

Putting Students First



2016

K12 ANNUAL REPORT





**Our mission
is to transform
learning for
every student
we serve.**

STUART J. UDELL
Chief Executive Officer

NATHANIEL A. DAVIS
Executive Chairman

To our fellow shareholders:

DO YOU REMEMBER YOUR FAVORITE TEACHER?

That talented educator who found a way to transform challenging subject matter into clear, engaging, and even meaningful lessons? Not just words or numbers on a blackboard to be memorized and recited, but that engaging leader who captured the imagination of an entire classroom by creating an inspiring and safe place where true learning took hold.

Chances are, this teacher knew that not every child learns the same way. So they found a way to identify learning gaps and build bridges toward successful academic outcomes for the diverse needs of every student in the class. Perhaps this teacher even “brought lessons to life” by showcasing tangible examples of how concepts in the classroom relate to the world around us.

Those are the hallmarks of a truly transformative educational experience. Every student deserves such a rich and engaging education to unlock and maximize their learning potential. This is the mission of K12.

Today’s student body is more diverse than ever with regard to backgrounds, learning needs, and educational challenges. Since K12’s mission is to transform learning for every student we serve, our offerings must be every bit as diverse. Our approach to education encompasses all facets of the modern student-teacher-parent experience—from differentiated instruction to timely interventional responses, and from easy-to-use communication platforms to improved data—in order to support effective teacher decision-making. Personalized learning is no longer a vision for the future. It is here. It is now. And day-in and day-out, the K12 personalized learning model benefits the students, families and teachers we serve.

Since our inception, K12 has been on the frontlines of the digital learning revolution, and in fiscal year 2016, we continued to innovate, expanding the boundaries of today’s personalized learning experience. We purposefully invested in our academic programs, our curriculum, and our technology. We supported strategic growth areas, expanding our state and school footprint, launching new program offerings, and executing on a strategic acquisition opportunity.

Success after School

Rachel Bishop graduated from Idaho Virtual Academy (IDVA) and then attended Idaho State University for nursing. Now, as a registered nurse on the surgical floor of a major hospital in Pocatello, Idaho, Rachel attributes her success to her education powered by K12. In high school, she would do coursework in the morning. If she found a math lesson challenging, she could take the time needed to complete it. On the other hand, if she was doing well in English, she could move more quickly. She spent afternoons volunteering at the local hospital. This schedule allowed Rachel to see if nursing really was right for her. By the time she got to college, she knew exactly what she wanted to be.



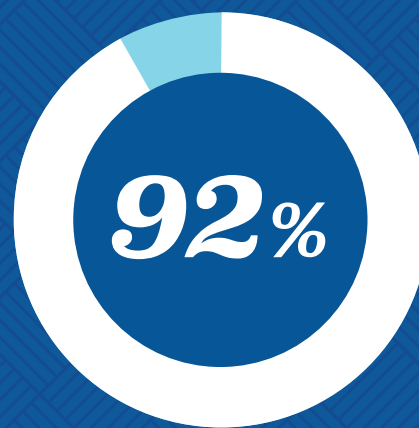
We believe these key investments, coupled with unparalleled insights into the K through 12 digital learning landscape amassed since our inception sixteen years ago, make us uniquely poised for growth in the future.

ACADEMIC PROGRAMS

Successful educational outcomes are fostered when teachers, administrators, and parents work in harmony to make a student's academic needs top priority. This year, K12 continued to invest in our *Students First* portfolio of programs, which expanded into 19 schools. *Students First* includes our *Strong Start* initiative, which ensures students are quickly and seamlessly on-boarded into the virtual classroom; *Walk to Class*, personalized outreach and online tutorials; and *Family Pulse Checks*, surveys to gauge family satisfaction and understand academic areas in need of increased focus.

**“I’m now
working my
dream job.”**

Rachel B.
2011 IDVA graduate



**92% OF K12 PARENTS SAY
THE CURRICULUM HAS HELPED
THEIR STUDENT PREPARE FOR
FUTURE SUCCESS**

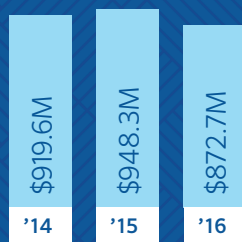
In addition to personalized outreach, we also leverage data-driven, predictive analytics to identify students and families who may need assistance with successful integration into our program. Our team then proactively reaches out to offer help. For this school year, more than 27,000 students were identified through this early detection program and received differentiated onboarding or specialized attention to ensure they were effectively transitioned to their online school. Initial results from these new programs are encouraging, with students engaging earlier in the school year and at a higher rate.

Once on-boarded, real learning occurs when the lesson begins and the classroom door closes, whether it’s a physical or virtual classroom door. We’ve built a platform that truly allows teachers to be great and, this year, we implemented multiple programs to further enhance teacher and school leader excellence. This includes the expansion of a year-long teacher induction and apprenticeship program to hire, train, develop, support, and reward the most valuable resource in student success—educators.

2016 Highlights

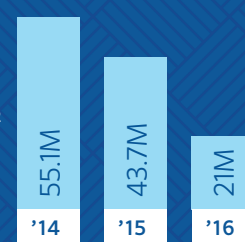
2016 REVENUE

\$872.7M



2016 OPERATING INCOME^{1,2}

\$21.0M



A reconciliation of Operating Income, EBITDA, and Free Cash Flow metrics to GAAP results can be found on page 141.

However, K12 is keenly aware that there are some instances when learning is inhibited by factors outside of an educator's control. This year, we continued to invest in a holistic system of wrap-around service programs, including our *Family Academic Support Teams, FAST*, to link families to school and community-based early intervention resources. *FAST* empowers students to overcome challenges, stay motivated in school, and ultimately succeed in life.

We will continue to evaluate and refine each of these programs in the coming year. K12 holds a unique position within our industry. With more than 100,000 students attending our fully managed partner schools, we have the ability to gain valuable, data-driven insights into our programs. We study these complex data sets to identify which students are successful in various learning environments and why. Ultimately, this data is used to inform instruction, enhancing student engagement and academic outcomes.

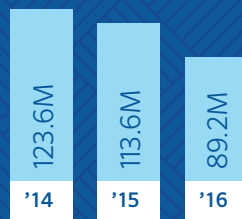
Our data consistently shows that the longer students remain in their virtual school environment, the stronger their academic results. Students enrolled three or more years in K12-managed public schools compared to students enrolled less than one year achieved 16 percent higher proficiency in English Language Arts and 14 percent higher proficiency in Mathematics, according to testing data from school year 2014-2015.

¹ During fiscal year 2014, the Company sold certain businesses and incurred charges relating to additional reserves, accelerated amortization and severance costs of \$32.2 million. In aggregate, the disposed businesses were responsible for \$16.9 million in revenue and have been excluded from 2014 revenues above. In 2015, the Company incurred charges related to end-of-life products, software and inventory, reserves, and severance costs that totaled \$28.4 million. Operating income and EBITDA for 2014 and 2015 are shown excluding the impact of these charges.

² In the fourth quarter of fiscal year 2016, K12 announced that it had reached a settlement with the State of California resolving all claims related to an Attorney General inquiry with no admission of liability or wrongdoing, and no fines or penalties. K12 took a net charge related to this settlement of \$7.1 million. Operating income and EBITDA are shown excluding this cost.

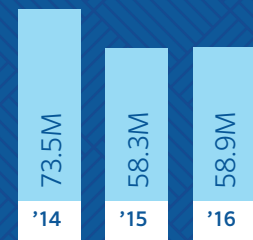
2016
EBITDA^{1,2}

\$89.2 M



2016
FREE CASH FLOW³

\$58.9 M



Improved student retention also has a direct financial benefit to K12. It minimizes the need for greater marketing spend and maximizes return on investment in curriculum and technology. This fiscal year, K12 improved student retention by more than 150 basis points compared to student performance through the same period last year. These figures demonstrate our investments in our academic programs are yielding measurable returns.

CURRICULUM AND TECHNOLOGY

In 2016, we also invested heavily in our next-generation online curriculum which rolls out this fall. Described as “highly intuitive and adaptive,” the new curriculum, called *Summit*, adjusts in response to the needs of the learner. What’s more, it’s mobile; content can truly be accessed anytime, anywhere.

Summit features rich and interactive videos and lessons to captivate students and empower them to understand the reason the content they are learning is relevant in the real world. Importantly, the curriculum includes powerful teacher tools and analytics to guide instruction and supports state standards and assessment mastery. We released our first eight courses in fiscal year 2017, and will build *Summit* across all of our lines of business over the next few years.

³ Free Cash Flow is defined as net cash provided by operating activities less purchases of property and equipment, and capitalized software and curriculum development costs.

Summit Curriculum Makes a Good Thing Even Better

For nearly two decades, a key differentiator in K12's high-quality online education for grades K-12 has been its award-winning curriculum. This year, with the launch of K12's Summit Curriculum, students will be able to reach new levels of learning through engaging course content aligned to state standards, differentiated instruction, easy-to-view analytics, and a mobile experience that allows learning to happen anytime, anywhere. Select courses will launch for the 2016-2017 school year with additional content to be released for 2017-2018.



MORE THAN
150
VIDEOS

IN EACH COURSE HELP
BRING LEARNING TO LIFE



This year we also expanded the use of our new online platform for middle school students which supports the “learn anywhere at any time” capability tailored for every student’s unique educational needs. The upgrade, to be rolled out for the upcoming school year, unifies the student user experience, aggregating resources into a single place and enabling a greater personalization of the student learning experience. The platform also provides dashboards to easily gauge performance, allowing students, parents and teachers to easily see and evaluate student progress and identify where additional work is needed.

We invested in a new school e-mail platform, constructing a communications ecosystem uniquely tailored to meeting the needs of today’s online students and educators. Communication will be fully mobile—not tethered to a device. Early feedback has been positive—easy to learn and easy to use—with improved family engagement, thus ensuring more effective teacher-parent and teacher-student communication.

Our investments in an enhanced curriculum, new learning management systems, and communication platforms are all designed to deliver exactly what a student or teacher needs when they need it. We believe these investments will also deliver game-changing operating and capital efficiencies across our business units and support growth opportunities in the years to come.


EXPANDING OUR REACH

This year, we expanded the network of K12-powered schools. We worked with various states and school boards to open new schools in new states that don’t yet offer a state-wide virtual school option as well as in states where we already operate at least one school. In each case, states and partners choose K12 because of our programs, our reputation for quality service and support, and our focus on compliance and adherence to state and federal requirements.

Alabama’s first-ever statewide virtual public school now serves students in grades K through 12. A new school in Virginia augments our existing presence and will begin serving student needs from across the state this fall. Academically at-risk student populations in Indiana and Nevada are benefiting from the opening of both Insight School of Indiana, serving grades 9 through 12, and Great Basin Virtual Academy for grades K through 8. Omaha Public Schools Online delivers a blended

A Rising Role Model

Damácia Howard, a 13-year-old Georgia Cyber Academy (GCA) student, enjoys an individualized education that allows her to explore her full potential. A straight-A student last year, Damácia is an incoming 8th grader and will take 9th grade literature and high school biology, physical science, and Spanish. Not only a success in academics, in July 2016, she was crowned Miss Georgia Pre-Teen 2016 Queen in the National American Miss competition. For her charitable work for Books for Africa, she was named Georgia State Middle-Level Winner of the Prudential Spirit of Community Awards, and she regularly inspires children at a Ronald McDonald House. Having already accomplished so much, we expect to see even more from this rising role model.



Damácia enjoys an individualized education that allows her to explore her full potential.

Damácia H., 2016
GCA student

learning curriculum to students in grades K through 8 in Nebraska. Highpoint Virtual Academy of Michigan focuses on dual-credit and early college programs. Snow Pond Arts Academy delivers a blended learning curriculum to high school students in Maine, with a strong focus on academics and the performing arts.

CAREER TECHNICAL EDUCATION

An exciting new avenue of focus for K12 is our Career Technical Education (CTE) program, which benefits both high school students and local economies. Our nation is experiencing a skills gap. Millions of well paying, skilled-trade jobs are going unfilled due to a mismatch between the skills of available workers and skills that manufacturers demand. This is occurring, ironically, as millions of people remain unemployed or underemployed. The vast majority of these skilled-trade jobs require education beyond high school but not necessarily a four-year degree.



MORE THAN
250
COURSES

OFFERED FOR
STUDENTS IN GRADES K-12

CTE delivers highly relevant educational alternatives linked to career pathways in business, health science, information technology, and manufacturing. Each pathway will empower students with the preparation and skills necessary to earn industry-recognized certifications that result in an immediate job or a head-start on a two- or four-year college degree.

Our partner school, launched in Wisconsin in cooperation with a local trade union, represents the first of several Career Technical offerings planned by K12 this year. For the upcoming school year, in partnership with school boards, we will also launch new CTE schools or programs in Nevada, Colorado, Utah, and South Carolina. Over the next three years, we plan a significant expansion of these programs to include dozens of courses with a comprehensive set of wrap-around services.

FUEL EDUCATION

This year, K12's institutional line of business, *Fuel Education (FuelEd)* also began to offer CTE courses to school districts and saw immediate interest in the solution. *FuelEd* adds the CTE offering to the industry's most extensive catalog of standards-based, pre-K through grade 12 courses, content, and assessments, designed and developed for online delivery from the outset.

School districts are increasingly leveraging online courses, content, and materials, as there is a real need to deliver academic programs that support the diverse needs of their student populations while remaining in-step with the digital education revolution. Digital content is being used to supplement classroom instruction, address homebound populations, and even to replace traditional textbooks. As more districts shift to online and digital models, we believe *FuelEd* is well-positioned to take advantage of this growth over the long-term. In the coming year, we will continue to refine our *FuelEd* service offerings to meet an ever-changing market demand.

STRATEGIC INVESTMENT

The K12 portfolio was expanded this fiscal year through a strategic acquisition that enhances our product set and diversifies our technology platform. We purchased *LTS Education Systems (LTS)*. *LTS*' core product is *Stride*, a SAAS offering that blends instruction, assessments, and games into a mobile skills practice and test-readiness solution. *Stride* is adaptive, gamified, engaging, and mobile, all of which supports our framework for personalizing the student learning experience. This product fills a gap we have in skills practice, assessment and test readiness across all grades and core subjects in reading, English language arts, math, science, and social studies.

Importantly, the product is game-based. Gamification of learning richly engages today's students, translating into enhanced concepts retention and improved outcomes. We believe gamification and game-based learning will be a significant factor in both future student success and corporate growth.

“Middle schoolers love feedback. It builds a conversation, and it builds community.”

Jennifer R., 2016
Fuel Education Virtual Educator
and Teacher Ambassador



Quick Teacher Response Means Greater Student Gains

As a social studies teacher with Fuel Education for more than three years, Jennifer Richardson provides feedback to her students within 24 hours through e-mail, phone calls, and online support sessions. Quick response helps her middle schoolers who are struggling with concepts and prevents negative impacts on their learning success. She’s also able to effectively connect with parents. In her previous position in a brick-and-mortar setting, she didn’t have as much contact with parents. Richardson is pleased to see how parents now use her regular feedback to engage with her and invest more deeply in their children’s education.



5,000
TEACHERS

APPROXIMATELY 5,000
TEACHERS WORK WITH
K12-POWERED SCHOOLS



**“By building
leaders, we can
have even greater
impact on young
people’s education.”**

Darren R., 2016
Vice President of School Leadership
Development and Support

Reaching Students by Building Leaders

Darren Reed, a former Teacher of the Year in Newport News, Virginia, and principal, loved what he did. “I never wanted to do anything but teach,” he says. But he also wanted to impact more students. As vice president of school leadership development and support, Reed now has greater influence by training a new generation of school leaders. In 2015, Reed spearheaded the Lead360@K12 Leadership Development and School Support Program. Based on six core leadership standards, Reed and his team established targeted professional development strategies, which will help K12 recruit, hire, and train world-class school leaders. “By building leaders, we can have even greater impact on young people’s education,” Reed says.



**OF ALL NEW K12-EMPLOYED
HEADS OF SCHOOL
RECEIVED PROFESSIONAL
DEVELOPMENT TRAINING**

FINANCIAL RESULTS

For fiscal year 2016, we posted revenues of \$872.7 million, a reduction of 8.0%. Operating income was \$13.9 million, a reduction of 24.5%.

Our declines in revenue and operating income for the year are largely attributable to a shift in our largest school contract from a managed to non-managed program. Excluding the impact of this transition, we would have seen underlying revenue and operating income growth in the year.

Our results were also impacted by a settlement with the State of California resolving all claims related to an Attorney General inquiry with no admission or findings of liability or wrongdoing, and no fines or penalties. Our emphasis has always been on doing the right thing, from ensuring an optimal learning experience to delivering the highest quality curriculum, and always working to ensure compliance with legal and regulatory requirements. With the settlement behind us, we now move forward with our full focus, as always, on serving students, enhancing curriculum, and building a stronger company for all of our stakeholders.

LOOKING AHEAD - ENDLESS OPPORTUNITIES

Our mission is to transform learning for every student we serve. Facilitated by a world-class, best-in-breed curriculum, we strive every day to accomplish our mission by providing a personalized learning experience for every child, regardless of their circumstances. Led by talented, imaginative, and experienced educators, the K12-powered learning environment consistently receives high praise from increasing numbers of families across the nation in search of an education solution that will help their child realize their full academic potential.

Pushing the boundaries of innovation in a sector as large and traditionally entrenched as education isn't easy. As K12 introduces new options into school districts across the nation, not everyone is accepting of blended and online programs. Many believe a for-profit firm can't possibly care so deeply about teaching and student success. However, we are an organization of passionate and committed educators. Supporting students to reach their academic goals is in our DNA. K12 cares as much, if not more, about student success as any not-for-profit.

We will not let critics sway us from innovating and delivering education techniques and programs tailor-made for students today and for the generations that follow.

Online and blended learning is still relatively young. Lessons are being learned as K12 grows and evolves. What always has and always will endure is our enterprise-wide, cultural commitment to engaging and empowering the students we serve. This commitment is far more than just good business. It's a personal passion we share with our thousands of team members at K12, our partner schools, and the school districts we serve. We're confident investments made in this fiscal year will raise the bar on our already formidable status as a digital learning pioneer and education innovator. K12 has never been better positioned to redefine an optimal teacher-student experience and ensure 21st century technologies help drive exceptional academic outcomes for all the students we serve.

Thank you for your support.



Nate Davis,
Executive Chairman



Stuart Udell,
Chief Executive Officer

Postsecondary Schools Where K12 Graduates Were Accepted in 2014 and 2015

Arizona State University

Baylor University

Boston University

Bowling Green State University

Brigham Young University

California Polytechnic
State University

Clemson University

Georgia State University

The Juilliard School

Miami University

Pennsylvania State University

Portland State University

University of Kansas

Texas A&M University

University of Maryland-
College Park

University of North Carolina

University of Pennsylvania

University of Washington-Seattle

* National Clearinghouse Student
Tracker Report 2014, 2015



FORM 10-K

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended June 30, 2016

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
(State or other jurisdiction of
incorporation or organization)

**2300 Corporate Park Drive
Herndon, VA 20171**

95-4774688
(I.R.S. Employer
Identification No.)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

Common Stock, \$0.0001 par value

New York Stock Exchange (NYSE)

Securities registered pursuant to Section 12(g) of the Act:

None

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined by Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a
smaller reporting company)

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

The aggregate market value of the registrant's voting and non-voting stock held by non-affiliates of the registrant as of December 31, 2015 was approximately \$228,694,506. Aggregate market value excludes an aggregate of approximately 12,933,353 shares of common stock held by officers and directors and by each person known by the registrant to own 5% or more of the outstanding common stock on such date. Exclusion of shares held by any of these persons should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

The number of shares of the registrant's common stock outstanding as of July 31, 2016 was 39,671,177.

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the registrant's definitive proxy statement for its 2016 annual meeting of stockholders to be filed pursuant to Regulation 14A with the Securities and Exchange Commission not later than 120 days after the registrant's fiscal year ended June 30, 2016, are incorporated by reference into Part III of this Form 10-K.

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CERTAIN DEFINITIONS

Unless the context requires otherwise, all references in this Annual Report on Form 10-K (the “Annual Report”) to “K12,” “K¹²,” “Company,” “we,” “our” and “us” refer to K12 Inc. and its consolidated subsidiaries.

SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Annual Report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve substantial risks and uncertainties. All statements other than statements of historical facts contained in this Annual Report on Form 10-K are forward-looking statements. We have tried, whenever possible, to identify these forward-looking statements using words such as “anticipates,” “believes,” “estimates,” “continues,” “likely,” “may,” “opportunity,” “potential,” “projects,” “will,” “expects,” “plans,” “intends” and similar expressions to identify forward-looking statements, whether in the negative or the affirmative. These statements reflect our current beliefs and are based upon information currently available to us. Accordingly, such forward-looking statements involve known and unknown risks, uncertainties and other factors which could cause our actual results, performance or achievements to differ materially from those expressed in, or implied by, such statements. These risks, uncertainties, factors and contingencies include, but are not limited to:

- reduction of per pupil funding amounts at the schools we serve;
- inability to achieve a sufficient level of new enrollments to sustain our business model;
- failure to enter into new managed school contracts or renew existing contracts, in part or in their entirety;
- failure of the schools we serve or us to comply with federal, state and local regulations, resulting in a loss of funding, an obligation to repay funds previously received, or contractual remedies;
- governmental investigations that could result in fines, penalties, settlements, or injunctive relief;
- declines or variations in academic performance outcomes of the students and schools we serve as curriculum and testing standards evolve;
- harm to our reputation resulting from poor performance or misconduct by operators or us in any school in our industry and/or in any school in which we operate;
- legal and regulatory challenges from opponents of virtual public education or for-profit education companies;
- discrepancies in interpretation of legislation by regulatory agencies that may lead to payment or funding disputes;
- termination of our contracts with schools due to a loss of authorizing charter;
- entry of new competitors with superior technologies and lower prices;
- unsuccessful integration of mergers, acquisitions and joint ventures;
- failure to further develop, maintain and enhance our technology, products, services and brands;
- inadequate recruiting, training and retention of effective teachers and employees;
- infringement of our intellectual property; and
- disruptions to our Internet-based learning and delivery systems resulting from cyber-attacks.

Forward-looking statements reflect our management’s expectations or predictions of future conditions, events or results based on various assumptions and management’s estimates of trends and

economic factors in the markets in which we are active, as well as our business plans. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. Our actual results and financial conditions may differ, possibly materially, from the anticipated results and financial conditions indicated in these forward-looking statements. There are a number of factors that could cause actual conditions, events or results to differ materially from those described in the forward-looking statements contained in this Annual Report. A discussion of factors that could cause actual conditions, events or results to differ materially from those expressed in any forward-looking statements appears in “Part 1—Item 1A—Risk Factors.”

Readers are cautioned not to place undue reliance on forward-looking statements in this Annual Report or that we make from time to time, and to consider carefully the factors discussed in “Part 1—Item 1A—Risk Factors” of this Annual Report in evaluating these forward-looking statements. These forward-looking statements are representative only as of the date they are made, and we undertake no obligation to update any forward-looking statement as a result of new information, future events or otherwise.

PART I

ITEM 1. BUSINESS

Company Overview

We are a technology-based education company. We offer proprietary curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade, or K-12. Our mission is to maximize a child’s potential by offering an engaging and effective education, regardless of geographic location or socio-economic background. We provide a continuum of technology-based educational products and solutions to public school districts, public schools, virtual charter schools, private schools and families as we strive to transform a student’s learning experience into one that delivers individualized education. In 2013, AdvancEd, a non-profit international accreditation agency for schools and school systems, renewed our five year quality assurance accreditation.

As an innovator in K-12 online education, we believe we have attained distinctive core competencies that allow us to meet the varied needs of our school customers and students. These core competencies include our ability to create engaging curriculum, train teachers to be effective in online instruction, provide turn-key management services to online schools, customize online learning programs for school districts, develop innovative new offerings, and assist legislators and policy makers in understanding the many dynamics of virtual and blended learning that can complement and transform traditional schools. These factors enable us to provide a unique set of products and services to three lines of business that share many common attributes, including curriculum, learning systems, management expertise, logistical systems and marketing. These lines of business are: Managed Public School Programs, which is comprised of virtual and blended schools (as more fully described below), Institutional business (educational products and services sold to school districts, public schools and other educational institutions that we do not manage), and Private Pay Schools and Other (private schools, including international, for which we charge student tuition and direct consumer sales).

Managed Public School Programs	Institutional	Private Pay Schools and Other
<ul style="list-style-type: none"> • Virtual schools • Blended schools <ul style="list-style-type: none"> —Hybrid schools —Passport schools 	<ul style="list-style-type: none"> • Non-managed Public School Programs • Institutional software and services 	<ul style="list-style-type: none"> • Managed private schools <ul style="list-style-type: none"> —K¹² International Academy —George Washington University Online High School —The Keystone School • Independent course sales (Consumer)

- **Managed Public School Programs**

Our Managed Public School Programs business includes both virtual and blended public schools where a district or independent charter board contracts with K12 to help provide a full-time program of educational products and services. The Managed Public School Programs are programs in which K12 provides substantially all of the management, technology and academic support services in addition to curriculum, learning systems and instructional services. In contrast, Non-managed Public School Programs do not offer primary administrative oversight. In fiscal year 2016, our Managed Public School Programs accounted for approximately 82% of our revenue.

Virtual Public Schools. In full-time virtual public schools, students receive online lessons over the Internet, utilize offline learning materials that we supply, and receive instruction from state certified teachers. In addition to providing our courses, course materials and, in certain cases, student computers, we also offer these schools a variety of management, technology and academic support services. The majority of our revenue is derived from long-term service agreements with the governing authorities of these virtual public schools.

Blended Public Schools. In addition to providing services to virtual public schools, we also sell our products and services to blended public schools that combine online and face-to-face instruction in many different arrangements with varying amounts of time spent by students in a physical learning center.

For both virtual and blended Managed Public School Programs, the governing authority with control over the schools negotiates contractual terms with us for all aspects of the management of the schools, including the creation and implementation of the academic plan, monitoring academic achievement, teacher recruitment and training, student enrollment and marketing, compensation recommendations for school personnel, implementation of student support services, financial and regulatory compliance support, procurement of curriculum, computers and other required services and equipment. The scope of services we provide may also vary in accordance with applicable state regulations and each governing authority's policies. Funding is provided primarily by state governments. For the 2015-16 school year, we provided these turn-key management services to Managed Public School Programs in 33 states and the District of Columbia.

- **Institutional**

We work closely as partners with a growing number of school districts and individual schools, enabling them to offer their students an array of online education solutions, including full-time virtual and blended programs, semester courses and supplemental educational products. Institutional business includes Non-managed Public School Programs and Institutional software and services where K12 provides curriculum and technology, and the school has an option to contract for instruction or other software and services we provide; however, the Institutional business offerings do not include primary administrative oversight to these programs. In addition to curriculum, systems and programs, we provide teacher training, teaching services and other support services. Our Institutional business customers include public schools, school districts, private schools, charter schools, early childhood learning centers and corporate partners. Additionally, we operate Middlebury Interactive Languages LLC ("MIL"), which was created as a joint venture with Middlebury College to develop and market online foreign language courses (see Notes to Consolidated Financial Statements, Note 10). For the 2015-16 school year, we served school districts or individual schools in all 50 states and the District of Columbia, including those where the regulatory environment restricts or prohibits statewide online programs.

- **Private Pay Schools and Other**

We operate three online private schools: The K¹² International Academy, the George Washington University Online High School and the Keystone School. We also have entered into agreements which

enable us to distribute our products and services to students from more than 100 countries. We pursue international opportunities where we believe there is significant demand for quality online education. Our principal customers are U.S. students, including those who reside in states where the online public school option is not available, as well as expatriate families and foreign students who wish to study in English. Additionally, our curriculum is sold to end user customers who desire to educate their children outside of the traditional school system or to supplement their child's traditional education.

We continue to make significant capital investments in our infrastructure and resources intended to improve student academic outcomes, including: (i) the ongoing development and enhancement of our current and next generation curriculum and software; (ii) implementation of a new learning management platform for our high school students; (iii) corporate and school infrastructure to improve scalability, increase data security and privacy, and attain cost savings; (iv) purchase and delivery of student computers and (v) conversion of interactive instructional products to enable delivery through tablets and mobile devices.

Our History

We were founded in 2000 to utilize advances in technology to provide children with access to a high-quality public school education regardless of their geographic location or socioeconomic background. Given the geographic flexibility of technology-based education, we believed that the pursuit of this mission could help address the growing concerns regarding the regionalized disparity in the quality of public school education, both in the United States and abroad. The convergence of these factors and rapid advances in Internet networks created the opportunity to make a significant impact by deploying online learning software and systems on a flexible, online platform.

In September 2001, we introduced our kindergarten through 2nd grade offering in Pennsylvania and Colorado, serving approximately 900 students in the two states combined. We subsequently added new grades and new schools in additional states. We also launched blended public schools that combine face-to-face time in the classroom with online instruction and opened an online private school to reach students worldwide. In school year 2015-16, we served virtual public schools with Managed Public School Programs in 33 states and the District of Columbia, specifically: Alabama, Arizona, Arkansas, California, Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Texas, Utah, Virginia, Washington, Wisconsin and Wyoming. We also serve schools in all 50 states through our Institutional business.

Our Market

The U.S. market for K-12 education is large and online learning is gaining greater acceptance. For example:

- According to the most recently available data from the 2015 Keeping Pace with K-12 Digital Learning report (“Keeping Pace”), over 50 million students attend K-12 public schools, and nearly five million students are enrolled in private schools. Five states mandate the completion of an online course prior to high school graduation. Full-time virtual charter schools served an estimated 275,000 students who took approximately 3.3 million semester equivalent courses online. Fourteen states have enacted online course choice laws. K12 is a sponsor of Keeping Pace along with 14 other educational organizations, including iNACOL.
- The 2015 Keeping Pace report further states that 47% of students in grades 9-12 pursue online learning to access courses not offered at the school, and 43% choose to take courses online to be able to work at their own pace. In addition, 2.2 million K-12 students participated in a formal online learning program.

- In addition, according to a report by National Home Education Research Institute, there are approximately 2.3 million home-educated students in the United States. Many of these students took an online course and a small percentage enrolled in a full-time online program.
- According to the National Center for Educational Statistics (“NCES”), a division of the U.S. Department of Education, the public school system alone encompassed more than 98,500 schools and approximately 13,500 districts during the 2012-13 school year.
- The NCES estimates that total spending in the K-12 market was projected to be \$669 billion for the 2012-13 school year, and that public school spending will increase by 4.5 percent, to \$699 billion, by 2022-23.

Many parents and educators are seeking alternatives to traditional classroom-based education for a variety of reasons. Demand for these alternatives is evident in the expanding number of choices available to parents and students. For example, from the time we were founded in school year 2000 to school year 2013, the percentage of public school students who attended charter schools increased from 0.7% to 4.6% according to the NCES. According to the 2015 Keeping Pace with K-12 Digital Learning report, there are approximately 6,700 public charter schools operating in 42 states and the District of Columbia with an estimated enrollment of approximately 2.9 million students. Similarly, acceptance of online learning initiatives, including not only virtual and blended public schools, but also online courses, credit recovery, remediation, testing and Internet-based professional development, has continued to grow. Districts are also rapidly adopting online learning to expand course offerings, provide schedule flexibility, increase graduation rates and lower the cost of delivering education.

Demand for Education Alternatives: The Market Opportunity and the K12 Solutions

As evidenced by the varying options being utilized by K-12 students, no single educational model works equally well for all students. Children today utilize technology in all aspects of their lives, and we expect them to extend their use of technology to their educational needs and choices. Our business is modeled on the premise that every student has the right to an education that is individualized and available anywhere that meets each student’s unique needs. We also believe all students can benefit from more engaging educational content.

We anticipate that full-time virtual schools will meet the needs of a small percentage of the overall K-12 student population, but do represent and will continue to represent a large and growing opportunity in absolute terms. Across our educational programs, families come from a broad range of social, economic and academic backgrounds. Like most parents, they share the desire for individualized instruction to maximize their children’s potential. Examples of students for whom this solution may fit include, but are not limited to, families with: (i) students seeking to learn at their own pace in a way that better accommodates their individual needs; (ii) students with safety, social and health concerns about their local school; (iii) students with disabilities who are seeking alternatives to traditional classrooms; (iv) students for whom the local public school is not meeting their needs; (v) students who seek or need greater flexibility than other alternatives, such as student-athletes and performers who are not able to attend regularly-scheduled classes; (vi) college-bound students who want to bolster their college readiness and application appeal by taking additional Advanced Placement (“AP”), honors and/or elective courses; (vii) students seeking career and technical skills; (viii) high school dropouts who have decided to re-enroll in school to earn a diploma; and (ix) students of military families who desire high quality, consistent education as they relocate to new locations. Our individualized learning approach allows students to optimize their educational experience and, therefore, their chances of achieving their goals.

Most students in the United States will continue to be educated in school buildings and classrooms. However we also believe that certain student segments will benefit from the availability of an online public education, and that states and districts will seek to incorporate online solutions into their school-based programs. One of the challenges traditional schools continue to face is adoption of technology and

innovative new learning devices. Our Managed Public School Programs offer a complete solution for districts and schools that need a turn-key option and we also offer, through our Institutional business, online curriculum and services on a solutions-oriented, customized basis for those customers who need less than a full-service offering. We believe this range of options creates the opportunity for us to serve the majority of students who will learn within school buildings. Therefore, we continue to invest significant resources, organically and through licensing or acquisitions, in developing product offerings that afford us the flexibility to serve different types of customers with varying value propositions and price points that are adaptable to an institution's capabilities and needs. Moreover, we have and will continue to pursue selected markets outside the United States where we believe our curricula can address local market needs.

We believe that our core competencies, coupled with the substantial investments we have made in our infrastructure and our prior strategic acquisitions and partnerships, position us to offer educational resources for all types of students. Our products and services offer students expanded educational opportunities regardless of whether a student chooses to remain in a classroom or seeks an alternative educational setting, attends public or private school, lives in the United States or abroad, wants to take online classes on a full or part-time basis, requires supplemental educational products, seeks career or technical training or is an advanced or remedial student.

Our Business Lines

Managed Public School Programs

As previously discussed, in our Managed Public School Programs, we provide substantially all of the management, technology and academic support services in addition to curriculum, learning systems and instructional services. We provide our Managed Public School Programs to both virtual and blended public school customers.

We believe that the acceptance of online education in grades K-12 continues to grow, and anticipate that increased overall demand for virtual options in education will translate into increased demand for both our Managed Public School Programs and our Institutional business (sold under the brand names Fuel Education or FuelEd). At the same time, the growth rate in the Managed Public School Programs business, which serves primarily virtual charter schools, has slowed. Regulatory requirements related to academic performance and accountability are expanding and the independent governing authorities of the virtual charter schools that contract with us are taking different approaches to virtual education depending upon their own charter school goals. This in turn may alter the nature of the agreements we have with those boards and the level of management services that meet their needs. For example, a managed public school board may decide to transition to a self-managed model. While these schools continue to purchase our curriculum and some of our management and technology services, they assume more of the daily operational responsibilities for themselves. In some Managed Public School Programs, full responsibility for academic performance resides with the governing authority or school board which employs the Head of School. Conversely, as new states offer an online public school option, we believe that contracting with us for a fully integrated, virtual school turn-key operation that we manage remains attractive. We have also recently experienced a situation where a board which initially elected a self-managed approach subsequently reverted back to obtaining a greater percentage of integrated school management services from the Company.

Virtual Public Schools

The majority of our revenue is derived from long-term service agreements with the governing authorities of the virtual public schools we serve. In addition to a comprehensive course catalog, related books and physical materials and, in certain cases, student computers, we also offer these schools a variety of management, technology and academic support services. Full-time virtual public school students access online lessons over the Internet and utilize offline learning materials we provide. Students receive

assignments, complete lessons, take assessments, and are instructed by certified teachers with whom they interact online, telephonically, in synchronous virtual classroom environments, and sometimes face-to-face. In a Non-managed virtual public school, the level of instructional and/or academic support management, technology services, and academic support services varies or may not be provided depending on the needs of the school. In either case, for parents who believe their child is not thriving in their current public school or for students and families who require time or location flexibility in their schooling, virtual and blended public schools can provide a compelling choice.

Virtual public school students are also provided the opportunity to participate in a wide variety of school activities, including outings and clubs. In addition to school-level activities, we sponsor a wide variety of extracurricular activities on a national basis, such as clubs, contests and college and career planning sessions.

Virtual public schools managed by K12 (often named virtual academies) typically serve K-8 or K-12 students, principally utilize the K¹² curriculum and attract both mainstream and all other types of learners. These virtual public schools include virtual academies, Insight schools which tend to focus on academically at-risk students, and iQ Academies which are typically only partially-managed by us, with responsibility for academic program and regulatory compliance resting with the host school or school district. We also manage career and technical education-focused online high schools which are designed to give students a head start on their career goals by earning technical and specialty trade credentials, college credits, and workplace experiences.

Blended Public Schools

In addition to our full-time virtual public schools, we offer a variety of management and support services and sell our products to blended public schools, which are public schools that combine online and face-to-face instruction for students in a variety of ways with varying amounts of time spent by students in a physical learning center. For the 2015-16 school year, we managed blended public schools in California, Illinois, Indiana, Minnesota, New Jersey and Pennsylvania.

In contrast to a typical brick and mortar public school, blended public schools can provide a greater selection of available courses, increased opportunities for self-paced, individualized instruction and greater scheduling flexibility. We manage two types of blended public schools—hybrid schools and Passport schools. These blended schools bring students and teachers physically together more often than a purely online program.

In the hybrid schools we manage, such as the Chicago Virtual Charter School, students attend a learning center on a part-time basis, where they receive face-to-face instruction, in addition to their online virtual curriculum and instruction.

Another type of blended school option is the Passport school which is specifically designed for academically at-risk students, particularly those who have previously dropped out of high school, and accordingly, includes more counseling and support services. Because many Passport students have work and/or child care responsibilities, most students spend half of each day on-site, working on-line and face to face with teachers, and complete the remainder of their daily work away from the learning center. The Hill House Passport Academy in Pennsylvania is an example of a Passport school.

Institutional

Our Institutional business consists of: (i) Non-managed Public School Programs; and (ii) institutional software and services. Public schools and school districts are increasingly adopting these online solutions to launch new learning models, cost-effectively expand course offerings, provide schedule flexibility, improve student engagement, increase graduation rates, replace textbooks and retain students. State education funds traditionally allocated for textbook and print materials are now also being authorized for the

purchase of digital content, including online courses, and in some cases mandated for access to online courses. To address these growing needs, our Institutional business provides curriculum and technology solutions, packaged in a portfolio of flexible learning and delivery models mapped to specific student and/or district needs. This portfolio provides a continuum of delivery models, from full-time Non-managed Public School Programs to individual course sales and other options that can be used in traditional classrooms to differentiate instruction. The goal of the Institutional business is to partner primarily with U.S.-based public schools and school districts to provide more options and better tools to empower teachers to improve student achievement through personalized learning. Our FuelEd suite of offerings has grown and includes K¹² curriculum, FuelEd Online Courses, FuelEd A+nywhere Learning Systems (“ALS”), and Middlebury Interactive Languages, LTS Education Systems, LearnBop and Career Pathways curriculum. Our extensive catalog of online curricula can address specific student needs, including AP, honors programs, world languages, remediation, credit recovery, alternative education, career and technology electives and college readiness. In connection with these solutions, we also offer state-certified teachers, training for school personnel in online instruction methods, and professional development and other support services as needed by our customers.

In addition to our extensive curricula catalog, Institutional business offers the PEAK platform and PEAK Library. PEAK is a proprietary software system designed to centrally manage in a single-user interface, multiple, independent online solutions. Schools can enroll students, assign courses and teachers, and then manage the learning experience with easy to use reporting and analytics on student progress. The PEAK Library currently supports the K¹² curriculum portfolio and teachers can build and modify assignments, assessments and courses to augment classroom instruction and develop lessons for sharing across the school district. PEAK also has the capability to support other third-party solutions, open educational resources and district and teacher-created content. For students, teachers and administrators, PEAK eliminates the complexity of managing multiple accounts and roles and provides a consistent online environment for full-time, credit recovery, world languages or blended classroom programs. We believe increasing ease-of-use for administrators and teachers is a critical factor in improving student support and therefore, improving student outcomes. PEAK addresses this need by serving all of the online instructional needs of a school or district in an integrated, data-driven manner.

