K12 INC
Form 10-Q
November 09, 2010

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the quarterly period ended September 30, 2010**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
**For the transition period from to**

**Commission File Number: 001-33883**

**K12 Inc.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware**<br>(State or other jurisdiction of incorporation or organization) | **95-4774688**<br>(IRS Employer Identification No.) |
| **2300 Corporate Park Drive**<br>**Herndon, VA**<br>(Address of principal executive offices) | **20171**<br>(Zip Code) |

**(703) 483-7000**
(Registrant s telephone number, including area code)

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 þ No o

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

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 o | Accelerated filer þ |
| 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 o     No þ

As of November 5, 2010, the Registrant had 31,006,061 shares of Common Stock, $0.0001 par value outstanding.

**K12 Inc.**

**Form 10-Q**

**For the Quarterly Period Ended September 30, 2010**

**Index**

## PART I FINANCIAL INFORMATION

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

## K12 INC.

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2010 | June 30, 2010 |
|---|---|---|
| | (In thousands, except share data) | |
| **ASSETS** | | |
| **Current assets** | | |
| Cash and cash equivalents | $ 62,348 | $ 81,751 |
| Restricted cash and cash equivalents | 1,500 | 3,343 |
| Accounts receivable, net of allowance of $1,763 and $1,363 at September 30, 2010 and June 30, 2010, respectively | 148,097 | 71,184 |
| Inventories, net | 16,549 | 26,193 |
| Current portion of deferred tax asset | 5,536 | 4,672 |
| Prepaid expenses | 6,849 | 8,849 |
| Other current assets | 11,286 | 7,286 |
| **Total current assets** | 252,165 | 203,278 |
| Property and equipment, net | 36,735 | 24,260 |
| Capitalized software development costs, net | 25,426 | 16,453 |
| Capitalized curriculum development costs, net | 44,426 | 39,860 |
| Deferred tax asset, net of current portion | | 5,912 |
| Intangible assets | 36,834 | 14,081 |
| Goodwill | 36,809 | 1,825 |
| Deposits and other assets | 2,202 | 2,213 |
| **Total assets** | $ 434,597 | $ 307,882 |
| **LIABILITIES, SERIES A SPECIAL STOCK, REDEEMABLE NONCONTROLLING INTEREST AND EQUITY** | | |
| **Current liabilities** | | |
| Accounts payable | $ 30,374 | $ 12,691 |
| Accrued liabilities | 10,995 | 8,840 |
| Accrued compensation and benefits | 5,008 | 10,563 |
| Deferred revenue | 38,262 | 9,593 |
| Current portion of capital lease obligations | 13,981 | 10,996 |
| Current portion of notes payable | 1,270 | 1,251 |

| | | |
|---|---|---|
| **Total current liabilities** | 99,890 | 53,934 |
| Deferred rent, net of current portion | 3,828 | 1,782 |
| Capital lease obligations, net of current portion | 12,572 | 7,710 |
| Notes payable, net of current portion | 330 | 655 |
| Other long term liabilities | 4,703 | 435 |
| **Total liabilities** | 121,323 | 64,516 |
| **Commitments and contingencies** | | |
| **Series A Special Stock** | 63,112 | |
| **Redeemable noncontrolling interest** | 20,000 | 17,374 |
| **Equity:** | | |
| K12 Inc. stockholders equity | | |
| Common stock, par value $0.0001; 100,000,000 shares authorized; 30,954,261 and 30,441,412 shares issued and outstanding at September 30, 2010 and June 30, 2010, respectively | 3 | 3 |
| Additional paid-in capital | 363,441 | 361,344 |
| Accumulated deficit | (137,298) | (139,496) |
| Total K12 Inc. stockholders equity | 226,146 | 221,851 |
| Noncontrolling interest | 4,016 | 4,141 |
| **Total equity** | 230,162 | 225,992 |
| **Total liabilities, Series A special stock, redeemable noncontrolling interest and equity** | $ 434,597 | $ 307,882 |

See notes to unaudited condensed consolidated financial statements.

