made. Foreign-invested enterprises like Rise King WFOE that need foreign exchange for the distribution of profits to its shareholders may effect payment from their foreign exchange accounts or purchase and pay foreign exchange rates at the designated foreign exchange banks to their foreign shareholders by producing board resolutions for such profit distribution. Based on their needs, foreign-invested enterprises are permitted to open foreign exchange settlement accounts for current account receipts and payments of foreign exchange along with specialized accounts for capital account receipts and payments of foreign exchange at certain designated foreign exchange banks.

Although the current Exchange Rules allow the convertibility of Chinese Renminbi into foreign currency for current account items, conversion of Chinese Renminbi into foreign exchange for capital items, such as foreign direct investment, loans or securities, requires the approval of SAFE, which is under the authority of the People's Bank of China. These approvals, however, do not guarantee the availability of foreign currency conversion. We cannot be sure that it will be able to obtain all required conversion approvals for our operations or the Chinese regulatory authorities will not impose greater restrictions on the convertibility of Chinese Renminbi in the future. Currently, most of our retained earnings are generated in Renminbi. Any future restrictions on currency exchanges may limit our ability to use retained earnings generated in Renminbi to make dividends or other payments in U.S. dollars or fund possible business activities outside China.

As of September 30, 2012 and December 31, 2011, there were approximately US$36.5 million and US$34.0 million in retained earnings in the aggregate, respectively, which were generated by our PRC subsidiary and VIEs in Renminbi included in our consolidated net assets, aside from US$2.3 million and US$2.2 million statutory reserve funds as of September 30, 2012 and December 31, 2011, respectively, that may be affected by increased restrictions on currency exchanges in the future and accordingly may further limit our PRC subsidiary' or VIEs' ability to make dividends or other payments in U.S. dollars to us, in addition to the approximately US$5.3 million and US$4.7 million of restricted net assets as of September 30, 2012 and December 31, 2011, respectively, as discussed above.

C. OFF-BALANCE SHEET ARRANGEMENTS

None.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not applicable to smaller reporting companies.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our disclosure controls and procedures as of the end of the fiscal quarter ended September 30, 2012, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based on this evaluation, our principal executive officer and principal financial officer have concluded that during the period covered by this report, the Company's disclosure controls and procedures were effective as of such date to ensure that information required to be disclosed by us in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the third fiscal quarter of 2012 covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are currently not a party to any legal or administrative proceedings and are not aware of any pending or threatened legal or administrative proceedings against us in all material aspects. We may from time to time become a party to various legal or administrative proceedings arising in the ordinary course of our business.

Item 1A. Risk Factors

This information has been omitted based on the Company's status as a smaller reporting company.

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

None.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit No. | Document Description |
|---|---|
| 31.1 | Certification of the Principal Executive Officer pursuant to Rule 13A-14(A)/15D-14(A) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of the Principal Accounting and Financial Officer pursuant to Rule 13A-14(A)/15D-14(A) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Principal Executive Officer and of the Principal Accounting and Financial Officer pursuant to 18 U.S.C. 1350 (Section 906 of the Sarbanes-Oxley Act of 2002). |
| 101 | Interactive Data Files |

SIGNATURES

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

| | | |
|---|---|---|
| | CHINANET ONLINE HOLDINGS, INC. | |
| Date: November 19, 2012 | By: | /s/ Handong Cheng<br>Name: Handong Cheng<br>Title: Chief Executive Officer<br>(Principal Executive Officer) |
| | By: | /s/ Zhige Zhang<br>Name: Zhige Zhang<br>Title: Chief Financial Officer<br>(Principal Accounting and Financial Officer) |

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