In fiscal year 2016, we continued to invest in our direct and indirect sales network and our product offerings. We acquired LTS Education Systems which offers test preparation and readiness curriculum and we released our new career and technical education, supplemental math and English language learner products. For the 2015-16 school year, we served school districts or individual schools in all 50 states and the District of Columbia through our Institutional business. Based upon school districts’ and academic administrators’ growing acceptance of online learning and desire for cost efficient, integrated and flexible educational solutions, we believe that the direct-to-district distribution channel offers further significant growth potential.

Private Pay Schools and Other

International and Private Pay Schools

We operate a variety of private schools that meet the needs of students ranging from simple correspondence courses to challenging college preparatory programs. Beyond our business in the United States, we are pursuing international opportunities where we believe there is significant demand for a quality online education. Our international customers are typically expatriate families and foreign students who desire a U.S. high school diploma and wish to study in English. For the 2015-16 school year, we served students in more than 100 countries. In addition, we have entered into agreements that enable us to distribute our products and services to our international school partners who use our courses to provide broad elective offerings and dual diploma programs.

We operate the K¹² International Academy, an online private school that serves students in both the United States and overseas. Through the K¹² International Academy, students may study in an academic program that ultimately leads to an accredited U.S. high school diploma. Students may also enroll in individual courses on a part-time basis. The K¹² International Academy utilizes the same curriculum, systems and teaching practices that we provide to the virtual public schools we manage in the United States. In addition, this school provides a unique international community including online clubs and events that enrich the student experience by allowing students to interact with peers in other countries. The school is accredited by AdvancED, and is recognized by the Commonwealth of Virginia as a degree granting institution of secondary learning.

The Keystone School (“Keystone”) is a private school that has been an innovator in home-based education and distance learning for over 35 years. Students attend Keystone for middle and high school on a full or part-time basis. It serves students through online courses with teacher support as well as print correspondence course programs. Keystone primarily uses our FuelEd curriculum and offers a lower-cost option to families than either of our other two private schools. Keystone is accredited by the Middle States Association—Commission on Elementary and Secondary Schools and AdvancED.

The George Washington University Online High School is operated in cooperation with the George Washington University. The program, which launched in the 2011-12 school year, offers K12’s college preparatory curriculum and is designed for high school students who are seeking a challenging academic experience and aspire to attend top colleges and universities. The school also provides extensive counseling throughout the high school years to help students make academic and extracurricular choices and maximize their future potential. The school is accredited by the Middle States Association—Commission on Elementary and Secondary Schools.

Consumer Sales

We also sell individual online courses and supplemental educational products directly to families. These purchasers desire to educate their children outside of the traditional public school system or to supplement their child’s existing public school education without the aid of an online teacher. Customers of our consumer products have the option of purchasing a complete grade-level curriculum or individual subjects depending on their child’s needs. Typical applications include summer school course work, home schooling and educational supplements.

Our Business Strategy

Our business strategy is driven by our mission to maximize every child’s potential by transforming the educational experience, delivering a quality education to schools and their students, and supporting our customers in their quest to improve academic outcomes and prepare them for college and career readiness. In furtherance of those objectives, we plan to continue investing in our curriculum and learning systems. These investments include initiatives to create and deploy a next generation curriculum, improve the effectiveness of our school workforce, develop new instructional approaches to increase student and parental engagement, and improve our systems and security architecture. This strategy consists of the following key elements:

Deliver better student outcomes. We are committed to improving student outcomes for every student in the schools we serve. To achieve this goal we will: (i) invest in training and professional development for teachers and school leaders; (ii) develop programs and initiatives designed to improve the learning experience, such as our interactive media projects, virtual science labs, AP test prep, specialized cohort academies and Family Academic Support Team initiatives; (iii) enhance our curriculum to make it more engaging, adaptive and accessible to all students anywhere; and (iv) update our content as state standards and state assessments change. We will also focus our marketing and enrollment efforts on helping students and families understand the unique demands and challenges of the online learning environment. We

believe a better understanding by parents and students will better prepare students for the work and improve their chance at academic success.

Improve student retention in our virtual schools. To ensure the best outcomes for students, we have partnered with the school boards we serve to make a concerted effort to enroll and retain students who are truly engaged and ready to learn. Research shows that students who remain in the same school setting longer generally perform better academically, and retention is especially challenging with virtual schools because families have the option of enrolling their children in a brick and mortar school or another virtual school. We therefore continue to refine our marketing programs to attract students who are most likely to succeed in a non-classroom based environment with the expectation of increasing academic success and student retention, recognizing that all students are eligible to enroll consistent with state requirements (e.g. enrollment caps, prior public student). Once students are enrolled, programs such as the Family Academic Support Team affect early intervention and focused engagement and retention strategies, strive to help students stay on track, improve engagement and ultimately give students a better chance at academic success.

Introduce New and Improved Products and Services. We intend to continue to expand our product line and offerings, both internally and through licensing or strategic acquisitions of products that address gaps in our current portfolio, including pursuing greater use of and access to tablet and mobile technology and adaptive learning technologies and solutions. In addition, we are endeavoring to serve new charter schools that attract students who are seeking career and technical education.

Increase Enrollments at Existing Virtual and Blended Public Schools. In the 2015-16 school year, we will manage virtual and blended public schools in 33 states and the District of Columbia. Some state regulations and school governing authorities and districts limit or cap student enrollment or enrollment growth. At the direction of our school board and school district customers, we will provide an opportunity for more students to attend these schools, and support their efforts to work with legislators, state departments of education, educators and parents to remove those enrollment caps.

Expand Virtual and Blended Public School Presence into Additional States and Cities. Due to the modularity of our curriculum and the comprehensiveness of our learning systems, we are able to efficiently adapt our curriculum to the individual educational standards of any state or school district with limited incremental capital investment. We will continue to work with states and school districts to authorize and establish new virtual and blended public schools and to contract with them to provide our curriculum, online learning platform, management services, and other related offerings.

Accelerate Institutional Business. The breadth of our FuelEd catalog, now ranging from pre-K to 12th grade, our instructional capabilities and our capacity to simplify a school district's management of multiple digital programs and vendors through our PEAK technology platform, are the key drivers for Institutional business growth. We will continue to work to accelerate the market adoption of these solutions and services as school districts partner with us to address a variety of academic needs and personalized learning for their students. We will continue to seek acquisitions of businesses that expand FuelEd's distribution and product portfolio, improve our platform and capabilities, and allow us to enter new markets to serve every child who is interested in the benefits of digital learning.

Add Enrollments in Our Private Schools. We currently operate three online private schools that we believe appeal to a broad range of students and families. We look to drive increased enrollments in these schools by increasing awareness, through targeted marketing programs and by solicitation of partnerships with traditional brick and mortar private schools.

Pursue International Opportunities to Offer Our Learning Systems. We believe there is strong worldwide demand for high-quality, online education from U.S. families living abroad, foreign students who seek a U.S.-style of education and the schools and school systems that serve them in their local

market. Our ability to operate virtually is not constrained by the need for a physical classroom or local teachers, which makes our learning systems ideal for use internationally.

Develop Additional Channels through Which to Deliver Our Learning Systems. We plan to evaluate other delivery channels on a routine basis and to pursue opportunities where we believe there is likely to be significant demand for our offering, such as direct classroom instruction, blended classroom models, career and technical education, supplemental educational products and individual products packaged and sold directly to consumers.

Pursue Strategic Partnerships and Acquisitions. We may pursue selective acquisitions at valuations that complement our existing educational offerings and business capabilities, and that are natural extensions of our core competencies. We may also pursue opportunities with highly-respected institutions where we can be a valued-added partner or contribute our expertise in curriculum development and educational services to serve more students.

Products and Services

Educational Philosophy

A primary focus of our educational philosophy is to make the academic performance of students our first priority. We are committed to continuously improving the quality of our curriculum and academic programs, including alignment with states that have adopted the Common Core State Standards (“CCSS”), the Common Core Assessments, and other state curriculum and assessment standards. We also continue to evaluate and use innovative technologies to deliver engaging and effective learning experiences for all students. We seek to leverage our product portfolios across our educational solutions and distribution channels and to invest in our content portfolio to ensure our students receive a meaningful learning experience that is individualized, engaging, accessible and effective.

The design, development and delivery of our products and services are grounded in the following set of guiding principles:

- *To deliver learning systems that are designed to help drive academic success and student engagement.* Our programs include a wide variety of curriculum and course options, onboarding programs to support our families and schools, as well tools to support the overall engagement and student management.
- *Employ Technology Appropriately for Learning.* All of our courses are delivered primarily through an online platform and generally include a significant amount of online content. We employ technology where we feel it is appropriate and can enhance the learning process, with the amount of online content increasing at higher grades. In addition to online content, our curriculum includes a rich mix of courses with and without materials. Furthermore, teachers utilize a variety of collaboration and communication tools to help support student and family communication. We believe our balanced use of technology and more traditional approaches helps to maximize the effectiveness of our learning systems.
- *Assess Every Objective to Ensure Mastery.* Ongoing assessments are the most effective way to evaluate a student’s mastery of a lesson or concept. To facilitate effective assessment, our curriculum states clear objectives for each lesson. Throughout a course, every student’s progress is assessed at a point when each objective is expected to be mastered, providing direction for appropriate pacing. These periodic and well-timed assessments reinforce learning and promote mastery of a topic before a student moves to the next lesson or course.

- *Individualized Learning.* We seek to create engaging curriculum content to capture a student’s attention to make learning more interesting and effective. It is our fundamental belief that each student learns in a highly individualized manner. Our instructional system allows students to learn from a curriculum that caters to their unique learning style and offers a high degree of program flexibility. Certain adaptive learning features being integrated into some curricular products can individualize lessons based on the level of student comprehension.
- *Prioritize Important, Rigorous Objectives.* Our content experts have developed a clear understanding of those subjects and concepts that are difficult for students, from both historical and cognitive points of view. Greater instructional effort is focused on the most important and most challenging concepts (as revealed by experience and research). We use existing research, feedback from parents and students, and experienced teacher judgments to determine these priorities, to modify our learning systems to guide the allocation of each student’s time and effort, and to align with evolving state curriculum and testing standards.
- *Facilitate Flexibility to Accommodate Variations in Ability.* We believe that each student should have access to a variety of instructional solutions that help challenge each student appropriately. Generally, meaningful progress for most students is to complete one academic year’s curriculum within a traditional school year. Our learning systems are designed to facilitate this flexibility to motivate and challenge each student to master each lesson.
- *Ensure Fundamental Content Soundness.* Our highly credentialed subject matter experts or “Content Specialists” bring their own scholarly and teaching backgrounds to course design and development and are required to maintain relationships with and awareness of guidelines from over 50 national and international subject-area associations.
- *Integrate Curriculum, Teachers and Technology to Maximize Student Learning.* We believe students learn better not just with great curriculum, but also great teachers and technology that allows them to access the content and teachers in a way that makes learning more engaging and effective.

Academic Performance

Our fundamental goal for every child who enrolls in a virtual public or private school managed by us, or a program offered through a school district or a Non-managed school, is to improve his or her academic performance. In fiscal year 2017, we will be publishing our 2016 K12 Annual Academic Report (“2016 Academic Report”) which will be available at <http://www.k12.com/what-is-K12/results>. By analyzing and communicating the results of our efforts, we aim to provide data for school boards and parents as they exercise school choice options, and to help educators working to improve academic achievement for every child in our increasingly diverse schools. We expect that our 2016 Academic Report will be more reflective of the changes made by individual states to develop their own accountability standards and assessments, thereby making year-over-year comparisons less relevant. We believe that none of our competitors serving virtual public schools publishes this volume or depth of academic performance data and analytics.

Each of the 33 states and the District of Columbia in which we manage virtual public schools measures academic performance using different state accountability methods. A number of states have adopted the Common Core State Standards for curriculum content and one of the two online assessment methods aligned to those standards, the Smarter Balanced Assessment Consortium (“Smarter Balanced”) or the Partnership for Assessment of Readiness for College and Careers (“PARCC”). However, as of school year 2015-16, a majority of the states in which we operate, such as Arizona, Florida and Indiana, currently rely on their own state-developed standards and assessments or commercially available assessments. Some states use a combination of a state-developed test and either the PARCC or Smarter Balanced test, while other states in which we operate never adopted the CCSS, including Virginia and Texas.

In the 2014-2015 school year, many states changed their accountability assessments. Across all K12 public school programs, only eight states did not change their state accountability tests in 2014-2015: Iowa, Minnesota, Oklahoma, Tennessee, Texas, Utah, Virginia, and Wyoming. The changes in state tests were in part a consequence of the Common Core State Standards, initially released in 2010. In that year, most states began the process of adopting the Common Core standards, encouraged by the federal grant program called Race to the Top, which favored applicants that agreed to adopt Common Core. The new content standards required new assessments so to develop assessments aligned to the Common Core, the federal government funded two testing consortia: the Partnership for Assessment of Readiness for College and Careers (“PARCC”) and the Smarter Balanced Assessment Consortium (“SBAC”). At one time, 24 states and the District of Columbia were signed on to administer the PARCC assessments. However, in the 2014-2015 school year, only the District of Columbia and 10 states fully administered the PARCC assessments. The Education Commission of the States notes that in 2015-2016, only six states and the District of Columbia plan to use the PARCC assessments. While the Smarter Balanced consortium has experienced fewer withdrawals, its members have decreased to 15 states that administered the full SBAC assessment in the 2015-2016 school year.

We share the view taken by many states that assessing a student’s academic performance by his or her learning growth is a more accurate measure of a school’s effectiveness than attaining a static proficiency score. Most of our schools administer nationally-recognized interim and/or benchmark assessments to measure student growth during the school year, to prepare students for state assessments and to guide instruction. To ensure all schools are utilizing best practices learned from the successful schools we manage and from other high performing schools across the country, we began the process of adopting a standardized academic plan that addresses teacher preparation, delivery of instruction, and student assessment. Effective instruction is informed by and evaluated based on student-level data. As part of the academic plan, schools implement plans to collect student-level data throughout the year from three types of assessments: diagnostic, formative interim, and summative. Baseline assessments are used to determine a student’s academic strengths and weaknesses and are administered at the beginning of the school year or when a student enrolls. Formative interim assessments are administered throughout the year to assess student mastery of the state standards and objectives. Summative assessments measure student learning at culminating points in a student’s academic career, such as the end of the semester or the end of the school year. In most cases, state tests serve as the summative assessment for schools. We provide recommendations for benchmark and interim formative assessments based on state standards and state assessments. In several cases charter authorizers, district partners or departments of education require specific assessments. We plan to report school performance on commonly-used assessments in future years.

In addition to the complexities involved in measuring academic performance of students, we believe the virtual public schools we serve face unique challenges impacting academic success not necessarily encountered to the same extent by traditional brick and mortar schools. These challenges include students who enter behind grade level or under-credited, high student mobility, lack of control over the student learning environment and higher than average percentages of students in student populations eligible for free or reduced-price lunch in many states. With rare exceptions, the data shows that students identified as eligible for free lunch had lower percentages at or above proficiency levels than students eligible for reduced-price lunch, and both groups usually underperformed students identified as not eligible for subsidized meals. In addition, for decades, educational research has shown that persistence—remaining and proceeding at pace in the same school setting—can benefit academic performance, while mobility—moving from one school setting to another—can have a destabilizing influence, causing students to struggle and lapse in academic performance.

While measuring academic performance is necessary, taking meaningful steps to improve student outcomes is an integral part of our mission. Accordingly, we continually strive to achieve that objective by undertaking new initiatives and improving existing programs, such as Strong Start, our Family Academic Support Teams and EmbarK¹² (described below under “*Our Products*”). To monitor student learning

progress during the school year, we are adding multiple equivalent assessments at the lesson, unit and semester level to ensure that our measurement of mastery is reliable and valid, as well as adopting data driven instruction that provides for targeted teacher intervention to assist students with lesson challenges.

In furtherance of our goal to improve academic performance, in fiscal year 2014 we established an Academic Committee of the K12 Board of Directors comprised of three members. The primary role of the Academic Committee is to make recommendations and assist management in discharging its responsibility to ensure continuous improvement in academic outcomes for the public and private schools served by the K12. With input and oversight from the Academic Committee, the education experts who are members of our K12 Educational Advisory Committee (“EAC”), formed in 2013, will further improve our focus on academic achievement and growth goals as well as advising us on specific tactics to be successful in these areas. The EAC met four times in fiscal year 2016. The members of our EAC are:

- Dr. David Driscoll, former Commissioner of Education, Commonwealth of Massachusetts
- Ms. Millie Fornell, former Chief of Staff, Miami-Dade School District
- Ms. Ann Foster, former Senior Vice President Strategy, Business Development and Connected Learning for Harcourt Education Group
- Dr. Beverly Hutton, Executive Director of the National Association of Secondary School Principals
- Mr. Timothy Murray, Executive Chairman, Voxy, Inc.
- Dr. Andrew Porter, former Dean of the Graduate School of Education, University of Pennsylvania
- Ms. Jessie Woolley-Wilson, President, CEO and Chairman of the Board of DreamBox Learning, Inc.
- Dr. Elanna Yalow, CEO of Knowledge Universe Early Learning Programs

Our Products

Our product approach is to continue investing in systems and technology to educate students more effectively and efficiently. Much of our investment has been in the development of K-12 online courses and management systems. We are planning specialized courses and programs designed to remediate the rapidly increasing number of students who are enrolling in schools behind grade level. Specifically, we are making, licensing or acquiring more individualized learning programs for students using adaptive learning technology, which requires a significant financial commitment to license or acquire, integrate and develop a specialized curriculum and a complex database.

As school districts confront the same issues that we are experiencing in the managed public schools, we believe that our solutions could gain widespread acceptance. Over the past year, we have been working on our new next generation curriculum that is being developed to help us deliver embedded assessment tools and rich media through adaptive learning pathways for our students. Our first release of these new courses is being introduced to the schools we manage in fall 2016. In addition, our PEAK system provides school districts and administrators a better way to manage their online education programs and content. In 2014, we entered into an agreement to transition our high school learning management system (“LMS”) to Desire2Learn, a pioneer in next-generation digital education systems, which should help us improve student engagement, retention and outcomes for our managed schools. During school year 2015-16, we migrated the virtual high schools we manage to this new platform.

Just as we pioneered the development of virtual schools, we are resolved to address the most challenging educational needs facing schools and districts. Our goal is to assist teachers, schools and districts in implementing individualized education programs to better serve their students. This can take a variety of forms including turn-key solutions, partnerships, vendor relationships, enterprise licenses, and purchases of curriculum and services.

Our investment strategy is not limited, however, to curriculum and systems. We are also making substantial investments in our service offerings to improve student outcomes. For example, as part of our Strong Start student onboarding program, we offered a diagnostic assessment tool that a number of Managed Public School Programs have utilized to develop targeted instructional plans for new students who often start school with us before their academic records arrive. We are also offering the Family Academic Support Team program in many of the schools we manage. The purpose of this program is to ensure students are ready to engage in their learning experience by helping them overcome non-academic barriers, including family, health, psychological, or social issues that create obstacles to achieving academic success for some students. Additionally, we continue to invest in improving the quality of teachers and school leaders through our professional development efforts.

Curriculum

K12 has one of the largest digital curriculum portfolios for the K-12 online education industry. The K¹² curriculum consists of a variety of online lessons and resources, offline instructional kits and materials and lesson guides. A single year-long K¹² course generally consists of 120 to 180 unique instructional lessons. Each lesson is designed to last approximately 45 to 60 minutes, although students are able to work at their own pace. We have a broad-based curriculum that includes courses across kindergarten, elementary, middle and high school, including world languages.

Since our inception, we have built core courses in English language arts, mathematics, science and history on a foundation of rigorous standards, following the guidance and recommendations of leading educational organizations at the national and state levels. For this reason, our K¹² curriculum was well positioned to satisfy the requirements of the CCSS when they were published in June 2010. Since then, we have been in the process of fully aligning our existing and new courses to the CCSS and other state standards and assessments. As the CCSS landscape is continually changing, we will monitor the decisions that states are making with regard to CCSS adoption and the associated assessments of the CCSS or other standards the states may adopt, which in turn may require further adjustments. We have and will continue to invest in and update our curriculum to stay current with emerging and developing standards like CCSS.

Online Lessons. For school year 2015-16, our K¹² online lessons were accessed by K-8 students through a proprietary learning management platform, which we call our Online School (“OLS”). Lessons are accessed through a third-party platform by high school students, as well as a number of other common industry platforms for students who access our FuelEd Online Courses. Each online lesson provides the roadmap for the entire lesson, including direction to specific online and offline materials, summaries of major objectives for the lesson and the actual lesson content with assessments. Digital versions of documents, readings, labs and other activities may also be included. Lessons utilize a combination of innovative technologies, including animations, demonstrations, audio, video and other graphic/digital interactivity, educational games and individualized feedback, all coordinated with offline textbooks and hands-on materials, to create an engaging, responsive and highly-effective curriculum. The formative and periodic summative, online assessments ensure that students have mastered the material and are ready to proceed to the next lesson, allowing them to work at their own pace. Pronunciation guides for key words and references to suggested additional resources, specific to each lesson and each student’s assignments and assessments, are also included.

Learning Kits. Many of our courses utilize learning kits in conjunction with the online lessons to maximize the effectiveness of our learning systems. In addition to receiving access to our online lessons through the Internet, each K-8 student receives a shipment of materials, including textbooks, art supplies, laboratory supplies (e.g., microscopes, scales, science specimens) and other reference materials which are referred to and incorporated in instruction throughout our curriculum. This approach is consistent with our guiding principle to utilize technology where appropriate for our learning systems, and combine it with other effective instructional methods. We have also created and/or converted additional K¹² textbooks and

resources used across our courses into an electronic format, enabling us to offer options to enhance the student experience without physical books.

Lesson Guides. Our courses are generally paired with a lesson guide and/or teacher resources. These resources are designed to work in coordination with the online lessons and include the following: overview information for learning coaches, lesson objectives, lesson outlines and activities, answer keys to student exercises and suggestions for explaining difficult concepts to students.

Pre-K and K-8 Courses

From pre-kindergarten through 8th grade, our courses are generally categorized into seven major subject areas: English language arts, mathematics, science, history, art, music and world languages. Our proprietary curriculum includes all of the courses that students need to complete their core kindergarten through 8th grade education; our pre-K offering, which we refer to as EmbarK¹², introduces students to core subjects through cross-curricular thematic units, building initial and fundamental relationships among concepts. Courses focus on developing fundamental skills and teaching the key knowledge building blocks or schemas—the “big ideas” that each student will need to master the major subject areas, meet state standards, including those formulated as the CCSS, and complete more advanced coursework. Unlike a traditional classroom education, and in conjunction with school teachers and counselors, our learning systems offer the flexibility for each student to take courses at different grade levels in a single academic year, providing flexibility for students to progress at their own level and pace within each subject area.

Our K¹² elementary language arts program is designed to deliver increased interactivity and make instruction even more engaging and efficient while integrating rewards, interactive practice and a virtual world. These courses support students at various skill levels via targeted, timely remediation, embody CCSS and include significant media integration. In addition, the flexibility of our learning systems allows us to tailor our curriculum to state specific requirements. For example, we have developed 171 courses specifically created for the public school standards in 18 states; we are aligning our courses to the CCSS and the Common Core Assessments; and in addition to the ongoing evolution of our K-5 Math+ program, we have also created over 85 custom Math+ sequences to serve specific state needs.

High School Courses

The curriculum available to high school students is much broader and varies from student to student, largely as a result of the increased flexibility in course selection available to high school students. Students also are able to select from a wide range of electives. We have augmented our lab program for lab science courses with the creation of alternate kit-free science labs as an augmentation or alternative for our formerly kit-based high school science labs in order to provide a more flexible and robust lab program across our physical science, earth science, biology, chemistry and physics courses. Our overall lab program now includes traditional kit-based labs based on either shipped-in or household materials, virtual labs, video-based labs, data- collection and data-manipulation labs, and field studies. This array provides schools with additional materials flexibility, and integrates diverse modalities directly into our science curriculum to promote conceptual mastery. Across all subject areas, the K12 proprietary core curriculum accounts for more than three quarters of our high school course enrollments. We are aligning our courses to the CCSS and the Common Core Assessments as well as various state standards. We also will be launching over 40 new courses to help support our focus on career and technical education.

FuelEd Online Courses. We also offer curriculum to schools and school districts marketed as our FuelEd Online Courses product line. FuelEd Online Courses are aligned to state and national standards, including many to the CCSS, and include more than 180 courses for middle and high school students, featuring core, AP, elective and credit recovery courses. FuelEd’s Online Courses are developed by subject matter experts, designed by multimedia teams and may be taught by Company-provided instructors at the customers’ option. FuelEd classes are primarily delivered over the Internet in a classroom or virtual

setting, and use a variety of interactive elements to keep students engaged. A deep understanding of K-12 pedagogy, as well as the human factors associated with online technology, is integrated into FuelEd's courses.

Middlebury Interactive Languages ("MIL"). We offer digital world language courses and residential summer language academies through MIL. These offerings include immersive language courses for K-12 students based on Middlebury College's pedagogy to help students gain a stronger base of comprehension and accelerate language acquisition. The age-appropriate language courses, which can be implemented fully online, in a blended learning environment or as supplemental material, use instructional tools such as animation, music, videos and other authentic materials to immerse students in the language and culture of study. We offer Chinese, French, German and Spanish courses for elementary, middle and high school students. In addition, MIL has developed a summer English language learner ("ELL") curriculum and new, digital, supplemental ELL courses for middle school student to be used in a blended environment. MIL also operates summer residential language academies, an immersive program for middle and high school students. Academy students live in language by taking the Language Pledge, a promise to communicate solely in their language of study for four weeks. Instruction is offered in Arabic, Chinese, French, German and Spanish at multiple college campuses in Vermont and internationally in Quebec, Spain and China.

Innovative Learning Applications

In order to continue to enhance the user experience and instructional methods of our learning systems, we strive to develop new technologies to adapt our curriculum to new devices and platforms.

- *Mobile Device Learning:* We have created numerous tools and applications for mobile devices. We expect our mobile applications will create the ability for a student to learn "on-the-go," allowing for more continuous learning, engagement and mastery of content. In addition, we rolled out our first fully mobile-enabled courseware in the fall of 2014 and have developed a core mobile catalog of 50 courses.
- *Interactive Games:* An active educational games initiative is delivering new methods for engagement, practice and review of K-12 concepts, including: narrative/immersive styles, rewards, persistent data, and complex algorithms. In fiscal year 2016, we acquired a personalized game based learning system that is designed to help students accelerate learning and practice on state standards. These games make use of extensive research and educational best practices and address targeted learning objectives.
- *Virtual Labs:* We have delivered alternatives for our educational partners who desire materials-free curriculum. This includes converting many of our existing materials-based high school science labs into highly interactive virtual labs and video lab simulations that meet state standards and still maintain teaching the original learning objectives. For example, in high school chemistry we have developed a virtual laboratory on chromatography, in which students separate a number of inks into their component pigments. This laboratory is performed at a virtual lab bench with all the materials and with the same procedures high school students would use in a physical chemistry laboratory.
- *eBook and Digital Book Distribution:* Through fiscal year 2016, we have created or converted additional K¹² textbooks used across our courses into an electronic format, including textbooks, reference guides, literature readers and lab manuals. This digital delivery ability enables us to offer options to our customers via interactive online books that enhance the student's reading experience, reinforce the student's learning approach and create a new method for delivering book and print materials. Each offline book is converted into an electronic book format with a custom user interface to be viewed via a standard web browser or a commercially available electronic reader (e.g. Kindle, Nook).

- *Adaptive Learning:* We offer certain courses that are adaptive, which enable individualized learning experiences as the course “adapts” at key points to student behavior and input. Based on assessment results or individual activity, these courses can automatically route students to an alternate explanation, additional practice or remediation on a prerequisite skill or crucial concept. In addition to remediation, the capability allows students to accelerate past previously mastered concepts, giving skillful students time for more challenging work. Our MARK¹² reading remediation product captures individual students’ successes and challenges as they practice phonemic awareness, alphabetic principles, accuracy and fluency, vocabulary and comprehension. The program serves the individual student more exercises, practice and review in areas of difficulty. Adaptation in this way tailors the instruction automatically for each student, making learning experiences more efficient and effective by building into the course the logic an expert teacher or tutor uses to differentiate instruction.
- *National Math Lab:* For use by a number of managed schools in certain states, the National Math Lab program is intended to help students develop the necessary skills to succeed in math. For fiscal year 2016, the program was redesigned to focus on students in Grades 3-8 who do not exhibit grade level proficiency in math, as determined by state assessments. National Math Lab provides nearly twice the usual amount of math instruction to students because it is taken in addition to their regular online math coursework. Students attend targeted synchronous mathematical instruction sessions provided by highly-trained math teachers four days per week to work specifically on skills needed to gain math proficiency on state exams.
- *Engaging Videos:* We continue to explore opportunities to enhance student engagement through strategic use of relevant multimedia. Multimedia is specifically used as appropriate for the subject matter. For example, our video on photosynthesis for high school biology allows students to witness the setup, procedure and data in a classic experiment in which an aquatic plant is exposed to light and produces oxygen bubbles. The high definition video and the presentation to the student of real data (which they then use in their analysis) make this video lab a multimedia experience that is coupled with a scientific method.

Learning Management Systems

For our K¹² curriculum users in grades K-8 in school year 2015-16, we provided a proprietary learning management system, our online school (“OLS”) platform. The OLS is a significant part of our ongoing effort to provide the most engaging and productive learning experience for students. The OLS platform is a web-based software platform that provides access to our online lessons, our lesson planning and scheduling tools, and our progress tracking tool which serves a key role in assisting parents and teachers in managing each student’s progress. The OLS is also the central system through which students, parents, teachers and administrators interact using email and Class Connect (our integrated synchronous session scheduler).

- *Lesson Planning and Scheduling Tools.* During a school year, a typical student will complete hundreds of lessons across six or more subject areas. In the OLS platform, our lesson planning and scheduling tools enable teachers and parents to establish an individualized plan for each student to complete his or her lessons. These tools are designed to dynamically update the lesson plan as a student progresses through each lesson and course, allowing flexibility to increase or decrease the pace at which the student advances through the curriculum while ensuring that the student progresses towards completion in the desired time frame. Moreover, changes can be made to the schedule at any point during the school year and the remainder of the student’s schedule will automatically be adjusted in the OLS. Unlike a traditional classroom education, our learning systems offer the flexibility for each student to take courses at different grade levels in a single academic year, providing flexibility for students to progress at their own level and pace within each

subject area. The curriculum includes assessments built into every lesson to guide and tailor the pace of progress to each child's needs.

- *Progress Tracking Tools.* Once a schedule has been established, the OLS delivers lessons based upon the specified parameters of the school and the teacher. Each day, a student is initially directed to a home page listing the schedule for that particular day and begins the school day by selecting one of the listed lessons. As each lesson is completed, the student returns to the day's schedule to proceed to the next subject. If a student does not complete a lesson by the end of the day on which it was originally scheduled, the lesson will be rescheduled to the next day and will resume at the point where the student left off. Our progress tracking tool allows students, parents, learning coaches and teachers to monitor student progress. In addition, information collected by our tracking tool regarding attendance and other pertinent data are transferred to our proprietary TotalView system for use in providing administrative support services. This instructional program includes several processes and educational techniques that embrace proactive intervention. As a result, we can provide high quality instruction and intervention aligned to student needs.

In fiscal year 2014, we entered into a strategic license agreement with Desire2Learn, a pioneer in next-generation digital education systems and learning platforms. At the beginning of school year 2015-16, we implemented this new virtual learning platform at the high schools we serve. Similar to our OLS, this new platform enables lesson planning, scheduling, tracking student progress and conducting assessments. The platform is used by over 50 K-12 organizations, and provides an industry-leading student experience which should help us improve student engagement, retention and outcomes for the Managed Public School Programs we serve.

The new platform helps us deliver a more personalized experience to our students and teachers. The intuitive experience enables students to access pertinent information more easily. This platform also includes an assessment tracking tool that enables teachers to easily view assessment data for their students so that they can proactively provide additional instruction to students as needed. Our assessment tools help us improve learning programs by providing information on the effectiveness of instructional activities and curriculum. Furthermore, our learning programs make use of a variety of formative and summative assessment instruments:

- Lesson assessments that verify mastery of the objectives for that lesson and to determine whether further study of the lesson is necessary.
- Unit assessments that show whether or not the student has retained key learning objectives for the unit, and identify specific objectives students may need to review before progressing.
- Semester assessments that verify student mastery of key learning objectives for the semester.

The platform also provides additional tools and reports that enable teachers to have better insights into students' progress as well as enable students to manage their day more effectively.

TotalView

TotalView is our proprietary student information system. TotalView is integrated with the OLS and several other proprietary systems including our online enrollment system that allows parents to complete school enrollment forms online and our Order Management System that generates orders for learning kits and computers to be delivered to students. TotalView stores student specific data and is used for a variety of functions, including enrolling students in courses, assigning progress marks and grades, tracking student demographic data, and generating student transcripts. The TotalView suite of online applications provides administrators, teachers, parents and students a unified view of student attendance, communications, and learning kit shipment tracking.

TotalView also includes an enrollment processing and tracking tool that allows us to closely monitor and manage the enrollment process for new students. Over the past several years, we have enhanced TotalView with additional functionality to better support the operation of the virtual and blended public schools.

PEAK

Institutional business offers an innovative platform called PEAK and the PEAK Library. PEAK is a proprietary software system designed to centrally manage in a single-user interface multiple, independent online school-based functions. Schools can enroll and activate students, assign courses and teachers, and then manage the learning experience with easy to use reporting and analytics on student progress. In addition, through the PEAK Library, teachers can build and modify assignments, assessments and courses and can augment classroom instruction and develop lessons for sharing across the school district. PEAK also has the capability to support other third-party solutions, open educational resources and district and teacher-created content. In fiscal year 2016, PEAK served nearly 900 school districts and school partners and nearly 400,000 students. As more districts adopt online learning, they are demanding more control and flexibility in managing their programs. PEAK provides extensive capabilities for districts wanting to operate multiple solutions or catalogs from a single application and offers rich personalization features that can be managed at the district, school or teacher level.

Our Services

We offer a comprehensive suite of services to students and their families as well as directly to virtual and blended public schools, traditional schools and school districts. Our services can be categorized broadly into academic support services and management and technology services.

Academic Support Services

Teachers and Related Services. Teachers are critical to students' educational success. Many teachers in the virtual and blended public schools that we manage are employed by the school, with the ultimate authority over these teachers residing with the school's governing body, including final hiring and termination decisions. As part of our service agreements, we typically contract to recruit, train and provide management support for these school-employed teachers. For our Institutional business customers, we provide instructors as needed using our staff of state-certified teachers and trainers.

We use a rigorous evaluation process for making teacher hiring recommendations to the schools we manage. We generally recruit teachers who, at a minimum, are state certified and meet each state's requirements for designation as a "Highly Qualified Teacher." We also seek to recruit teachers who have the skill set necessary to be successful in a virtual environment. Teaching in a virtual or blended public school is characterized by enhanced one-on-one student-teacher and parent-teacher interaction, so these teachers must have strong interpersonal communications skills. Additionally, a virtual or blended public school teacher must be creative in finding ways to effectively connect with their students and integrate themselves into the daily lives of the students' families. We assess these teacher characteristics by requiring teachers to deliver and record a sample lesson on our online platform and answer questions both via video and essay as part of the hiring screening process. Throughout a teacher's employment in a managed program, we provide tools for teacher management and evaluation.

New teachers participate in our comprehensive training program during which, among other things, they are introduced to our educational philosophy, our curriculum and technology applications, and are provided strategies for communicating and connecting with students and their families in a virtual environment. We also provide ongoing professional development opportunities for teachers so that they may stay abreast of changing educational standards, key learning trends, and sound pedagogical strategies which we believe enhance their teaching abilities and effectiveness.

Advanced and Special Education Services. We believe that our learning systems can be appropriate to address the educational needs of both advanced and special education students because they employ flexible teaching methods and students can use them at their own pace. For students requiring special attention, we employ a national director who is an expert on the delivery of special education services in a virtual or blended public school environment and who supports the special education programs at the schools we serve. We periodically review and, in cooperation with the schools, may assist and facilitate the development and implementation of Individualized Education Plans for students with special needs. Each school's special education program is designed to be compliant with the federal Individuals with Disabilities Education Act and state special education requirements. Each student with special needs is assigned a certified special education teacher and the school arranges for any required ancillary services, including speech and occupational therapy, and any required assistive technologies, such as special computer displays or speech recognition software. We support advanced and talented students through our advanced learner program. Advanced learners are able to participate in a wide variety of enrichment opportunities and clubs. Advanced students are connected to each other across state boundaries through learning circles, book clubs, and other special-interest activities. In addition, for students needing English language learning assistance ("ELL Students"), we work with the schools and parents to advise on these programs, including with translation services in our enrollment centers.

Supporting Academically At-Risk Learners. Our objective is to narrow the achievement gap for those students who enter our virtual or blended public schools behind their same-age peers. To that end, students are given both formative and summative assessments during the course of the school year in order to identify those students needing specific remedial support as well as measure the effectiveness of the support. We also offer the Passport school program, which is designed for academically at-risk students, particularly those who have previously dropped out of high school, and which includes more counseling and support services.

Student Support Services. We provide students attending virtual or blended public schools that we manage and their families with a variety of support services as a means to help them meet their educational needs and goals, and to address any questions or concerns that students and their parents have during the course of their education. We plan and coordinate social events to offer students opportunities to meet and socialize with their school peers where practical. Finally, in connection with our high school offering, each student is assigned a homeroom teacher, and/or an advisor and a guidance counselor who assists them with academic issues, college and career planning and other support as needed.

Management and Technology Services

Turn-key Services. For most Managed Public School programs, we provide a turn-key suite of services whereby we take responsibility for all aspects of the management of the schools, including the provision of online curriculum and lesson materials, monitoring academic achievement, teacher hiring recommendations and training, financial management and regulatory compliance, marketing and enrollment support, and provision of computers and other required products and services.

Accreditation. In 2013, AdvancED renewed our accreditation for another five years. AdvancED is a non-profit organization that serves more than 30,000 public and private schools and districts across the United States. It was created by the merger of the preK-12 divisions of the North Central Accreditation Association Commission on Accreditation and School Improvement and the Southern Association of Colleges and Schools Council on Accreditation and School Improvement, and the subsequent addition of the Northwest Accreditation Commission. Many of the schools we manage also maintain regional accreditations with other accrediting associations.

Compliance and Tracking Services. Operating a virtual or blended public school entails many of the compliance and regulatory requirements of a traditional public school, as well as applicable charter provisions or other requirements specifically adopted for online public schools. We have developed

management systems and processes designed to track compliance with those requirements, including tracking appropriate student information and meeting various state and federal reporting, record keeping and privacy requirements for the schools we serve. For example, we collect enrollment related information, monitor attendance and administer proctored state tests. Further, as we have expanded into new states, our processes have grown increasingly robust. In fiscal year 2014, we created the position of Chief School Compliance Officer (“CSCO”) to supplement and oversee school compliance. Among other responsibilities, our CSCO complements our corporate compliance and ethics function and reviews and advises our managed public schools on applicable regulatory policies, practices and procedures. The CSCO reports semi-annually to the Audit Committee.

Financial Management Services. For the schools we manage, we oversee the preparation of the annual budget and coordinate with the school’s governing body to determine its annual objectives. In addition, we implement an internal control framework, develop policies and procedures, provide accounting services and payroll administration, oversee all federal entitlement programs, arrange for external audits and support state and local financial compliance reporting by the schools.

Facility, Operations and Technology Support Services. We generally operate administrative offices and all other facilities on behalf of the schools we manage. We provide these schools with technology infrastructure. In addition, we provide a comprehensive help desk solution for students and school staff to address their computer or other technical issues.

Human Resources Support Services. We are actively involved in recruiting virtual and blended public school administrators, teachers and staff, through a thorough interview and orientation process. To better facilitate the hiring process, we review and analyze the profiles of teachers that have been highly effective in our managed public and blended schools learning systems to identify the attributes desired in future new hires. While many schools employ teachers directly, we also help negotiate and secure employment benefits and payroll services for school staff on behalf of the schools and administer employee benefit plans for school employees. Additionally, we assist the schools we serve in drafting and implementing administrative policies and procedures.