**K12 INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Three Months Ended September 30, | |
|---|---|---|
| | 2010 | 2009 |
| | (In thousands, except share and per share data) | |
| **Revenues** | $ 134,871 | $ 106,325 |
| **Cost and expenses** | | |
| Instructional costs and services | 75,082 | 58,093 |
| Selling, administrative, and other operating expenses | 50,498 | 33,327 |
| Product development expenses | 3,911 | 2,238 |
| **Total costs and expenses** | 129,491 | 93,658 |
| **Income from operations** | 5,380 | 12,667 |
| **Interest expense, net** | (297) | (357) |
| **Income before income tax expense and noncontrolling interest** | 5,083 | 12,310 |
| **Income tax expense** | (2,931) | (5,368) |
| **Net income** | 2,152 | 6,942 |
| **Add net loss attributable to noncontrolling interest** | 46 | 141 |
| **Net income K12 Inc.** | $ 2,198 | $ 7,083 |
| **Net income attributable to common stockholders per share (see Note 3):** | | |
| Basic | $ 0.07 | $ 0.24 |
| Diluted | $ 0.07 | $ 0.24 |
| **Weighted average shares used in computing per share amounts:** | | |
| Basic | 30,343,696 | 29,378,074 |
| Diluted | 30,805,106 | 29,948,550 |

See notes to unaudited condensed consolidated financial statements.

**K12 INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF EQUITY**

| | K12 Inc Stockholders | | | | | |
|---|---|---|---|---|---|---|
| | Common Stock | | Additional Paid-in | Accumulated | Noncontrolling | Total Stockholders |
| | Shares | Amount | Capital | Deficit | Interest | Equity |
| Balances at June 30, 2010 | 30,441,412 | $ 3 | $ 361,344 | $ (139,496) | $ 4,141 | $ 225,992 |
| Stock based compensation expense | | | 3,413 | | | 3,413 |
| Exercise of stock options | 127,899 | | 1,109 | | | 1,109 |
| Excess tax benefit from stock-based compensation | | | 122 | | | 122 |
| Issuance of restricted stock awards | 426,863 | | | | | |
| Forfeitures of restricted stock awards | (41,913) | | | | | |
| Accretion of redeemable noncontrolling interests to estimated redemption value | | | (2,547) | | | (2,547) |
| Net income/(loss)(1) | | | | 2,198 | (125) | 2,073 |
| Balances at September 30, 2010 | 30,954,261 | $ 3 | $ 363,441 | $ (137,298) | $ 4,016 | $ 230,162 |

(1) Net income/(loss) attributable to noncontrolling interests excludes $0.1 million due to the redeemable noncontrolling interest related to Middlebury Interactive Languages, which is reported outside of permanent equity in the condensed consolidated balance sheets at September 30, 2010 and June 30, 2010.

See notes to unaudited condensed consolidated financial statements.

**K12 INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Three Months Ended September 30, 2010 | 2009 |
|---|---|---|
| | (In thousands) | |
| **Cash flows from operating activities** | | |
| Net income | $ 2,152 | $ 6,942 |
| **Adjustments to reconcile net income to net cash used in operating activities:** | | |
| Depreciation and amortization expense | 9,392 | 6,233 |
| Stock based compensation expense | 3,413 | 1,882 |
| Excess tax benefit from stock-based compensation | (122) | (332) |
| Deferred income taxes | 2,358 | 4,949 |
| (Reduction of) provision for doubtful accounts | (82) | 63 |
| Provision for inventory obsolescence | 664 | 255 |
| Provision for (reduction of) student computer shrinkage and obsolescence | 71 | (260) |
| Changes in assets and liabilities: | | |
| Restricted cash | 1,843 | |
| Accounts receivable | (69,741) | (54,297) |
| Inventories | 9,760 | 11,745 |
| Prepaid expenses | 2,764 | 3,441 |
| Other current assets | (4,267) | (4,379) |
| Deposits and other assets | 148 | 340 |
| Accounts payable | 12,866 | 96 |
| Accrued liabilities | 1,680 | 2,682 |
| Accrued compensation and benefits | (5,915) | (3,409) |
| Deferred revenue | 25,987 | 20,671 |
| Deferred rent | 2,190 | (37) |
| **Net cash used in operating activities** | (4,839) | (3,415) |
| **Cash flows from investing activities** | | |
| Purchase of property and equipment | (6,374) | (412) |
| Capitalized software development costs | (2,187) | (2,441) |
| Capitalized curriculum development costs | (3,208) | (3,391) |
| **Net cash used in investing activities** | (11,769) | (6,244) |
| **Cash flows from financing activities** | | |
| Repayments on capital lease obligations | (3,720) | (2,841) |
| Repayments on notes payable | (306) | (378) |
| Proceeds from exercise of stock options | 1,109 | 1,383 |
| Excess tax benefit from stock-based compensation | 122 | 332 |
| **Net cash used in financing activities** | (2,795) | (1,504) |