Competition

As a general matter, we face varying degrees of competition from a variety of education companies because the scope of our offerings and the customers we serve encompass many separate and distinct segments of the education business. We compete primarily with companies that provide online curriculum and school support services to K-12 virtual and blended public schools, and school districts. These companies include Pearson PLC (Connections Academy and Advanced Academics), White Hat Management, LLC, and National Network of Digital Schools Management Foundation Inc., among others. We also face competition from online and print curriculum developers. The online curriculum providers include Apex Learning Inc., Compass Learning Inc., Edgenuity Inc., Glynlyon, Inc., Edmentum Inc., Renaissance Learning, Inc., Rosetta Stone Inc. and traditional textbook publishers including Houghton Mifflin Harcourt, McGraw-Hill Companies and Pearson PLC. Other competing online curriculum providers, including IXL Learning, Inc. and LearnZillion, Inc., offer a “freemium” model which provides curriculum at no charge but charges for additional products or services and certain other providers. We also compete with institutions such as The Laurel Springs School (Nobel Learning Communities, Inc.) and Penn Foster Inc. for online private school students. Additionally, we compete with state-administered online programs such as Florida Virtual School.

We believe that the primary factors on which we compete are:

- extensive experience in, and understanding of, K-12 virtual schooling;
- track record of student academic gains and customer satisfaction;

- quality of integrated curriculum and materials with an online delivery platform;
- qualifications, experience and training teachers for online instruction;
- comprehensiveness of school management and student support services;
- platform designed to allow school district partners to centrally manage multiple online solutions;
- integrated K-12 solutions, with components designed and built to work together;
- ability to scale across our lines of business; and
- sophisticated government affairs knowledge and experience in virtual school regulatory environments.

Broadly speaking, we participate in the market for K-12 education. In states where we enter into long-term service agreements to manage virtual and blended public schools, we believe that we generally serve less than 1% of the public school students in that state. The customers for Institutional business are schools and school districts seeking individual courses to supplement their course catalogs or school districts seeking to offer an online education program to serve the needs of a small subset of their overall student population. Defining a more precise relevant market upon which to base a share estimate would not be meaningful due to significant limitations on the comparability of data among jurisdictions. For example, some providers to K-12 virtual public schools serve only high school students; others serve the elementary and middle school students, and some serve both. There are also providers of online virtual K-12 education that operate solely within individual states or geographic regions rather than globally as we do. Furthermore, some school districts offer their own virtual programs with which we compete. Parents in search of an alternative to their local public school have a number of alternatives beyond virtual and blended public schools, including private schools, public charter schools and home schooling. In our International and Private Pay schools, we compete for students seeking an English-based K-12 education worldwide, and we currently draw students from more than 100 countries. In addition, our integrated learning systems consist of components that face competition from many different types of education companies, such as traditional textbook publishers, test and assessment firms and private education management companies. Finally, our learning systems are designed to operate domestically and internationally over the Internet, and thus the geographic market for many of our products and services is global and indeterminate in size.

Key Functional Areas

Public Affairs, School Development, Student Recruitment and Marketing

We seek to increase public awareness of the educational and fiscal benefits of our online learning options through full-time virtual and blended instructional models as well as supplementary course options. We receive numerous inquiries from school districts, legislators, public charter school boards, community leaders, state departments of education, educators and parents who express the desire to have a choice in public school options. Our public affairs and school development teams work together with these interested parties to identify and pursue opportunities to expand the use of our products and services in new and existing jurisdictions.

Our student recruitment and marketing team is responsible for generating interest in new student enrollments, developing websites and media assets, conducting market and customer research, and enhancing the onboarding experience of students. This team employs a variety of strategies designed to better understand and address the requirements of our target markets.

Operations

The physical learning kits that accompany our online lessons are an essential component of many of our courses. A student enrolling in one of our courses may receive multiple textbooks, art supplies, laboratory supplies (e.g. microscopes and scales) and other reference materials designed to enhance the learning experience. We package these books and materials into course-specific learning kits. Because each student's curriculum is customized, the combination of kits for each student must also be customized. In fiscal year 2016, we assembled approximately seven million items into more than 640,000 kits.

Over our 16 years of operation, we believe that we have gained significant experience in the sourcing, assembly and delivery of school supplies and materials. We have developed strong relationships with partners allowing us to source goods at favorable price, quality and service levels. Our fulfillment partner stores our inventory, assembles our learning kits and ships the kits to students. We have invested in systems, including our Order Management System, to automatically translate the curriculum selected by each enrolled student into an order to build the corresponding individualized learning kit. As a result, we believe we have an end-to-end warehousing and fulfillment operation that will cost-effectively scale as the business grows in scope and complexity.

For many of our virtual and blended public school customers, we attempt to reclaim any materials that could be cost-effectively re-utilized in the next school year. These items, once returned to our fulfillment centers, are refurbished and included in future learning kits. This reclamation process allows us to maintain lower materials costs. Our fulfillment activities are highly seasonal, and are centered on the start of school in August or September. Accordingly, approximately 65% of our annual materials inventory is received between March and May and approximately 65% of shipments to customers occur between June and September. In order to ensure that students in virtual and blended public schools have access to our OLS, we often provide students with a computer and all necessary support. We source computers and ship them to students when they enroll and reclaim the computers at the end of a school year or upon termination of their enrollment or withdrawal from the school in which they are enrolled.

Technology

Our online learning systems, along with our back office support systems, are built on our proprietary Service Oriented Architecture ("SOA") to ensure high availability and redundancy. The flexibility and security enabled by our SOA are the core principles of our systems' foundation.

Service Oriented Architecture. All of our systems leverage our SOA that is built on top of Enterprise Java. The SOA allows us to develop iterative solutions expeditiously to meet both present and future market needs. Our high availability and scalability are also facilitated by this architecture. The SOA also enables integration with third-party solutions in our platform with ease and efficiency.

Availability and Redundancy. Our SOA allows for primary and secondary equipment to be utilized at all network and application tiers. Each application layer is load balanced across multiple servers, which, along with our network management capabilities, allows for additional hardware to be inserted into our network providing us with optimal scalability and availability as evidenced by our typically greater than 99% uptime over a growing user base. We regularly backup critical data and store this backup data at an offsite location.

Security. Our security measures and policies include dividing application layers into multiple zones controlled by firewall technology. Sensitive communications are encrypted between client and server and our server-to-server accessibility is strictly controlled and monitored. We also have engaged an outside firm to manage unwanted traffic that may target our services and systems. We protect sensitive information and meet regulatory and contractual commitments through policy and control governance that is validated on a semi-annual basis. We maintain a layered security architecture and regularly retain third parties to test our networks, servers and applications for vulnerabilities. We manage a business-centric information security

program that is appropriate for our constantly changing IT compliance and information security threat landscape.

Physical Infrastructure. We utilize leading vendors to provide a foundation for our SOA. Our systems are housed offsite in data centers that provide a robust, redundant network backbone, power and geographically separated disaster recovery. Our second data center, geographically separated from our primary center, operates as a ready business continuity site with secured, near-real time data replication from our primary data center. We routinely monitor our physical infrastructure for security, availability and performance.

Other Information

Intellectual Property

We continue to invest in our intellectual property as we develop more courses for new grades and expand into adjacent education markets, both in the United States and overseas. Through acquisitions, we have also acquired curriculum, patents and trademarks that expand our portfolio of educational products and services. We continue to add features and tools to our proprietary learning platform and support systems to assist teachers and students and improve educational outcomes, such as adaptive learning technologies. These intellectual property assets are critical to our success and we avail ourselves of the full protections provided under the patent, copyright, trademark and trade secrets laws. We also routinely utilize confidentiality and licensing agreements with our employees, the virtual and blended public schools, traditional schools, school districts and private schools that we serve, individual consumers, contractors and other businesses and persons with which we have commercial relationships.

Our patent portfolio includes issued patents and pending applications directed towards various aspects of our educational products and offerings. In particular, the first family of patent applications we filed in the U.S. and in foreign countries was directed towards the first generation of our system and method of virtual schooling and includes two issued patents. Further, two U.S. patents were issued for our systems and methods of online foreign language instruction. We have been issued patents in the United States and in a foreign country for aspects of the second generation of our virtual school application.

We own and register the copyrights to the lessons contained in the courses that comprise our proprietary curriculum. We also have obtained federal and state registrations for numerous trademarks that are related to our offerings and we have applied to the U.S. Patent and Trademark Office to register certain new trademarks. As a result of the acquisitions we have made, we also own U.S. and foreign trademarks and a portfolio of domain names.

We grant access to individuals to use our software in order to utilize our online learning systems. Similarly, schools are granted access to utilize our online learning systems in order to access TotalView and our other systems. These licenses are intended to protect our ownership and the confidentiality of the embedded information and technology contained in our software and systems. We also own many of the trademarks and service marks that we use as part of the student recruitment and branding services we provide to schools. Those marks are licensed to the schools for use during the term of the products and services agreements.

Our employees, contractors and other parties with access to our confidential information sign agreements that prohibit the unauthorized use or disclosure of our proprietary rights, information and technology.

Employees

As of June 30, 2016, we had approximately 4,800 employees, including approximately 2,500 teachers. A majority of these employees are located in the United States. In addition, there are approximately 2,000 teachers who are employed by virtual or blended public schools that we manage under turn-key solution

contracts with those schools but are not direct employees of K12. None of our employees are represented by a labor union or covered by a collective bargaining agreement; however, certain managed public schools we serve employ unionized teachers. We believe that our employee relations are good.

Corporate Information

Our principal executive office is located at 2300 Corporate Park Drive, Herndon, Virginia 20171 and our telephone number is (703) 483-7000. Our website address is www.K12.com.

Available Information

We make available, free of charge through our website, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), promptly after they are electronically filed with the Securities and Exchange Commission (the “SEC”). Our earnings conference calls are web cast live via our website. In addition to visiting our website, you may read and copy public reports we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Washington D.C. 20549, or at www.sec.gov. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Information contained on our website is expressly not incorporated by reference into this Annual Report.

REGULATION

We and the virtual and blended public schools that we serve are subject to regulation by each of the states in which we operate. The state laws and regulations that impact our business are primarily those that authorize or restrict our ability to operate these schools, as well as the applicable funding mechanisms for the schools. To the extent these schools receive federal funds, such as through a grant program or financial support dedicated for the education of low-income families, these schools also become subject to additional federal regulation.

State Laws Authorizing or Restricting Virtual and Blended Public Schools. The authority to operate a virtual or blended public school is dependent on the laws and regulations of each state. Laws and regulations vary significantly from one state to the next and are constantly evolving. In states that have implemented specific legislation to support virtual and blended public schools, the schools are able to operate under these statutes. Other states provide for virtual and blended public schools under existing public charter school legislation or provide that school districts and/or state education agencies may authorize them. Some states do not currently have legislation that provides for virtual and blended public schools or have requirements that effectively prohibit such schools and, as a result, may require new legislation before virtual and blended public schools can open in the state. We currently serve virtual and blended public schools or school district-led programs in 33 states plus the District of Columbia.

Obtaining new legislation in the remaining states can be a protracted and uncertain process. When determining whether to pursue expansion into new states in which the laws are ambiguous, we research the relevant legislation and political climate and then make an assessment of the perceived likelihood of success before deciding to commit resources. Specifically, we take into account numerous factors including, but not limited to, the regulations of the state educational authorities, whether the overall political environment is amenable to school choice, whether current funding levels for virtual school and blended schools enrollments are adequate and accessible, and the presence of non-profit and for-profit competitors in the state.

State Laws and Regulations Applicable to Virtual and Blended Public Schools. Virtual and blended public schools that purchase our curriculum and management services are often governed and overseen by a non-profit or a local or state education agency, such as an independent public charter school board, local school district or state education authority. We generally receive funds for products and services rendered

to operate virtual public schools or blended schools under detailed service agreements with that governing authority. Virtual and blended public schools are typically funded by state or local governments on a per student basis. A virtual or blended public school that fails to comply with the state laws and regulations applicable to it may be required to repay these funds and could become ineligible for receipt of future state funds.

To be eligible for state funding, some states require that virtual and blended public schools be organized as not-for-profit charters exempt from taxation under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”). The schools must then be organized exclusively for charitable educational purposes, and not for the benefit of private, for-profit management companies. The board or governing authority of the not-for-profit virtual or blended public school must retain ultimate accountability and control for the school’s operations to retain its tax-exempt status. It may not delegate its responsibility and accountability for the school’s operations. Our service agreements with these virtual and blended public schools are therefore structured to ensure the full independence of the not-for-profit board and preserve its arms-length ability to exercise its fiduciary obligations to operate a virtual or blended public school.

Laws and regulations affect many aspects of operating a virtual or blended public school. They can dictate the content and sequence of the curriculum, the methods for counting student enrollments for funding purposes, graduation requirements, use of approved textbooks, the length of the school year and the school day, the accessibility of curriculum and technology to students with disabilities, teacher:student ratios, the assessment of student performance and any accountability requirements. In addition, a virtual or blended public school may be obligated to comply with states’ requirements to offer programs for specific populations, such as students at risk of dropping out of school, advanced and talented students, non-English speaking students, pre-kindergarten students and students with disabilities. Tutoring services and the use of technology may also be regulated. Other state laws and regulations may affect the school’s compulsory attendance requirements, treatment of absences and make-up work, and access by parents to student records and teaching and testing materials.

In addition to federal laws protecting the privacy of student education records, a growing number of states are enacting laws to protect the privacy of student data and to guard against its misuse. As a general matter these laws are designed to prevent third-party vendors to schools from using student data for non-educational purposes and ensuring the security of personally identifiable information. In addition, virtual or blended public schools may have to comply with state requirements that school campuses report various types of data as performance indicators of the success of the program.

States have laws and regulations concerning certification, training, experience and continued professional development of teachers and staff with which a virtual or blended public school may be required to comply. There are also numerous laws pertaining to employee salaries and benefits, statewide teacher retirement systems, workers’ compensation, unemployment benefits and matters related to employment agreements and procedures for termination of school employees. A virtual or blended public school must also comply with requirements for performing criminal background checks on school staff, reporting criminal activity by school staff and reporting suspected child abuse.

As with any public school, virtual and blended public schools must comply with state laws and regulations applicable to governmental entities, such as open meetings or sunshine laws, which may require the board of trustees of a virtual or blended public school to provide advance public notice of and hold its meetings open to the public unless an exception in the law allows an executive session. Failure to comply with these requirements may lead to personal civil and/or criminal penalties for board members or officers or the invalidation of actions taken during meetings that were not properly noticed and open to the public. Virtual and blended public schools must also comply with public information or open records laws, which require them to make school records available for public inspection, review and copying unless a specific

exemption in the law applies. Additionally laws pertaining to records privacy and retention and to standards for maintenance of records apply to virtual and blended public schools.

Other types of regulation applicable to virtual and blended public schools include restrictions on the use of public funds, the types of investments made with public funds, the collection of and use of student fees and controlling accounting and financial management practices.

There remains uncertainty about the extent to which virtual and blended public schools we serve may be required to comply with state laws and regulations applicable to traditional public schools because the concept of virtual and blended public schools is still evolving, especially as technology advances. Although we receive state funds indirectly, according to the terms of each service agreement with the local public school entity, our receipt of state funds subjects us to extensive state regulation and scrutiny. States routinely conduct audits of these schools, to verify enrollment, attendance, information technology security, fiscal accountability, special education services and other regulatory issues. While we may believe that a virtual public school or blended school we serve is compliant with state law, an agency's different interpretation of law in a particular state, or the application of facts to such law, could result in findings of non-compliance, potentially affecting future funding or repayment of past funding.

Regulations Restricting Virtual and Blended Public School Growth and Funding. As a public schooling alternative, some state and regulatory authorities have elected to proceed cautiously with virtual and blended public schools while providing opportunities for taxpayer families seeking this alternative. Statutes, regulations or policies that control the growth of virtual and blended public schools range from setting caps on statewide student enrollments, to prescribing the number of schools in a state, to limiting the percentage of time students may receive instruction online. Funding regulations can also have this effect.

Statutes or regulations that hinder our ability to serve certain jurisdictions include: restrictions on student eligibility, such as mandating attendance at a traditional public school prior to enrolling in a virtual or blended public school; caps on the total number of students in a virtual or blended public school; restrictions on grade levels served; geographic limitations on enrollments; fixing the percentage of per pupil funding that must be paid to teachers; state-specific curriculum requirements; and limits on the number of charters that can be granted in a state.

Funding regulations for virtual public schools and blended schools can take a variety of forms. These regulations include: (i) attendance—some state daily attendance rules were designed for traditional classroom procedures and applying them to track daily attendance and truancy in an online setting can cause disputes to arise over interpretation and funding; (ii) enrollment eligibility—some states place restrictions on the students seeking to enroll in virtual and blended public schools, resulting in lower aggregate funding levels; and (iii) teacher contact time—some states have regulations that specify minimum levels of teacher-student face-to-face time. These regulations can create logistical challenges for statewide virtual and blended public schools, reduce funding and eliminate some of the economic, academic and technological advantages of virtual learning.

Federal and State Grants. We have worked with some entities to secure public and grant funding that flows to virtual and blended public schools that we serve. These grants are awarded to the not-for-profit entity that holds the charter of the virtual or blended public school on a competitive basis in some instances and on an entitlement basis in other instances. Grants awarded to public schools and programs—whether by a federal or state agency or nongovernmental organization—often include reporting requirements, procedures and obligations.

Foreign Laws and Regulations. Schools we operate in other countries are subject to local laws and regulations. We oversee and rely on the administrators in each school on a continuous basis and seek the advice of local legal and regulatory experts as-needed.

Federal Laws Applicable to Virtual Public Schools and Blended Schools

Five primary federal laws are directly applicable to the day-to-day provision of educational services we provide to virtual and blended public schools:

No Child Left Behind Act (“NCLB”) and Every Student Succeeds Act (“ESSA”)

In December 2015, the NCLB amendments to the Elementary and Secondary Education Act were replaced by a new federal law known as the Every Student Succeeds Act, which took effect on August 2, 2016, and is authorized for four years. The ESSA represents a major change in federal education law by shifting education policy decision making back to the states and by providing most funding through block grants, rather than through individual programs as prescribed under NCLB. Of particular significance to the Company is that the states will now have the discretion to develop and design their own assessment systems in the coming years. In addition, states have been given the authority to adopt different types of annual accountability standards for academic achievement, including proficiency and growth standards for all students and subgroups. The ESSA makes clear that the U.S. Department of Education has a more limited role to impose federal mandates, direction or control over the authority given to the states than before under NCLB. Finally, there are provisions that provide significant grants to support the start up of new charter schools with priority to states that serve at-risk students through dropout prevention and recovery and other grants to support language instruction for English language learners and immigrant students.

Key changes under the newly reauthorized ESSA law include: (i) Adequate Yearly Progress (“AYP”) has been eliminated; (ii) Highly Qualified teachers provision eliminated; (iii) Testing/Accountability remains for grades 3-8 and once in high school but there are no prescribed sanctions; and (iv) computer adaptive testing can now be used for accountability assessments but must include a “growth” component. ESSA is to be fully implemented by school year 2017-18, and previous NCLB waivers become null and void as of August 1, 2016. School year 2016-17 will be a planning year as local education agencies and state education agencies are required to submit accountability plans to the U.S. Department of Education by June 2017.

Individuals with Disabilities Education Act (“IDEA”). The IDEA is implemented through regulations governing every aspect of the special education of a child with one or more of the specific disabilities listed in the Act. The IDEA created a responsibility on the part of a school to identify students who may qualify under the IDEA and to perform periodic assessments to determine the students’ needs for services. A student who qualifies for services under the IDEA must have in place an individual education plan, which must be updated at least annually, created by a team consisting of school personnel, the student, and the parent. This plan must be implemented in a setting where the child with a disability is educated with non-disabled peers to the maximum extent appropriate. The Act provides the student and parents with numerous due process rights relating to the student’s program and education, including the right to seek mediation of disputes and make complaints to the state education agency. The schools we manage are responsible for ensuring the requirements of this Act are met. The virtual public schools and blended schools are required to comply with certain requirements in the Act concerning teacher certification and training. We, the virtual public school or the blended school could be required to provide additional staff, related services and supplemental aids and services at our own cost to comply with the requirement to provide a free appropriate public education to each child covered under the IDEA. If we fail to meet this requirement, we, the virtual public school or blended school could lose federal funding and could be liable for compensatory educational services, reimbursement to the parent for educational service the parent provided and payment of the parent’s attorney’s fees.

Sections 504 and 508 of the Rehabilitation Act of 1973. A virtual public school or blended school receiving federal funds is subject to Section 504 of the Rehabilitation Act of 1973 (“Section 504”) insofar as the regulations implementing the Act govern the education of students with disabilities as well as

personnel and parents. Section 504 prohibits discrimination against a person on the basis of disability in any program receiving federal financial assistance if the person is otherwise qualified to participate in or receive benefit from the program. Students with disabilities not specifically listed in the IDEA may be entitled to specialized instruction or related services pursuant to Section 504 if their disability substantially limits a major life activity. Beginning in 2011, the Office of Civil Rights (“OCR”) of the United States Department of Education interpreted both Section 504 and Title II of the Americans with Disabilities Act to apply to elementary and secondary schools and to require that students with disabilities be afforded substantially equivalent ease of use as students without disabilities. As applied to online public schools, such “web accessibility” requires technical capabilities similar to those applied to procurements of information technology by the federal government under Section 508 of the Rehabilitation Act of 1973 (“Section 508”) or standards adopted by the world-wide web consortium. If a school fails to comply with the requirements and the procedural safeguards of Section 504, it may lose federal funds even though these funds flow indirectly to the school through a local board. In the case of bad faith or intentional wrongdoing, some courts have awarded monetary damages to prevailing parties in Section 504 lawsuits. In May 2016, the U.S. Department of Justice issued a supplemental notice of proposed rulemaking soliciting additional public comments on the appropriate standard for determining Web accessibility compliance under Section 508 and Title II of the ADA and allowed two years for covered entities to come into full compliance after issuance of its final rules.

Family Educational Rights and Privacy Act. Virtual public schools and blended schools are also subject to the Family Educational Rights and Privacy Act (“FERPA”) which protects the privacy of a student’s educational records and generally prohibits a school from disclosing a student’s records to a third party without the parent’s prior consent. The law also gives parents certain procedural rights with respect to their minor children’s education records. A school’s failure to comply with this law may result in termination of its eligibility to receive federal education funds.

Communications Decency Act. The Communications Decency Act of 1996 (“CDA”) provides protection for online service providers against legal action being taken against them because of certain actions of others. For example, the CDA states that no provider or user of an interactive computer service shall be treated as the publisher or speaker of any data given by another provider of information content. Further, Section 230 of the CDA grants interactive online services of all types, broad immunity from tort liability so long as the information at issue is provided or posted by a third party. As part of our technology services offering, we provide an online school platform on which teachers and students may communicate. We also conduct live classroom sessions using Internet-based collaboration software and we may offer certain online community platforms for students and parents. While the CDA affords us with some protection from liability associated with the interactive online services we offer, there are exceptions to the CDA that could result in successful actions against us that give rise to financial liability.

Other Federal Laws. Other federal laws that may apply to virtual managed schools depend on the demographics associated with that school. For example, Title VI of the Civil Rights Act of 1964 has been deemed to apply to ELL Students, as further defined in the joint guidance issued by the U.S. Departments of Justice and Education in January 2015. There are also other federal laws and regulations that affect other aspects of our business such as the identify theft rules adopted by the Federal Trade Commission and for which we have adopted policies to ensure compliance. The Children’s Internet Protection Act requires that school districts that receive certain types of federal funding must ensure that they have technology which blocks or filters certain material from being accessed through the Internet. We have developed procedures by which computers that we ship to students meet this requirement. If we fail to comply with these and other federal laws, we could be determined ineligible to receive funds from federal programs or face penalties.

ITEM 1A. RISK FACTORS

Risks Related to Government Funding and Regulation of Public Education

The majority of our revenues come from Managed Public School Programs and depend on per pupil funding amounts and payment formulas remaining near the levels existing at the time we execute service agreements with the managed public schools we serve. If those funding levels or formulas are materially reduced or modified due to economic conditions or political opposition, new restrictions adopted or payments delayed, our business, financial condition, results of operations and cash flows could be adversely affected.

The public schools we contract with are financed with government funding from federal, state and local taxpayers. Our business is primarily dependent upon those funds. Budget appropriations for education at all levels of government are determined through the political process, which may be affected by negative views of for-profit education companies or conditions in the economy at large, such as the recessionary climate in the United States which led to budgetary pressures on state and local governments from 2008-13 and significant declines in public school funding. The political process and general economic conditions create a number of risks that could have an adverse effect on our business including the following:

- Legislative proposals can and have resulted in budget or program cuts for public education, including the virtual and blended public schools and school districts we serve, and therefore have reduced and could potentially limit or eliminate the products and services those schools purchase from us, causing our revenues to decline. From time to time, proposals are introduced in state legislatures that single out virtual and blended public schools for disparate treatment.
- Economic conditions could reduce state education funding for all public schools, and could be disproportionate for the managed public schools we serve. Our annual revenue growth is impacted by changes in federal, state and district per pupil funding levels. For example, due to the budgetary problems arising from the recession, many states reduced per pupil funding for public education affecting many of the public schools we serve, including even abrupt mid-year cuts in certain states, which in some cases were retroactively applied to the start of the school year as a result of formulaic adjustments. In addition, as we enter into service agreements with multiple managed public schools in a single state, the aggregate impact of funding reductions applicable to those schools could be material. We have management agreements with 16 schools in California, for example, and while each school is independent with its own governing authority and no single school in California accounts for more than 10% of our revenue, regulatory actions that affect the level or timing of payments for all similarly situated schools in that state could adversely affect our financial condition. The specific level of federal, state and district funding for the coming years is not yet known for specific states and, taken as a whole, it is reasonable to believe that a number of the public schools we serve could experience lower per pupil enrollment funding, while others may increase funding, as economic conditions or political conditions change.
- As a public company, we are required to file periodic financial and other disclosure reports with the SEC. This information may be referenced in the legislative process, including budgetary considerations, related to the funding of alternative public school options, including virtual public schools and blended schools. The disclosure of this information by a for-profit education company, regardless of parent satisfaction and student performance, may nonetheless be used by opponents of virtual and blended public schools to propose funding reductions or restrictions.
- From time to time, government funding to schools and school districts is not provided when due, which sometimes causes the affected schools to delay payments to us for our products and services. These payment delays have occurred in the past and can deprive us of significant working capital until the matter is resolved, which could hinder our ability to implement our growth strategies and conduct our business. For example, in fiscal year 2016, the Commonwealth of Pennsylvania was

unable to approve a budget, including funding for public school education, by its deadline of June 30, 2015, and thus the Agora Cyber Charter School received no funds and could not make timely contractual payments to the Company for our products and services, even though we continued to incur the costs to keep the school operating. The Commonwealth's budget impasse was resolved in March of 2016, resulting in a receivable to be paid back in installments under a settlement agreement executed in June 2016.

Failure to comply with regulatory requirements, poor academic performance, or misconduct by us or operators of other virtual public schools could tarnish the reputation of all the school operators in our industry, which could have a negative impact on our business.

As a non-traditional form of public education, online public school operators will be subject to scrutiny, perhaps even greater than that applied to traditional brick and mortar public schools or public charter schools. Not all virtual public schools will have successful academic programs or operate efficiently, and new entrants may not perform well either. Such underperformance could create the impression that virtual schooling is not an effective way to educate students, whether or not our learning systems achieve satisfactory performance. Consistently poor academic performance could also lead to termination of an approved provider status in some jurisdictions.

Beyond academic performance issues, some virtual school operators, including us, have been subject to governmental investigations alleging the misuse of public funds or failures in regulatory compliance. These allegations have attracted significant adverse media coverage and have prompted legislative hearings and regulatory responses. These investigations have focused on specific companies and individuals, or even entire industries, such as the announced industry-wide investigation of for-profit virtual schools by the Attorney General of California in 2015. The precise impact of these governmental investigations on our current and future business is difficult to discern, in part because of the number of states in which we operate, the range of purported malfeasance or performance issues involved, or interest by state regulatory authorities. If these situations, or any additional alleged misconduct, cause all virtual public schools to be viewed by the public and/or policymakers unfavorably, we may find it difficult to expand into new states or renew our contracts to manage these schools. In addition, these factors could serve as the impetus for more restrictive legislation which could limit our future business opportunities, such as legislation enacted in Tennessee in 2015 that extended the sunset of virtual public schools in 2019.

Opponents of virtual and blended public schools have sought to challenge the establishment and expansion of such schools through the judicial process. If these interests prevail, it could damage our ability to sustain or grow our current business or expand in certain jurisdictions.

We have been, and will likely continue to be, subject to public policy lawsuits filed against virtual and blended schools by those who do not share our belief in the value of this form of public education. Whether or not we are a named party to these lawsuits, legal claims have involved challenges to the constitutionality of authorizing statutes, methods of instructional delivery, funding provisions and the respective roles of parents and teachers. For example, in 2014, the New Jersey Education Association, the state affiliate of a national teachers union, challenged the grant of a charter to the Newark Preparatory Charter School that was contracting with us for educational products and services. In this instance, the court denied the union's challenge and sustained the grant of the charter.

Should we fail to comply with the laws and regulations applicable to the Managed Public School Programs and the Institutional business districts we serve, such failures could result in a loss of public funding and an obligation to repay funds previously received, which could adversely affect our business, financial condition and results of operations.

Once authorized by law, virtual and blended public schools are generally subject to extensive regulation, as are the school districts served by our Institutional business. These regulations cover specific program standards and financial requirements including, but not limited to: (i) student eligibility standards; (ii) numeric and geographic limitations on enrollments; (iii) state-specific curriculum requirements; (iv) restrictions on open-enrollment policies by and among districts; (v) prescribed teacher: student ratios and teacher funding allocations from per pupil funding; and (vi) teacher certification and reporting requirements. State and federal funding authorities conduct regular program and financial audits of the public schools we serve to ensure compliance with applicable regulations. If a final determination of non-compliance is made, additional funds may be withheld which could impair that school's ability to pay us for services in a timely manner, or the school could be required to repay funds received during the period of non-compliance. Additionally, the indemnity provisions in our standard service agreements with virtual and blended public schools and school districts may require us to return any contested funds on behalf of the school.

Virtual and blended public schools are relatively new, and enabling legislation therefore is often ambiguous and subject to discrepancies in interpretation by regulatory authorities, which may lead to disputes over our ability to invoice and receive payments for services rendered.

Statutory language providing for virtual and blended public schools is sometimes interpreted by regulatory authorities in ways that may vary from year to year making compliance subject to uncertainty. More issues normally arise during our first few school years of doing business in a state because the enabling legislation often does not address specific issues, such as what constitutes proper documentation for enrollment eligibility in a virtual or blended school. From time to time there are changes to the regulators' approach to determining the eligibility of virtual or blended school students for funding purposes. Another issue may be differing interpretations on what constitutes a student's substantial completion of a semester in a public school. These regulatory uncertainties may lead to disputes over our ability to invoice and receive payments for services rendered, which could adversely affect our business, financial condition and results of operations.

The operation of virtual and blended public charter schools depends on the maintenance of the authorizing charter and compliance with applicable laws. If these charters are not renewed, our contracts with these schools would be terminated.

In many cases, virtual and blended public schools operate under a charter that is granted by a state or local authorizer to the charter holder, such as a community group or an established not-for-profit corporation, which typically is required by state law to qualify for student funding. In fiscal year 2016, approximately 82% of our revenue was derived from Managed Public School Programs, the majority of which were virtual and blended public schools operating under a charter. The service agreement for these schools is with the charter holder or the charter board. Non-profit public charter schools qualifying for exemption from federal taxation under Code Section 501(c)(3) as charitable organizations must also operate on an arms-length basis in accordance with Internal Revenue Service rules and policies to maintain that status and their funding eligibility. In addition, all state public charter school statutes require periodic reauthorization. If a virtual or blended public school we manage fails to maintain its tax-exempt status and funding eligibility, fails to renew its charter, or if its charter is revoked for non-performance or other reasons that may be due to actions of the independent charter board completely outside of our control, our contract with that school would be terminated. For example, in January 2015, the State of

Delaware revoked the charter for the Maurice J. Moyer Academy Charter School due to non-performance of charter requirements.

Actual or alleged misconduct by our senior management and directors or officials could make it more difficult for us to enter into new contracts or renew existing contracts.

If we or any of our current or former directors, officers, key employees or officials are accused or found to be guilty of serious crimes or civil violations, including the mismanagement or improper accounting of public funds, or violations of the federal securities laws, the schools we serve could be barred or discouraged from entering into or renewing service agreements with us. As a result, our business and revenues would be adversely affected.

New laws or regulations not currently applicable to for-profit education companies in the K-12 sector could be enacted and negatively impact our operations and financial results.

As the provision of online K-12 public education matures, novel issues may arise that could lead to the enactment of new laws or regulations similar to, or in addition to, laws or regulations applicable to other areas of education and education at different levels. For example, for-profit education companies that own and operate post-secondary colleges depend in significant respect on student loans provided by the federal government to cover tuition expenses, and federal laws prohibit incentive compensation for success in securing enrollments or financial aid to any person engaged in student recruiting or admission activities. In contrast, while students in virtual or blended public K-12 schools are entitled to a free public education with no federal or state loans necessary for tuition, laws could be enacted that make for-profit management companies serving such schools subject to similar or other restrictions.

Risks Related to Our Business and Our Industry

The schools we contract with and serve are governed by independent governing bodies that may shift their priorities or change objectives in ways adverse to us, or react negatively to acquisitions or other transactions.

We contract with and provide a majority of our products and services to virtual and blended public schools governed by independent boards or similar governing bodies. While we typically share a common objective at the outset of our business relationship, over time our interests could diverge resulting in changes adverse to our business. For example, in fiscal year 2014, the Agora Cyber Charter School expressed its intention to assume management of the school beginning in the 2014-15 school year while continuing to purchase curriculum and other services from us. In late fiscal year 2016, the Agora board determined to reinstate portions of the management contract it had unbundled the prior year. As these independent boards shift their priorities or change objectives, reduce or modify the scope of services and products we provide, or terminate their relationship with us, our ability to generate revenues consistently over time would be adversely affected.

Our contracts with the managed public schools we serve are subject to periodic renewal, and each year some of these agreements are set to expire. If we are unable to renew several such contracts or if a single significant contract expires during a given year, our business, financial condition, results of operations and cash flow could be adversely affected.

In fiscal year 2016, we had contracts to provide our full range of products and services in 33 states and the District of Columbia. Some of these contracts are scheduled to expire in any given year and may not be renewed or may be renewed on terms much less favorable to us. Due to significant advance notice provisions or on the request of a school's charter authority, we usually begin to engage in renewal negotiations before and during the final year of these contracts and any renewed contract could involve a restructuring of our services and management arrangements that could lower our revenue or even change how revenue and expenses are recognized. If we are unable to renew contracts or if contract renewals have

significantly less favorable terms or unbundle previously provided services, our business, financial condition, results of operations and cash flow could be adversely affected.

If the schools we serve fail to enroll or reenroll a sufficient number of students, our business, financial condition and results of operations will be adversely affected.

Our revenues are a direct function of how many students are enrolled in our Managed Public School Programs, the number of school districts and students who subscribe to the programs offered in our Institutional business, and the enrollments in our three international and private pay schools.

Because families have alternative choices both within and outside the public school system for educating their children, it is typical during each school year that some students withdraw from schools using our online education services and switch to their traditional local public schools, other charter school alternatives or private schools. While our Managed Public School Programs also accept new student enrollment throughout the year where permitted, generally our average student enrollment declines as the school year progresses such that we serve on average fewer students at the end of any given school year than at the beginning of the year. If our Managed Public School Programs experience higher withdrawal rates during the year and/or enroll fewer new students as the year progresses than we have experienced in the past, our revenues, result of operations and financial conditions would be adversely affected.

Similarly, at the start of each new school year students who had remained enrolled through the end of the previous year may have graduated from eighth or twelfth grade or have left our Managed Public School Programs for any number of reasons. To the extent our Managed Public School Programs do not retain previously enrolled students from the prior year, they must attract new students at the start of the year to sustain their average student enrollment year over year, as well as to grow their enrollment each year, based upon enrollment objectives determined by the governing authority of those schools. If the schools we serve in the aggregate are able only to sustain prior year enrollment levels, our revenues may not grow from the prior year, absent improved revenue capture or the addition of new schools. More fundamentally, if average student enrollment at the schools we serve declines from one year to the next, our revenues, results of operations and financial condition will be adversely affected.

We also contract with virtual public schools and schools districts to provide marketing and enrollment services, and we provide similar services directly to our international and private pay schools. However, many of our customers with Non-managed Public School Programs are responsible for their own marketing and enrollment activities. Efforts on our part to sustain or increase enrollments in the face of higher student withdrawals or fewer returning students at the start of a school year may lead to higher costs for us, and may adversely affect our operating margin. If we or our Non-managed Program partners are unsuccessful in marketing plans or enrollment processes for the schools, the average student enrollment at the schools may not grow or could even decline, and adversely affect our revenues, results of operations and financial condition.

As we continue to refine our marketing efforts, and support the enrollment activities for our Managed Public School Programs, changes in our marketing efforts and enrollment activities could lead to decline in overall enrollment at the schools we serve.

As parents evaluate public school choices for their children, we are segmenting our marketing efforts to better attract students who are most likely to benefit from and succeed in virtual education programs and who are likely to remain enrolled with a virtual school over several years. Our research leads us to believe that students with parents who are active and regularly engaged in their education are more likely to be successful in a virtual school, although there is no formula that can predict the success of any particular student. Our more segmented marketing efforts, therefore, may not be wholly successful, and could lead to an overall decline in enrollment for our Managed Public School Programs, thus adversely affecting our revenue and results from operations.

The student demographics at the schools we serve have been changing, which can lead to higher costs and affect our ability to sustain or grow our operating income.

The schools we serve are publicly funded and are generally obligated to accept all students meeting state or district criteria for enrollment. Because an online education environment may offer a better educational opportunity for students falling behind grade level, our Managed Public School Programs have experienced in recent years a higher academically at-risk student population, requiring supplemental services and closer one-on-one involvement by teachers and school personnel, leading to higher costs to us in providing full management and curriculum services to the schools. We consider students academically at-risk if they were not proficient on the previous year's state assessment, are credit-deficient, have previously dropped out, have failed courses, or score lower than average on diagnostic or benchmark assessments. These factors are used by the state to identify at-risk students in several states and have been found through research to impact future student performance. Recent studies have documented that full-time online charter school students are eligible for free/reduced lunch at higher rates than traditional charter schools and students in online charter schools scored lower on state assessments prior to enrolling in the online school. The schools we serve also enroll a significant percentage of special needs students with learning and/or physical disabilities, which also add to the total costs incurred by the schools.

Education of high school students is generally more costly than K-8 as more teachers with subject matter expertise (e.g. chemistry, calculus) must be hired to support an expansive curriculum, electives, and counseling services. As the relative percentage of high school students increases as part of the total average enrollment in our Managed Public School Programs, our costs are likely to increase.

As our costs structure evolves due to the demographics, educational profile and mix of the students enrolled in our Managed Public School Programs, our profit margins may decline, and we may have increasing difficulty in sustaining or growing our operating income commensurate with our revenues.

If student performance falls, state accountability standards are not achieved, teachers or administrators tamper with state test scoring, or parent and student satisfaction declines, a significant number of students may not remain enrolled in a virtual or blended public school that we serve, or charters may not be renewed or enrollment caps could be put in place, or enrollment practices could be limited and our business, financial condition and results of operations will be adversely affected.

The success of our business depends in part on the choice of a family to have their child begin or continue his or her education in a virtual or blended public school that we serve. This decision is based on many factors, including student performance and parent and student satisfaction. Students may perform significantly below state averages or the virtual or blended public school may fail to meet state accountability standards. Like many traditional brick and mortar public schools, not all of the managed public schools we serve meet the requirements of their applicable accountability frameworks, as large numbers of new enrollments from students underperforming in traditional schools can decrease overall results or the underperformance of any one subgroup can lead to the entire school failing to meet accountability expectations and potentially lead to the school's closure. For example, in Tennessee, the Commissioner of Education has statutory authority to close a virtual school if an accountability trigger is met. In addition, although serving academically at-risk students is an important aspect of our mission to educate any child regardless of circumstance, the performance of these students can adversely affect a school's standing under applicable accountability standards. We expect that, as our enrollments increase and the portion of students that have not used our learning systems for multiple years increases, the average performance of all students using our learning systems may decrease, even if the individual performance of other students improves over time. This effect may also be exacerbated if students enrolled in schools that we provide services to or acquire are predominately below state proficiency standards or experience low graduation rates. Moreover, under the new Every Student Succeeds Act, state authorities may change their testing benchmarks in ways that negatively impact the schools we serve.