| | | |
|---|---|---|
| **Net change in cash and cash equivalents** | (19,403) | (11,163) |
| **Cash and cash equivalents**, beginning of period | 81,751 | 49,461 |
| **Cash and cash equivalents**, end of period | $ 62,348 | $ 38,298 |

See notes to unaudited condensed consolidated financial statements.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

## 1. Description of the Business

K12 Inc. and its subsidiaries (K12 or the Company) are a technology-based education company. The Company offers proprietary curriculum and educational services created for individualized delivery to students in kindergarten through 12th grade, or K-12. The K12 proprietary curriculum is research-based and combines content with innovative technology to allow students to receive an effective and engaging education regardless of geographic location or socio-economic background. This learning system combines a cognitive research-based curriculum with an individualized learning approach well-suited for virtual public schools, online school district-wide programs, public charter schools, hybrid programs and private schools that combine varying degrees of online and traditional classroom instruction, and other educational applications.

The Company delivers its learning system to students primarily through virtual public schools and is building an institutional business with sales directly to school districts. The Company offers its proprietary curriculum, learning kits, use of a personal computer, online learning platform and varying levels of academic and management services, which can range from targeted programs to complete turnkey solutions.

As of September 30, 2010, the Company served virtual public schools or hybrid schools in 27 states and the District of Columbia. The Company expanded into two new states for fiscal year 2011: Massachusetts and Michigan. In addition, the Company sells access to its on-line curriculum and learning kits directly to individual consumers.

In April 2010, the Company formed a joint venture with Middlebury College known as Middlebury Interactive Languages LLC (MIL) to develop online foreign language courses. This new venture will create innovative, online language programs for pre-college students and will leverage Middlebury s recognized experience in foreign language instruction and K12 s expertise in online education. In July 2010, the Company acquired all of the stock of KC Distance Learning, Inc. (KCDL), a provider of online curriculum and public and private virtual education. On November 2, 2010, the Company announced the acquisition of American Education Corporation (AEC), a leading provider of research-based core curriculum instructional software for kindergarten through adult learners. The AEC transaction is expected to close prior to the end of December 2010. These acquisitions and the formation of MIL increase K12 s portfolio of innovative, high quality instructional and curriculum offerings.

## 2. Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2010, the condensed consolidated statements of operations for the three months ended September 30, 2010 and 2009, the condensed consolidated statements of cash flows for the three months ended September 30, 2010 and 2009, and the condensed consolidated statements of equity for the three months ended September 30, 2010 are unaudited. The unaudited interim financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company s financial position as September 30, 2010, the results of operations for the three months ended September 30, 2010 and 2009, cash flows for the three months ended September 30, 2010 and 2009 and the condensed consolidated statements of equity for the three months ended September 30, 2010. The results of the three month period ended September 30, 2010 are not necessarily indicative of the results to be expected for the year ending June 30, 2011 or for any other interim period or for any other future fiscal year. The consolidated balance sheet as of June 30, 2010 has been derived from the audited consolidated financial statements at that date.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities Exchange Act of 1934, as amended ( Exchange Act ). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

present a fair statement of our consolidated results of operations, financial position and cash flows. Preparation of the Company s financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and footnotes. Actual results could differ from those estimates. This quarterly report on Form 10-Q should be read in conjunction with the financial statements and the notes thereto included in the Company s latest annual report on Form 10-K filed on September 13, 2010, which contains the Company s audited financial statements for the fiscal year ended June 30, 2010.

## 3. Summary of Significant Accounting Policies

***Revenue Recognition***

Revenues are principally earned from long-term contractual agreements to provide on-line curriculum, books, materials, computers and management services to public charter schools and school districts. In addition to providing the curriculum, books and materials, under most contracts, the Company is responsible to the virtual public schools for all aspects of the management of schools, including monitoring academic achievement, teacher hiring and training, compensation of school personnel, financial management, enrollment processing and procurement of curriculum, equipment and required services. The schools receive funding on a per student basis from the state in which the public school or school district is located.

Where the Company has determined that they are the primary obligor for substantially all expenses under these contracts, the Company records the associated per student revenue received by the school from its state funding school district up to the expenses incurred in accordance with ASC 605 (formerly Emerging Issues Task Force (EITF) 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*). For contracts in which the Company is not the primary obligor, the Company records revenue based on its net fees earned per the contractual agreement.

The Company generates revenues under contracts with virtual public schools which include multiple elements. These elements include providing each of a school s students with access to the Company s on-line school and the on-line component of lessons; learning kits which include books and materials designed to complement and supplement the on-line lessons; the use of a personal computer and associated reclamation services; internet access and technology support services; the services of a state-certified teacher and; all management and technology services required to operate a virtual public school.

The Company has determined that the elements of our contracts are valuable to schools in combination, but do not have standalone value. While we have sold some of these elements in various combinations or bundles to schools and school districts, the value of each element across these combinations is indeterminable and we have concluded that we do not have sufficient objective and reliable evidence of fair value for each element. As a result, the elements within our multiple-element contracts do not qualify for treatment as separate units of accounting. Accordingly, the Company accounts for revenues received under multiple element arrangements as a single unit of accounting and recognizes the entire arrangement based upon the approximate rate at which we incur the costs associated with each element. In certain schools where the Company has a direct relationship with the state funding school district, the Company recognizes the associated per student revenue on a pro-rata basis over the school year.

Under the contracts with the schools where the Company provides turnkey management services, the Company has generally agreed to absorb any school operating losses of the schools in a given school year. These school operating losses represent the excess of costs over revenues incurred by the virtual public schools as reflected on their financial statements. The costs include Company charges to the schools. These school operating losses may reduce the Company s ability to collect invoices in full. Accordingly, the Company s amount of recognized revenue reflects this reduction.

Other revenues are generated from individual customers who prepay and have access for 12 or 24 months to curriculum via the Company s Web site. The Company recognizes these revenues pro rata over the maximum term

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

of the customer contract, which is either 12 or 24 months. Revenues from associated learning kits are recognized upon shipment.

***Consolidation***

The condensed consolidated financial statements include the accounts of the Company, its wholly-owned and affiliated companies that the Company owns, directly or indirectly, and all controlled subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

***Reclassifications***

Certain prior year amounts related to capitalized software development costs and other long term liabilities have been reclassified to conform to the current year presentation.

***Series A Special Stock***

Equity that is redeemable upon occurrence of an event outside the Company s control should be classified outside of permanent equity per ASC 480, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. The Series A Special Stock ( Series A Shares ) as described further in Note 11, is considered redeemable outside of the Company s control and classified separately outside of permanent equity at its initial fair value.

***Goodwill and Intangibles***

We record as goodwill the excess of purchase price over the fair value of the identifiable net assets acquired. Finite-lived intangible assets acquired in business combinations subject to amortization are recorded at their fair value in accordance with ASU Topic 350. Finite-lived intangible assets include trade names and non-compete agreements. Such intangible assets are amortized on a straight-line basis over their estimated useful lives.

In accordance with ASC 360 *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews its recorded finite-lived intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. If the total of the expected undiscounted future cash flows is less than the carrying amount of the asset, a loss is recognized for the difference between fair value and the carrying value of the asset.