Students in the managed public schools we serve are required to periodically complete standardized state testing and the results of this testing may have an impact on school funding. Further, to avoid the consequences of failing to meet applicable required proficiency or accountability standards, teachers or school administrators may engage in improperly altering student test scores, especially if teacher performance and compensation is evaluated on these results. Finally, parent and student satisfaction may decline as not all parents and students are able to devote the substantial time and effort necessary to complete our curriculum. A student's satisfaction may also suffer if his or her relationship with the virtual or blended public school teacher does not meet expectations. If student performance or satisfaction declines, students may decide not to remain enrolled in a virtual or blended public school that we serve and our business, financial condition and results of operations could be adversely affected.

The changing nature of state curriculum standards and new state assessments could result in a decline in state test scores that might adversely affect our enrollment and financial conditions, and cause academic performance to decline.

Several states have adopted the CCSS, also known as the College and Career Readiness Standards, but are not choosing to use the assessments developed by two national testing consortia that align with the CCSS curriculum. Instead, these states are electing to use existing or new state-developed or commercially-available assessments to evaluate student performance. As a result, teachers are teaching to new standards and students are tested with new assessments which may make initial test results lower than in previous years and require additional investments. As the managed public schools we serve undertake these transitions, and given the growing number of at-risk students enrolling in these schools, academic performance could temporarily or permanently suffer such that these schools may become a less attractive alternative, enrollments could decline, and our financial condition and results of operations could be negatively impacted.

Mergers, acquisitions and joint ventures present many risks, and we may not realize the financial and strategic goals that formed the basis for the transaction.

When strategic opportunities arise to expand our business, we may acquire or invest in other companies using cash, stock, debt, asset contributions or any combination thereof. We may face risks in connection with these or other future transactions, including the possibility that we may not realize the anticipated cost and revenue synergies or further the strategic purpose of any acquisition if our forecasts do not materialize. The pursuit of acquisitions may divert the resources that could otherwise be used to support and grow our existing lines of business. Acquisitions may also create multiple and overlapping product lines that are offered, priced and supported differently, which could cause customer confusion and delays in service. Customers may decline to renew their contracts or the contracts of acquired businesses might not allow us to recognize revenues on the same basis. These transactions may also divert our management's attention and our ongoing business may be disrupted by acquisition, transition or integration activities. In addition, we may have difficulty separating, transitioning and integrating an acquired company's systems and the associated costs in doing so may be higher than we anticipate.

There may also be other adverse effects on our business, operating results or financial condition associated with the expansion of our business through acquisitions. We may fail to identify or assess the magnitude of certain liabilities, shortcomings or other circumstances prior to acquiring a company or technology, which could result in unexpected accounting treatment, unexpected increases in taxes due or a loss of anticipated tax benefits. Our use of cash to pay for acquisitions may limit other potential uses of our cash, including investment in other areas of our business, stock repurchases, dividend payments and retirement of outstanding indebtedness. If we issue a significant amount of equity for future acquisitions, existing stockholders may be diluted and earnings per share may decrease. We may pay more than the acquired company or assets are ultimately worth and we may have underestimated our costs in continuing the support and development of an acquired company's products. Our operating results may be adversely

impacted by liabilities resulting from a stock or asset acquisition, which may be costly, disruptive to our business, or lead to litigation.

We may be unable to obtain required approvals from governmental authorities on a timely basis, if it all, which could, among other things, delay or prevent us from completing a transaction, otherwise restrict our ability to realize the expected financial or strategic goals of an acquisition or have other adverse effects on our current business and operations. We may face contingencies related to intellectual property, financial disclosures, and accounting practices or internal controls. Finally, we may not be able to retain key executives of an acquired company.

The occurrence of any of these risks could have a material adverse effect on our business, results of operations, financial condition or cash flows, particularly in the case of a larger acquisition or several concurrent acquisitions.

If market demand for online options in public schooling does not increase or continue or if additional states do not authorize or adequately fund virtual or blended public schools, our business, financial condition and results of operations could be adversely affected.

Over the previous five fiscal years, we entered into service agreements for managed virtual public schools and blended schools in many new states bringing our total to 33 states and the District of Columbia for the 2016-17 school year. Without adding additional states, our Public School Program revenues may become increasingly dependent on serving more virtual schools in existing states. We also may not be able to fill available enrollment slots as forecasted. If the market demand for virtual and blended public schools does not increase or declines, if the remaining states are hesitant to authorize virtual or blended public schools, if enrollment caps are not removed or raised, or if the funding of such schools is inadequate, our opportunities for growth and our ability to sustain our revenues, results from operations and financial conditions would be adversely affected. For example, in FY 2016, while we entered into management agreements with newly-authorized virtual charter schools in North Carolina and Maine, they both imposed strict enrollment caps.

Increasing competition in the education industry sectors that we serve could lead to pricing pressures, reduced operating margins, loss of market share, departure of key employees and increased capital expenditures.

As a general matter, we face varying degrees of competition from a variety of education providers because our learning systems integrate all the elements of the education development and delivery process, including curriculum development, textbook publishing, teacher training and support, lesson planning, testing and assessment and school performance and compliance management. In both our Managed Public School Programs and Institutional businesses, we compete with companies that provide online curriculum and support services. We also compete with public school districts that offer K-12 online programs of their own or in partnership with other online curriculum vendors. We anticipate intensifying competition from such competitors and by new entrants. Our competitors may adopt similar curriculum delivery, school support and marketing approaches, with different pricing and service packages that may have greater appeal than our offerings. For example, price competition in the Institutional business is vigorous. In addition, some of our Managed Public School Programs could seek to transition to a self-administered school by seeking competitive alternatives to portions of the products and services now provided entirely by us under our integrated fully managed service agreements. If we are unable to successfully compete for new business, win and renew contracts, including fully managed public school contracts, or students fail to realize sufficient gains in academic performance, our revenues, opportunities for growth and operating margins may decline. Price competition from our current and future competitors could also result in reduced revenues, reduced margins or the failure of our product and service offerings to achieve or maintain more widespread market acceptance.

We may also face competition from publishers of traditional educational materials that are substantially larger than we are and have significantly greater financial, technical and marketing resources, and may enter the field through acquisitions and mergers. Many of these traditional publishers have developed their own online curriculum products and teaching materials that compete directly with our Institutional business products. As a result, they may be able to devote more resources and move quickly to develop products and services that are superior to our platform and technologies. We may not have the resources necessary to acquire or compete with technologies being developed by our competitors, which may render our online delivery format less competitive or obsolete. These new and well-funded entrants may also seek to attract our key executives as employees based on their acquired expertise in virtual education where such specialized skills are not widely available.

Our future success will depend in large part on our ability to maintain a competitive position with our curriculum and our technology, as well as our ability to increase capital expenditures to sustain the competitive position of our product and retain our talent base. We cannot assure that we will have the financial resources, technical expertise, marketing, distribution or support capabilities to compete effectively.

Regulatory frameworks on the accessibility of technology and curriculum are continually evolving due to legislative and administrative developments and the rapid evolution of technology, which could result in increased product development costs and compliance risks.

Our online curriculum is made available to students through computers and other display devices connected to the Internet. This curriculum includes a combination of software applications that include graphics, pictures, videos, animations, sounds and interactive content that present challenges to people with disabilities. A number of states and federal authorities have considered or are considering how electronic and information technology procured with state funds should be made accessible to persons with such disabilities. To the extent they enact or interpret laws and regulations to require greater accessibility, we will have to modify our curriculum offerings to satisfy those requirements. For example, in March 2014, the OCR entered into an agreement with the South Carolina Charter School District (“District”) to ensure that the seven Internet-based public charter schools in the state provide students with disabilities an equal opportunity to access each school’s website and online learning environment by December 31, 2015, in compliance with Section 504 and Title II of the Americans with Disabilities Act. However, in May 2016, the U.S. Department of Justice issued a supplemental notice of proposed rulemaking soliciting additional public comments on the appropriate standard for determining Web accessibility compliance under Section 508 and Title II of the ADA and extended by two years the deadline for covered entities to come into full compliance after issuance of its final rules. In addition, to the extent that we enter into federal government contracts or Section 508 standards are adopted by regulators, similar requirements could be imposed on us under Section 508 of the Rehabilitation Act of 1974. Beyond the significant product development costs associated with these evolving regulations, a failure to meet such requirements could also result in loss or termination of material contracts or in potential legal liability.

Our Managed Public School Programs business revenues are based in part on our estimate of the total funds each school will receive in a particular school year and our estimate of the full year expenses to be incurred by each school. As a result, differences between our quarterly estimates and the actual funds received and expenses incurred could have an adverse impact on our results of operations and cash flows.

We recognize revenues ratably from certain of our fees charged to Managed Public School Programs over the course of our fiscal year. To determine the pro rata amount of revenues to recognize in a fiscal quarter, we estimate the total funds each school will receive in a particular school year. Additionally, we take responsibility for any operating deficits incurred at most of the Managed Public School Programs we serve. Because this may impair our ability to collect the full amount invoiced in a period and therefore collection cannot reasonably be assured, we reduce revenues by the estimated pro rata amount of the

school's operating loss. We review our estimates of total funds and operating expenses periodically, and we revise as necessary, amortizing any adjustments over the remaining portion of the fiscal year. Actual school funding received and school operating expenses incurred may vary from our estimates or revisions and could adversely impact our revenues, results from operations and cash flows.

Our business is subject to seasonal fluctuations, which may cause our operating results to fluctuate from quarter-to-quarter and adversely impact our working capital and liquidity throughout the year.

Our revenues and operating results normally fluctuate as a result of seasonal variations in our business, principally due to the number of months in a fiscal quarter that our school customers are fully operational and serving students. In the typical academic year, our first and fourth fiscal quarters have fewer than three full months of operations, whereas our second and third fiscal quarters will have three complete months of operations. We ship learning kits to students in the beginning of the school year, our first fiscal quarter, generally resulting in higher learning kit revenues and margins in the first fiscal quarter relative to the other quarters. In aggregate, the seasonality of our revenues has generally produced higher revenues in the first quarter of our fiscal year.

Our operating expenses are also seasonal. Instructional costs and services increase in the first fiscal quarter primarily due to the costs incurred to ship learning kits at the beginning of the school year. These instructional costs may increase significantly quarter-to-quarter as school operating expenses increase. The majority of our selling and marketing expenses are incurred in the first and fourth fiscal quarters, as our primary enrollment season is July through September.

We expect quarterly fluctuations in our revenues and operating results to continue. These fluctuations could result in volatility and adversely affect our cash flow. As our business grows, these seasonal fluctuations may become more pronounced. As a result, we believe that sequential quarterly comparisons of our financial results may not provide an accurate assessment of our financial position.

Risks Related to Our Operations

We plan to continue to create new products, expand distribution channels and pilot innovative educational programs to enhance academic performance. If we are unable to effectively manage these initiatives or they fail to gain acceptance, our business, financial condition, results of operations and cash flows would be adversely affected.

As we create and acquire new products, expand our existing customer base and pilot new educational programs, we expect to face challenges distinct from those we currently encounter, including:

- our development of public blended schools has produced different operational challenges than those we previously encountered. In addition to the online component, these schools sometimes require us to lease facilities for classrooms, staff classrooms with teachers, provide meals and kitchen facilities, adhere to local safety and fire codes, purchase additional insurance and fulfill many other responsibilities;
- the acquisition or opening of additional managed public schools in states where we already have a contract with such schools can potentially create customer dissatisfaction, complicating the school selection process for prospective parents, and present marketing differentiation challenges depending on the facts and circumstances in that state;
- operating in international markets may require us to conduct our business differently than we do in the United States or in existing countries. Additionally, we may have difficulty training and retaining qualified teachers or generating sufficient demand for our products and services in international markets. International opportunities will also present us with different legal, operational, tax and currency challenges;

- the use of our curriculum in classrooms will produce challenges with respect to adapting our curriculum for effective use in a traditional classroom setting;
- our online private school business is dependent on a tuition-based financial model and may not be able to enroll a sufficient number of students over time to achieve long-run profitability or deliver a high level of customer satisfaction;
- our participation in summer foreign language instruction camps through MIL could generate new legal liabilities and financial consequences associated with our responsibility for students housed on leased college campuses on a 24-hour basis over the duration of the camp; and
- our continual efforts to innovate and pilot new programs to enhance student learning may not always succeed or may encounter unanticipated opposition.

Our failure to manage these business expansion programs, or any new business expansion program or new distribution channel we pursue, may have an adverse effect on our business, financial condition, results of operations and cash flows.

High quality teachers are critical to the success of our learning systems. If we are not able to continue to recruit, train and retain quality certified teachers, our curriculum might not be effectively delivered to students, compromising their academic performance and our reputation. As a result, our brand, business and operating results may be adversely affected.

High quality teachers are critical to maintaining the value of our learning systems and assisting students with their daily lessons. In addition, teachers in the public schools we manage or who provide instruction in connection with the online programs we offer to school districts, must be state certified (with limited exceptions or temporary waiver provisions in various states), and we must implement effective internal controls in each jurisdiction to ensure valid teacher certifications, as well as the proper matching of certifications with student grade levels and subjects to be taught. Teachers must also possess strong interpersonal communications skills to be able to effectively instruct students in a virtual school setting, and the technical skills to use our technology-based learning systems. There is a limited pool of teachers with these specialized attributes and the managed public schools and school districts we serve must provide competitive compensation packages to attract and retain such qualified teachers.

The teachers in many managed public schools we serve are not our employees and the ultimate authority relating to those teachers resides with an independent not-for-profit the governing body, which oversees the schools. However, under many of our service agreements with virtual and blended public schools, we have responsibility to recruit, train and manage these teachers. The teacher recruitment and student assignment procedures and processes for our Managed Public School Programs must also comply with individual state certification and reporting requirements. We must also provide continuous training to virtual and blended public school teachers so they can stay abreast of changes in student demands, academic standards and other key trends necessary to teach online effectively, including measures of effectiveness. We may not be able to recruit, train and retain enough qualified teachers to keep pace with school demand while maintaining consistent teaching quality in the various managed public schools we serve. Shortages of qualified teachers, failures to ensure proper teacher certifications in each state, or decreases in the quality of our instruction, whether actual or perceived, could have an adverse effect on our Managed Public School Programs and Institutional businesses.

School teachers are subject to union organizing campaigns, and if the teachers employed by us or at the managed public schools we serve join a union, collective bargaining agreements negotiated with union representatives could result in higher operating expenses and the loss of management flexibility and innovation for which charter schools were created.

If the teachers at any one of the public schools we serve were to join a union, the school authority or we would be obliged to negotiate a collective bargaining agreement with union representatives. A collective bargaining agreement could impact teacher salaries, benefits, work rules, restrictions on the teaching work-day and the time devoted to online communications with students, teacher tenure, and limitations on our flexibility to reassign or remove teachers for inadequate performance. This could result in higher expenses for school operations and could impede the sustainability of or any growth in enrollment at the school due to the loss of management flexibility and innovation. This could result in higher costs to us in providing management and curriculum services to the school, and adversely affect our operating margins and overall revenues. For example, in June 2016, the California Teachers Association was recognized by the California Public Employee Relations Board to be the exclusive representative for all of the teachers employed by the California Virtual Academies to negotiate a collective bargaining agreement with those schools.

We rely on third-party service providers to host some of our solutions and any interruptions or delays in services from these third parties could impair the delivery of our products and harm our business.

We currently outsource some of our hosting services to third parties. We do not control the operation of any third party facilities. These facilities are vulnerable to damage or interruption from natural disasters, fires, power loss, telecommunications failures and similar events. They are also subject to break-ins, computer viruses, sabotage, intentional acts of vandalism and other misconduct. The occurrence of any of these disasters or other unanticipated problems could result in lengthy interruptions in our service. Furthermore, the availability of our proprietary and third-party LMSs could be interrupted by a number of additional factors, including our customers' inability to access the Internet, the failure of our network or software systems due to human or other error, security breaches or ability of the infrastructure to handle spikes in customer usage. Interruptions in our service may reduce our revenue, cause us to issue credits or pay penalties, cause customers to terminate their subscriptions and adversely affect our renewal rates and our ability to attract new customers. Our business will also be harmed if our customers and potential customers believe our service is unreliable.

We operate a complex company-wide enterprise resource planning ("ERP") system and if it were to experience significant operating problems, it could adversely affect our business and results of operations.

We operate a complex company-wide, integrated ERP system to handle various business, operating and financial processes which handles a variety of important functions, such as order entry, invoicing, accounts receivable, accounts payable, financial consolidation and internal and external financial and management reporting matters. If the ERP system experiences significant problems it could result in operational issues including delayed billing and accounting errors and other operational issues which could adversely affect our business and results of operations. System delays or malfunctioning could also disrupt our ability to timely and accurately process and report results of our operations, financial position and cash flows, which could impact our ability to timely complete important business processes.

The continued development of our product and service brands is important to our business. If we are not able to maintain and enhance these brands, our business and operating results may suffer.

Enhancing brand awareness is critical to attracting and retaining students, and for serving additional virtual and blended public schools, school districts and online private schools and we intend to spend significant resources to accomplish that objective. These efforts include sales and marketing directed to targeted locations as well as the national marketplace, discreet student populations, the educational

community at large, key political groups, image-makers and the media. As we continue to seek to increase enrollments and extend our geographic reach and product and service offerings, maintaining quality and consistency across all of our services and products may become more difficult to achieve, and any significant and well-publicized failure to maintain this quality and consistency will have a detrimental effect on our brands. We cannot provide assurances that our new sales and marketing efforts will be successful in further promoting our brands in a competitive and cost-effective manner. For example, in fiscal year 2014 we discontinued the use of our Aventa Learning and A+ brands and introduced a new brand for marketing all of the curriculum and programs we offer to school districts under the FuelEd brand. If we are unable to further enhance our brand recognition and increase awareness of our products and services, or if we incur excessive sales and marketing expenses, our business and results of operations could be adversely affected.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products, services and brand.

Our patent, trademarks, trade secrets, copyrights, domain names and other intellectual property rights are important assets. For example, we have been granted five patents relating to the hardware and network infrastructure of our OLS, including the system components for creating and administering assessment tests and our lesson progress tracker and two patents related to foreign language instruction. Additionally, we are the copyright owner of the courses comprising our proprietary curriculum.

Various events outside of our control pose a threat to our intellectual property rights. For instance, effective intellectual property protection may not be available in every country in which our products and services are distributed or made available through the Internet. Also, the efforts we have taken to protect our proprietary rights may not be sufficient or effective. Any significant impairment of our intellectual property rights could harm our business or our ability to compete. Also, protecting our intellectual property rights is costly and time consuming. Any unauthorized use of our intellectual property could make it more expensive to do business and harm our operating results.

It is possible that we may not be able to sufficiently protect our innovations. In addition, given the costs of obtaining patent protection, we may choose not to protect certain innovations that later turn out to be important. Further, there is always the possibility that the scope of the protection gained will be insufficient or that an issued patent be deemed invalid or unenforceable.

We also seek to maintain certain intellectual property as trade secrets. This secrecy could be compromised by outside parties, whether through breach of our network security or otherwise, or by our employees or former employees, intentionally or accidentally, which would cause us to lose the competitive advantage resulting from these trade secrets. Third parties may acquire domain names that are substantially similar to our domain names leading to a decrease in the value of our domain names and trademarks and other proprietary rights.

Lawsuits against us alleging infringement of the intellectual property rights of others and such actions would be costly to defend, could require us to pay damages or royalty payments and could limit our ability or increase our costs to use certain technologies in the future.

Companies in the Internet, software, technology, education, curriculum and media industries own large numbers of patents, copyrights, trademarks and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. Regardless of the merits, intellectual property claims are time-consuming and expensive to litigate or settle. For example, a non-practicing entity sued us in 2011 alleging that our proprietary learning systems infringed three of its patents although its lawsuit was ultimately dismissed on the merits. In addition, to the extent claims against us are successful, we may have to pay substantial monetary damages or discontinue certain products, services or practices that are found to be in violation of another party's rights. We also may have to seek a

license and make royalty payments to continue offering our products and services or following such practices, which may significantly increase our operating expenses.

We may be subject to legal liability resulting from the actions of third parties, including independent contractors, business partners, or teachers, which could cause us to incur substantial costs and damage our reputation.

We may be subject, directly or indirectly, to legal claims associated with the actions of or filed by our independent contractors, business partners, or teachers. In the event of accidents or injuries or other harm to students, we could face claims alleging that we were negligent, provided inadequate supervision or were otherwise liable for their injuries and our insurance may not cover the expenses of litigation or settlement amounts. Additionally, we could face claims alleging that our independent curriculum contractors or teachers infringed the intellectual property rights of third parties. A liability claim against us or any of our independent contractors, business partners, or teachers could adversely affect our reputation, enrollment and revenues. Even if unsuccessful, such a claim could create unfavorable publicity, cause us to incur substantial expenses and divert the time and attention of management.

Unauthorized disclosure or manipulation of student, teacher and other sensitive data, whether through breach of our network security or otherwise, could expose us to costly litigation, jeopardize our contracts with virtual public schools or blended schools, and damage our reputation.

Maintaining our network security and internal controls over access rights is of critical importance because our systems store proprietary and confidential student, parent and teacher information, such as names, addresses, and other personal information. Although we have developed systems and processes that are designed to protect this information and prevent data loss and other security breaches, including systems and processes designed to reduce the impact of a security breach at a third party vendor, such measures cannot provide absolute security. Individuals and groups may develop and deploy viruses, worms and other malicious software programs that attack or attempt to infiltrate our systems. The techniques used to obtain unauthorized access or breach security systems change frequently and may be difficult to detect. Therefore we may be unable to anticipate these techniques or implement adequate preventative measures. Failure to prevent or mitigate data loss or other security breaches, including breaches of our vendors' technology and systems, could expose us or our students, parents or teachers to a risk of loss or misuse of such information, adversely affect our operating results, result in litigation or potential liability for us, and otherwise harm our business.

If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise, third parties may receive or be able to access student records and we could be subject to liability or our business could be interrupted. Penetration of our network security could have a negative impact on our reputation and could lead virtual public schools, blended schools and parents to choose competitive offerings. As a result, we may be required to expend significant resources to provide additional protection from the threat of these security breaches or to alleviate problems caused by these breaches. Additionally, we run the risk that employees or vendors could illegally disclose confidential educational information.

We rely on the Internet to enroll students and to deliver our products and services to children, which exposes us to a growing number of legal risks and increasing regulation.

We collect information regarding students during the online enrollment process and a significant amount of our curriculum content is delivered over the Internet. As a result, specific federal and state laws that could have an impact on our business include the following:

- the Children's Online Privacy Protection Act, as implemented by regulations of the Federal Trade Commission (revised July 2013), imposes restrictions on the ability of online companies to collect and use personal information from children under the age of 13;

- the Family Educational Rights and Privacy Act, which imposes parental or student consent requirements for specified disclosures of student information to third parties, and emerging state student data privacy laws;
- the Communications Decency Act, which provides website operators immunity from most claims arising from the publication of third-party content;
- numerous state cyberbullying laws which require schools to adopt policies on harassment through the Internet or other electronic communications;
- emerging state student data privacy laws which require schools to adopt privacy policies applicable to virtual schools; and
- federal and state laws that govern schools' obligations to ELL students and students with disabilities.

In addition, the laws applicable to the Internet are still developing. These laws impact pricing, advertising, taxation, consumer protection, quality of products and services, and are in a state of change. New or amended laws may also be enacted, which could increase the costs of regulatory compliance for us or force us to change our business practices. As a result, we may be exposed to substantial liability, including significant expenses necessary to comply with such laws and regulations and indemnification of schools we operate for liabilities resulting from a school's failure to comply with such laws and regulations.

System disruptions and vulnerability from security risks to our online computer networks could impact our ability to generate revenues and damage our reputation, limiting our ability to attract and retain students.

The performance and reliability of our technology infrastructure is critical to our reputation and ability to attract and retain virtual public schools, blended schools, school district customers, parents and students. Any sustained system error or failure, or a denial of service ("DNS") attack, could limit our users' access to our online learning systems, and therefore, damage our ability to generate revenues or provide sufficient documentation to comply with state laws requiring proof that students completed the required number of hours of instruction. Our technology infrastructure could be vulnerable to interruption or malfunction due to events beyond our control, including natural disasters, terrorist activities and telecommunications failures.

We utilize a single logistics vendor for the management, receiving, assembly and shipping of all of our learning kits and printed educational materials. In addition, we utilize the same vendor at a second location for the reclamation and redeployment of our student computers. This partnership depends upon execution on the part of us and the vendor. Any material failure to execute properly for any reason, including damage or disruption to any of the vendor's facilities would have an adverse effect on our business, financial condition and results of operations.

Substantially all of the inventory for our learning kits and printed materials is located in one warehouse facility, which is operated by a third-party logistics vendor that handles receipt, assembly and shipping of all physical learning materials. If this logistics vendor were to fail to meet its obligations to deliver learning materials to students in a timely manner, or if a material number of such shipments are incomplete or contain assembly errors, our business and results of operations could be adversely affected. In addition, we provide computers for a substantial number of our students. Execution or merger integration failures which interfere with the reclamation or redeployment of computers may result in additional costs. Furthermore, a natural disaster, fire, power interruption, work stoppage or other unanticipated catastrophic event, especially during the period from April through June when we are awaiting receipt of most of the curriculum materials for the school year and have not yet shipped such materials to students, could significantly disrupt our ability to deliver our products and operate our business. If any of our material inventory items were to experience any significant damage, we would be unable to meet our contractual obligations and our business would suffer.

Any significant interruption in the operation of our data centers could cause a loss of data and disrupt our ability to manage our network hardware and software and technological infrastructure.

We host our products and serve all of our students from third-party data center facilities. As part of our risk mitigation plan, we opened a second data center in a different geographic location. Even with such redundancy, we may not be able to prevent a significant interruption in the operation of these facilities or the loss of school and operational data due to a natural disaster, fire, power interruption, act of terrorism or other unanticipated catastrophic event. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or manage our transition to utilizing the expansions or upgrades, could reduce our ability to manage our network and technological infrastructure, which could result in lost sales, enrollment terminations and impact our brand reputation.

Additionally, we do not control the operation of these facilities and must rely on another party to provide the physical security, facilities management and communications infrastructure services related to our data centers. Although we believe we would be able to enter into a similar relationship with another party should this relationship fail or terminate for any reason, our reliance on a single vendor exposes us to risks outside of our control. If this vendor encounters financial difficulty such as bankruptcy or other events beyond our control that causes it to fail to secure adequately and maintain its hosting facilities or provide the required data communications capacity, students of the schools we serve may experience interruptions in our service or the loss or theft of important customer data.

Any significant interruption in the operation of our enrollment centers could disrupt our ability to recommend educational options to parents, respond to service requests and process enrollments.

Our primary enrollment center operations are housed in our corporate headquarters and in a facility located in Knoxville, Tennessee. We are able to reroute calls to the other facility if one facility is unable to temporarily service calls. Rerouting of calls may not be able to prevent a significant interruption in the operation of any of the facilities due to natural disasters, accidents, failures of our fulfillment provider. Any significant interruption in the operation of any primary facility, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, could reduce our ability to respond to service requests, receive and process orders and provide products and services, which could result in lost and cancelled sales, and damage to our brand reputation.

Capacity limits on some of our technology, transaction processing systems and network hardware and software may be difficult to project and we may not be able to expand and upgrade our systems in a timely manner to meet significant unexpected increased demand.

As the number of schools we serve increases and our student base grows, the traffic on our transaction processing systems and network hardware and software will rise. We may be unable to accurately project the rate of increase in the use of our transaction processing systems and network hardware and software. In addition, we may not be able to expand and upgrade our systems and network hardware and software capabilities to accommodate significant unexpected increased or peak use. If we are unable to appropriately upgrade our systems and network hardware and software in a timely manner, our operations and processes may be temporarily disrupted.

Our efforts to expand capacity may not produce the operational and financial results for which those investments were intended.

As we have grown to serve more schools, students and families in an increasing number of states and countries, we have invested in infrastructure systems and technology to keep pace such as new communication systems, enterprise hardware and software systems, and enrollment centers. In the absence

of compatible business processes, adequate employee training, integration with other dependent systems, and sufficient staffing, this expanded capacity alone may not result in improved performance or outcomes.

We may be unable to keep pace with changes in our industry and advancements in technology as our business and market strategy evolves.

As changes in our industry occur or macroeconomic conditions fluctuate we may need to adjust our business strategies or find it necessary to restructure our operations or businesses, which could lead to changes in our cost structure, the need to write down the value of assets, or impact our profitability. We also make investments in existing or new businesses, including investments in technology and expansion of our business lines. These investments may have short-term returns that are negative or less than expected and the ultimate business prospects of the business may be uncertain.

As our business and market strategy evolves, we also will need to respond to technological advances and emerging industry standards in a cost-effective and timely manner in order to remain competitive, such as the ubiquitous use of tablets for public school applications, adaptive learning technologies, and web accessibility standards. The need to respond to technological changes may require us to make substantial, unanticipated expenditures. There can be no assurance that we will be able to respond successfully to technological change.

Middlebury College exercised its right under our joint venture agreement to require us to purchase its ownership interest in our joint venture, which could adversely affect our financial condition or cause dilution to stockholders.

As a result of the May 4, 2015 put notice from Middlebury College, we are obligated to purchase Middlebury's interest in the joint venture at a mutually agreed upon fair market value, or for a value determined by an independent valuation. We have the right to pay the redemption cost in cash, stock or a combination thereof, at our option, which form of consideration has not yet been determined. In accordance with the terms of the joint venture agreement, we are in the process of determining the redemption cost value. It is uncertain what the value will be and therefore, we cannot at this time determine the form of the redemption payment and the exact impact to our financial condition or dilution to stockholders.

We may be unable to attract and retain skilled employees.

Our success depends in large part on continued employment of senior management and key personnel who can effectively operate our business, which is necessary in the highly regulated public education sector involving a publicly-traded for-profit company. This complexity requires us to attract and retain management and employees with specialized skills and knowledge across many disciplines. If any of these employees leave we and we fail to effectively manage a transition to new personnel, or if we fail to attract and retain qualified and experienced professionals on acceptable terms, our business, financial conditions and results of operations could be adversely affected.

Our success also depends on our having highly trained financial, technical, recruiting, sales and marketing personnel. We will need to continue to hire additional personnel as our business grows. A shortage in the number of people with these skills or our failure to attract them to our Company could impede our ability to increase revenues from our existing products and services, ensure full compliance with federal and state regulations, launch new product offerings, and would have an adverse effect on our business and financial results.

In addition, we are subject to the Fair Labor Standards Act and other state and federal employment laws. These laws govern such matters as minimum wage, overtime and other working conditions, that can increase our labor costs or subject us to liabilities to our employees. Regulatory changes that increase the number of workers eligible for overtime based on salary levels and other labor costs may increase in the

future which could have a material adverse effect on our business, financial condition and results of operations.

Healthcare reform legislation could have a negative impact on our business, financial condition and results of operations.

The Patient Protection and Affordable Care Act, which was adopted in 2010, may significantly affect the provision of both healthcare services and benefits in the U.S. We continually monitor the impact on our business and the steps necessary to mitigate such impact, including potential further modifications to our current benefit plans and operational changes to minimize the effect of the legislation on our cost structure. If we cannot effectively modify our programs and operations in response to these mandates, our business, financial condition and results of operations may be adversely impacted.

We partially self-insure our group health insurance program and actual claims may differ from our estimates, which could materially impact our results of operations.

Effective January 1, 2016, we modified our group health insurance program and now self-insure all eligible employees and their family members subject to a stop loss insurance policy with a per person limit of \$500,000 and an aggregate limit of 125% of expected claims based on a formulaic determination of the expected claims. Liabilities associated with the risks that are retained by the Company are estimated, in part, by considering historical claims experience, demographic factors, severity factors and other actuarial assumptions. Our results could be materially impacted by claims and other expenses related to our group health insurance program if future occurrences and claims differ from these assumptions and historical trends and exceed the limitations of liability under the stop loss insurance policy.

We may need additional capital in the future, but there is no assurance that funds will be available on acceptable terms.

We may need to raise additional funds in order to achieve growth or fund other business initiatives. This financing may not be available in sufficient amounts or on terms acceptable to us and may be dilutive to existing stockholders. Additionally, any securities issued to raise funds may have rights, preferences or privileges senior to those of existing stockholders. If adequate funds are not available or are not available on acceptable terms, our ability to expand, develop or enhance services or products, or respond to competitive pressures will be limited.

Our curriculum and approach to instruction may not achieve widespread acceptance, which would limit our growth and profitability.

The curriculum offerings and approach to individualized learning are based on the structured delivery, clarification, verification and practice of lesson subject matter. While we seek to align our curriculum with state standards in the jurisdictions where we manage virtual and blended public schools and these schools offer accredited diplomas, this approach is not accepted by all academics and educators, who may favor less formalistic methods and have the ability to negatively influence the market for our products and services. In addition, the acceptance and adoption of the CCSS grade level requirements and proposed common assessments of those standards is uncertain and continues to change at the state and district level. As a result, the standards for measuring student achievement could vary from state to state, and even from district to district, and therefore, we cannot anticipate at this time the impact these varying standards may have in terms of requiring additional investment on our part, or on our ability to sustain or expand our operating margins.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our headquarters are located in approximately 176,000 square feet of office space in Herndon, Virginia. The facilities are under leases that expire between August 2019 and May 2022. In addition, we lease approximately 210,000 square feet in multiple locations throughout the United States under individual leases that expire between June 2017 and October 2022.

ITEM 3. LEGAL PROCEEDINGS

In the ordinary conduct of our business, we are subject to lawsuits, arbitrations and administrative proceedings from time to time. We vigorously defend these claims; however, no assurances can be given as to the outcome of any pending legal proceedings. We believe, based on currently available information, that the outcome of any existing or known threatened proceedings, even if determined adversely, should not have a material adverse effect on our business, financial condition, liquidity or results of operations.

On September 24, 2015, in connection with an industry-wide investigation styled “In the Matter of the Investigation of For-Profit Virtual Schools,” we received a civil investigative subpoena for specified documents and responses to interrogatories from the Attorney General of the State of California, Bureau of Children’s Justice (“BCJ”). On July 8, 2016, K12 and the California Virtual Academy (“CAVA”) charter schools (“CAVA Schools”) entered into: (i) a Settlement Agreement and Release of a previously sealed Qui Tam lawsuit alleging false attendance reporting; (ii) a Stipulation for Entry of Final Judgment (“Stipulation”) in connection with the BCJ’s investigation as it pertained to us; and (iii) a Final Judgment enjoining us from engaging in certain business practices in California, and requiring that we and CAVA Schools undertake certain Conduct Provisions. The Settlement Agreement and Release provides for us to pay the State of California \$2.5 million, and the Qui Tam plaintiff \$0.1 million to settle the attendance reporting claims and in which we and the CAVA Schools deny any and all liability and wrongdoing. The Stipulation specifies that the Attorney General, the Company and the CAVA Schools have concluded the BCJ investigation and agreed to implement the Conduct Provisions of the Final Judgment “without admissions of findings of fact or law or wrongdoing, misconduct or illegal acts by K12 or the CAVA Schools, or any facts alleged in the [Attorney General’s] Complaint.” The Final Judgment provides for us to pay the State of California \$6.0 million “to defray the costs of this action and to fund the investigation and prosecution of enforcement cases to protect the rights of children,” and further includes a release of all legal claims that could be brought by the Attorney General involving the covered conduct. The Conduct Provisions of the Final Judgment require us to continue to improve our business practices and compliance programs as they generally relate to the operations and promotional activities of K12 and the CAVA Schools. The proceeding settlement costs were offset by insurance reimbursable administrative costs of approximately \$1.5 million.

On July 20, 2016, a securities class action lawsuit captioned *Babulal Tarapara v. K12 Inc. et. al.* was filed against us, two of our officers and one of our former officers in the United States District Court for the Northern District of California, Case No. 3:16-cv-04069. The plaintiff purports to represent a class of persons who purchased or otherwise acquired our common stock between November 7, 2013 and October 27, 2015, inclusive, and alleges violations by us and the individual defendants of Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and Rule 10b-5 promulgated under the Exchange Act, and violations by the individual defendants of Section 20(a) of the Exchange Act. The complaint alleges, among other things, that we and the individual defendants made false or misleading statements and omitted to disclose material facts concerning students’ academic progress, graduate eligibility for University of California and California State University admission, class sizes, the individualized and flexible nature of the instruction provided by us, the quality of materials provided to students, reporting with respect to student attendance and funding, and that as a result of the aforementioned practices we were exposed to liability and would be forced to end these purported practices. The complaint seeks unspecified monetary damages and other relief. We intend to defend vigorously against each and every allegation and claim set forth in the complaint.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

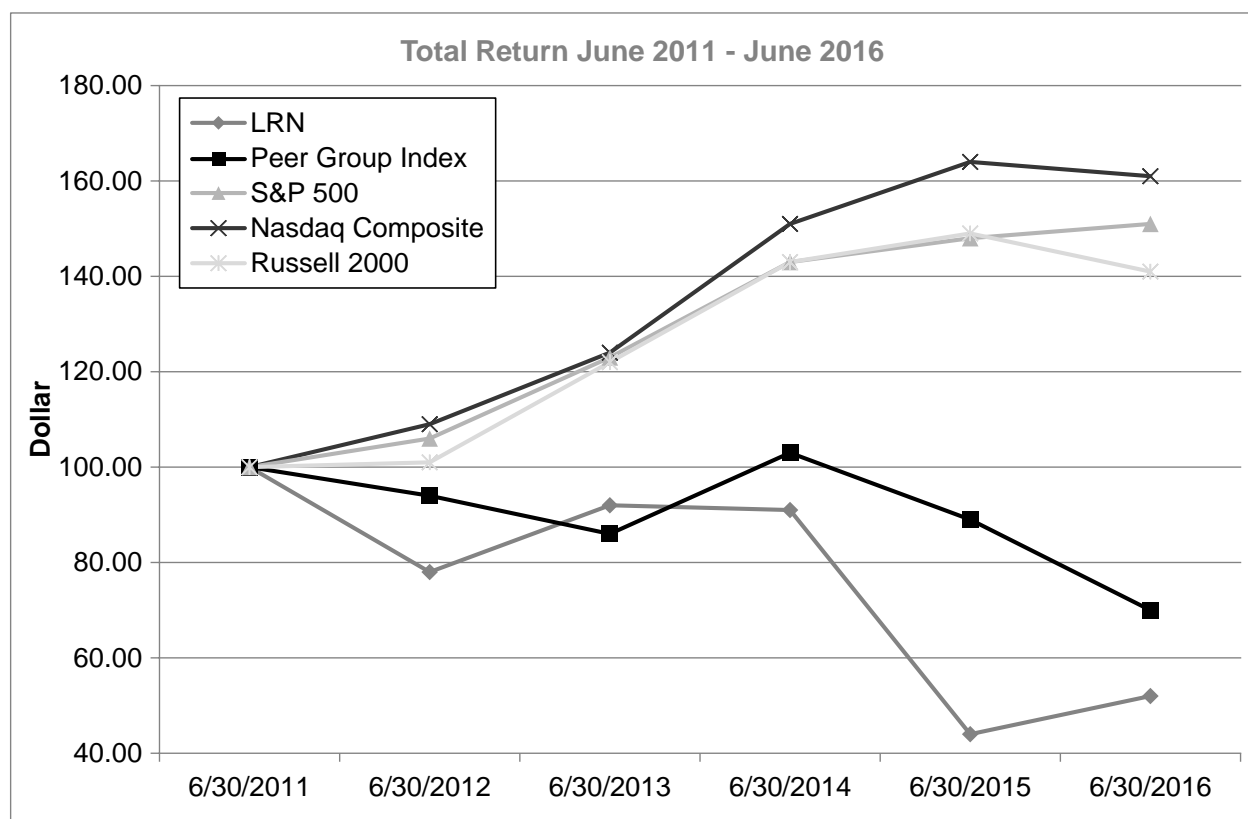
Our common stock, par value \$0.0001 per share, is traded on the New York Stock Exchange (the "NYSE") under the symbol "LRN." Set forth below are the high and low sales prices for our common stock, as reported on the NYSE. As of July 31, 2016, there were 37 registered holders of our common stock.

	<u>High</u>	<u>Low</u>
Quarter ended:		
June 30, 2016	\$12.91	\$ 9.16
March 31, 2016	11.19	7.11
December 31, 2015	14.45	8.80
September 30, 2015	14.95	12.15
June 30, 2015	17.63	12.53
March 31, 2015	17.71	10.07
December 31, 2014	16.59	11.08
September 30, 2014	24.51	15.96

Stock Performance Graph

The graph below matches the cumulative return of holders of K12 Inc.'s common stock with the cumulative returns of the S&P 500 index, the NASDAQ Composite Index, the Russell 2000 Index and our Peer Group Index, which is composed of American Public Education Inc., Apollo Group Inc., Bridgepoint Education Inc., Capella Education Company, Devry Inc., Grand Canyon Education Inc., ITT Educational Services, Inc., Pearson PLC, Rosetta Stone Inc., Scholastic Corporation, Strayer Education Inc. and Universal Technical Institute. The graph assumes that the value of the investment in our common stock, in each index (including reinvestment of dividends) was \$100 on June 30, 2011 and tracks it through June 30, 2016. All prices reflect closing prices on the last day of trading at the end of each calendar quarter.

**COMPARISON OF TWENTY QUARTER CUMULATIVE TOTAL RETURN(1)(2)
Among K12 Inc., S&P 500 Index, NASDAQ Composite Index, Russell 2000 Index and Peer Group Index**



	30-Jun-11	30-Jun-12	30-Jun-13	30-Jun-14	30-Jun-15	30-Jun-16
LRN	100	78	92	91	44	52
Peer Group Index	100	94	86	103	89	70
S&P 500	100	106	123	143	148	151
Russell 2000	100	101	122	143	149	141
Nasdaq Composite	100	109	124	151	164	161

- (1) The information presented above in the stock performance graph shall not be deemed “soliciting material” or to be “filed” with the SEC or subject to Regulation 14A or 14C, except to the extent that we subsequently specifically request that such information be treated as soliciting material or specifically incorporate it by reference into a filing under the Securities Act of 1933, as amended (the “Securities Act”), or a filing under the Exchange Act.
- (2) The stock price performance shown on the graph is not necessarily indicative of future price performance. Information used in the graph was obtained from a source we believe to be reliable, but we do not assume responsibility for any errors or omissions in such information.

Dividend Policy

We have never declared or paid any cash dividends on our common stock and we currently do not anticipate paying any cash dividends for the foreseeable future. Instead, we anticipate that all of our earnings on our common stock will be used to provide working capital, to support our operations, and to finance the growth and development of our business, including potentially the acquisition of, or investment

in, businesses, technologies or products that complement our existing business. Any future determination relating to dividend policy will be made at the discretion of our Board of Directors and will depend on a number of factors, including, but not limited to, our future earnings, capital requirements, financial condition, future prospects, applicable Delaware law, which provides that dividends are only payable out of surplus or current net profits and other factors our Board of Directors might deem relevant.

Stock-based Incentive Plan Information

The following table provides certain information as of June 30, 2016, with respect to our equity compensation plans under which common stock is authorized for issuance:

Equity Compensation Plan Information As of June 30, 2016

	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance under Equity Compensation Plans (Excluding Securities Reflected in First Column)
Equity compensation plans approved by security holders(1)	<u>2,350,175</u>	<u>\$20.20</u>	<u>2,957,517</u>

Includes shares under the 2007 Equity Incentive Award Plan.

(1) The 2007 Equity Incentive Award Plan (the “EIP”) adopted in October 2007, as amended in 2010 and approved by the stockholders, contains an “evergreen provision” that allows for an annual increase in the number of shares available for issuance under the EIP on July 1 of each year during the ten-year term of the EIP ending October 30, 2017. The annual increase in the number of shares shall be equal to the least of:

- 4% of our outstanding common stock on the applicable July 1;
- 2,745,098 shares; or
- a lesser number of shares as determined by our Board of Directors.

Issuer Purchases of Equity Securities

On November 4, 2013, the Board of Directors authorized the repurchase of up to \$75.0 million of our outstanding common stock over a two year period. Any purchases under the buyback were dependent upon business and market conditions and other factors. The stock purchases were made from time to time and through a variety of methods including open market purchases and trading plans that were adopted in accordance with the Rule 10b-18 of the Exchange Act. For the fiscal year ended June 30, 2015, we paid approximately \$26.5 million in cash to redeem 1,307,402 shares of common stock at an average price of \$20.23 per share. There were no repurchases of shares made during the fiscal year ended June 30, 2016. As of June 30, 2016 and 2015 total shares purchased under the plan were 3,502,598, at an average cost of \$21.41 per share, and there were no shares remaining to be repurchased under the plan.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth our selected consolidated statement of operations, balance sheet and other data as of the dates and for the periods indicated. You should read this data together with “Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and related notes, included elsewhere in this Annual Report. The selected consolidated statements of operations data for each of the years in the three year period ended June 30, 2016, and the selected consolidated balance sheet data as of June 30, 2016 and 2015, have been derived from our audited consolidated financial statements, which are included elsewhere in this Annual Report. The selected consolidated statements of operations data for the years ended June 30, 2013 and 2012 and selected consolidated balance sheet data as of June 30, 2014, 2013 and 2012, have been derived from our audited consolidated financial statements not included in this Annual Report. Our historical results are not necessarily indicative of future operating results.

	Year Ended June 30,				
	2016	2015	2014	2013	2012
	(In thousands)				
Consolidated Statement of Operations Data:					
Revenues	\$872,700	\$948,294	\$919,553	\$848,220	\$708,407
Cost and expenses					
Instructional costs and services	546,510	607,756	569,219	498,398	408,560
Selling, administrative and other operating expenses	302,205	307,730	313,258	283,032	245,274
Product development expenses	10,071	14,381	14,220	21,084	25,593
Total costs and expenses	858,786	929,867	896,697	802,514	679,427
Income from operations	13,914	18,427	22,856	45,706	28,980
Realized gain on sale of assets	—	—	6,404	—	—
Interest income (expense), net and other	(617)	(3,291)	(69)	851	(989)
Income before income tax expense and noncontrolling interest	13,297	15,136	29,191	46,557	27,991
Income tax expense	(4,746)	(5,810)	(11,075)	(20,023)	(11,882)
Net income	8,551	9,326	18,116	26,534	16,109
Add net loss attributable to noncontrolling interest	484	1,662	1,484	1,577	1,434
Net income attributable to common stockholders, including Series A stockholders(1)	<u>\$ 9,035</u>	<u>\$ 10,988</u>	<u>\$ 19,600</u>	<u>\$ 28,111</u>	<u>\$ 17,543</u>

	Year Ended June 30,				
	2016	2015	2014	2013	2012
	(In thousands except share and per share data)				
Net income attributable to common stockholders per share:					
Basic	\$ 0.24	\$ 0.29	\$ 0.50	\$ 0.72	\$ 0.46
Diluted(1)	\$ 0.23	\$ 0.29	\$ 0.50	\$ 0.72	\$ 0.45
Weighted average shares used in computing per share amounts:					
Basic	37,613,782	37,330,569	38,987,470	36,267,345	35,802,678
Diluted(1)	38,850,388	37,625,425	39,230,516	39,017,345	38,740,863
Other Data:					
Net cash provided by operating activities	\$ 121,778	\$ 120,085	\$ 122,873	\$ 94,387	\$ 32,991
Depreciation and amortization	\$ 68,225	\$ 83,801	\$ 86,267	\$ 65,737	\$ 58,033
Stock-based compensation expense	\$ 18,617	\$ 21,299	\$ 22,828	\$ 14,374	\$ 10,067
EBITDA(2)	\$ 82,139	\$ 102,228	\$ 115,527	\$ 111,443	\$ 87,013
Capital Expenditures:					
Capitalized curriculum development costs	\$ 21,627	\$ 18,057	\$ 15,411	\$ 18,560	\$ 16,123
Purchases of property, equipment and capitalized software development costs	\$ 41,273	\$ 43,683	\$ 33,958	\$ 31,785	\$ 32,477
New capital lease obligations(3)	\$ 10,878	\$ 14,654	\$ 24,132	\$ 24,703	\$ 27,209
Total capital expenditures	\$ 73,778	\$ 76,394	\$ 73,501	\$ 75,048	\$ 75,809

	As of June 30,				
	2016	2015	2014	2013	2012
	(In thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$213,989	\$195,852	\$196,109	\$181,480	\$144,652
Total assets	\$734,055	\$708,599	\$711,667	\$718,896	\$648,835
Total short-term debt	\$ 13,210	\$ 16,635	\$ 20,492	\$ 19,785	\$ 17,095
Total capital lease obligations, net of current portion	\$ 9,922	\$ 13,022	\$ 16,447	\$ 16,107	\$ 15,901
Total K12 Inc. stockholders' equity	\$558,720	\$536,938	\$528,930	\$530,162	\$473,494
Working capital	\$322,843	\$348,306	\$351,441	\$348,762	\$289,226

- (1) For the years ended, June 30, 2013 and 2012, diluted net income per common share reflects pro rata net income allocated to the 2,750,000 non-voting shares of the Series A Special Stock issued in the acquisition of KCDL in July 2010. These shares were converted into common stock on September 3, 2013 and no Series A Special stock remains outstanding as of June 30, 2016 and 2015.
- (2) EBITDA consists of net income, plus interest expense, net and other, income tax expense, depreciation and amortization minus noncontrolling interest charges. Interest expense, net primarily consists of interest expense for capital leases, long-term and short-term borrowings, as well as interest income/expense related to our Web investment. We use EBITDA in addition to income from operations and net income as a measure of operating performance. However, EBITDA is not a recognized measurement under U.S. generally accepted accounting principles, or GAAP, and when analyzing our operating performance, investors should use EBITDA in addition to, and not as an alternative for, net income as determined in accordance with GAAP. Because not all companies use

identical calculations, our presentation of EBITDA may not be comparable to similarly titled measures of other companies. Furthermore, EBITDA is not intended to be a measure of free cash flow for our management's discretionary use, as it does not consider certain cash requirements such as capital expenditures, tax payments, interest payments, or other working capital.

We believe EBITDA is useful to an investor in evaluating our operating performance because it is widely used to measure a company's operating performance without regard to items such as depreciation and amortization, which can vary depending upon accounting methods and the book value of assets, and to present a meaningful measure of corporate performance exclusive of our capital structure and the method by which assets were acquired. Our management uses EBITDA:

- as an additional measurement of operating performance because it assists us in comparing our performance on a consistent basis;
- in presentations to the members of our Board of Directors to enable our Board to have the same measurement basis of operating performance as is used by management to compare our current operating results with corresponding prior periods and with the results of other companies in our industry; and
- on an adjusted basis in determining compliance with the terms of our credit agreement.

The following table provides a reconciliation of net income to EBITDA:

	Year Ended June 30,				
	2016	2015	2014	2013	2012
	(In thousands)				
Net Income attributable to common stockholders, including Series A stockholders	\$ 9,035	\$ 10,988	\$ 19,600	\$ 28,111	\$17,543
Interest expense, net and other	617	3,291	69	(851)	989
Income tax expense	4,746	5,810	11,075	20,023	11,882
Depreciation and amortization(4)(5)(6)	68,225	83,801	86,267	65,737	58,033
Noncontrolling interest	(484)	(1,662)	(1,484)	(1,577)	(1,434)
EBITDA	<u>\$82,139</u>	<u>\$102,228</u>	<u>\$115,527</u>	<u>\$111,443</u>	<u>\$87,013</u>

- (3) New capital lease obligations are primarily for student computers and related equipment.
- (4) For fiscal year 2016, selling, administrative and other operating expenses includes \$7.1 million of expense related to the Settlement agreement with the State of California.
- (5) For fiscal year 2015, depreciation and amortization includes \$13.9 million of expense related to accelerated depreciation and amortization for certain curriculum, learning systems and other fixed assets that will no longer be used or developed, computer peripherals that will not be reclaimed, and the write-off of capitalized software that will be abandoned.
- (6) For fiscal year 2014, depreciation and amortization includes approximately \$18.6 million for certain curriculum, learning systems and other fixed assets that will no longer be used or developed, computers that we estimate will not be returned and additional provisions for the decision to discontinue certain products and for excess inventory relative to anticipated demand.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") contains certain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Historical results may not indicate future performance. Our forward-looking statements reflect our current views about future events, are based on assumptions, and are subject to known and unknown risks and uncertainties that could cause actual results to differ materially from those contemplated by these statements. Factors that may cause differences between actual results and those contemplated by forward-looking statements include, but are not limited to, those discussed in "Risk Factors" in Part I, Item 1A, of this Annual Report. We undertake no obligation to publicly update or revise any forward-looking statements, including any changes that might result from any facts, events, or circumstances after the date hereof that may bear upon forward-looking statements. Furthermore, we cannot guarantee future results, events, levels of activity, performance, or achievements.

This MD&A is intended to assist in understanding and assessing the trends and significant changes in our results of operations and financial condition. As used in this MD&A, the words, "we," "our" and "us" refer to K12 Inc. and its consolidated subsidiaries. This MD&A should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this Annual Report. The following overview provides a summary of the sections included in our MD&A:

- *Executive Summary*—a general description of our business and key highlights of the fiscal year ended June 30, 2016.
- *Key Aspects and Trends of Our Operations*—a discussion of items and trends that may impact our business in the upcoming year.
- *Critical Accounting Policies and Estimates*—a discussion of critical accounting policies requiring critical judgments and estimates.
- *Results of Operations*—an analysis of our results of operations in our consolidated financial statements.
- *Liquidity and Capital Resources*—an analysis of cash flows, sources and uses of cash, commitments and contingencies, seasonality in the results of our operations, the impact of inflation, and quantitative and qualitative disclosures about market risk.

Executive Summary

We are a technology-based education company. We offer proprietary curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade, or K-12. Our mission is to maximize a child's potential by providing access to an engaging and effective education, regardless of geographic location or socio-economic background. Since our inception, we have invested to develop and acquire curriculum and online learning platforms that promote mastery of core concepts and skills for students of all abilities. K12 provides a continuum of technology-based educational products and solutions to virtual and blended public schools, school districts, charter schools, private schools and families as we strive to transform the educational experience into one that delivers individualized education on a highly scalable basis. These unique set of products and services are provided primarily to three lines of business: Managed Public School Programs (curriculum and services sold to managed public schools), Institutional (curriculum, technology and services provided to school districts, public schools and other educational institutions that we do not manage), and Private Pay Schools and Other (managed private schools for which we charge student tuition, including international, and direct consumer sales).

In fiscal year 2016, revenue decreased to \$872.7 million from \$948.3 million, a decrease of 8.0% primarily attributable to our Managed Public School Programs. In fiscal year 2016, operating income decreased to \$13.9 million, from \$18.4 million in fiscal year 2015, a decrease of 24.5%; net income attributable to common stockholders decreased to \$9.0 million from \$11.0 million, a decrease of 18.2% and EBITDA, a non-GAAP measure (see reconciliation of net income to EBITDA in “Item 6—Selected Financial Data”), decreased to \$82.1 million from \$102.2 million, a decrease of 19.7%. The operating income for fiscal year 2016 included charges of \$7.1 million related to the Settlement Agreement with the State of California. The operating income for fiscal year 2015 included charges of \$25.2 million from bad debt expense, the write-off of capitalized software and curriculum that will no longer be used or developed, certain computer peripherals and other fixed assets that will not be reclaimed, severance and related stock-based compensation, and additional provisions for inventory that we previously anticipated using.

We believe that the acceptance of online education in grades K-12 continues to grow, and anticipate that increased overall demand for virtual options in education will translate into increased demand for both our Managed Public School Programs and our Institutional business (sold under the brand names Fuel Education or FuelEd). At the same time, the growth rate in the Managed Public School Programs business, which serves primarily virtual charter schools, has slowed. Regulatory requirements related to academic performance and accountability are expanding and the independent governing authorities of the virtual charter schools that contract with us are taking different approaches to virtual education depending upon their own charter school goals. This in turn may alter the nature of the agreements we have with those boards and the level of management services that meet their needs. We continue to work with all independent governing authorities to offer the curriculum, technology and services to meet the needs of fully-managed virtual and blended schools as well as the self-managed virtual and blended schools, offering additional services to the self-managed schools as needed.

In fiscal year 2015, we revised the description of the line of business previously known as Managed Public Schools and now describe it as Managed Public School Programs which includes both virtual and blended public schools where a district or independent charter board has contracted with us to provide a full-time program of educational products and services. Managed Public School Programs are where K12 provides substantially all of the management, technology and academic support services in addition to curriculum, learning systems and instructional services. Non-managed Public School Programs are where K12 provides curriculum and technology, and the school has an option to contract for instruction or other services. Non-managed Public School Programs do not offer primary administrative oversight. Our Managed Public School Programs line of business accounted for approximately 82% of our revenue in fiscal year 2016. For the 2015-16 school year, we had Managed Public School Programs in 33 states and the District of Columbia.

Through our Institutional business, we work closely as partners with a growing number of school districts and individual schools, enabling them to offer their students an array of online education solutions, including full-time virtual and blended programs, semester courses and supplemental solutions. In addition to curriculum, systems and programs, we also provide teacher training, teaching services and other support services. The services we provide to these schools and school districts are designed to assist them in launching their own online learning programs which vary according to the needs of the individual school and school district and may include teacher training programs, administrator support and our PEAK management system. PEAK is a platform designed to centrally manage multiple online solutions across a school or district through one application. With our array of services, schools and districts can offer programs that allow students to participate part-time, supplementing their education with core courses, electives, credit recovery options, remediation and supplemental content options as well as full-time virtual and blended programs. Adding to our Institutional product offerings, during fiscal year 2016 we acquired LTS Education Systems, which provides personalized, digital game based on-line test preparation and readiness solutions focused on math, reading and English language arts, science and history.

Our Private Pay Schools and Other include three online private schools that we operate in which parents can enroll students on a tuition basis for a full-time online education or individual courses to supplement their children's traditional instruction. These schools are: (1) K¹² International Academy, an online private school that enables us to offer students worldwide the same full-time education programs and curriculum that we provide to the virtual and blended public schools, (2) The Keystone School, a private school that offers online and correspondence courses, and (3) the George Washington University Online High School, a school that offers college preparatory curriculum and is designed for high school students who are seeking a challenging academic experience.

Financial Statement Overview

Student enrollment in our Managed Public School Programs experienced a shift in the mix of students with an increased level of high school students. The continued expansion of our Institutional and our Private Pay Schools and Other also shifts the mix of our revenue and associated costs of providing services, including additional sales personnel, third-party distributor costs and third-party royalty costs for our Institutional business. We may continue to experience changes in our enrollment, revenue and cost mix as we continue to expand into markets different than our traditional Managed Public School Programs.

Our headcount growth from approximately 3,300 employees at the beginning of 2013 to approximately 4,800 at the end of our 2016 fiscal year, including teachers associated with our enrollment growth, the growth of the Institutional business, including the expansion of a sales force, and the decision to have more K12-employed teachers in our managed schools have also directly impacted our operating expenses during the last three years. We believe that all the above factors reduce the comparability of our operating results between periods.

Key Aspects and Trends of Our Operations

Revenues—Overview

We generate a significant portion of our revenues from the sale of curriculum, management and technology services to managed virtual and blended public schools, where we provide turn-key management services. Approximately 82% of our revenues were derived from this source in fiscal year 2016. We anticipate that these revenues will continue to represent the majority of our total revenues over the next several years. However we also expect revenues in other aspects of our business to increase as we execute on our growth strategy. Our growth strategy includes increasing revenues in other distribution channels, adding enrollments in our private schools and expanding our Institutional business, and pursuing international opportunities to offer our learning systems. Combined revenues from these other sectors were significantly smaller than that from the Managed Public School Programs in fiscal year 2016. Our success in executing our strategies will impact future growth. We provide products and services primarily to three lines of business: Managed Public School Programs, Institutional and Private Pay Schools and Other.

Factors affecting our revenues include:

- (i) the number of enrollments;
- (ii) the mix of enrollments across grades and states;
- (iii) management services provided to the schools and school districts;
- (iv) state or district per student funding levels and attendance requirements;
- (v) prices for our products and services;
- (vi) growth in our other customer types; and
- (vii) revenues from new initiatives, mergers and acquisitions.

Managed Public School Programs

We define an enrollment as any student enrolled in a virtual or blended public school which qualifies as a Public School Program. Generally, students will take four to six courses, except for some kindergarten students who may participate in half-day programs. We count each half-day kindergarten student as an enrollment. School sessions generally begin in August or September and end in May or June. To ensure that all schools are reflected in our measure of enrollments, we consider the number of students on the first Wednesday of October to be our opening enrollment level, and the number of students enrolled on the last day of May to be our ending enrollment level. For each period, average enrollments represent the average of the month-end enrollment levels for each school month in the period. We continually evaluate our enrollment levels by state, by school and by grade. We track new student enrollments and withdrawals throughout the year.

We believe that our revenue growth from enrollments depends upon the following:

- the number of states and school districts in which we operate;
- the mix of students served;
- the restrictive terms of local laws or regulations, including enrollment caps;
- the appeal of our curriculum and instructional model to students and families;
- the specific school or school district requirements including credit recovery or special needs;
- the effectiveness of our program in delivering favorable academic outcomes;
- the quality of the teachers working in the schools we serve;
- the effectiveness of our marketing and recruiting programs to attract new enrollments; and
- retention of students through successive grade levels.

In fiscal year 2016, total average student enrollments in Managed Public School Programs decreased by 11,644 or 10.2%, to 102,935 as compared to total average student enrollments of 114,579 in fiscal year 2015. The decline in enrollments largely resulted from the reclassification of Agora from Managed Public Schools Programs to a Non-Managed Public School Program based on a new service agreement further described below. We continually evaluate our trends in revenues by monitoring the number of student enrollments in total, by state, by school and by grade, assessing the impact of changes in school funding levels and the pricing of our curriculum and educational services. In fiscal years 2016 and 2015, the growth rate of our revenue exceeded the growth in our managed school average student enrollments primarily due to increases in the per-pupil rate of achieved state funding in certain states, school mix (distribution of enrollments by school) and other factors, including changes in state funding rates and higher utilization in federal and state restricted funding per managed student.

Enrollments in Managed Public School Programs on average generate substantially more revenues than enrollments served through our Institutional where we provide limited or no management services. Similarly, revenues earned per pupil across our private school programs vary. As we continue to build our Institutional and increase enrollment in Private Pay Schools and Other, enrollment mix is expected to shift and may impact growth in revenues relative to the growth in enrollments.

During the fiscal years ended June 30, 2016 and 2015, we had a contract with Agora Cyber Charter School (“Agora”) that represented approximately \$18.5 million and \$129.8 million of revenue, respectively.

In fiscal year 2015, Agora renegotiated its service agreement and entered into a three year contract with us to purchase our curriculum and certain technology services, while the school board assumed daily operational responsibilities, including its charter renewal process and marketing and enrollment activities.

The net impact of this event on the fiscal year 2016 revenues attributable to the loss of the management component of the Agora contract was approximately \$111 million.

Institutional

While Managed Public School Programs constitute the majority of our revenue, there is increasing demand by public school districts, public schools and other educational institutions for more limited components of our online services and products than are used in Managed Public School Programs. Sales to those entities are conducted through our Institutional business organization. While we expect long-term growth opportunities in our Institutional business, the sector continues to experience significant competitive pricing pressures.

The Institutional business portfolio contains an array of curriculum and technology solutions packaged in a portfolio of flexible learning and delivery models mapped to specific student, school and district needs. This portfolio provides a continuum of delivery models, from full and part-time virtual to blended learning and other options that can be used in traditional classrooms to differentiate instruction. The Institutional business course catalog is comprehensive and enables districts to offer their students educational opportunities that otherwise might not be financially justifiable, such as Advanced Placement (“AP”), honors, world languages, remediation, credit recovery, alternative education, career and technology electives and college readiness. In connection with these solutions, we also offer state-certified teachers, professional development and other support services as needed by our customers.

Given the variables discussed in further detail below, we believe that the best performance metric for the Institutional business is revenues. The customers served by the Institutional business organizations purchase curriculum in a variety of ways, making consistent comparisons on the basis of enrollments less relevant. For example, we serve not only full-time students, but also students taking semester-long courses, students who recover credits through concentrated four to eighteen-week programs, students who are using our curricula as a supplemental enhancement to their traditional textbook, and teachers who may present our lessons on an interactive whiteboard as either the core of their instruction or as an engaging supplement to their lecture. Given all these variables, it is therefore difficult to identify a single metric (such as a full time equivalent or “FTE”), or combination of metrics (such as course enrollments or programs sold), that can accurately capture the Institutional business. Therefore, our efforts to do so led us to the conclusion that at this time, revenue is the best performance metric for the Institutional business.

Sales opportunities in the Institutional business are driven by a number of factors in a diverse customer population, which determine the deliverable and price. These factors include:

- *Type of Customer*—A customer can be a U.S.-based public, private or public charter school, a district, regional education agency, or a commercial company that provides services to students.
- *Curriculum Needs*—We sell our curriculum solutions based on the scope of the customer need, and a solution is generally purchased as end-user access to a complete catalog, individual course or supplemental content title.
- *License Options*—Depending on the scope of the solution, a license can be purchased for individual course enrollments, annual seat, school or district-wide site licenses or a perpetual license (a prepaid lifetime license). We may charge incrementally if we are hosting the solution.
- *Hosting*—Customers may host curricula themselves or license our hosted solution. We are able to track all students for customers who use our hosted solution. However, more often in large-scale, district-wide implementations, a customer may choose to host the curriculum, and in that case we have no visibility of individual student usage for counting enrollments.

- *Services Menu*—Instructional services may be provided and priced per-enrollment or bundled in the overall price of the solution. Additional services, including professional development, title maintenance and support may also be provided and are priced based on the scope of services.

On June 9, 2016, Agora signed a new service agreement with us that extends through 2019 and included additional services including curriculum and certain technology services while the school board retained daily operational responsibilities. The agreement also calls for payment terms of outstanding receivables to be paid over an approximate two-year period resulting in reclassification of a portion to long-term assets (Deposits and other assets).

Private Pay Schools and Other

Private schools are managed schools where tuition is paid directly by the family of the student. We receive no public funds for students in our private schools. We operate three private online schools at differing price points and service levels. Our revenue is derived from tuition receipts that are a function of course enrollments and program price. In some circumstances, a third-party school may elect to enroll one of its students in a K¹² private school course as a supplement to the student's regular on-campus instruction. In such cases, the third-party school may pay the K¹² private school tuition.

We believe our revenue growth depends primarily on the recruitment of students into our programs through effective marketing and word-of-mouth referral based on the quality of our service. In addition, through high service quality, we seek to retain existing students and increase the total number of courses each student takes with us. In some cases, students return each summer and take only one course. In other cases, students choose a K¹² private school as their principal form of education and may stay for many years. The flexibility of our programs, the quality of our curriculum and teaching, and the student community features lead to customer satisfaction and therefore, retention.

We have entered into agreements which enable us to distribute our products and services to our international school partners throughout the world who use our courses as a supplement to their on-campus academic programs. These courses provide students with additional electives, AP courses, and sometimes include dual-degree programs that the school cannot offer on its own.

We sometimes offer additional teacher assistance, counseling, clubs and other additive services to our basic course offerings. We do not include students in our consumer sales business as we are not involved in the progress of these students in the same way as we do in our other programs.

Instructional Costs and Services Expenses

Instructional costs and services expenses include expenses directly attributable to the educational products and services we provide. The public schools we manage are the primary drivers of these costs, including teacher and administrator salaries and benefits and expenses of related support services. We also employ teachers and administrators for instruction and oversight in our Institutional business and Private Pay Schools and Other business. Instructional costs also include fulfillment costs of student textbooks and materials, depreciation and reclamation costs of computers provided for student use, the cost of any third-party online courses and the amortization of capitalized curriculum and related systems. Our instructional costs are variable and are based directly on our number of schools and enrollments.

Our high school offering requires increased instructional costs as a percentage of revenue compared to our kindergarten to 8th grade offering. This is due to the following: (i) generally lower student-to-teacher ratios; (ii) higher compensation costs for some teaching positions requiring subject-matter expertise; (iii) ancillary costs for required student support services, including college placement, SAT preparation and guidance counseling; (iv) use of third-party courses to augment our proprietary curriculum; and (v) use of a third-party learning management system to service high school students. Over time, we may partially offset these factors by obtaining productivity gains in our high school instructional

model, replacing third-party high school courses with proprietary content, replacing our third-party learning management system with another third-party system, leveraging our school infrastructure and obtaining purchasing economies of scale.

We have deployed and are continuing to develop new delivery models, including blended schools, where students receive limited face-to-face instruction in a learning center to complement their online instruction, and other programs that utilize brick and mortar facilities. The maintenance, management and operations of these facilities necessitate additional costs, which are generally not required to operate typical virtual public schools. We are pursuing expansion into new states for both virtual public and other specialized charter schools. If we are successful, we will incur start-up costs and other expenses associated with the initial launch of a school, including the funding of building leases and leasehold improvements.

Selling, Administrative and Other Operating Expenses

Selling, administrative and other operating expenses include the salaries and benefits of employees engaged in business development, public affairs, sales and marketing, and administrative functions and transaction and due diligence expenses related to mergers and acquisitions.

Product Development Expenses

Product development expenses include research and development costs and overhead costs associated with the management of both our curriculum development and internal systems development teams. In addition, product development expenses include the amortization of internal systems. We measure and track our product development expenditures on a per course or project basis to measure and assess our development efficiency. In addition, we monitor employee utilization rates to evaluate our workforce efficiency. We plan to continue to invest in additional curriculum development and related software in the future, primarily to produce additional high school courses, world language courses and new releases of existing courses and to continue to upgrade our content management system and online schools. We capitalize selected costs incurred to develop our curriculum, beginning with application development, through production and testing into capitalized curriculum development costs. We capitalize certain costs incurred to develop internal systems into capitalized software development costs.

Expense Management

We are constantly searching for ways to deliver more value at a lower cost for our customers and we take pride in our ability to deliver highly-individualized, effective education solutions at significant savings to taxpayers. We have sought to increase efficiencies whenever possible without affecting educational quality. We believe our scale and infrastructure investment positions us for greater efficiency in future periods while allowing us to deliver more value for students.

Critical Accounting Policies and Estimates

The discussion of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with U.S. GAAP. In the preparation of our consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, as well as the related disclosures of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The results of our analysis form the basis for making assumptions about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions, and the impact of such differences may be material to our consolidated financial statements. Our critical accounting policies have been discussed with the Audit Committee of our Board of Directors.

We believe that the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our consolidated financial statements:

Revenue Recognition

In accordance with Accounting Standards Codification (“ASC”) 605, *Revenue Recognition*, we recognize revenue when the following conditions are met: (1) persuasive evidence of an arrangement exists; (2) delivery of physical goods or rendering of services is complete; (3) the seller’s price to the buyer is fixed or determinable; and (4) collection is reasonably assured.

We have determined that the separate elements of our multiple element contracts with managed schools do not have standalone value. Accordingly, we account for revenues received under multiple element arrangements with managed schools as a single unit of accounting and recognize the entire arrangement over the term of the contractual service period. While we have concluded that the elements of our contracts do not have standalone value, we invoice schools in accordance with the established contractual terms and rates. Generally, this means that for each enrolled student, we invoice their school on a per student basis for the following items: (1) access to our online school and online curriculum; (2) learning kits; and (3) student computers. We also invoice for management and technology services. We apply ASC 605 to each of these items as follows:

- *Access to the Online School and Online Curriculum.* Our proprietary learning management system (“OLS”) revenues are generally earned on a per course basis from schools and school districts. Students enrolled through a school are provided access to the OLS and online curriculum. Revenues are earned ratably over the school year, typically 10 months, or over the semester depending on the length of the course.
- *Learning Kits.* The lessons in our online school are often accompanied with selected printed materials, workbooks, laboratory materials and other manipulative items which we provide to students. We generally ship all learning kits to a student when their enrollment is approved. Once materials have been shipped, our efforts are substantially complete. Therefore, we recognize revenues upon shipment. Shipments to schools that occur in the fourth fiscal quarter that are for the following school year are recorded in deferred revenues. We also earn reclamation fee income when we reclaim materials for schools at the end of the school year or when a student withdraws from the school.
- *Student Computers.* We provide many enrolled students with the use of a personal computer and complete technical support through our call center. Revenues are generally earned ratably over the school year and we also earn revenues for reclamation services when a student withdraws from a school and returns the computer which may occur in a subsequent school year.
- *Management, Technology and Educational Services.* Under most of our statewide virtual public and blended school contracts, we provide the boards of managed schools with turn-key management and technology services. We recognize these revenues ratably over our fiscal year as administrative offices of the school remain open for the entire year. Our management and technology service fees are generally a contracted percentage of yearly school funding. To determine the pro rata amount of revenues to recognize in a fiscal quarter, we estimate the total funds each school will receive in a particular school year. Total funds for a school are primarily a function of the number of students enrolled in the school and established per enrollment funding levels which are generally published on an annual basis by the state or school district.

To determine the pro rata amount of revenues to recognize in a fiscal quarter, we estimate the total funds each school will receive in a particular school year. Total funds for a school are primarily a function of the number of students enrolled in the school and established per enrollment funding levels which are generally published on an annual basis by the state or school district. We review our estimates of funding

periodically, and revise as necessary, amortizing any adjustments to earned revenues over the remaining portion of the fiscal year. Actual school funding may vary from these estimates, and the impact of these differences could have a material impact on our results of operations. Since the end of the school year coincides with the end of our fiscal year, annual revenues are generally based on actual school funding and actual costs incurred (including costs for our services to the schools plus other costs the schools may incur) in the calculation of school operating losses. Our schools reported results are subject to annual school district financial audits, which incorporate enrollment counts, funding and other routine financial audit considerations. The results of these audits are incorporated into our monthly funding estimates and for the reported fiscal years ended June 30, 2015, 2014 and 2013, our aggregate funding estimates differed from actual reimbursements impacting total reported revenue by 0.4%, (0.1%), and 0.2%, respectively.

Under the contracts where we provide turnkey management services to schools, we have generally agreed to absorb any operating losses of the schools in a given school year. These school operating losses represent the excess of costs incurred over revenues earned by the virtual or blended public school as reflected on its respective financial statements, including our charges to the schools. To the extent a school does not receive funding for each student enrolled in the school, the school would incur an operating loss for the unfunded enrollment. If losses due to unfunded enrollments result in a net operating loss for the year that loss is reflected as a reduction in the revenue and net receivables that we collect from the school. A school net operating loss in one year does not necessarily mean we anticipate losing money on the entire contract with the school. However, a school operating loss may reduce our ability to collect its management fees in full and recognized revenues are reduced accordingly to reflect the expected cash collections from such schools. We amortize the estimated school operating loss against revenues based upon the percentage of actual revenues in the period to total estimated revenues for the fiscal year.

For turnkey revenue service contracts, a school operating loss may reduce our ability to collect our management fees in full though as noted it does not necessarily mean that we incur a loss during the period with respect to our services to that school. We recognize revenue, net of our estimated portion of school operating losses, to reflect the expected cash collections from such schools. Revenue is recognized based on our performance of services under the contract, which we believe is proportionate to our incurrence of costs. We incur costs directly related to the delivery of services. Most of these costs are recognized throughout the year; however, certain costs related to upfront delivery of printed materials, workbooks, laboratory materials and other items are provided at the beginning of the school year and are recognized as expense when shipped.

Each state or school district has variations in the school funding formulas and methodologies that we use to estimate funding for revenue recognition at our respective schools. As we build the funding estimates for each school, we are mindful of the state definition for count dates on which reported enrollment numbers will be used for per pupil funding. The parameters we consider in estimating funding for revenue recognition purposes include school district count definitions (which may vary by district and by state), withdrawal rates, average daily attendance, special needs enrollment, student demographics, progress trajectory and historical completion, student location, funding caps and other state specified categorical program funding. We consider the latest information available to us and other material relevant information at the time of the estimates we make each period on a school-by-school basis.

Management periodically reviews its estimates of full-year school revenues and operating expenses and amortizes the net impact of any changes to these estimates over the remainder of the fiscal year. Actual school operating losses may vary from these estimates or revisions, and the impact of these differences could have a material impact on results of operations. Since the end of the school year coincides with the end of our fiscal year, annual revenues are generally based on actual school funding and actual costs incurred (including costs for our services to the schools plus other costs the schools may incur) in the calculation of school operating losses. For the years ended June 30, 2016, 2015 and 2014, our revenue included a reduction for these school operating losses of \$57.1 million, \$65.2 million and \$49.8 million, respectively.

A school operating loss may result from a combination of cost increases or funding reductions attributable to the following:

- costs associated with opening new schools including the initial hiring of teachers, administrators and the establishment of school infrastructure;
- school requirements to establish contingency reserves;
- one-time costs, such as legal claims;
- funding reductions due to the inability to qualify specific students for funding;
- regulatory or academic performance thresholds that may restrict the ability of a school to fund all expenses;
- inadequate school funding in particular states;
- providing services without receiving state funding when enrollments occur after enrollment count dates; and
- burdensome regulations creating excessive costs.

We generate a small percentage of our revenues from the sale of perpetual licenses of curriculum and ongoing support to schools. We account for the license and support of separate units of accounting and recognize revenues associated with the license up front and ongoing maintenance and support over the performance period. We also generate a small percentage of our revenues through the sale of our online courses and learning kits directly to consumers, as well as providing hosting services to certain customers. We record revenue for consumer services over the term of the course subscription.

For the year ended June 30, 2016, special education students comprise approximately 13% of our student population and approximately 19% of estimated funding for revenue recognition purposes at our schools. We compute revenue at the school level not based on the type of student served; therefore, we are unable to determine the revenue and profitability by student type. For each student enrolled, we receive basic per pupil funds determined by state funding and count definitions, and policies which vary from state-to-state. Additionally, based on the needs of the student population, we may receive supplemental special education state funding grants and federal funding under the Individuals with Disabilities Act. While we do not track profitability at the student level, these supplemental funding programs are intended to offset part of the costs of the education needs of children with learning disabilities through reimbursement of qualifying costs under the programs.

Capitalized Curriculum Development Costs

Our curriculum is primarily developed by our employees and, to a lesser extent, by independent contractors. Generally, our courses cover traditional subjects and utilize examples and references designed to remain relevant for long periods of time. The online nature of our curriculum allows us to incorporate user feedback rapidly and make ongoing corrections and improvements. For these reasons, we believe that our courses, once developed, have an extended useful life, similar to computer software. We also publish textbooks and other offline materials. Our curriculum is integral to our learning systems. Our customers generally do not acquire our curriculum or future rights to it.

Due to the similarity in development stages and long economic life of curriculum to computer software, we capitalize curriculum development costs incurred during the application development stage in accordance with ASC 350, Intangibles—Goodwill and Other. ASC 350 provides guidance for the treatment of costs associated with computer software development and defines those costs to be capitalized and those to be expensed. Costs that qualify for capitalization are external direct costs, payroll and payroll-related costs. Costs related to general and administrative functions are not capitalizable and are expensed as incurred. We capitalize curriculum development costs during the design, development and deployment

phases of the project. Many of our new courses leverage off of proven delivery platforms and are primarily content, which has no technological hurdles. As a result, a significant portion of our courseware development costs qualify for capitalization due to the concentration of our development efforts on the content of the courseware. Capitalization ends when a course is available for general release to our customers, at which time amortization of the capitalized costs begins. Capitalized costs are recorded in capitalized curriculum development costs. The period of time over which these development costs will be amortized is generally five years. This is consistent with the capitalization period used by others in our industry and corresponds with our product development lifecycle. We wrote down approximately \$2.6 and \$2.2 million of capitalized curriculum development costs due to its decision to discontinue certain curriculum during the fiscal years ended June 30, 2015 and 2014, respectively. There were no material write-downs of capitalized curriculum development costs for the fiscal year ended June 30, 2016.

Software Developed or Obtained for Internal Use

We develop our own proprietary computer software programs to provide specific functionality to support both our unique education offerings and the student and school management services. These programs enable us to develop courses, process student enrollments, meet state documentation requirements, track student academic progress, deliver online courses to students, coordinate and track the delivery of course-specific materials to students and provide teacher support and training. These applications are integral to our learning systems and we continue to enhance existing applications and create new applications. Our customers do not acquire our software or future rights to it.