ASC 350 *Goodwill and Other Intangible Assets*, prescribes a two-step process for impairment testing of goodwill and intangibles with indefinite lives, which is performed annually, as well as when an event triggering impairment may have occurred. The first step tests for impairment, while the second step, if necessary, measures the impairment. Goodwill and intangible assets deemed to have an indefinite life are tested for impairment on an annual basis, or earlier when events or changes in circumstances suggest the carrying amount may not be fully recoverable. The Company has elected to perform its annual assessment on May 31st.

***Fair Value Measurements***

The carrying values reflected in our consolidated balance sheets for cash and cash equivalents, receivables, and short and long term debt approximate their fair values.

The following table summarizes certain fair value information at June 30, 2010 for assets and liabilities measured at fair value on a recurring basis. The redeemable noncontrolling interest is a result of the Company s venture with Middlebury College to form a new entity, Middlebury Interactive Languages. Under the agreement, Middlebury College has an irrevocable election to sell all (but not less than all) of its Membership Interest to the

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

Company ( put right ). The fair value of the redeemable noncontrolling interest reflects management s best estimate of the redemption value of the put right.

| | | Fair Value Measurements Using: | | |
|---|---|---|---|---|
| Description | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Input (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | (In thousands) | | |
| Redeemable Noncontrolling Interest | $ 17,374 | $ | $ | $ 17,374 |
| Total | $ 17,374 | $ | $ | $ 17,374 |

The following table summarizes certain fair value information at September 30, 2010 for assets and liabilities measured at fair value on a recurring basis. The Series A Shares are a result of the Company s acquisition of KC Distance Learning Inc. (see Note 11). The fair value of the Series A Shares represents management s best estimate of the value at the time of the acquisition, and values are subject to change based on final analysis.

| | | Fair Value Measurements Using: | | |
|---|---|---|---|---|
| Description | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Input (Level 2) | Significant Unobservable Inputs (Level 3) |
| | | (In thousands) | | |
| Redeemable Noncontrolling Interest | $ 20,000 | $ | $ | $ 20,000 |
| Series A Special Stock | 63,112 | | | 63,112 |
| Total | $ 83,112 | $ | $ | $ 83,112 |

The following table presents activity related to our fair value measurements categorized as Level 3 of the valuation hierarchy, valued on a recurring basis, for the three months ended September 30, 2010. There have been no transfers in or out of Level 3 of the hierarchy for the period presented.

| | Three Months Ended September 30, 2010 | | | |
|---|---|---|---|---|
| | **Fair Value June 30, 2010** | **Purchases, Issuances, and Settlements** | **Unrealized Gains/(Losses)** | **Fair Value September 30, 2010** |
| | (In thousands) | | | |
| Redeemable Noncontrolling Interest | $ 17,374 | $ | $ 2,626 | $ 20,000 |
| Series A Special Stock | | 63,112 | | 63,112 |
| Total | $ 17,374 | $ 63,112 | $ 2,626 | $ 83,112 |

The fair value of the redeemable noncontrolling interest as of September 30, 2010 was estimated to be $20.0 million. The fair value was measured in accordance with ASC 480, *Classification and Measurement of Redeemable Securities*, and determined by management with assistance from a third party valuation firm. In determining the fair value of the redeemable noncontrolling interest, the Company incorporated a number of assumptions and estimates including utilizing various valuation methodologies including an income-based approach. The fair value of the Series A Shares as of September 30, 2010 was measured in accordance with ASC 480, *Classification and Measurement of Redeemable Securities,* and represents the value at the acquisition date of KC Distance Learning Inc. (see Note 11), which was estimated to be $63.1 million, and approximates the value of the Company s common stock at the acquisition date of July 23, 2010.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

***Net Income Per Common Share***

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding during the period. The weighted average number of shares of common stock outstanding includes vested restricted stock awards. Diluted earnings per share reflects the potential dilution that could occur assuming conversion or exercise of all dilutive unexercised stock options, unvested restricted stock awards and warrants. The dilutive effect of stock options, restricted stock awards, and warrants was determined using the treasury stock method. Under the treasury stock method, the proceeds received from the exercise of stock options and restricted stock awards, the amount of compensation cost for future service not yet recognized by the Company, and the amount of tax benefits that would be recorded in additional paid-in capital when the stock options and restricted stock awards become deductible for income tax purposes are all assumed to be used to repurchase shares of the Company s common stock. Stock options and restricted stock awards are not included in the computation of diluted earnings per share when they are antidilutive. Common stock outstanding reflected in our condensed consolidated balance sheet includes restricted stock awards outstanding.

Securities that may participate in undistributed earnings with common stock are considered participating securities. Since the Series A Shares participate in all dividends and distributions declared or paid on or with respect to common stock of the Company (as if a holder of common stock), the Series A Shares meet the definition of participating security under ASC 260, *Participating Securities and the Two-Class Method under FASB Statement No. 128*. All securities that meet the definition of a participating security, regardless of whether the securities are convertible, non-convertible, or potential common stock securities, are included in the computation of both basic and diluted EPS (as a reduction of the numerator) using the two-class method. Under the two-class method all undistributed earnings in a period are to be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed.

The following schedule presents the calculation of basic and diluted net income per share:

| | Three Months Ended September 30, | |
|---|---|---|
| | **2010** | **2009** |
| | **(In thousands, except share and per share data)** | |
| **Basic earnings per share computation:** | | |
| Net income | $ 2,198 | $ 7,083 |
| Amount allocated to participating Series A stockholders | 137 | |
| Income available to common stockholders basic | $ 2,061 | $ 7,083 |
| Weighted average common shares basic historical | 30,343,696 | 29,378,074 |
| Basic net income per share | $ 0.07 | $ 0.24 |
| **Diluted earnings per share computation:** | | |

| | | | | |
|---|---|---|---|---|
| Net income | $ | 2,198 | $ | 7,083 |
| Amount allocated to participating Series A stockholders | | 137 | | |
| Income available to common stockholders diluted | $ | 2,061 | $ | 7,083 |
| Shares computation: | | | | |
| Weighted average common shares basic historical | | 30,343,696 | | 29,378,074 |
| Effect of dilutive stock options and restricted stock awards | | 461,410 | | 570,476 |
| Weighted average common shares diluted | | 30,805,106 | | 29,948,550 |
| Diluted net income per share | $ | 0.07 | $ | 0.24 |

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

***Recent Accounting Pronouncements***

In June 2009, the FASB issued Accounting Standards Codification ( ASC ) Topic 860 ( ASC 860 ) *Accounting for Transfers of Financial Assets an Amendment of FASB Statement No. 140*, which requires additional information regarding transfers of financial assets, including securitization transactions, and where companies have continuing exposure to the risks related to transferred financial assets. ASC 860 eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. ASC 860 is effective for fiscal years beginning after November 15, 2009. ASC 860 is effective for the Company on July 1, 2010. The adoption did not have a material impact on our condensed consolidated financial statements during the first quarter.

In June 2009, the FASB issued an amendment to ASC 810, *Consolidation*, which modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. ASC 810 clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity s purpose and design and a company s ability to direct the activities of the entity that most significantly impact the entity s economic performance. ASC 810 requires an ongoing reassessment of whether a company is the primary beneficiary of a variable interest entity. ASC 810 also requires additional disclosures about a company s involvement in variable interest entities and any significant changes in risk exposure due to that involvement. ASC 810 is effective for fiscal years beginning after November 15, 2009 and is effective for the Company on July 1, 2010. The adoption of the policy did not have a material impact on our condensed consolidated financial statements during the first quarter.

In October 2009, the FASB issued ASU 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force*. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration and the use of the relative selling price method is required. The new guidance eliminated the residual method of allocating arrangement consideration to deliverables and includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. ASU 2009-13 is effective for revenue arrangements entered into or materially modified in fiscal years beginning after June 15, 2010. ASU 2009-13 is effective for the Company on July 1, 2010. Early adoption is permitted, however the Company chose not to adopt early. The adoption did not have a material impact on our condensed consolidated financial statements during the first quarter.