We capitalize software development costs incurred during development in accordance with ASC 350. These capitalized development costs are included in capitalized software development costs and are generally amortized over three years. During the fiscal year ended June 30, 2016, 2015 and 2014 we wrote down approximately 0.5 million, zero and 3.8 million, respectively, of capitalized software projects after determining the assets either have no future use or are being sunset.

Impairment of Long-lived Assets

Long-lived assets include property, equipment, capitalized curriculum and software developed or obtained for internal use. In accordance with ASC 360, *Property, Plant and Equipment*, we review our recorded long-lived assets for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. We determine the extent to which an asset may be impaired based upon our expectation of the asset's future usability as well as on a reasonable assurance that the future cash flows associated with the asset will be in excess of its carrying amount. 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. We wrote down approximately \$2.6 million of capitalized curriculum development costs due to its decision to discontinue certain curriculum during the fiscal years ended June 30, 2015. During the fiscal years ended June 30, 2016, 2015 and 2014 we wrote down approximately zero, \$4.8 million and \$3.8 million, respectively, of capitalized software projects after determining the assets either have no future use. During the fiscal year ended June 30, 2015, we wrote down approximately \$6.5 million primarily related to computer peripherals shipped to students and for which no reclamation will be processed. There was no such write-down during fiscal year ended June 30, 2016 and 2014.

Income Taxes

We account for income taxes in accordance with ASC 740, *Income Taxes*. ASC 740 prescribes the use of the asset and liability method to compute the differences between the tax bases of assets and liabilities and the related financial amounts, using currently enacted tax laws. If necessary, a valuation allowance is established, based on the weight of available evidence, to reduce deferred tax assets to the amount that is more likely than not to be realized. Realization of the deferred tax assets, net of deferred tax liabilities, is

principally dependent upon achievement of sufficient future taxable income. We exercise significant judgment in determining our provisions for income taxes, our deferred tax assets and liabilities and our future taxable income for purposes of assessing our ability to utilize any future tax benefit from our deferred tax assets.

Although we believe that our tax estimates are reasonable, the ultimate tax determination involves significant judgments that could become subject to examination by tax authorities in the ordinary course of business. We periodically assess the likelihood of adverse outcomes resulting from these examinations to determine the impact on our deferred taxes and income tax liabilities and the adequacy of our provision for income taxes. Changes in income tax legislation, statutory income tax rates or future taxable income levels, among other things, could materially impact our valuation of income tax assets and liabilities and could cause our income tax provision to vary significantly among financial reporting periods.

We have a valuation allowance on net deferred tax assets of \$4.3 million and \$2.8 million as of June 30, 2016 and 2015, respectively, for the amount that more likely than not will not be realized.

Stock-based Compensation

We recognize stock-based compensation expense under the provisions of ASC 718, *Compensation—Stock Compensation*. We use the Black-Scholes option pricing model to calculate the fair value of stock options at their respective grant date. The use of option valuation models requires the input of highly subjective assumptions, including the expected stock price volatility and the expected term of the option. The fair value of restricted stock awards is the fair market value on the date of grant. We recognize these compensation costs on a straight-line basis over the requisite service period, which is generally the vesting period of the award. During 2014 to 2016, we granted more restricted stock awards than stock options, resulting in increased stock-based compensation that will be recognized over the required service periods. In addition, the vesting period is generally three years for restricted stock compared to four years for stock options. The increase in restricted stock awards and the shorter vesting period has increased our stock-based compensation costs, and this increased cost is expected to continue in future periods.

Goodwill and Other Intangible Assets

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. Finite-lived intangible assets include the trade names, customer contracts and curriculum and such intangible assets are amortized on a straight-line basis over their estimated useful lives. We periodically evaluate the remaining useful lives of intangible assets and adjust our amortization period if it is determined that such intangible assets have a shorter useful life. We evaluate the recoverability of our recorded goodwill and other intangible assets annually, or whenever a triggering event of impairment may occur. The Company has determined it has two reporting units K12 and Middlebury. We apply a two-step approach in testing goodwill for impairment for each reporting unit. The first step tests for potential impairment by comparing the fair value of reporting units with reporting units' net asset values. If the fair value of the reporting unit exceeds the carrying value of the reporting unit's net assets, then goodwill is not impaired and no further testing is required. If the fair value of reporting unit is below the reporting unit's carrying value, then the second step is required to measure the amount of potential impairment. The second step requires an assignment of the reporting unit's fair value to the reporting unit's assets and liabilities, using the initial acquisition accounting guidance related to business combinations, to determine the implied fair value of the reporting unit's goodwill. The implied fair value of the reporting unit's goodwill is then compared with the carrying amount of the reporting unit's goodwill to determine the goodwill impairment loss to be recognized, if any. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, we record an impairment loss equal to the difference. During the fiscal year ended June 30, 2015, we used a qualitative approach to evaluate goodwill for impairment. During the fiscal year ended June 30, 2016 we performed step one of the impairment test. The estimated

K12 reporting unit fair value exceeded its carrying value by approximately 10.2% and Middlebury reporting unit exceeded its fair value by approximately 29.8%. Based on the test results, our reporting units passed step one of the impairment test and no further testing was required. There were no impairment charges for the years ended June 30, 2016 and 2015. During the fiscal year ended June 30, 2014, we determined that based on rebranding of the Institutional business, we fully amortized certain trade names that are no longer going to be used and recorded a \$5.2 million impairment charge for the fiscal year ended June 30, 2014. During the fiscal year ended June 30, 2014, we also sold certain business assets and wrote off approximately \$3.4 million of goodwill and \$0.4 million of net intangible assets related to the assets of the business that were sold.

Consolidation of Noncontrolling Interest

Our consolidated financial statements reflect the results of operations of our Middle East, Middlebury Interactive Languages, LearnBop joint ventures. The Middle East joint venture was sold in June 2014. Earnings or losses attributable to our partners are classified as “net loss attributable to noncontrolling interest” in the accompanying consolidated statements of operations. Net income or net loss attributable to noncontrolling interest adjusts our consolidated net results of operations to reflect only our share of the after-tax earnings or losses of an affiliated company.

Redeemable Noncontrolling Interest

The joint venture agreement with Middlebury College stipulates, starting at any time after the May 2015, Middlebury may give written notice of its irrevocable election to sell all of its Membership Interest to us (put right). The purchase price for Middlebury’s Membership Interest shall be its fair market value and we may, in our sole discretion, pay the purchase price in cash or shares of the our common stock. On May 4, 2015, Middlebury College, under the joint venture agreement, exercised its right to require us to purchase all of its ownership interest in our joint venture.

The redeemable noncontrolling interests are redeemable outside of the Company’s control. Because of this the Company records the redemption fair value outside of permanent equity in accordance with ASC 480-10-S99. The Company adjusts the redeemable noncontrolling interests to redemption value on each balance sheet date with changes in redemption values recognized as an adjustment to retained earnings, or in the absence of retained earnings, by adjustment to additional paid-in-capital. The estimated redeemable noncontrolling interest was \$6.8 million as of June 30, 2016 and June 30, 2015.

At June 30, 2016, the Company was still in discussions with Middlebury to settle the terms under the put right; the outcome of which could result in a value different than the value of the redeemable noncontrolling interest. There has been no change in the estimated fair value of the noncontrolling interest since June 30, 2015. The Company has the right to pay the redemption cost in cash, stock or a combination thereof, at the Company’s option, which form of consideration has not yet been determined.

On July 31, 2014, we acquired a 51% interest in LearnBop, Inc. (“LearnBop”) The purpose of the acquisition was to complement our K-12 math curriculum as LearnBop has developed an adaptive math curriculum learning software. As part of this transaction, the non-controlling shareholders have a non-transferable put right to sell the remaining minority interest to us, which is exercisable between July 31, 2018 and December 31, 2018. The price of the put right will be determined based on the trailing twelve month revenue and contribution margin as defined in the Stockholders’ Agreement between us and LearnBop. Additionally, we have a non-transferable call option to purchase the remaining minority interest at a price of \$3.0 million, which becomes exercisable January 1, 2019 or thereafter. The redeemable value as of the end of each fiscal year is based on the estimated value of the put right, while the redeemable value during interim periods is based on management updates from the date of the most recent internal valuation. As of June 30, 2016, the estimated redeemable noncontrolling interest was approximately \$0.7 million.

Segment Reporting

We operate in one operating and reportable business segment: we are a technology-based education company. We offer proprietary curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade, or K-12. We have the following three lines of business: Managed Public School Programs, Institutional and Private Pay Schools and Other. Our Chief Executive Officer is the Chief Operating Decision Maker (the “CODM”). Our CODM manages our business primarily by function and reviews financial information on a consolidated basis, accompanied by disaggregated information on revenues by line of business as well as certain operational data, for purposes of allocating resources and evaluating financial performance. The CODM only evaluates profitability based on consolidated results.

Results of Operations

We have three lines of business: Managed Public School Programs, Institutional (educational products and services provided to school districts, public schools and other educational institutions that we do not manage), and Private Pay Schools and Other (private schools for which we charge student tuition and make direct consumer sales).

Managed Public School Programs	Institutional	Private Pay Schools and Other
<ul style="list-style-type: none"> • Virtual schools • Blended schools <ul style="list-style-type: none"> —Hybrid schools —Passport schools 	<ul style="list-style-type: none"> • Non-managed Public School Programs • Institutional software and services 	<ul style="list-style-type: none"> • Managed private schools <ul style="list-style-type: none"> —K¹² International Academy —George Washington University Online High School —The Keystone School • Independent course sales (Consumer)

Enrollment Data

The following table sets forth total enrollment data for students in our Managed Public School Programs and Non-managed Public School Programs. Managed Public School Programs include schools where K12 provides substantially all of the management, technology and academic support services in addition to curriculum, learning systems and instructional services. Non-managed Public School Programs include schools where K12 provides curriculum and technology, and the school can also contract for instruction or other educational services. Non-managed Public School Programs, however, do not offer primary administrative oversight services.

	Year ended		Growth	
	June 30,		2016/2015	
	2016	2015	Change \$	Change %
Managed Public School Programs(1)(2) . . .	102,935	114,579	(11,644)	(10.2)%
Non-managed Public School Programs(1) . .	26,970	20,053	6,917	34.5%

- (1) If a school changes from a Managed to a Non-managed Program, the corresponding enrollment classification would change in the period in which the contract arrangement changed.
- (2) Managed Public School Programs include enrollments for which K12 receives no public funding or revenue

Revenue by Business Lines

Revenue is captured by business line based on the underlying customer contractual agreements. Periodically, a customer may change business line classification. For example, a district that purchases a single course (Institutional business customer) may decide to convert to a full-time virtual school program

(Managed Public School customer). Changes in business line classification occur at the time the contractual agreement is modified. The following represents our revenue for our three lines of business for the fiscal year ended June 30, 2016 and 2015.

(\$ in thousands)	Year ended		Growth	
	June 30,		2016 / 2015	
	2016	2015	Change \$	Change %
Managed Public School Programs	\$717,059	\$813,677	\$(96,618)	(11.9)%
Institutional				
Non-managed Public School Programs	55,601	39,321	16,280	41.4%
Institutional Software & Services	52,990	48,770	4,220	8.7%
Total Institutional	108,591	88,091	20,500	23.3%
Private Pay Schools and Other	47,050	46,526	524	1.1%
Total	<u>\$872,700</u>	<u>\$948,294</u>	<u>\$(75,594)</u>	<u>(8.0)%</u>

Beginning in fiscal 2016, the Company presented revenue from Non-managed Public School Programs as part of the Institutional line of business, along with the Institutional Software and Services, which together constitute total Institutional revenue. In the prior year these revenues were presented as part of the Public School Programs line of business, which included both managed and non-managed public school programs. We believe this revised presentation clarifies and better aligns the disclosure of Non-Managed Program revenues with the Company's operational and sales structure.

The following table sets forth statements of operations data and the amounts as a percentage of revenues for each of the periods indicated:

	Year Ended June 30,					
	2016		2015		2014	
	(Dollars in thousands)					
Revenues	\$872,700	100.0%	\$948,294	100.0%	\$919,553	100.0%
Cost and expenses						
Instructional costs and services	546,510	62.6%	607,756	64.1%	569,219	61.9%
Selling, administrative and other operating expenses	302,205	34.6%	307,730	32.5%	313,258	34.1%
Product development expenses	10,071	1.2%	14,381	1.5%	14,220	1.5%
Total costs and expenses	<u>858,786</u>	<u>98.4%</u>	<u>929,867</u>	<u>98.1%</u>	<u>896,697</u>	<u>97.5%</u>
Income from operations	13,914	1.6%	18,427	1.9%	22,856	2.5%
Realized gain on sale of assets	—	0.0%	—	0.0%	6,404	0.7%
Interest expense, net and other	(617)	(0.1)%	(3,291)	(0.3)%	(69)	0.0%
Income before income tax expense and noncontrolling interest	13,297	1.5%	15,136	1.6%	29,191	3.2%
Income tax expense	(4,746)	(0.5)%	(5,810)	(0.6)%	(11,075)	(1.2)%
Net income	8,551	1.0%	9,326	1.0%	18,116	2.0%
Add net loss attributable to noncontrolling interest	484	0.1%	1,662	0.2%	1,484	0.1%
Net income attributable to common stockholders	<u>\$ 9,035</u>	<u>1.1%</u>	<u>\$ 10,988</u>	<u>1.2%</u>	<u>\$ 19,600</u>	<u>2.1%</u>

Comparison of Years Ended June 30, 2016 and 2015

Revenues. Our revenues for the year ended June 30, 2016 were \$872.7 million, representing a decrease of \$75.6 million, or 8.0%, from \$948.3 million for the year ended June 30, 2015. Managed Public School Program revenue decreased \$96.6 million, or (11.9) %, year over year. The decline in Managed Public School Programs revenue was primarily attributable to the 10.2% decline in enrollments, largely resulting from the loss of the management component of the Agora contract, offset in part by increases in the per pupil rate of achieved state funding in certain states. The full fiscal year net impact of the Agora program transition to a non-managed program resulting in an approximate decrease of \$111 million of total revenue from the prior year.

We provide the schools and school boards we serve with academic programs sufficiently rigorous to yield strong academic results. These challenging performance expectations for students in a virtual public school can result in parents opting to withdraw their students from a managed public school and enroll in other school options. We have also seen some of our virtual public schools transition from Managed Public School Programs to self-administered schools by seeking competitive alternatives to portions of the products and services now entirely provided by us. While any one of these factors alone is not necessarily indicative of a material trend in the growth rate in enrollments, continuing to experience a combination of these factors could negatively impact enrollment growth, revenues and operating income. There also is increasing competition from several sources including online or blended offerings by traditional public schools that are recognizing the value of online study and curriculum delivery.

Institutional revenue increased \$20.5 million, or 23.3% from the prior year primarily due to transition of the Agora contract from a managed to non-managed programs.

Instructional Costs and Services Expenses. Instructional costs and services expenses for the year ended June 30, 2016 were \$546.5 million, representing a decrease of \$61.3 million, or 10.1%, from \$607.8 million for the year ended June 30, 2015. This decrease in expense was primarily associated with the transition of the Agora contract from managed to non-managed programs. Additionally, during the year ended June 30, 2015, there was \$9.6 million of expense related to accelerated depreciation and amortization for certain curriculum, learning systems and other fixed assets that will no longer be used or developed, computers that we estimated would not be returned and additional provisions for the decision to discontinue certain products and for excess inventory relative to anticipated demand. Instructional costs and services expenses were 62.6% of revenue during the year ended June 30, 2016, a decrease from 64.1% for the year ended June 30, 2015. Excluding the impact of the charges noted above, instructional costs and services were 62.6% and 63.1% of revenue for the years ended June 30, 2016 and 2015.

Selling, Administrative, and Other Operating Expenses. Selling, administrative, and other operating expenses for the year ended June 30, 2016 were \$302.2 million, representing a decrease of \$5.5 million, or 1.8%, from \$307.7 million for the year ended June 30, 2015. Included in expenses for the year ended June 30, 2016 was \$7.1 million of expense related to the Settlement Agreement with the State of California. Included in expenses for the year ended June 30, 2015 was \$7.5 million of expense related to uncollectible receivables, as well as \$4.8 million for the write-off of capitalized software that will no longer be developed. Selling, administrative, and other operating expenses were 34.6% of revenue during the year ended June 30, 2016, an increase from 32.5% for the year ended June 30, 2015. This increase of expenses as a percentage to revenue was primarily attributable to the legal settlement described above.

Product Development Expenses. Product development expenses for the year ended June 30, 2016 were \$10.1 million, representing a decrease of \$4.3 million, or 29.9% from \$14.4 million for the year ended June 30, 2015. As a percentage of revenue product development expenses decreased to 1.2% for the year ended June 30, 2016, as compared to 1.5% for the year ended June 30, 2015.

Interest Expense, net and Other. Net interest expense for the year ended June 30, 2016 was \$0.6 million as compared to net interest expense of \$3.3 million in the same period in the prior year, a

decrease of \$2.7 million. Net interest expense for the year ended June 30, 2015 comprised primarily of \$3.2 million interest income write off for Web International Education Group, Ltd investment partially offset by \$0.4 million income from Web investment.

Income Tax Expense. We had an income tax expense of \$4.7 million for the year ended June 30, 2016, or 35.7% of income before taxes, as compared to income tax expense of \$5.8 million, or 38.4% of our income before taxes for the year ended June 30, 2015. Our overall effective tax rate decreased from the prior year primarily due to decreases in unrecognized tax benefits primarily resulted from audit resolution in a certain foreign jurisdiction, additional tax benefits related to research activities of the Company, and provision true ups.

Net Income. Net income was \$8.6 million for the year ended June 30, 2016, compared to net income of \$9.3 million for the year ended June 30, 2015, a decrease of \$0.7 million, due to the factors noted above.

Noncontrolling Interest. Net loss attributable to noncontrolling interest for the year ended June 30, 2016 was \$0.5 million as compared to net loss attributable to noncontrolling interest of \$1.7 million for the same period in the prior year. Noncontrolling interest reflects the after-tax losses attributable to minority interest owners in our investments.

Comparison of Years Ended June 30, 2015 and 2014

Revenues. Our revenues for the year ended June 30, 2015 were \$948.3 million, representing an increase of \$28.7 million, or 3.1%, from \$919.6 million for the year ended June 30, 2014. Public School Program revenue increased \$30.3 million, or 3.7%, year over year. The growth in Managed Public School Program revenue was primarily attributable to increases in achieved funding in certain states, among other factors, while overall enrollments slightly increased by 0.7%. Managed Program enrollments declined 3.9%, while corresponding revenue increased 2.5% for the year ended June 30, 2015 compared to 2014 due primarily to increases in the per-pupil rate of achieved state funding in certain states, school mix (distribution of enrollments by school), and other factors. We attribute the decline in our Managed Public School Programs enrollments to a number of events unrelated to market demand, such as the imposition in Tennessee of an enrollment cap midway through the enrollment season, and a delay in the grant of a charter impacting our attendant service contract and start of enrollments for a school in Colorado. In addition, we provide the schools and school boards we serve with academic programs sufficiently rigorous to yield strong academic results. These challenging performance expectations for students in a virtual public school can result in parents opting to withdraw their students from a managed public school and enroll in other school options. We have also seen some of our virtual public schools transition from Managed Public School Programs to self-administered schools by seeking competitive alternatives to portions of the products and services now entirely provided by us. While any one of these factors alone is not necessarily indicative of a material trend in the growth rate in enrollments, continuing to experience a combination of these factors could negatively impact enrollment growth, revenues and operating income. There also is increasing competition from several sources including online or blended offerings by traditional public schools that are recognizing the value of online study and curriculum delivery.

Institutional revenue increased \$0.2 million, or 0.5% from the year ended June 30, 2014. Excluding the effect from the sale of certain businesses that were included in the prior period revenue, Institutional increased \$4.3 million, or 9.6%. Private Pay Schools and Other revenue decreased \$1.8 million, or 3.7%, from the prior year due to the sale of certain businesses. Excluding the effect from the sale of certain businesses that were included in the prior period revenue, Private Pay Schools and Other revenue increased \$11.1 million, or 31.3%.

Instructional Costs and Services Expenses. Instructional costs and services expenses for the year ended June 30, 2015 were \$607.8 million, representing an increase of \$38.6 million, or 6.8%, from \$569.2 million for the year ended June 30, 2014. During the year ended June 30, 2015, there was \$9.6 million of expense related to accelerated depreciation and amortization for certain curriculum, learning systems and other fixed assets that will no longer be used or developed, computer peripherals that will not be reclaimed, and for excess inventory relative to anticipated demand. During the year ended June 30, 2014, there was \$18.6 million of expense related to accelerated depreciation and amortization for certain curriculum, learning systems and other fixed assets that will no longer be used or developed, computers that we estimated would not be returned and additional provisions for the decision to discontinue certain products and for excess inventory relative to anticipated demand. Excluding the impact of the charges noted above, instructional costs and services would have increased \$47.7 million, or 8.7%. The increase in expense was primarily associated with the increased hiring of teachers and instructional support staff, increases in salary and other personnel benefits and increased special education and other related service fees in our Managed Public School Programs as part of our initiatives to improve the student experience and academic outcome. Instructional costs and services expenses were 64.1% of revenue during the year ended June 30, 2015, an increase from 61.9% for the year ended June 30, 2014. Excluding the impact of the charges noted above, instructional costs and services were 63.1% and 59.9% of revenue for the years ended June 30, 2015 and 2014.

Selling, Administrative, and Other Operating Expenses. Selling, administrative, and other operating expenses for the year ended June 30, 2015 were \$307.7 million, representing a decrease of \$5.6 million, or 1.8%, from \$313.3 million for the year ended June 30, 2014. During the year ended June 30, 2015, there was \$7.5 million of expense related to uncollectible receivables, as well as \$4.8 million for the write-off of capitalized software that will no longer be developed. Also included in expense during the year ended June 30, 2015 was \$3.4 million related to severance and accelerated stock compensation costs for executives and other employees. Included in expense during the year ended June 30, 2014 was \$7.4 million related to severance and accelerated stock compensation costs for the termination of employment of our former Chief Executive Officer and other employees, and \$5.2 million related to an impairment charge on trade names that were to no longer be used. Excluding the charges noted above, selling, administrative, and other operating expenses decreased \$8.7 million, or 2.9% for the year ended June 30, 2015 as compared to the year ended June 30, 2014. Selling, administrative, and other operating expenses were 32.5% of revenue during the year ended June 30, 2015, a decrease from 34.1% for the year ended June 30, 2014. Excluding the impact of the charges noted above, selling, administrative, and other operating expenses were 30.8% and 32.7% of revenue for the years ended June 30, 2015 and 2014. The reduction as a percentage of revenue primarily reflects our overall cost savings initiatives.

Product Development Expenses. Product development expenses for the year ended June 30, 2015 were \$14.4 million, representing an increase of \$0.2 million, or 1.4% from \$14.2 million for the year ended June 30, 2014. As a percentage of revenues, product development expenses remained flat at 1.5% for the year ended June 30, 2015, as compared to the same period in the prior year.

Interest Expense, net and Other. Net interest expense for the year ended June 30, 2015 was \$3.3 million as compared to net interest expense of \$0.1 million in the same period in the prior year. Net interest expense was primarily associated with the write-off of approximately \$3.2 million in previously recorded interest income related to our investment in Web International Education Group, Ltd., as well as interest expense on our student computer capital leases.

Income Tax Expense. We had an income tax expense of \$5.8 million for the year ended June 30, 2015, or 38.4% of income before taxes, as compared to income tax expense of \$11.1 million, or 37.9% of our income before taxes for the year ended June 30, 2014.

Net Income. Net income was \$9.3 million for the year ended June 30, 2015, compared to net income of \$18.1 million for the year ended June 30, 2014, a decrease of \$8.8 million. During the fiscal year ended June 30, 2014, we sold certain businesses which were approximately break-even.

Noncontrolling Interest. Net loss attributable to noncontrolling interest for the year ended June 30, 2015 was \$1.7 million as compared to net loss attributable to noncontrolling interest of \$1.5 million for the year ended June 30, 2014. Noncontrolling interest reflects the after-tax losses attributable to minority interest owners in our investments.

Discussion of Seasonality of Financial Condition

Certain accounts in our balance sheet are subject to seasonal fluctuations. As our enrollments and revenues grow, we expect these seasonal trends to be amplified. The bulk of our materials are shipped to students prior to the beginning of the school year, usually in July or August. In order to prepare for the upcoming school year, we generally build up inventories during the fourth quarter of our fiscal year. Therefore, inventories tend to be at the highest levels at the end of our fiscal year. In the first quarter of our fiscal year, inventories tend to decline significantly as materials are shipped to students. In our fourth quarter, inventory purchases and the extent to which we utilize early payment discounts will impact the level of accounts payable.

Accounts receivable balances tend to be at the highest levels in the first quarter of our fiscal year as we begin billing for all enrolled students and our billing arrangements include upfront fees for many of the elements of our offering. These upfront fees result in seasonal fluctuations to our deferred revenue balances. We routinely monitor state legislative activity and regulatory proceedings that might impact the funding received by the schools we serve and to the extent possible, factor potential outcomes into our business planning decisions.

Generally, deferred revenue balances related to the schools tend to be highest in the first quarter, when the majority of students enroll. Since the deferred revenue is amortized over the course of the school year, which typically ends in May or June, the balance is normally at its lowest at the end of our fiscal year. Generally, deferred revenues from virtual and blended public schools have not been a source of liquidity as most schools receive their funding over the course of the school year.

The deferred revenue related to our direct-to-consumer business results from advance payments for twelve month subscriptions to our online school. These advance payments are amortized over the life of the subscription and tend to be highest at the end of the fourth quarter and first quarter, when the majority of subscriptions are sold.

Liquidity and Capital Resources

As of June 30, 2016, we had net working capital, or current assets minus current liabilities, of \$322.8 million. Our working capital includes cash and cash equivalents of \$214.0 million, including \$4.1 million associated with our two joint ventures, and accounts receivable of \$169.6 million. Our working capital provides a significant source of liquidity for our normal operating needs. Our accounts receivable balance fluctuates throughout the fiscal year based on the timing of customer billings and collections and tends to be highest in our first fiscal quarter as we begin billing for students. In addition, our cash and accounts receivable were significantly in excess of our accounts payable and short-term accrued liabilities at June 30, 2016.

On January 31, 2014, we executed a \$100.0 million unsecured line of credit to be used for general corporate operating purposes with Bank of America, N.A. (“BOA”). The line has a five-year term, bears interest at the higher of the Bank’s prime rate plus 0.25%, or the Federal Funds Rates plus 0.75%, or the LIBOR rate plus 1.25%; and incorporates customary financial and other covenants, including but not

limited to a maximum debt leverage and a minimum fixed charge coverage ratio. As of June 30, 2016, we were in compliance with these covenants and we had no borrowings outstanding on the line of credit.

We incur capital lease obligations for student computers under a lease line of credit with PNC Equipment Finance, LLC with annual lease availability limits. We had \$35.0 million of availability for new leasing during fiscal year 2016. Interest rates on the new borrowings were based upon an initial rate of 2.34% modified by changes in the three year interest rate swaps rate as published in the Federal Reserve Statistical Release H.15, "Selected Interest Rates," between June 25, 2015 and the Lease Commencement Date, as defined in the lease line of credit. This availability originally expired in July 2015, but was extended to July 2017. Interest rates on the new borrowings beginning in August 2016 under the extended agreement are based upon an initial rate of 1.88% modified by changes in the three year interest rate swaps rate as published in the Federal Reserve Statistical Release H.15, "Selected Interest Rates," between April 29, 2016 and the Lease Commencement Date, as defined in the lease line of credit.

As of June 30, 2016, the aggregate outstanding balance under the lease lines of credit was \$23.1 million. Borrowings bore interest at rates ranging from 1.95% to 2.88% and included a 36-month payment term with a \$1 purchase option at the end of the term. We have pledged the assets financed to secure the outstanding leases. We may extend our lease line of credit for additional periods, or consider alternative arrangements for financing student computers.

On November 4, 2013, the Board of Directors authorized the repurchase of up to \$75.0 million of our outstanding common stock over a two year period. Any purchases under the buyback are dependent upon business and market conditions and other factors. The stock purchases are made from time to time and may be made through a variety of methods including open market purchases and trading plans that may be adopted in accordance with the Rule 10b-18 of the Exchange Act. For the year ended June 30, 2015, we paid approximately \$26.5 million in cash to redeem 1,307,402 shares of common stock at an average price of \$20.23 per share. As of June 30, 2016 total shares purchased under the plan were 3,502,598, at an average cost of \$21.41 per share, and there were no shares remaining to be repurchased under the plan.

Our cash requirements consist primarily of day-to-day operating expenses, capital expenditures and contractual obligations with respect to office facility leases, capital equipment leases and other operating leases. We expect to make future payments on existing leases from cash generated from operations. We believe that the combination of funds to be generated from operations, net working capital on hand and access to our line of credit will be adequate to finance our ongoing operations for the foreseeable future. In addition, to a lesser degree, we continue to explore acquisitions, strategic investments and joint ventures related to our business that we may acquire using cash, stock, debt, contribution of assets or a combination thereof.

On May 4, 2015, Middlebury College, under the joint venture agreement, exercised its right to require us to purchase all of its ownership interest in our joint venture. We have the right to pay the redemption cost in cash, stock or a combination thereof, at our option, which form of consideration has not yet been determined.

Operating Activities

Net cash provided by operating activities for the years ended June 30, 2016, 2015 and 2014 was \$121.8 million, \$120.1 million and \$122.9 million, respectively.

Net cash provided by operating activities for the year ended June 30, 2016 was \$121.8 million compared to \$120.1 million for the year ended June 30, 2015. The increase of \$1.7 million in cash provided by operations between periods was primarily attributable to changes in working capital which increased approximately \$26.7 million, offset by decrease in net income including non-cash adjustments which decreased approximately \$25.0 million. These changes in working capital were primarily attributable to the timing of cash payments related to accounts receivable and accounts payable offset by increased accrued

liabilities. Cash from operations is impacted by the timing of cash collections from products and services provided and payment of operating costs to fund the continued growth and expansion of our business.

Net cash provided by operating activities for the year ended June 30, 2015 was \$120.1 million compared to \$122.9 million for the year ended June 30, 2014. The decrease of \$2.8 million in cash provided by operations between periods was primarily attributable to net income including non-cash adjustments which increased approximately \$6.1 million, offset by an overall use of cash flows from changes in working capital of \$8.9 million. These changes in working capital were primarily attributable to the timing of cash payments related to accounts payable and decreased accrued liabilities, offset in part by improved collections of accounts receivable. Cash from operations is impacted by the timing of cash collections from products and services provided and payment of operating costs to fund the continued growth and expansion of our business.

Net cash provided by operating activities for the year ended June 30, 2014 was \$122.9 million compared to \$94.4 million for the year ended June 30, 2013. The \$28.5 million improvement in cash flow from operations between periods was attributable primarily to increased accounts receivable collections and less investment in inventory during the year ended June 30, 2014 than during the prior year. Cash from operations is impacted by the timing of cash collections from products and services provided and payment of operating costs to fund the continued growth and expansion of our business.

Investing Activities

Net cash used in investing activities for the years ended June 30, 2016, 2015 and 2014 was \$82.9 million, \$68.3 million and \$45.8 million, respectively.

Net cash used in investing activities for the year ended June 30, 2016 increased \$14.6 million from 2015. This increase was due primarily to the \$20.1 million investment in LTS Education Systems and a \$1.1 million increase in capital expenditures for property and equipment, capitalized software and curriculum, offset by the prior year investment in LearnBop for \$6.5 million.

Net cash used in investing activities for the year ended June 30, 2015 increased \$22.5 million from 2014. This increase was due primarily to the \$6.5 million investment in LearnBop and a \$12.4 million increase in capital expenditures for property and equipment, capitalized software and curriculum, \$5.7 million received on the sale of assets in 2014, offset by the investment in a mortgage note to a managed school partner for \$2.1 million that was made in the prior year.

Net cash used in investing activities for the year ended June 30, 2014 decreased \$4.5 million from 2013. This decrease was a result of cash received of \$5.7 million related to a sale of assets and a net decrease of approximately \$1.0 million in net capital expenditures for other property and equipment, capitalized software and curriculum development, offset in part by a note made to a managed school partner of \$2.1 million.

Financing Activities

Net cash used in financing activities for the years ended June 30, 2016, 2015 and 2014, was \$20.8 million, \$50.4 million and \$63.4 million, respectively.

For the year ended June 30, 2016, our primary use of cash in financing activities consisted primarily of payments on capital lease obligations incurred for the acquisition of student computers totaling \$17.4 million and the repurchase of restricted stock for income tax withholding of \$3.4 million.

For the year ended June 30, 2015, our primary use of cash in financing activities was in connection with our share repurchase program for the purchase of treasury stock, and the payment of capital lease obligations incurred for the acquisition of student computers. For the year ended June 30, 2016, we purchased treasury stock which totaled approximately \$26.5 million. We made \$48.5 million in treasury

stock purchases during the year ended June 30, 2015. At June 30, 2015, the total shares of common stock purchased were 3,502,598, and there were no shares remaining under the plan for repurchase. The year ended June 30, 2015 included approximately \$9.7 million less in proceeds from the exercise of stock options than in the prior fiscal year. The timing of cash from the exercise of options impacts our net cash provided by financing activities.

For the year ended June 30, 2014, our primary uses of cash in financing activities were the purchase of treasury stock and the payment of capital lease obligations incurred for the acquisition of student computers. For the year ended June 30, 2015, we purchased treasury stock which totaled approximately \$48.5 million. We made no treasury stock purchases during the year ended June 30, 2014. Our cash payments for capital leases increased approximately \$2.4 million due to increased purchases of student computers financed under capital leases. In addition, the year ended June 30, 2014 included a reduction of \$8.1 million in the excess tax benefit from stock based compensation. The year ended June 30, 2014 included approximately \$3.0 million more in proceeds from the exercise of stock options than the year ended June 30, 2013, which partially offset the increased uses noted above. The timing of cash from the exercise of options impacts our net cash used in financing activities.

Contractual Obligations

Our contractual obligations consist primarily of leases for office space, capital leases for equipment and other operating leases. The following summarizes our long-term contractual obligations as of June 30, 2016, which decreased from \$81.2 million as of June 30, 2015:

	Contractual Obligations—Payments due by period				
	Total	< 1 year	1 - 3 years	3 - 5 years	> 5 years
	(In thousands)				
Contractual obligations at June 30, 2016					
Capital leases(1)	\$23,641	\$13,572	\$10,069	\$ —	\$ —
Operating leases	46,080	8,579	16,942	14,240	6,319
Total	<u>\$69,721</u>	<u>\$22,151</u>	<u>\$27,011</u>	<u>\$14,240</u>	<u>\$6,319</u>

(1) Includes interest expense.

For the schools to which we provide turn-key management services, we typically take responsibility for any school operating losses that the school may incur. These individual school operating losses, if they occur, are recorded at the time as a reduction in revenues. Potential school operating losses are not included as a commitment or obligation in the above table as they cannot be determined at this time and many may not even occur.

Off-Balance Sheet Arrangements

We have provided guarantees of approximately \$7.1 million related to lease commitments on the buildings for certain of our schools. We contractually guarantee that certain schools under our management will not have annual operating deficits and our management fees from these schools may be reduced accordingly to cover any school operating deficits. Other than these lease and operating deficit guarantees, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Impact of Inflation

We believe that inflation has not had a material impact on our results of operations for any of the years in the three year period ended June 30, 2016. We cannot be sure that future inflation will not have an adverse impact on our operating results and financial condition.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09), which supersedes most existing revenue recognition guidance under US GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). On July 9, 2015, the FASB voted to defer the effective date of the new revenue recognition standard by one year. Based on the Board’s decision, public organizations would apply the new revenue standard to annual reporting periods beginning after December 15, 2017. We are currently evaluating the impact of the pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard.

In April 2015, the FASB issued ASU 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*. (ASU 2015-05) provides guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the entity should account for the arrangement as a service contract. ASU 2015-05 does not change the accounting for service contracts. ASU 2015-05 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. We do not expect the adoption of this guidance to have a material impact on its financial statements.

In September 25, 2015, the FASB issued ASU 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments*, which eliminates the requirement to restate prior period financial statements for measurement period adjustments. The new guidance requires that the cumulative impact of a measurement period adjustment (including the impact on prior periods) be recognized in the reporting period in which the adjustment is identified. The new standard should be applied prospectively to measurement period adjustments that occur after the effective date. We are currently evaluating this guidance, as well as the effect on our consolidated financial statements.

In November 2015, the FASB issued the guidance ASU 2015-17, *Balance Sheet Classification of Deferred Taxes* to simplify the presentation of deferred income taxes, which removes the requirement to separate deferred tax liabilities and assets into current and noncurrent amounts and instead requires all such amounts be classified as noncurrent on the Company’s consolidated balance sheets. We adopted the guidance on a prospective basis in the fourth quarter of the year ended June 30, 2016 and prior periods were not retrospectively adjusted.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the

balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. We are currently evaluating this guidance, as well as the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation—Stock Compensation (Topic 718)*. This update was issued as part of the FASB's simplification initiative and affects all entities that issue share-based payment awards to their employees. The amendments in this update cover such areas as the recognition of excess tax benefits and deficiencies, the classification of those excess tax benefits on the statement of cash flows, an accounting policy election for forfeitures, the amount an employer can withhold to cover income taxes and still qualify for equity classification and the classification of those taxes paid on the statement of cash flows. This update is effective for annual and interim periods beginning after December 15, 2016, which will require us to adopt these provisions in the first quarter of fiscal 2018. This guidance will be applied either prospectively, retrospectively or using a modified retrospective transition method, depending on the area covered in this update. Early adoption is permitted. We have not yet selected a transition date nor have we determined the effect of the standard on our ongoing financial reporting.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

At June 30, 2016 and 2015, we had cash and cash equivalents totaling \$214.0 million and \$195.9 million, respectively. We did not enter into market risk sensitive instruments for trading purposes during fiscal years 2016, 2015 and 2014. Future interest and investment income is subject to the impact of interest rate changes and we may be subject to changes in the fair value of our investment portfolio as a result of changes in interest rates. At June 30, 2016, a 1% gross increase in interest rates earned on cash would result in \$2.1 million annualized increase in interest income.

Our short-term debt obligations under our revolving credit facility are subject to interest rate exposure, however as we had no outstanding balance on this facility as of June 30, 2016, fluctuations in interest rates would not have any impact on our interest expense.

Foreign Currency Exchange Risk

We currently operate in several foreign countries, but we do not transact a material amount of business in a foreign currency. At June 30, 2016, a 1% change in exchange rates between the U.S. dollar and British pound would result in an approximate impact of zero on our financial statements. If we enter into any material transactions in a foreign currency or establish or acquire any subsidiaries that measure and record their financial condition and results of operation in a foreign currency, we will be exposed to currency transaction risk and/or currency translation risk. Exchange rates between U.S. dollars and many foreign currencies have fluctuated significantly over the last few years and may continue to do so in the future. Accordingly, we may decide in the future to undertake hedging strategies to minimize the effect of currency fluctuations on our financial condition and results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
K12 Inc.
Herndon, Virginia

We have audited the accompanying consolidated balance sheets of K12 Inc. and subsidiaries (the Company) as of June 30, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 2016. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in the accompanying index. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of K12 Inc. and subsidiaries at June 30, 2016 and 2015, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2016, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), K12 Inc. and subsidiaries' internal control over financial reporting as of June 30, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated August 9, 2016 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

McLean, Virginia
August 9, 2016

K12 INC.
CONSOLIDATED BALANCE SHEETS

	June 30,	
	2016	2015
	(In thousands, except share and per share data)	
ASSETS		
Current assets		
Cash and cash equivalents	\$213,989	\$195,852
Accounts receivable, net of allowance of \$10,813 and \$9,657 at June 30, 2016 and June 30, 2015, respectively.	169,554	188,246
Inventories, net	30,631	29,571
Deferred tax asset	—	8,989
Prepaid expenses	9,634	11,428
Other current assets	22,047	24,877
Total current assets	445,855	458,963
Property and equipment, net	28,447	34,407
Capitalized software, net	70,055	62,683
Capitalized curriculum development costs, net	63,367	58,696
Intangible assets, net	23,102	21,195
Goodwill	87,285	66,160
Deposits and other assets	15,944	6,495
Total assets	\$734,055	\$708,599
LIABILITIES, REDEEMABLE NONCONTROLLING INTEREST AND EQUITY		
Current liabilities		
Current portion of capital lease obligations	\$ 13,210	\$ 16,635
Accounts payable	25,919	29,819
Accrued liabilities	26,877	12,486
Accrued compensation and benefits	31,042	26,790
Deferred revenue	25,964	24,927
Total current liabilities	123,012	110,657
Capital lease obligations, net of current portion	9,922	13,022
Deferred rent, net of current portion	6,661	7,692
Deferred tax liability	18,458	22,456
Other long term liabilities	9,780	8,233
Total liabilities	167,833	162,060
Commitments and contingencies	—	—
Redeemable noncontrolling interests	7,502	9,601
Equity		
K12 Inc. stockholders' equity		
Common stock, par value \$0.0001; 100,000,000 shares authorized; 43,184,068 and 41,837,894 shares issued and 39,681,470 and 38,335,296 shares outstanding at June 30, 2016 and June 30, 2015, respectively.	4	4
Additional paid-in capital	675,436	663,461
Accumulated other comprehensive loss	(293)	(1,065)
Accumulated deficit	(41,427)	(50,462)
Treasury stock of 3,502,598 shares at cost	(75,000)	(75,000)
Total K12 Inc. stockholders' equity	558,720	536,938
Total liabilities, redeemable noncontrolling interest and equity	\$734,055	\$708,599

See accompanying notes to consolidated financial statements.