In January 2010, the FASB issued ASU 2010-06, *Fair Value Measurements and Disclosures*, which requires new disclosures for transfers in and out of Level 1 and Level 2 and activity in Level 3 of the fair value hierarchy. ASU 2010-06 requires separate disclosure of the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and a description of the reasons for the transfers. In the reconciliation for fair value measurements using Level 3 inputs, a reporting entity should present separately information about purchases, sales, issuances and settlements. ASU 2010-06 is effective for new disclosures and clarification of existing disclosures for interim and annual periods beginning after December 15, 2009 except for disclosures about purchases, sales, issuances and settlements in the Level 3 activity rollfoward. The provisions of ASU 2010-06 related to new disclosures and clarification of existing disclosures was adopted by the Company beginning January 1, 2010. As ASU 2010-06 relates only to disclosure, the adoption of these provisions did not have a material impact on its financial condition, results of operations, and disclosures. The provisions of ASU 2010-06 related to Level 3 rollforward activity are effective for fiscal years beginning after December 31, 2010 and will be effective for the Company on July 1, 2011. The Company is currently evaluating the impact that the adoption of ASU 2010-06 will have on our financial condition, results of operations, and disclosures.

**4. Income taxes**

The provision for income taxes is based on earnings reported in the condensed consolidated financial statements. A deferred income tax asset or liability is determined by applying currently enacted tax laws and rates to

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

the expected reversal of the cumulative temporary differences between the carrying value of assets and liabilities for financial statement and income tax purposes. Deferred income tax expense is measured by the change in the deferred income tax asset or liability during the year.

## 5. Long-term Obligations

***Capital Leases***

As of September 30 and June 30, 2010, computer equipment and software under capital leases are recorded at a cost of $42.0 million and $38.8 million, respectively and accumulated depreciation of $16.7 million and $22.9 million, respectively. The Company s equipment lease line of credit with Hewlett-Packard Financial Services Company ( HPFSC ) expired on August 31, 2010. Prior borrowings under the HPFSC equipment lease line had interest rates ranging from 4.96% to 8.83% and included a 36-month payment term with a $1 purchase option at the end of the term. The Company had pledged the assets financed with the HPFSC equipment lease line to secure the amounts outstanding. The Company entered into a guaranty agreement with HPFSC to guarantee the obligations under this equipment lease and financing agreement.

The Company has a new three-year equipment lease line of credit with PNC Equipment Finance, LLC effective August 2010 for new purchases. The equipment lease line expires on March 31, 2011. The interest rate on new advances under the PNC equipment lease line is set at the time the funds are advanced based upon interest rates in the Federal Reserve Statistical Release H.15. Borrowings under the equipment lease line have an interest rate of 3.0% and include a 36-month payment term with a $1 purchase option at the end of the term.

***Notes Payable***

The Company has purchased computer software licenses and maintenance services through notes payable arrangements with various vendors at interest rates ranging up to 6.1% and payment terms of three years. The balance of notes payable at September 30, and June 30, 2010 was $1.6 million and $1.9 million, respectively.

The following is a summary as of September 30, 2010 of the present value of the net minimum payments on capital leases and notes payable under the Company s commitments:

| **September 30,** | **Capital Leases** | **Notes Payable** | **Total** |
|---|---|---|---|
| 2011 | $ 14,852 | $ 1,339 | $ 16,191 |
| 2012 | 9,140 | 335 | 9,475 |
| 2013 | 3,800 | | 3,800 |
| Thereafter | | | |
| Total minimum payments | 27,792 | 1,674 | 29,466 |
| Less amount representing interest (imputed average capital lease interest rate of 6.1%) | (1,239) | (74) | (1,313) |

| | | | |
|---|---|---|---|
| Net minimum payments | 26,553 | 1,600 | 28,153 |
| Less current portion | (13,981) | (1,270) | (15,251) |
| Present value of minimum payments, less current portion | $ 12,572 | $ 330 | $ 12,902 |

**6. Line of Credit**

The Company has a $35 million line of credit with PNC Bank that expires in December 2012. As of September 30 and June 30, 2010, there was no outstanding balance on the line of credit.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

## 7. Stock Option Plan

***Stock Options***

Stock option activity during the three months ended September 30, 2010 was as follows:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Life (Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding, June 30, 2010 | 3,913,847 | $ 16.81 | | |
| Granted | 44,000 | 26.23 | | |
| Exercised | (127,899) | 8.67 | | |
| Forfeited or canceled | (70,368) | 21.93 | | |
| Outstanding, September 30, 2010 | 3,759,580 | $ 17.10 | 4.91 | $ 45,305 |
| Stock options exercisable at September 30, 2010 | 2,021,807 | $ 13.50 | 4.29 | $ 31,395 |

The total intrinsic value of options exercised during the three months ended September 30, 2010 was $2.1 million.

The following table summarizes the option grant activity for the three months ended September 30, 2010.

| Grant Date | Options Granted | Weighted-Average Exercise Price | Weighted Average Grant-Date Fair Value | Intrinsic Value |
|---|---|---|---|---|
| September 2010 | 44,000 | $ 26.23 | $ 11.16 | $ |
| | 44,000 | | | |

As of September 30, 2010, there was $7.8 million of total unrecognized compensation expense related to unvested stock options granted. The cost is expected to be recognized over a weighted average period of 2.84 years. During the three months ended September 30, 2010 and September 30, 2009, the Company recognized $1.4 million and $1.7 million, respectively of stock based compensation expense related to stock options.

***Restricted Stock Awards***

Restricted stock award activity during the three months ended September 30, 2010 was as follows:

| | Shares | Weighted-Average Fair Value |
|---|---|---|
| Nonvested, June 30, 2010 | 187,850 | $ 18.46 |
| Granted | 426,863 | 24.86 |
| Vested | (88,484) | 22.88 |
| Forfeited or canceled | (5,402) | 17.46 |
| Nonvested, September 30, 2010 | 520,827 | $ 22.97 |

As of September 30, 2010, there was $9.9 million of total unrecognized compensation expense related to unvested restricted stock awards granted. The cost is expected to be recognized over a weighted average period of 3.0 years. The total fair value of shares vested during the three months ended September 30, 2010 was $2.0 million. During the three months ended September 30, 2010 and September 30, 2009, the Company recognized $2.0 million and $0.2 million, respectively of stock based compensation expense related to restricted stock awards.

**K12 Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements (Continued)**

## 8. Related Party

In April 2010, the Company entered into a license agreement with an affiliate of the Company in the amount of $1.2 million of which the remaining balance of $0.2 million was paid to the affiliate in July 2010. In September 2010, the Company made a payment in the amount of $3.3 million to KCDL Holdings Inc. representing trade payables assumed in the acquisition of KC Distance Learning, Inc. KCDL Holdings Inc. is an affiliate of the Learning Group, LLC a related party. Additionally, KC Distance Learning has capital leases with an outstanding balance due to KCDL Holdings Inc. in the amount of $1.0 million as of September 30, 2010.

## 9. Commitments and Contingencies

***Litigation***

In the ordinary conduct of business, the Company is subject to lawsuits, arbitrations and administrative proceedings from time to time. The Company expenses legal costs as incurred.

***Aventa Learning***

In June 2010, the shareholders of Aventa Learning, Inc. (Aventa) filed a lawsuit against KC Distance Learning, Inc. which is currently pending in the U.S. District Court for the Western District of Washington, *Axtman et al. v. KC Distance Learning, Inc.* (Case No. 2:10-cv-01022-JLR). The lawsuit alleges, among other things, that KCDL did not honor the terms of an earn-out provision contained in an asset purchase agreement after certain assets of Aventa were acquired by KCDL in 2007. In addition, the plaintiffs allege breach of contract and misrepresentation claims, and seek the remedy of rescission for alleged violation of the Securities Act of Washington. On July 23, 2010, the Company acquired all of the shares of KCDL, which is now a wholly-owned