K12 INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended June 30,		
	2016	2015	2014
	(In thousands, except share and per share data)		
Revenues	\$ 872,700	\$ 948,294	\$ 919,553
Cost and expenses			
Instructional costs and services	546,510	607,756	569,219
Selling, administrative and other operating expenses	302,205	307,730	313,258
Product development expenses	10,071	14,381	14,220
Total costs and expenses	858,786	929,867	896,697
Income from operations	13,914	18,427	22,856
Realized gain on sale of assets	—	—	6,404
Interest (expense), net and other	(617)	(3,291)	(69)
Income before income tax expense and noncontrolling interest	13,297	15,136	29,191
Income tax expense	(4,746)	(5,810)	(11,075)
Net income	8,551	9,326	18,116
Add net loss attributable to noncontrolling interest	484	1,662	1,484
Net income attributable to common stockholders, including Series A stockholders	\$ 9,035	\$ 10,988	\$ 19,600
Net income attributable to common stockholders per share, excluding Series A stockholders:			
Basic	\$ 0.24	\$ 0.29	\$ 0.50
Diluted	\$ 0.23	\$ 0.29	\$ 0.50
Weighted average shares used in computing per share amounts:			
Basic	37,613,782	37,330,569	38,987,470
Diluted	38,850,388	37,625,425	39,230,516

See accompanying notes to consolidated financial statements.

K12 INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended June 30,		
	2016	2015	2014
	(In thousands)		
Net income	\$8,551	\$ 9,326	\$18,116
Other comprehensive income (loss), net of tax foreign currency translation adjustment	772	(953)	182
Total other comprehensive income, net of tax	9,323	8,373	18,298
Comprehensive loss attributable to noncontrolling interest	484	1,662	1,484
Comprehensive income attributable to common stockholders, including Series A stockholders	\$9,807	\$10,035	\$19,782

See accompanying notes to consolidated financial statements.

K12 INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	K12 Inc. Stockholders										
	Common Stock		Common Stock—A		Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Treasury Stock		Noncontrolling Interest	Total
	Shares	Amount	Shares	Amount				Shares	Amount		
<i>(In thousands, except share data)</i>											
Balance, June 30, 2013	37,440,662	\$ 4	2,750,000	\$ 63,112	\$548,390	\$ (294)	\$(81,050)	—	\$ —	\$ 3,596	\$533,758
Net income (loss)(1)	—	—	—	—	—	—	19,600	—	—	(209)	19,391
Foreign currency translation adjustments	—	—	—	—	—	182	—	—	—	—	182
Conversion of Series A to Common Stock	2,750,000	—	(2,750,000)	(63,112)	63,112	—	—	—	—	—	—
Purchase of Treasury Stock	—	—	—	—	—	—	—	(2,195,196)	(48,548)	—	(48,548)
Stock-based compensation expense	—	—	—	—	22,828	—	—	—	—	—	22,828
Exercise of stock options	531,262	—	—	—	10,294	—	—	—	—	—	10,294
Excess tax benefit (expense) from stock-based compensation	—	—	—	—	1,075	—	—	—	—	—	1,075
Issuance of restricted stock awards	704,131	—	—	—	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(93,423)	—	—	—	—	—	—	—	—	—	—
Accretion of redeemable noncontrolling interests to estimated redemption value	—	—	—	—	(1,645)	—	—	—	—	—	(1,645)
Retirement of restricted stock for tax withholding	(188,570)	—	—	—	(5,018)	—	—	—	—	—	(5,018)
Deconsolidation of certain businesses	—	—	—	—	—	—	—	—	—	(3,387)	(3,387)
Balance, June 30, 2014	41,144,062	\$ 4	—	\$ —	\$639,036	\$ (112)	\$(61,450)	(2,195,196)	\$(48,548)	\$ —	\$528,930
Net income(1)	—	—	—	—	—	—	10,988	—	—	—	10,988
Foreign currency translation adjustments	—	—	—	—	—	(953)	—	—	—	—	(953)
Purchase of Treasury Stock	—	—	—	—	—	—	—	(1,307,402)	(26,452)	—	(26,452)
Stock-based compensation expense	—	—	—	—	21,299	—	—	—	—	—	21,299
Exercise of stock options	99,935	—	—	—	553	—	—	—	—	—	553
Excess tax benefit (expense) from stock-based compensation	—	—	—	—	(2,793)	—	—	—	—	—	(2,793)
Issuance of restricted stock awards	822,698	—	—	—	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(66,480)	—	—	—	—	—	—	—	—	—	—
Accretion of redeemable noncontrolling interests to estimated redemption value	—	—	—	—	8,038	—	—	—	—	—	8,038
Retirement of restricted stock for tax withholding	(162,321)	—	—	—	(2,672)	—	—	—	—	—	(2,672)
Balance, June 30, 2015	41,837,894	\$ 4	—	\$ —	\$663,461	\$(1,065)	\$(50,462)	(3,502,598)	\$(75,000)	\$ —	\$536,938
Net income(1)	—	—	—	—	—	—	\$ 9,035	—	—	—	\$ 9,035
Foreign currency translation adjustments	—	—	—	—	—	772	—	—	—	—	772
Stock-based compensation expense	—	—	—	—	18,616	—	—	—	—	—	18,616
Exercise of stock options	1,000	—	—	—	14	—	—	—	—	—	14
Excess tax benefit (expense) from stock-based compensation	—	—	—	—	(4,876)	—	—	—	—	—	(4,876)
Issuance of restricted stock awards	1,704,843	—	—	—	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(95,980)	—	—	—	—	—	—	—	—	—	—
Accretion of redeemable noncontrolling interests to estimated redemption value	—	—	—	—	1,615	—	—	—	—	—	1,615
Retirement of restricted stock for tax withholding	(263,689)	—	—	—	(3,394)	—	—	—	—	—	(3,394)
Balance, June 30, 2016	43,184,068	\$ 4	—	\$ —	\$675,436	\$ (293)	\$(41,427)	(3,502,598)	\$(75,000)	\$ —	\$558,720

(1) Net income attributable to noncontrolling interest excludes \$0.5 million, \$1.7 million and \$1.3 million for the years ended June 30, 2016, 2015 and 2014, respectively, due to the redeemable noncontrolling interest related to Middlebury Interactive Languages and LearnBop, which is reported outside of permanent equity in the consolidated balance sheet (See Note 10).

See accompanying notes to consolidated financial statements.

K12 INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended June 30,		
	2016	2015	2014
	(In thousands)		
Cash flows from operating activities			
Net income	\$ 8,551	\$ 9,326	\$ 18,116
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization expense	68,225	80,282	86,267
Stock-based compensation expense	18,616	21,299	22,828
Excess tax benefit from stock-based compensation	(6)	(118)	(1,679)
Deferred income taxes	(3,818)	(3,094)	(5,754)
Provision for doubtful accounts	4,610	9,300	1,439
Provision for inventory obsolescence	691	1,406	4,293
Provision for student computer shrinkage and obsolescence	(459)	(430)	(526)
Impairment loss on other assets	200	3,200	—
Expensed computer peripherals	2,625	3,519	—
Realized gain on sale of assets	—	—	(6,404)
Changes in assets and liabilities:			
Accounts receivable	14,463	(1,892)	(12,257)
Inventories	(1,751)	2,853	6,272
Prepaid expenses	1,860	(4,073)	2,735
Other current assets	2,830	(2,579)	(1,645)
Deposits and other assets	(8,910)	(1,440)	(212)
Accounts payable	(3,900)	(1,192)	9,778
Accrued liabilities	15,497	(7,854)	5,474
Accrued compensation and benefits	4,255	9,389	(4,214)
Deferred revenue	636	621	(1,429)
Deferred rent and other liabilities	(2,437)	1,562	(209)
Net cash provided by operating activities	<u>121,778</u>	<u>120,085</u>	<u>122,873</u>
Cash flows from investing activities			
Purchases of property and equipment	(5,008)	(9,928)	(7,405)
Capitalized software development costs	(36,265)	(33,755)	(26,553)
Capitalized curriculum development costs	(21,627)	(18,057)	(15,411)
Mortgage note to a managed school partner	—	—	(2,100)
Net cash received on sale of assets	—	—	5,665
Acquisition of LearnBop, Inc.	—	(6,512)	—
Acquisition of LTS Education Systems, net of cash acquired	(19,953)	—	—
Net cash used in investing activities	<u>(82,853)</u>	<u>(68,252)</u>	<u>(45,804)</u>
Cash flows from financing activities			
Repayments on capital lease obligations	(17,402)	(21,939)	(22,694)
Repayments on notes payable	—	—	(390)
Purchase of treasury stock	—	(26,452)	(48,548)
Proceeds from exercise of stock options	14	553	10,294
Net proceeds from investment in noncontrolling interest	—	—	1,275
Excess tax benefit from stock-based compensation	6	118	1,679
Retirement of restricted stock for tax withholding	(3,394)	(2,672)	(5,018)
Net cash used in financing activities	<u>(20,776)</u>	<u>(50,392)</u>	<u>(63,402)</u>
Effect of foreign exchange rate changes on cash and cash equivalents	<u>(12)</u>	<u>(1,698)</u>	<u>962</u>
Net change in cash and cash equivalents	18,137	(257)	14,629
Cash and cash equivalents, beginning of year	<u>195,852</u>	<u>196,109</u>	<u>181,480</u>
Cash and cash equivalents, end of year	<u>\$213,989</u>	<u>\$195,852</u>	<u>\$196,109</u>

See accompanying notes to consolidated financial statements.

K12 Inc.
Notes to Consolidated Financial Statements

1. Description of the Business

K12 Inc., together with its subsidiaries (“K12” or the “Company”), is a technology-based education company. The Company offers proprietary curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade (“K-12”). The Company’s mission is to maximize a child’s potential by providing access to an engaging and effective education, regardless of geographic location or socio-economic background. The Company’s learning systems combine curriculum, instruction and related support services to create an individualized learning approach well-suited for virtual and blended public schools, school districts, charter schools and private schools that utilize varying degrees of online and traditional classroom instruction, and other educational applications. These unique set of products and services are provided primarily to three lines of business: Managed Public School Programs (curriculum and services sold to managed public schools in 33 states and the District of Columbia), Institutional (curriculum, technology and services provided to school districts, public schools and other educational institutions that the Company does not manage), and Private Pay Schools and Other (private schools for which the Company charges student tuition and makes direct consumer sales).

The Company works closely as partners with a growing number of public schools, school districts, charter schools and private schools enabling them to offer their students an array of solutions, including full-time virtual programs, semester course and supplemental solutions. In addition to curriculum, systems and programs, the Company provides teacher training, teaching services and other support services.

2. Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The Company operates in one operating and reportable business segment as a technology-based education company providing proprietary curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade. The Chief Operating Decision Maker evaluates profitability based only on consolidated results.

3. Summary of Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (“GAAP”) requires management to make estimates and assumptions affecting the reported amounts of assets and liabilities and contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, the Company evaluates its estimates and assumptions, including those related to allowance for doubtful accounts, inventory reserves, amortization periods, the allocation of purchase price to the fair value of net assets and liabilities acquired in business combinations, fair values used in asset impairment evaluations, valuation of long-lived assets, accrual for incurred but not reported (“IBNR”) claims, fair value of redeemable noncontrolling interest, contingencies, income taxes and stock-based compensation expense. The Company bases its estimates on historical experience and various assumptions that it believes are reasonable under the circumstances. The results of the analysis form the basis for making assumptions about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Revenue Recognition and Concentration of Revenues

Revenues are principally earned from long-term contractual agreements to provide online curriculum, books, materials, computers and management services to virtual and blended public schools, traditional schools, school districts, virtual charter schools, and private schools. In addition to providing the curriculum, books and materials, under most contracts, the Company provides management services and technology to virtual and blended public 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. Shipments of materials for schools that occur in the fourth fiscal quarter and for the upcoming school year are recorded in deferred revenues.

Where the Company has determined that it is 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 Accounting Standards Codification (“ASC”) 605, *Revenue Recognition*. As a result of being the primary obligor, amounts recorded as revenues and school operating expenses for the years ended June 30, 2016, 2015, and 2014, were \$294.7 million, \$338.2 million and \$265.2 million, respectively. For contracts where the Company is not the primary obligor, the Company records revenue based on its net fees earned under the contractual agreement.

The Company generates revenues under turnkey management contracts with virtual and blended public schools which include multiple elements. These elements include:

- providing each of a school’s students with access to the Company’s online school and the component of lessons;
- offline learning kits, which include books and materials to supplement the online lessons, where required;
- the use of a personal computer and associated reclamation services;
- internet access and technology support services;
- the services of a state-certified teacher, where required; and
- management and technology services necessary to operate a virtual public or blended school. In certain managed school contracts, revenue is determined directly by per enrollment funding.

The Company has determined that the elements of its contracts are valuable to schools in combination, but do not have standalone value. As a result, the elements within the Company’s multiple-element contracts do not qualify as separate units of accounting. Accordingly, the Company accounts for revenues under multiple element arrangements as a single unit of accounting and recognizes the entire arrangement based upon the approximate rate at which it incurs the costs associated with each element. Revenue from certain managed schools is recognized ratably over the period services are performed.

To determine the pro rata amount of revenues to recognize in a fiscal quarter, management estimates the total funds each school will receive in a particular school year. Total funds for a school are primarily a function of the number of students enrolled in the school and established per enrollment funding levels which are generally published on an annual basis by the state or school district. Management reviews its

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

estimates of funding periodically, and revise as necessary, amortizing any adjustments to earned revenues over the remaining portion of the fiscal year. Actual school funding may vary from these estimates and the impact of these differences could impact the Company's results of operations. Since the end of the school year coincides with the end of the Company's fiscal year, annual revenues are generally based on actual school funding and actual costs incurred (including costs for the Company's services to the schools plus other costs the schools may incur) in the calculation of school operating losses. The Company's schools reported results are subject to annual school district financial audits, which incorporate enrollment counts, funding and other routine financial audit considerations. The results of these audits are incorporated into the Company's monthly funding estimates and for the reported fiscal years ended June 30, 2015, 2014 and 2013, the Company's aggregate funding estimates differed from actual reimbursements impacting total reported revenue by approximately 0.4%, (0.1)%, and 0.2%, respectively.

Under the contracts where the Company provides turnkey management services to schools, the Company has generally agreed to absorb any operating losses of the schools in a given school year. These school operating losses represent the excess of costs incurred over revenues earned by the virtual or blended public school as reflected on its respective financial statements, including Company charges to the schools. To the extent a school does not receive funding for each student enrolled in the school, the school would still incur costs associated with serving the unfunded enrollment. If losses due to unfunded enrollments result in a net operating loss for the year that loss is reflected as a reduction in the revenue and net receivables that the Company collects from the school. A school net operating loss in one year does not necessarily mean the Company anticipates losing money on the entire contract with the school. However, a school operating loss may reduce the Company's ability to collect its management fees in full and recognized revenues are reduced accordingly to reflect the expected cash collections from such schools. The Company amortizes the estimated school operating loss against revenues based upon the percentage of actual revenues in the period to total estimated revenues for the fiscal year.

For turnkey revenue service contracts, a school operating loss may reduce the Company's ability to collect its management fees in full though as noted it does not necessarily mean that the Company incurs a loss during the period with respect to its services to that school. The Company recognizes revenue, net of its estimated portion of school operating losses, to reflect the expected cash collections from such schools. Revenue is recognized based on the Company's performance of services under the contract, which it believes is proportionate to its incurrence of costs. The Company incurs costs directly related to the delivery of services. Most of these costs are recognized throughout the year; however, certain costs related to upfront delivery of printed materials, workbooks, laboratory materials and other items are provided at the beginning of the school year and are recognized as expense when shipped.

Each state or school district has variations in the school funding formulas and methodologies that it uses to estimate funding for revenue recognition at its respective schools. As the Company builds the funding estimates for each school, it is mindful of the state definition for count dates on which reported enrollment numbers will be used for per pupil funding. The parameters the Company considers in estimating funding for revenue recognition purposes include school district count definitions, withdrawal rates, average daily attendance, special needs enrollment, student demographics, academic progress and historical completion, student location, funding caps and other state specified categorical program funding. The estimates the Company makes each period on a school-by-school basis takes into account the latest information available to it and considers material relevant information at the time of the estimate.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Management periodically reviews its estimates of full-year school revenues and operating expenses and amortizes the net impact of any changes to these estimates over the remainder of the fiscal year. Actual school operating losses may vary from these estimates or revisions, and the impact of these differences could have a material impact on results of operations. Since the end of the school year coincides with the end of the Company's fiscal year, annual revenues are generally based on actual school funding and actual costs incurred (including costs for the Company's services to the schools plus other costs the schools may incur) in the calculation of school operating losses. For the years ended June 30, 2016, 2015 and 2014, the Company's revenue included a reduction for these school operating losses of \$57.1 million, \$65.2 million, and \$49.8 million, respectively.

The Company provides certain online curriculum and services to schools and school districts under subscription and perpetual license agreements. Revenue under these agreements is recognized in accordance with the ASC 605 when all of the following conditions are met: there is persuasive evidence of an arrangement; delivery has occurred or services have been rendered; the amount of fees to be paid by the customer is fixed and determinable; and the collectability of the fee is probable. Revenue from the licensing of curriculum under subscription arrangements is recognized on a ratable basis over the subscription period. Revenue from the licensing of curriculum under non-cancelable perpetual arrangements is recognized when all revenue recognition criteria have been met. Revenue from professional consulting, training and support services are deferred and recognized ratably over the service period.

Other revenues are generated from individual customers who prepay and have access for one to two years to company-provided online curriculum. The Company recognizes these revenues pro rata over the maximum term of the customer contract. Revenues from associated offline learning kits are recognized upon shipment.

During the years ended June 30, 2016, 2015 and 2014, approximately 82%, 86% and 88%, respectively, of the Company's revenues were recognized from schools the Company managed. During the year ended June 30, 2016 the Company had a contract with one school that represented approximately 10% of revenue. During the years ended June 30, 2015 and June 30, 2014 the Company had a contract with a different school that represented approximately 14% and 13% of revenue, respectively. Approximately 9% of accounts receivable was attributable to the respective customers as of June 30, 2016 and 2015.

In fiscal year 2015, Agora renegotiated its service agreement and entered into a three year contract with the Company to utilize the Company's curriculum and purchase certain technology services, while the school board assumed daily operational responsibilities, including its charter renewal process and marketing and enrollment activities. The net impact of this event on the fiscal year 2016 revenues attributable to the loss of the management component of the Agora contract was approximately \$111 million.

On June 9, 2016, Agora signed a new service agreement with us that extends through 2019 and included additional services including curriculum and certain technology services while the school board retained daily operational responsibilities. The agreement also calls for payment terms of outstanding receivables to be paid over an approximate two-year period resulting in reclassification of a portion to long-term assets (Deposits and other assets).

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Shipping and Handling Costs

Shipping and handling costs are expensed when incurred and are classified as instructional costs and services in the accompanying consolidated statements of operations. Shipping and handling charges invoiced to a customer are included in revenues.

Research and Development Costs

All research and development costs, including patent application costs, are expensed as incurred.

Cash and Cash Equivalents

Cash and cash equivalents generally consist of cash on hand and cash held in money market and demand deposit accounts. The Company considers all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

Allowance for Doubtful Accounts

The Company maintains an allowance for uncollectible accounts primarily for estimated losses resulting from the inability or failure of individual customers to make required payments. The Company analyzes accounts receivable, historical percentages of uncollectible accounts, and changes in payment history when evaluating the adequacy of the allowance for uncollectible accounts. The Company records an allowance for estimated uncollectible accounts in an amount approximating anticipated losses. Actual write-offs might exceed the recorded allowance.

Inventories

Inventories consist primarily of textbooks and curriculum materials, a majority of which are supplied to virtual and blended public schools and utilized directly by students. Inventories represent items that are purchased and are recorded at the lower of cost (first-in, first-out method) or market value. Excess and obsolete inventory reserves are established based upon the evaluation of the quantity on hand relative to demand. During the years ended June 30, 2016 and 2015, the Company increased the provision for excess and obsolete inventory by \$0.7 million and \$1.4 million primarily related to the decision to discontinue certain products and excess inventory relative to anticipated demand. The excess and obsolete inventory reserve at June 30, 2016 and 2015, was \$2.6 million and \$2.2 million, respectively.

Other Current Assets

Other current assets consist primarily of textbooks, curriculum materials and other supplies which are expected to be returned upon the completion of the school year. Materials not returned are expensed as part of instructional costs and services.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation expense is calculated using the straight-line method over the estimated useful life of the asset (or the lesser of the term of the lease and the estimated useful life of the asset under capital lease). Amortization of assets capitalized under capital lease arrangements is included in depreciation and amortization expense. Leasehold improvements are amortized over the lesser of the lease term or the

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

estimated useful life of the asset. The Company determines the lease term in accordance with ASC 840, *Leases*, as the fixed non-cancelable term of the lease plus all periods for which failure to renew the lease imposes a penalty on the lessee in an amount such that renewal appears, at the inception of the lease, to be reasonably assured. Property and equipment are depreciated over the following useful lives:

	<u>Useful Life</u>
Student and state testing computers	3 years
Computer hardware	3 years
Computer software	3 - 5 years
Web site development	3 years
Office equipment	5 years
Furniture and fixtures	7 years
Leasehold improvements	3 - 12 years

The Company makes an estimate of unreturned student computers based on an analysis of recent trends of returns and utilization rates, as well as information obtained from the student computer processing systems. As a result, the Company recorded accelerated depreciation of \$2.8 million, \$5.0 million and \$6.5 million for the years ended June 30, 2016, 2015 and 2014, respectively, for computers that the Company estimates will not be returned by students.

In addition, during the fiscal year ended June 30, 2015, the Company wrote down approximately \$6.5 million primarily related to computer peripherals and other fixed assets shipped to students, and for which no reclamation will be processed. There were no material write downs for the year ended June 30, 2016. Additionally, beginning in fiscal 2016 the Company no longer recovers peripheral equipment as it was determined to be uneconomical. Accordingly, the Company fully expenses peripherals upon shipment and the impact was immaterial.

Capitalized Software

The Company develops software for internal use. Software development costs incurred during the application development stage are capitalized in accordance with ASC 350, *Intangibles—Goodwill and Other*. The Company amortizes these costs over the estimated useful life of the software, which is generally three years. Capitalized software development costs are stated at cost less accumulated amortization.

Capitalized software development additions totaled \$36.3 million, \$33.8 million and \$26.6 million for the years ended June 30, 2016, 2015 and 2014, respectively. The Company wrote down approximately \$0.5 million and \$3.8 million of capitalized software projects after determining the assets either had no future use or are being sunset for the years ended June 30, 2016 and 2014. This write down was included in the selling, administrative and other operating expenses. There were no material write-downs of capitalized software projects for the year ended June 30, 2015.

Amortization expense for the years ended June 30, 2016, 2015 and 2014, was \$28.9 million, \$26.8 million and \$20.1 million, respectively.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Capitalized Curriculum Development Costs

The Company internally develops curriculum, which is primarily provided as online content and accessed via the Internet. The Company also creates textbooks and other materials that are complementary to online content.

The Company capitalizes curriculum development costs incurred during the application development stage in accordance with ASC 350. The Company capitalizes curriculum development costs during the design and deployment phases of the project. Many of the Company's new courses leverage off of proven delivery platforms and are primarily content, which has no technological hurdles. As a result, a significant portion of the Company's courseware development costs qualify for capitalization due to the concentration of its development efforts on the content of the courseware. Capitalization ends when a course is available for general release to its customers, at which time amortization of the capitalized costs begins. The period of time over which these development costs will be amortized is generally five years.

Total capitalized curriculum development additions were \$21.6 million, \$18.1 million and \$15.4 million for the years ended June 30, 2016, 2015 and 2014, respectively. These amounts are recorded on the accompanying consolidated balance sheets, net of amortization and impairment charges. Amortization charges are recorded in instructional costs and services on the accompanying consolidated statements of operations. Amortization expense for the years ended June 30, 2016, 2015 and 2014 was \$17.0 million, \$20.1 million and \$19.0 million, respectively. There were no material write-downs of capitalized curriculum development costs for the year ended June 30, 2016. The Company wrote down approximately \$2.6 million and \$2.2 million of capitalized curriculum development costs due to an assessment of recoverability of certain curriculum, as well as a decision to discontinue certain curriculum during the years ended June 30, 2015 and 2014.

Noncontrolling Interest

Earnings or losses attributable to other stockholders of a consolidated affiliated company are classified separately as "noncontrolling interest" in the Company's consolidated statements of operations. Net loss attributable to noncontrolling interest reflects only its share of the after-tax earnings or losses of an affiliated company. Income taxes attributable to noncontrolling interest are determined using the applicable statutory tax rates in the jurisdictions where such operations are conducted. The Company's consolidated balance sheets reflect noncontrolling interests within the equity section of the consolidated balance sheets, except for redeemable noncontrolling interests. Noncontrolling interest was classified separately in the Company's consolidated statements of stockholders' equity. Except for the redeemable non-controlling interests, the businesses with non-controlling interests were sold during fiscal 2014, and therefore the Company no longer has these non-controlling interests after the sale date.

Redeemable Noncontrolling Interests

Noncontrolling interests in subsidiaries that are redeemable outside of the Company's control for cash or other assets are classified outside of permanent equity at redeemable value, which approximates fair value. However, if the redemption amount is other than fair value (e.g. fixed or variable), the redeemable noncontrolling interest is accounted for at the fixed or variable redeemable value. The redeemable noncontrolling interests are adjusted to their redeemable value at each balance sheet date. The resulting increases or decreases in the estimated redemption amount are affected by corresponding charges against retained earnings, or in the absence of retained earnings, additional paid-in-capital.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Goodwill and Intangible Assets

The Company records 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. Finite-lived intangible assets include trade names, acquired customers and non-compete agreements. Such intangible assets are amortized on a straight-line basis over their estimated useful lives. As of June 30, 2016 and 2015, finite-lived intangible assets were recorded at \$42.0 million and \$37.4 million, respectively, and accumulated amortization of \$18.9 million and \$16.2 million, respectively. Amortization expense for the years ended June 30, 2016, 2015 and 2014 was \$2.7 million, \$2.6 million and \$8.0 million, respectively. During the year ended June 30, 2014, the Company determined that based on rebranding of the Institutional business, the Company fully amortized certain trade names that were no longer going to be used and recorded a \$5.2 million impairment charge. There was no material impairment charge for the years ended June 30, 2016 and 2015. Future amortization of intangible assets is \$2.9 million, \$2.8 million, \$2.8 million, \$2.7 million and \$2.3 million in the years ended June 30, 2017 through June 30, 2021, respectively and \$9.2 million thereafter. As of June 30, 2016 and 2015, the goodwill balance was \$87.3 million and \$66.2 million, respectively.

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 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. ASC 350 also allows preparers to qualitatively assess goodwill impairment through a screening process which would permit companies to forgo Step 1 of their annual goodwill impairment process. This qualitative screening process will hereinafter be referred to as “Step 0”. 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. Examples of such events or circumstances include, but are not limited to, significant underperformance relative to historical or projected future operating results, significant changes in the manner of use of acquired assets or the strategy for the Company’s business, significant negative industry or economic trends, and/or a significant decline in the Company’s stock price for a sustained period. The Company has determined it has two reporting units K12 and Middlebury. The Company performs its annual assessment on May 31st. We apply a two-step approach in testing goodwill for impairment for each reporting unit. The Company has determined it has two reporting units K12 and Middlebury. The first step tests for potential impairment by comparing the fair value of reporting units with reporting units’ net asset values. If the fair value of the reporting unit exceeds the carrying value of the reporting unit’s net assets, then goodwill is not impaired and no further testing is required. If the fair value of reporting unit is below the reporting unit’s carrying value, then the second step is required to measure the amount of potential impairment. The second step requires an assignment of the reporting unit’s fair value to the reporting unit’s assets and liabilities, using the initial acquisition accounting guidance related to business combinations, to determine the implied fair value of the reporting unit’s goodwill. The implied fair value of the reporting unit’s goodwill is then compared with the carrying amount of the reporting unit’s goodwill to determine the goodwill impairment loss to be recognized, if any. If the carrying value of a reporting unit’s goodwill exceeds its implied fair value, we record an impairment loss equal to the difference. During the fiscal year ended June 30, 2016 we performed step one of the impairment test. The estimated K12 reporting unit fair value exceeded its

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

carrying value by approximately 9.8% and Middelburry reporting unit exceeded its fair value by approximately 29.8%. Based on goodwill impairment analysis results the Company determined that no impairment needed to be recorded. During the fiscal years ended June 30, 2015 and 2014 there were no facts and circumstances that indicated that the fair value of the reporting units may be less than their current carrying amount. There were no goodwill impairment charges for the years ended June 30, 2016, 2015 and 2014.

On July 31, 2014, the Company acquired a 51% majority interest in LearnBop, Inc., for \$6.5 million in cash (see Note 12).

On April 21, 2016, The Company acquired 100% interest in LTS Education Systems (“LTS”), for \$23.2 million in cash and contingent consideration (see Note 12).

The following table represents goodwill additions/reductions during fiscal years ended June 30, 2016, 2015 and 2014:

<u>(\$ in millions)</u>	<u>Amount</u>
<i>Goodwill</i>	
Balance as of June 30, 2014	\$58.1
Acquisition of LearnBop	8.1
Balance as of June 30, 2015	\$66.2
Acquisition of DL	21.1
Balance as of June 30, 2016	<u>\$87.3</u>

Intangible Assets:

<u>(\$ in millions)</u>	<u>June 30, 2016</u>			<u>June 30, 2015</u>		
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Value</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Net Carrying Value</u>
Trade names	\$17.6	\$ (6.9)	\$10.7	\$17.5	\$ (5.7)	\$11.8
Customer and distributor relationships	20.1	(10.6)	9.5	18.2	(9.1)	9.1
Developed technology	2.9	(1.2)	1.7	1.2	(1.2)	—
Other	1.4	(0.2)	1.2	0.5	(0.2)	0.3
	<u>\$42.0</u>	<u>\$(18.9)</u>	<u>\$23.1</u>	<u>\$37.4</u>	<u>\$(16.2)</u>	<u>\$21.2</u>

There were no impairment charges during fiscal years ended June 30, 2016 and June 30, 2015.

Impairment of Long-Lived Assets

Long-lived assets include property, equipment, capitalized curriculum and software developed or obtained for internal use. In accordance with ASC 360, *Property, Plant and Equipment*, management reviews the Company’s recorded long-lived assets for impairment annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. The Company determines the extent to which an asset may be impaired based upon its expectation of the asset’s future usability as well as on a reasonable assurance that the future cash flows associated with the asset will be in

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

excess of its carrying amount. 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.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740, *Income Taxes*. Under ASC 740, deferred tax assets and liabilities are computed based on the difference between the financial reporting and income tax bases of assets and liabilities using the enacted marginal tax rate. ASC 740 requires that the net deferred tax asset be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the net deferred tax asset will not be realized.

Sales Taxes

Sales tax collected from customers is excluded from revenues. Collected but unremitted sales tax is included as part of accrued liabilities in the accompanying consolidated balance sheets. Revenues do not include sales tax as the Company considers itself a pass-through conduit for collecting and remitting sales tax.

Stock-Based Compensation

The Company estimates the fair value of share-based awards on the date of grant. The fair value of stock options is determined using the Black-Scholes option-pricing model and the fair value of restricted stock awards is based on the closing price of the Company's common stock on the date of grant. The determination of the fair value of the Company's stock option awards and restricted stock awards is based on a variety of factors including, but not limited to, the Company's common stock price, expected stock price volatility over the expected life of awards, and actual and projected exercise behavior. Additionally, the Company has estimated forfeitures for share-based awards at the dates of grant based on historical experience, adjusted for future expectation. The forfeiture estimate is revised as necessary if actual forfeitures differ from these estimates.

Advertising and Marketing Costs

Advertising and marketing costs consist primarily of internet advertising, online marketing, direct mail, print media and television commercials and are expensed when incurred. Advertising costs totaled \$31.2 million, \$29.6 million and \$40.3 million for the years ending June 30, 2016, 2015 and 2014, respectively.

Series A Special Stock

The Company issued 2,750,000 shares of Series A Special stock in July 2010 in connection with an acquisition. The holders of the Series A Special stock had the right to convert those shares into common stock on a one-for-one basis and the right to vote on all matters presented to K¹² stockholders, other than for the election and removal of directors, for which holders of the Series A Special stock had no voting rights. These shares were converted into common stock on September 3, 2013 and no Series A Special stock were outstanding as of June 30, 2016 and June 30, 2015.

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Net Income Per Common Share

The Company calculates net income (loss) per share in accordance with ASC 260, *Earnings Per Share*. Under ASC 260, basic net income (loss) per common share is calculated by dividing net income (loss) by the weighted-average number of common shares outstanding during the reporting period. The weighted average number of shares of common stock outstanding includes vested restricted stock awards. Diluted net income (loss) per share (“EPS”) reflect the potential dilution that could occur assuming conversion or exercise of all dilutive unexercised stock options. The dilutive effect of stock options and restricted stock awards 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 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 net income (loss) per share when they are antidilutive. Common stock outstanding reflected in the Company’s consolidated balance sheets include restricted stock awards outstanding. Securities that may participate in undistributed net income with common stock are considered participating securities.

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

	Year Ended June 30,		
	2016	2015	2014
	(In thousands except shares and per share data)		
Basic earnings per share computation:			
Net income available to common stockholders	\$ 9,035	\$ 10,988	\$ 19,600
Weighted average common shares—basic	37,613,782	37,330,569	38,987,470
Basic net income per share	<u>\$ 0.24</u>	<u>\$ 0.29</u>	<u>\$ 0.50</u>
Dilutive earnings per share computation:			
Net income attributable to common stockholders	\$ 9,035	\$ 10,988	\$ 19,600
Share computation:			
Weighted average common shares—basic	37,613,782	37,330,569	38,987,470
Effect of dilutive stock options and restricted stock awards	1,236,606	294,856	243,046
Weighted average common shares outstanding—diluted . . .	<u>38,850,388</u>	<u>37,625,425</u>	<u>39,230,516</u>
Diluted net income per share	<u>\$ 0.23</u>	<u>\$ 0.29</u>	<u>\$ 0.50</u>

At June 30, 2016, the Company had 43,184,068 shares of common stock issued and 39,681,470 shares outstanding.

As of June 30, 2016, 2015 and 2014, the shares of common stock issuable in connection with stock options of 2,548,762, 2,784,593 and 558,186 respectively, were not included in the diluted income per common share calculation since their effect was antidilutive.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

Fair Value Measurements

ASC 820, *Fair Value Measurements*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in the principal or most advantageous market for the asset or liability, in an orderly transaction between market participants at the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

ASC 820 describes three levels of inputs that may be used to measure fair value:

- Level 1: Inputs based on quoted market prices for identical assets or liabilities in active markets at the measurement date.
- Level 2: Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3: Inputs reflect management’s best estimate of what market participants would use in pricing the asset or liability at the measurement date. The inputs are unobservable in the market and significant to the instruments valuation.

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

The redeemable noncontrolling interest includes the Company’s joint venture with Middlebury College to form Middlebury Interactive Languages (“MIL”). Under the agreement, Middlebury College has an irrevocable election to sell all of its membership interest to the Company (put right). The fair value of the redeemable noncontrolling interest reflects management’s best estimate of the redemption value of the put right.

The following table summarizes certain fair value information at June 30, 2016 and 2015 for assets and liabilities measured at fair value on a recurring basis.

<u>Description</u>	<u>Fair Value</u>	<u>Fair Value Measurements Using:</u>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Input (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
		(In thousands)		
Redeemable Noncontrolling Interest in Middlebury Joint Venture	\$6,801	\$—	\$—	\$6,801
Total	<u>\$6,801</u>	<u>\$—</u>	<u>\$—</u>	<u>\$6,801</u>

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

The following table presents activity related to the Company’s fair value measurements categorized as Level 3 of the valuation hierarchy, valued on a recurring basis, for the fiscal year ended June 30, 2016.

<u>Description</u>	<u>Fiscal Year Ended June 30, 2016</u>			<u>Fair Value June 30, 2016</u>
	<u>Fair Value June 30, 2015</u>	<u>Purchases, Issuances, and Settlements</u>	<u>Unrealized Gains/(Losses)</u>	
		(In thousands)		
Redeemable Noncontrolling Interest in				
Middlebury Joint Venture	\$6,801	\$—	\$—	\$6,801
Total	<u>\$6,801</u>	<u>\$—</u>	<u>\$—</u>	<u>\$6,801</u>

The fair value of the redeemable noncontrolling interest in the Middlebury Joint Venture was accounted for in accordance with ASC 480 10 S99, Accounting for Redeemable Equity Instruments. The fair value of the Middlebury Joint Venture was based upon a valuation from a third party valuation firm as of June 30, 2016. The valuation approach utilized an income approach with key assumptions including forecasted cash flows, a discount rate that utilizes a risk adjusted weighted average cost of capital and estimated terminal value. As of June 30, 2016 and 2015 the fair value of the Middlebury Joint Venture was estimated at \$6.8 million.

On May 4, 2015, Middlebury College, under the joint venture agreement, exercised its right to require the Company to purchase all of its ownership interest in the joint venture. The Company has the right to pay the redemption cost in cash, stock or a combination thereof, at the Company’s option, which form of consideration has not yet been determined.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09), which supersedes most existing revenue recognition guidance under US GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). On July 9, 2015, the FASB voted to defer the effective date of the new revenue recognition standard by one year. Based on the Board’s decision, public organizations would apply the new revenue standard to annual reporting periods beginning after December 15, 2017. We are currently evaluating the impact of the pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard.

In April 2015, the FASB issued ASU 2015-05, *Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement*, which provides

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

3. Summary of Significant Accounting Policies (Continued)

guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the entity should account for the arrangement as a service contract. ASU 2015-05 does not change the accounting for service contracts. ASU 2015-05 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The Company does not expect the adoption of this guidance to have a material impact on its financial statements.

In September 25, 2015, the FASB issued ASU 2015-16, *Simplifying the Accounting for Measurement-Period Adjustments*, which eliminates the requirement to restate prior period financial statements for measurement period adjustments. The new guidance requires that the cumulative impact of a measurement period adjustment (including the impact on prior periods) be recognized in the reporting period in which the adjustment is identified. The new standard should be applied prospectively to measurement period adjustments that occur after the effective date. The Company does not expect the adoption of this guidance to have a material impact on its financial statements.

In November 2015, the FASB issued the guidance ASU No. 2015-17, *Balance Sheet Classification of Deferred Taxes* to simplify the presentation of deferred income taxes, which removes the requirement to separate deferred tax liabilities and assets into current and noncurrent amounts and instead requires all such amounts be classified as noncurrent on the Company's consolidated balance sheets. The Company adopted the guidance on a prospective basis in the fourth quarter of the year ended June 30, 2016 and prior periods were not retrospectively adjusted.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating this guidance, as well as the effect on our consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation—Stock Compensation (Topic 718)*. This update was issued as part of the FASB's simplification initiative and affects all entities that issue share-based payment awards to their employees. The amendments in this update cover such areas as the recognition of excess tax benefits and deficiencies, the classification of those excess tax benefits on the statement of cash flows, an accounting policy election for forfeitures, the amount an employer can withhold to cover income taxes and still qualify for equity classification and the classification of those taxes paid on the statement of cash flows. This update is effective for annual and interim periods beginning after December 15, 2016, which will require us to adopt these provisions in the first quarter of fiscal 2018. This guidance will be applied either prospectively, retrospectively or using a modified retrospective transition method, depending on the area covered in this update. Early adoption is permitted. The Company has not yet selected a transition date nor have we determined the effect of the standard on our ongoing financial reporting.

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

4. Property and Equipment and Capitalized Software

Property and equipment consist of the following at:

	June 30,	
	2016	2015
	(In thousands)	
Student computers	\$ 34,143	\$ 44,823
Computer software	25,434	26,368
Computer hardware	16,233	17,559
Leasehold improvements	12,048	12,070
Office equipment	1,538	1,515
Furniture and fixtures	5,870	6,002
Web site development costs	1,115	1,115
State testing computers	5,837	2,654
	102,218	112,106
Less accumulated depreciation and amortization	(73,771)	(77,699)
	\$ 28,447	\$ 34,407

The Company recorded depreciation expense related to property and equipment reflected in selling, administrative and other operating expenses of \$6.4 million, \$6.0 million and \$9.4 million during the years ended June 30, 2016, 2015 and 2014, respectively. Depreciation expense of \$12.6 million, \$27.5 million and \$28.1 million related to computers leased to students is reflected in instructional costs and services during the years ended June 30, 2016, 2015 and 2014, respectively. There were no significant write downs of capitalized software projects during the year ended June 30, 2016. During the year ended June 30, 2015, the Company wrote down approximately \$4.8 million of capitalized software projects after determining the assets either have no future use or are being sunset. Amortization expense of \$0.5 million, \$0.9 million and \$1.7 million related to student software costs is reflected in instructional costs and services during the years ended June 30, 2016, 2015 and 2014, respectively.

In the course of its normal operations, the Company incurs maintenance and repair expenses. Those are expensed as incurred and amounted to \$11.6 million, \$11.2 million and \$10.2 million for the years ended June 30, 2016, 2015 and 2014, respectively.

Capitalized software consists of the following at:

	June 30,	
	2016	2015
	(In thousands)	
Capitalized software costs	\$ 176,374	\$144,285
Less accumulated depreciation and amortization	(106,319)	(81,602)
	\$ 70,055	\$ 62,683

The Company recorded amortization expense of \$23.4 million, \$19.4 million and \$18.2 million related to capitalized software development reflected in instructional costs and services during the years ended June 30, 2016, 2015 and 2014, respectively. The Company recorded amortization of capitalized software development costs reflected in selling, administrative and other operating expenses of \$5.5 million, \$7.4 million and \$1.9 million during the years ended June 30, 2016, 2015 and 2014, respectively. The

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

4. Property and Equipment and Capitalized Software (Continued)

Company wrote down approximately \$0.5 million and \$3.8 million of capitalized software projects after determining the assets either have no future use or are being sunset during the years ended June 30, 2016 and 2014. Write downs of capitalized software projects are included in amortization expense. There were no material write-downs of capitalized software costs for the years ended June 30, 2015.

5. Income Taxes

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

Deferred tax assets and liabilities result primarily from temporary differences in book versus tax basis accounting. Deferred tax assets and liabilities consist of the following:

	June 30,	
	2016	2015
	(In thousands)	
Deferred tax assets (liabilities):		
Net operating loss carryforward	\$ 5,464	\$ 4,059
Reserves	5,892	5,042
Accrued expenses	11,494	9,837
Stock compensation expense	11,735	13,113
Other assets	2,628	1,666
Deferred rent	1,922	1,998
Deferred revenue	—	396
Federal tax credits	20	20
State tax credits	841	912
Total deferred tax assets	<u>39,996</u>	<u>37,043</u>
Deferred tax liabilities		
Capitalized curriculum development	(13,821)	(11,301)
Capitalized software and website development costs	(25,435)	(22,635)
Property and equipment	(1,931)	(1,166)
Investment in Middlebury Interactive Languages	(20)	(599)
Returned materials	(4,883)	(5,944)
Deferred revenue	(128)	—
Purchased intangibles	(7,897)	(6,074)
Total deferred tax liabilities	<u>(54,115)</u>	<u>(47,719)</u>
Net deferred tax liability before valuation allowance	(14,119)	(10,676)
Valuation Allowance	(4,339)	(2,791)
Net deferred tax liability	<u>(18,458)</u>	<u>\$(13,467)</u>
Reported as:		
Current deferred tax assets	—	\$ 8,989
Long-term deferred tax liabilities	(18,458)	(22,456)
Net deferred tax liability	<u>\$(18,458)</u>	<u>\$(13,467)</u>

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

5. Income Taxes (Continued)

The Company maintains a valuation allowance on net noncurrent deferred tax assets of \$4.3 million and \$2.8 million as of June 30, 2016 and 2015, respectively, predominantly related to state, foreign income tax net operating losses (“NOL”) and operating losses related to its tax non-consolidating entity. The Company does not believe it is more likely than not that it will utilize these deferred tax assets.

The Company has not provided for U.S. deferred income taxes on undistributed foreign earnings because such earnings are considered to be permanently reinvested. Undistributed earnings of certain consolidated foreign subsidiaries at June 30, 2016 amounted to \$20.7 million. If such earnings were not permanently reinvested, a U.S. deferred income tax liability of approximately \$8.3 million would have been required.

At June 30, 2016, the Company had available federal and state NOL carryforwards of \$2.3 million and \$0.2 million, respectively, net of valuation allowances. The federal NOLs, if unused, expire in 2020 and the state NOLs expire on various dates.

For the years ended June 30, 2016 and 2015, the Company has evaluated whether a change in the Company’s ownership of outstanding classes of stock as defined in Internal Revenue Code Section 382 could prohibit or limit the Company’s ability to utilize its NOLs. The Company has concluded it is more likely than not that the Company will be able to fully utilize its NOLs subject to the Section 382 limitation.

The related components of the income tax expense for the years ended June 30, 2016, 2015 and 2014 were as follows:

	Year Ended June 30,		
	2016	2015	2014
	(In thousands)		
Current:			
Federal	\$ 4,651	\$ 6,490	\$14,025
State	1,152	1,964	2,748
Foreign	<u>2,761</u>	<u>450</u>	<u>56</u>
Total current	8,564	8,904	16,829
Deferred:			
Federal	(1,648)	(2,291)	(6,185)
State	(97)	(1,635)	(362)
Foreign	<u>(2,073)</u>	<u>832</u>	<u>793</u>
Total deferred	<u>(3,818)</u>	<u>(3,094)</u>	<u>(5,754)</u>
Total income tax expense	<u>\$ 4,746</u>	<u>\$ 5,810</u>	<u>\$11,075</u>

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

5. Income Taxes (Continued)

The provision for income taxes can be reconciled to the income tax that would result from applying the statutory rate to the net income before income taxes as follows:

	<u>Year Ended June 30,</u>		
	<u>2016</u>	<u>2015</u>	<u>2014</u>
U.S. federal tax at statutory rates	35.0%	35.0%	35.0%
Permanent items	4.8	2.3	1.3
Lobbying	5.3	5.0	(0.2)
Transaction costs	—	—	(0.1)
State taxes, net of federal benefit	3.8	1.8	4.3
Research and development tax credits	(8.1)	(1.7)	(0.7)
Domestic production activities deduction	(5.2)	(6.5)	(6.4)
Change in valuation allowance	2.9	5.2	2.4
Effects of foreign operations	(0.9)	(13.6)	(4.0)
Reserve for unrecognized tax benefits	(6.3)	6.1	3.9
Noncontrolling Interests	4.2	5.5	1.8
Other	0.2	(0.7)	0.6
Provision for income taxes	<u>35.7%</u>	<u>38.4%</u>	<u>37.9%</u>

The effective income tax rates during the years ended June 30, 2016, 2015 and 2014 were 35.7%, 38.4%, and 37.9%, respectively. The primary causes of the changes in the effective tax rate were decreases in unrecognized tax benefits primarily resulted from audit resolution in a certain foreign jurisdiction, and additional tax benefits related to research activities of the Company, and provision true ups.

Tax Uncertainties

The Company follows the provisions of ASC 740-10 which applies to all tax positions related to income taxes. ASC 740-10 provides a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. ASC 740-10 clarifies accounting for income taxes by prescribing a minimum probability threshold that a tax position must meet before a financial statement benefit is recognized. If the probability for sustaining a tax position is greater than 50%, then the tax position is warranted and recognition should be at the highest amount which would be expected to be realized upon ultimate settlement.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

5. Income Taxes (Continued)

The Company recognizes interest and penalties, if any, related to unrecognized tax benefits in income tax expense. At June 30, 2016 and June 30, 2015, the Company had \$0.1 million and \$0.2 million, respectively, in accrued interest and penalties.

	Year Ended June 30,		
	2016	2015	2014
	(In thousands)		
Balance at beginning of the year	\$ 3,558	\$2,555	\$1,346
Additions for prior year tax positions	351	137	702
Additions for current year tax positions	290	989	507
Reductions for prior year tax positions	(1,975)	(123)	—
Balance at end of the year	\$ 2,224	\$3,558	\$2,555

For the year ended June 30, 2016, decreases in unrecognized tax benefits primarily resulted from audit resolution in a certain foreign jurisdiction. If recognized, all of the \$2.2 million balance of unrecognized tax benefits would affect the effective tax rate. We do not anticipate a significant increase or decrease in unrecognized tax benefits in the next twelve months.

The Company or one of its subsidiaries files income tax returns in the U.S. federal, foreign and various state jurisdictions. Given the federal and certain state net operating losses generated in prior years, the statute of limitations for all tax years beginning with the period ended June 30, 2003 are still open. The statute of limitations for certain states for certain subsidiaries that have generated income may only extend back to 2011. The returns of the foreign subsidiaries are open to examination for the periods dating back to 2011.

6. Lease Commitments

Capital Leases

The Company incurs capital lease obligations for student computers under a lease line of credit with PNC Equipment Finance, LLC with annual borrowing limits. The Company had annual borrowing availability under the lease line of credit of \$35.0 million as of June 30, 2016 and 2015, respectively. As of June 30, 2016 and 2015, the aggregate outstanding balance under the lease line of credit, including balances from prior years, was \$23.1 million and \$29.7 million, respectively, with lease interest rates ranging from 1.95% to 2.88%. Individual leases under the lease line of credit include 36-month payment terms with a \$1 purchase option at the end of each lease term. The Company has pledged the assets financed to secure the outstanding leases. The lease line of credit was subject to cross default compliance provisions in the Company's line of credit agreement with PNC Bank, N.A. (see Note 7). The net carrying value of leased student computers as of June 30, 2016 and 2015 was \$14.0 million and \$17.5 million, respectively.

The Company incurs capital lease obligations for student computers under a lease line of credit with PNC Equipment Finance, LLC with annual lease availability limits. The Company had \$35.0 million of availability for new leasing during fiscal year 2016. Interest rates on the new borrowings were based upon an initial rate of 2.34% modified by changes in the three year interest rate swaps rate as published in the Federal Reserve Statistical Release H.15, "Selected Interest Rates," between June 25, 2015 and the Lease Commencement Date, as defined in the lease line of credit. This availability originally expired in July 2015,

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

6. Lease Commitments (Continued)

but was extended to July 2017. Interest rates on the new borrowings beginning in August 2015 under the extended agreement are based upon an initial rate of 1.88% modified by changes in the three year interest rate swaps rate as published in the Federal Reserve Statistical Release H.15, "Selected Interest Rates," between April 29, 2015 and the Lease Commencement Date, as defined in the lease line of credit.

The following is a summary as of June 30, 2016 of the present value of the net minimum lease payments on capital leases under the Company's commitments:

<u>As of June 30,</u>	<u>Capital Leases</u> <u>(\$ in thousands)</u>
2017	\$ 13,572
2018	7,243
2019	<u>2,827</u>
Total minimum payments	23,642
Less amount representing interest (imputed weighted average capital lease interest rate of 2.63%)	<u>(510)</u>
Net minimum payments	23,132
Less current portion	<u>(13,210)</u>
Present value of minimum payments, less current portion	<u>\$ 9,922</u>

Operating Leases

The Company has fixed non-cancelable operating leases with terms expiring through 2022 for office space leases. Office leases generally contain renewal options and certain leases provide for scheduled rate increases over the lease terms.

Rent expense was \$7.8 million, \$8.1 million and \$8.8 million for the years ended June 30, 2016, 2015 and 2014, respectively.

Future minimum lease payments under non-cancelable operating leases with initial terms of one year or more are as follows:

<u>(\$ in thousands)</u>	<u>Year Ending</u> <u>June 30,</u>
2017	\$ 8,579
2018	8,474
2019	8,468
2020	7,341
2021	6,899
Thereafter	<u>6,319</u>
Total future minimum lease payments	<u>\$46,080</u>

7. Line of Credit

On January 31, 2014, the Company executed a \$100.0 million unsecured line of credit to be used for general corporate operating purposes with Bank of America, N.A. ("BOA"). The line has a five-year term,

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

7. Line of Credit (Continued)

bears interest at the higher of the Bank's prime rate plus 0.25%, or the Federal Funds Rates plus 0.75%, or the LIBOR rate plus 1.25%; and incorporates customary financial and other covenants, including but not limited to a maximum debt leverage and a minimum fixed charge coverage ratio.

The Credit Agreement contains a number of financial and other covenants that, among other things; restrict the Company and its subsidiaries' ability to incur additional indebtedness, grant liens or other security interests, make certain investments, make specified restricted payments including dividends, dispose of assets or stock including the stock of its subsidiaries, make capital expenditures above specified limits and engage in other matters customarily restricted in senior credit facilities. The agreement incorporates customary financial and other covenants, including but not limited to maximum debt leverage and minimum fixed charge coverage ratios. As of June 30, 2016 and 2015, the Company was in compliance with these covenants and the Company had no borrowings outstanding on the line of credit.

8. Equity Transactions

The Company's Third Amended and Restated Certificate of Incorporation authorizes the Company to issue 100,000,000 shares of Common Stock and 10,000,000 shares of Preferred Stock. No Preferred Stock was issued or outstanding as of June 30, 2016 or 2015.

Series A Special Stock

The Company issued 2,750,000 shares of Series A Special Stock in connection with its acquisition of KC Distance Learning, Inc. The holders of the Series A Special Stock had the right to convert those shares into common stock on a one-for-one basis and for the right to vote on all matters presented to K stockholders, other than for the election and removal of directors, for which holders of the Series A Special Stock had no voting rights. These shares were converted into common stock on September 3, 2013 and no Series A Special Stock remains outstanding as of June 30, 2016.

Common Stock Repurchases

On November 4, 2013, the Board of Directors authorized the repurchase of up to \$75.0 million of the Company's outstanding common stock over a two year period. Any purchases under the buyback are dependent upon business and market conditions and other factors. The stock purchases are made from time to time and may be made through a variety of methods including open market purchases and trading plans that may be adopted in accordance with the Rule 10b-18 of the Exchange Act. For fiscal year ended June 30, 2015, the Company paid approximately \$26.5 million in cash to redeem 1,307,402 shares of common stock at an average price of \$20.23 per share. As of June 30, 2016, total shares purchased under the plan were 3,502,598, at an average cost of \$21.41 per share, and there were no shares remaining to be repurchased under the plan. No stock purchases were made during the fiscal year ended June 30, 2016.

9. Stock Option Plan

The Company adopted a Stock Option Plan in May 2000 (the "Option Plan") under which, employees, outside directors and independent contractors could participate in the Company's future performance through awards of nonqualified stock options to purchase common stock. In October 2007, the Company's Board adopted the 2007 Equity Incentive Award Plan, as amended (the "2007 Plan") increasing the number of common stock shares reserved for issuance to 4,213,921 shares plus increases in the shares pursuant to an "evergreen provision" that may be issued under the 2007 Plan over the course of

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

9. Stock Option Plan (Continued)

its ten-year term. Under the evergreen provision, the 2007 Plan provides that the number of shares available for issuance automatically increases by an amount equal to the least of i) 4% of the Company's outstanding common stock on the applicable July 1, or ii) 2,745,098 shares, or iii) a lesser number of shares as determined by the Company's Board of Directors. In fiscal year 2016, the Company's Board of Directors authorized 1,533,412 additional shares for issuance pursuant to the 2007 Plan's evergreen provision. Through June 30, 2016, the remaining aggregate number of shares of the Company's common stock authorized for future issuance under the 2007 Plan was 2,957,517. Through June 30, 2016, there were 5,571,567 shares of the Company's common stock that were issued and remain outstanding as a result of equity awards granted under the 2007 Plan.

Each stock option is exercisable pursuant to the vesting schedule set forth in the stock option agreement granting such stock option, generally over four years. No stock option shall be exercisable after the expiration of its option term. The Company has granted stock options under the 2007 Plan and the Company has also granted stock options to executive officers under stand-alone agreements outside the 2007 Plan.

Compensation expense for all equity-based compensation awards is based on the grant-date fair value estimated in accordance with the provisions of ASC 718. The Company recognizes these compensation costs on a straight-line basis over the requisite service period, which is generally the vesting period of the award.

The Company uses the Black-Scholes option pricing model method to calculate the fair value of stock options. The use of option valuation models requires the input by management of highly subjective assumptions, including the expected stock price volatility, the expected life of the option term and forfeiture rate. These assumptions are utilized by the Company in determining the estimated fair value of stock options.

The fair value of the Company's service and performance based stock options was estimated as of the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Year Ended June 30,		
	2016	2015	2014
Dividend yield	0.00%	0.00%	0.00%
Expected volatility	54.5%	48% to 51%	49% to 55%
Risk-free interest rate	1.00%	1.27% to 1.71%	1.23% to 1.73%
Expected life of the option term (in years)	5.11	4.97 to 5.11	4.82 to 5.14
Forfeiture rate	12%	12% to 28%	12% to 28%

The fair value of the options granted for the years ended June 30, 2016, 2015 and 2014 was \$3.2 million, \$4.4 million and \$3.0 million, respectively. This amount will be expensed over the required service period.

Dividend yield—The Company has never declared or paid dividends on its common stock and has no plans to do so in the foreseeable future.

Expected volatility—Volatility is a measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

9. Stock Option Plan (Continued)

Risk-free interest rate—The assumed risk free rate used is a zero coupon U.S. Treasury security with a maturity that approximates the expected term of the option.

Expected life of the option term—The period of time that the options granted are expected to remain unexercised. Options granted during the year have a maximum term of eight years. The Company estimates the expected life of the option term based on an average life between the dates that options become fully vested and the maximum life of options granted.

Forfeiture rate—The estimated percentage of options granted that are expected to be forfeited or canceled before becoming fully vested. The Company uses a forfeiture rate based on historical forfeitures of different classification levels of employees in the Company.

Stock option activity including stand-alone agreements during the years ended June 30, 2016, 2015 and 2014 are as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding, June 30, 2013	2,893,188	\$20.17	4.98	\$50,038
Granted	306,220	26.90		
Exercised	(531,262)	17.49		
Forfeited or canceled	(89,745)	22.63		
Outstanding, June 30, 2014	2,578,401	\$21.44	4.57	\$42,754
Granted	617,985	16.12		
Exercised	(99,935)	5.68		
Forfeited or canceled	(181,858)	29.85		
Outstanding, June 30, 2015	2,914,593	\$20.33	4.05	\$88,200
Granted	243,112	13.43		
Exercised	(1,000)	13.66		
Forfeited or canceled	(806,530)	18.55		
Outstanding, June 30, 2016	<u>2,350,175</u>	<u>\$20.20</u>	3.94	\$46,573
Stock options exercisable at June 30, 2016	<u>1,700,623</u>	<u>\$21.57</u>	2.93	\$37,335

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last day of the year and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2016. The amount of aggregate intrinsic value will change based on the fair market value of the Company's stock.

The total intrinsic value of options exercised for the years ended June 30, 2016, 2015 and 2014 was zero, \$0.3 million and \$7.4 million, respectively.

As of June 30, 2016, there was \$4.2 million of total unrecognized compensation expense related to unvested stock options granted under the Stock Option Plans adopted in May 2000 and October 2007. The cost is expected to be recognized over a weighted average period of 2.57 years. During the years ended

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

9. Stock Option Plan (Continued)

June 30, 2016, 2015 and 2014, the Company recognized \$3.7 million, \$5.5 million and \$7.0 million, respectively, of stock based compensation expense. Included in expense for the year ended June 30, 2016, the Company recorded stock-based compensation of \$0.4 million associated with accelerated vesting of option awards for executives and other employees. During the year ended June 30, 2014, the Company recorded stock-based compensation of \$1.6 million associated with extending the exercise period of certain option awards to the Company's former Chief Executive Officer upon his resignation from the Board of Directors and \$1.5 million associated with accelerated vesting of option awards to the Company's former Chief Executive Officer and other employees upon termination of employment.

Restricted Stock Awards

The Company has approved grants of restricted stock awards ("RSA") pursuant to the 2007 Plan. Under the 2007 Plan, employees, outside directors and independent contractors are able to participate in the Company's future performance through the awards of restricted stock. Each RSA vests pursuant to the vesting schedule set forth in the restricted stock agreement granting such RSAs, generally over three years. Under the 2007 Plan, there have been no awards of restricted stock to independent contractors.

Restricted stock award activity during the years ended June 30, 2016, 2015 and 2014 was as follows:

	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>
Nonvested, June 30, 2013	928,137	\$22.97
Granted	704,131	31.49
Vested	(559,250)	25.11
Canceled	<u>(93,423)</u>	<u>26.24</u>
Nonvested, June 30, 2014	979,595	\$22.97
Granted	822,698	17.54
Vested	(490,309)	15.63
Canceled	<u>(66,480)</u>	<u>22.46</u>
Nonvested, June 30, 2015	1,245,504	\$22.30
Granted	1,704,843	10.13
Vested	(722,577)	22.24
Canceled	<u>(95,980)</u>	<u>20.25</u>
Nonvested, June 30, 2016	<u>2,131,790</u>	<u>\$12.46</u>

During the year ended June 30, 2016, 111,690 new performance based restricted stock awards were granted and 231,332 were outstanding at June 30, 2016. During the year ended June 30, 2016, 131,104 performance or market based awards vested. Vesting of the performance-based restricted stock awards is contingent on certain financial performance goals.

During the year ended June 30, 2015, 117,553 new performance based restricted stock awards were granted and 277,764 were outstanding at June 30, 2015. During the year ended June 30, 2015, 43,604 performance or market based awards vested. Vesting of the performance-based restricted stock awards is contingent on certain financial performance goals.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

9. Stock Option Plan (Continued)

The fair value of restricted stock awards granted for the year ended June 30, 2016 was \$14.5 million. As of June 30, 2016, there was \$15.0 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 1.7 years. The total fair value of shares vested during the year ended June 30, 2016 was \$8.2 million. During the years ended June 30, 2016, 2015 and 2014, the Company recognized \$14.8 million, \$15.8 million and \$15.8 million, respectively, of stock-based compensation expense related to restricted stock awards. Included in the expense for the year ended June 30, 2016, the Company recorded stock-based compensation of \$0.4 million associated with accelerated vesting of equity awards to executives and other employees. During the year ended June 30, 2015, the Company recorded stock-based compensation of \$2.5 million associated with accelerated vesting of equity awards to executives and other employees. During the year ended June 30, 2014, the Company recorded stock-based compensation of \$3.6 million associated with accelerated vesting of equity awards to the Company's former Chief Executive Officer and other employees upon termination of employment.

Equity Incentive Market Based Awards

During the year ended June 30, 2016, the Company granted the opportunity to earn 592,359 restricted stock awards, having a weighted average grant date value of \$5.30 per share, to our new Chief Executive Officer and Executive Chairman. During the year ended June 30, 2016, the Company recognized \$0.9 million of stock-based compensation expense related to the awards. As of June 30, 2016, there was unrecognized compensation expense of \$2.2 million, which is expected to be recognized on an accelerated basis over the requisite service period, or an estimated remaining weighted average life of 1.6 years.

The awards were granted pursuant to the 2007 Plan and 50% of shares granted vest immediately upon achievement of specified average closing prices of the Company's stock for any period of 30 consecutive days and the remaining 50% vesting ratably in semi-annual intervals until the applicable two or three year anniversary from grant date. Additionally, vesting is dependent upon continuing service by the grantee as an employee of the Company at each vest date, unless the grantee is eligible for earlier vesting. The fair value was determined using a Monte Carlo simulation model incorporating the following factors: stock price on the grant date of \$9.64, risk free rate of return of 0.75 percent, and expected volatility of approximately 50 percent.

Performance Share Units

During the year ended June 30, 2016, the Company granted a total of 1,154,602 PSUs to certain senior executives, having a weighted average grant date fair value of \$12.92 per share. The PSUs were granted pursuant to the terms of the 2007 Plan and vest upon achievement of certain performance criteria associated with a Board-approved Long Term Incentive Plan ("LTIP") and continuation of employee service over a two to three year period. The level of performance will determine the number of PSUs earned as measured against threshold, target and stretch achievement levels of the LTIP. Each PSU represents the right to receive one share of the Company's common stock, or at the option of the Company, an equivalent amount of cash, and are classified as an equity award in accordance with *Accounting Standards Codification 718—Stock Compensation*. If actual performance exceeds the target criteria for a full award, then additional PSUs up to 562,301 could be earned by the participants.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

9. Stock Option Plan (Continued)

In addition to the LTIP performance conditions, there is a service vesting condition which stipulates that thirty percent of the earned award will vest quarterly beginning November 15, 2017 and seventy percent of the earned award will vest on August 15, 2018, in both cases dependent upon continuing service by the grantee as an employee of the Company, unless the grantee is eligible for earlier vesting upon a change in control and qualifying termination, as defined by the PSU agreement. For equity performance awards, including the PSUs, subject to graduated vesting schedules for which vesting is based on achievement of a performance metric in addition to grantee service, stock-based compensation expense is recognized on an accelerated basis by treating each vesting tranche as if it was a separate grant. For the year ended June 30, 2016, the Company determined the achievement of the performance conditions were not probable, therefore no expense was recorded during the year ended June 30, 2016.

Performance Share Unit activity during the year ended June 30, 2016 was as follows:

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested, June 30, 2015	—	—
Granted	1,154,602	12.92
Vested	—	—
Canceled	(65,000)	13.45
Nonvested, June 30, 2016	1,089,602	\$12.91

10. Redeemable Noncontrolling Interest

Investment in LearnBop, Inc.

On July 31, 2014, the Company acquired a majority interest in LearnBop, Inc. (“LearnBop”), for \$6.5 million in cash in return for a 51% interest in LearnBop. The purpose of the acquisition was to complement the Company’s K-12 math curriculum as LearnBop has developed an adaptive math curriculum learning software. As part of this transaction, the non-controlling shareholders have a non-transferable put right, which is exercisable between July 31, 2018 and December 31, 2018 for the remaining minority interest. The price of the put right will be determined based on the trailing twelve month revenue and contribution margin as defined in the Stockholders’ Agreement between the Company and LearnBop. Additionally, the Company has a non-transferable call option for the remaining minority interest at a price of \$3.0 million, which becomes exercisable January 1, 2019 or thereafter. Acquisition costs incurred by the Company related to this transaction included in selling, administrative and other operating expenses were \$0.1 million.

The purchase price of \$6.5 million was allocated to the underlying assets and liabilities based on their estimated fair value at the date of acquisition. The Company recorded goodwill of \$8.1 million, which will be non-deductible for tax purposes. Recognition of goodwill is largely attributed to the value paid for LearnBop’s capabilities in providing adaptive learning software for math curriculum to K-12 students. The Company has not disclosed current period or pro-forma revenue and earnings attributable to LearnBop as they are immaterial.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

10. Redeemable Noncontrolling Interest (Continued)

The Company finalized its allocation of the purchase price of LearnBop as of June 30, 2015. The purchase price was allocated as follows:

LearnBop (in millions):

<u>As of July 31, 2014</u>	<u>Amount</u>
Current assets	\$ 0.1
Capitalized software	0.9
Goodwill	8.1
Current liabilities	(0.1)
Redeemable noncontrolling interest	<u>(2.5)</u>
Fair value of total consideration transferred	<u>\$ 6.5</u>

Given the provision of the put rights, the redeemable noncontrolling interests are redeemable outside of the Company's control and are recorded outside of permanent equity at their redemption value in accordance with ASC 480-10-S99, *Accounting for Redeemable Equity Instruments*. The Company will adjust the redeemable noncontrolling interests to redemption value on each balance sheet date with changes in redemption value recognized as an adjustment to retained earnings, or in the absence of retained earnings, by adjustment to additional paid-in-capital.

The noncontrolling interest is redeemable at other than fair value as the redemption value is determined based on a specified formula. The noncontrolling interest becomes redeemable after the passage of time, and therefore the Company records the carrying amount of the noncontrolling interest at the greater of (i) the initial carrying amount, increased or decreased for the noncontrolling interest's share of net income or loss, or (ii) the redemption value.

According to ASC 480-10-S99, to the extent that the noncontrolling interest holder has the contractual right to receive an amount upon share redemption that is other than fair value of such shares, only the portion of the periodic adjustment to the instrument's carrying amount that reflects redemption in excess of fair value is treated like a dividend for earnings per share computation purposes. No adjustment to the earnings per share computation was necessary as estimated fair value of the noncontrolling interest is greater than the redemption value.

Middlebury College Joint Venture

In May 2010, the Company entered into an agreement to establish a joint venture with Middlebury College ("Middlebury") to form Middlebury Interactive Languages LLC ("MIL"). The venture creates and distributes innovative, online language courses under the trademark Middlebury and other marks. The joint venture agreement provided Middlebury with the right at any time after the fifth (5th) anniversary of forming the joint venture, to irrevocably elect to sell all of its membership interest to the Company (put right) at the fair market value of Middlebury's membership interest. Additionally, Middlebury had an option to repurchase the camp programs at fair market value along with other contractual rights as certain milestones associated with its Language Academy summer camp programs were not met. On May 4, 2015, Middlebury exercised its right to require the Company to purchase all of its ownership interest in the joint venture but it has not exercised its option to repurchase the camps programs.

The redeemable noncontrolling interests are redeemable outside of the Company's control. Because of this, the Company records the redemption fair value outside of permanent equity in accordance with ASC 480-10-S99. The Company adjusts the redeemable noncontrolling interests to redemption value on

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

10. Redeemable Noncontrolling Interest (Continued)

each balance sheet date with changes in redemption values recognized as an adjustment to retained earnings, or in the absence of retained earnings, by adjustment to additional paid-in-capital.

At June 30, 2016, the Company was still in discussions with Middlebury to settle the terms under the put right; the outcome of which could result in a value different than the value of the redeemable noncontrolling interest. The Company has the right to pay the redemption cost in cash, stock or a combination thereof, at the Company's option, which form of consideration has not yet been determined.

The following is a summary of the activity of the redeemable noncontrolling interest at June 30, 2016 and 2015:

(In thousands)	Value
Balance of redeemable noncontrolling interest at June 30, 2014	\$16,801
Net loss	(1,662)
Acquisition of LearnBop	2,500
Adjustment to redemption value	<u>(8,038)</u>
Balance of redeemable noncontrolling interest at June 30, 2015	\$ 9,601
Net loss	(484)
Adjustment to redemption value	<u>(1,615)</u>
Balance of redeemable noncontrolling interest at June 30, 2016	<u>\$ 7,502</u>

11. Commitments and Contingencies

Litigation

In the ordinary conduct of the Company's business, the Company is subject to lawsuits, arbitrations and administrative proceedings from time to time. The Company believes that the outcome of any existing or known threatened proceedings, even if determined adversely, should not have a material adverse effect on the Company's business, financial condition, liquidity or results of operations.

On September 24, 2015, in connection with an industry-wide investigation styled "In the Matter of the Investigation of For-Profit Virtual Schools," the Company received a civil investigative subpoena for specified documents and responses to interrogatories from the Attorney General of the State of California, Bureau of Children's Justice ("BCJ"). On July 8, 2016, K12 and the California Virtual Academy ("CAVA") charter schools ("CAVA Schools") entered into: (i) a Settlement Agreement and Release of a previously sealed Qui Tam lawsuit alleging false attendance reporting; (ii) a Stipulation for Entry of Final Judgment ("Stipulation") in connection with the BCJ's investigation as it pertained to us; and (iii) a Final Judgment enjoining us from engaging in certain business practices in California, and requiring that the Company and CAVA Schools undertake certain Conduct Provisions. The Settlement Agreement and Release provides for us to pay the State of California \$2.5 million, and the Qui Tam plaintiff \$0.1 million to settle the attendance reporting claims and in which we and the CAVA Schools deny any and all liability and wrongdoing. The Stipulation specifies that the Attorney General, the Company and the CAVA Schools have concluded the BCJ investigation and agreed to implement the Conduct Provisions of the Final Judgment "without admissions of findings of fact or law or wrongdoing, misconduct or illegal acts by K12 or the CAVA Schools, or any facts alleged in the [Attorney General's] Complaint." The Final Judgment provides for the Company to pay the State of California \$6.0 million "to defray the costs of this action and to fund the investigation and prosecution of enforcement cases to protect the rights of children," and further includes a release of all legal claims that could be brought by the Attorney General involving the

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

11. Commitments and Contingencies (Continued)

covered conduct. The Conduct Provisions of the Final Judgment require the Company to continue to improve its business practices and compliance programs as they generally relate to the operations and promotional activities of K12 and the CAVA Schools. The proceeding settlement costs were offset by insurance reimbursable administrative costs of approximately \$1.5 million reflected in selling, administrative and other operating expenses. The resulting charge of \$7.1 million was recorded in selling, administrative and other operating expenses for the year ended June 30, 2016.

On July 20, 2016, a securities class action lawsuit captioned *Babulal Tarapara v. K12 Inc. et. al.* was filed against us, two of our officers and one of our former officers in the United States District Court for the Northern District of California, Case No. 3:16-cv-04069. The plaintiff purports to represent a class of persons who purchased or otherwise acquired our common stock between November 7, 2013 and October 27, 2015, inclusive, and alleges violations by us and the individual defendants of Section 10(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 10b-5 promulgated under the Exchange Act, and violations by the individual defendants of Section 20(a) of the Exchange Act. The complaint alleges, among other things, that we and the individual defendants made false or misleading statements and omitted to disclose material facts concerning students' academic progress, graduate eligibility for University of California and California State University admission, class sizes, the individualized and flexible nature of the instruction provided by us, the quality of materials provided to students, reporting with respect to student attendance and funding, and that as a result of the aforementioned practices we were exposed to liability and would be forced to end these purported practices. The complaint seeks unspecified monetary damages and other relief. We intend to defend vigorously against each and every allegation and claim set forth in the complaint.

Consulting Agreement

On August 3, 2015, Mr. Timothy L. Murray, then President and Chief Operating Officer of the Company, notified us of his intent to resign, which became effective on September 15, 2015. The Company and Mr. Murray entered into a Consulting Agreement, effective September 16, 2015, whereby Mr. Murray provided transition and other consulting services for a term of up to six months and payment of \$43,985 per month for services rendered. The Consulting Agreement terminated on December 31, 2015.

Employment Agreements

The Company has entered into employment agreements with certain executive officers that provide for severance payments and, in some cases other benefits, upon certain terminations of employment. Except for the agreements with the Company's Executive Chairman and CEO that have two and three year terms, respectively, all other agreements provide for employment on an "at-will" basis. If the employee is terminated for "good reason" or without cause, the employee is entitled to salary continuation, and in some cases benefit continuation, for varying periods depending on the agreement.

Off-Balance Sheet Arrangements

The Company provided guarantees of approximately \$7.1 million related to lease commitments on the buildings for certain of the Company's schools. The Company contractually guarantees that certain schools under the Company's management will not have annual operating deficits and the Company's management fees from these schools may be reduced accordingly to cover any school operating deficits. Other than these lease and operating deficit guarantees, the Company did not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company's

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

11. Commitments and Contingencies (Continued)

financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

12. Acquisitions and Investments

Investment in Web International Education Group Ltd. (Web)

In January 2011, the Company invested \$10.0 million to obtain a 20% minority interest in Web International Group, Ltd. (“Web”), a provider of English language learning centers in cities throughout China. From January 2011 through May 2013, the Company recorded its investment in Web as an available for sale debt security because of the ability to put the investment to other Web shareholders in return for the original \$10.0 million investment plus interest. The Company’s option to purchase no less than 51% of Web expired on March 31, 2013 and on May 6, 2013, the Company exercised its right to put its investment back to Web for return of its original \$10.0 million investment plus interest of 8%, which Web was contractually required to pay by May 31, 2014, as amended. The Company reclassified this \$10.0 million investment, recording it in other current assets.

The receivable is due and the Company accrued interest up through December 31, 2014. However, given the difficulties in expatriating money from China, and the resulting administrative hurdles related to collecting this receivable, starting January 1, 2015, the Company discontinued the accrual of interest. Furthermore, during Q4 2015, and upon further negotiation with Web, the Company wrote off the full amount of accrued interest totaling \$3.2 million. This amount was recorded in interest expense, net and other, for the year ended June 30, 2015. During the year ended June 30, 2016 the Company and Web have continued negotiations to determine an appropriate mechanism to pay the total outstanding principal. At June 30, 2016, the Web investment of \$10 million was included in other current assets.

During the years ended June 30, 2016, 2015 and 2014, the Company recorded interest income of zero, zero and \$0.8 million, respectively, associated with Web.

Investment in School Mortgage

On September 11, 2013, the Company issued a mortgage note (“Mortgage”) lending \$2.1 million to a managed school partner. The note bears interest at a fixed rate of 5.25% per year and has a term of five years. Monthly principal and interest payments will be made beginning October 2013 with a final balloon payment of \$1.8 million at the term of the loan. The Mortgage is primarily secured by the underlying property.

The Mortgage and ancillary documents include customary affirmative and financial covenants for secured transactions of this type. The Company has recorded this as a note receivable and the current amounts are included in other current assets while the non-current amounts are included in deposits and other assets on the consolidated balance sheets.

During the year ended June 30, 2016, Moyer defaulted on the loan agreement for non-payment of principal and interest, to schools closure, and other contractual defaults. The Company continues to exercise its rights under the existing arrangement, including the appointment of a receiver and the continued pursuit of foreclosure.

During the years ended June 30, 2016 and 2015, the Company conducted an appraisal of the property to assess its market value. At June 30, 2016, the estimated market value had declined below the note’s carrying value, resulting in an impairment loss of \$0.2 million. There was no impairment loss during the year ended June 30, 2015.

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

12. Acquisitions and Investments (Continued)

Acquisition of LearnBop, Inc.

On July 31, 2014, the Company acquired a majority interest in LearnBop, Inc., for \$6.5 million in cash in return for a 51% interest in LearnBop. The purpose of the acquisition is to complement the Company’s K-12 math curriculum as LearnBop has developed an adaptive math curriculum learning software. As part of this transaction, the non-controlling shareholders have a non-transferable put right, which is exercisable between July 31, 2018 and December 31, 2018 for the remaining minority interest. The price of the put right will be determined based on the trailing twelve month revenue and contribution margin as defined in the Stockholders’ Agreement between the Company and LearnBop. Additionally, the Company has a non-transferable call option for the remaining minority interest at a price of \$3.0 million, which becomes exercisable January 1, 2019 or thereafter. Acquisition costs incurred by the Company related to this transaction included in selling, administrative and other operating expenses were \$0.1 million.

Acquisition of LTS Education Systems

On April 21, 2016 the Company completed its acquisition of Disguise the Learning, Inc. dba LTS Education Systems (“LTS”), a provider of personalized, digital game—based online learning solutions. With its acquisition of LTS, the Company aims to expand its online courses offerings in math, reading, english language arts, science and history.

The total purchase price consideration for this acquisition was \$23.2 million, which consisted primarily of cash of \$20.3 million and \$2.9 million of contingent consideration (earn-out liability), of which \$21.1 million was allocated to goodwill, \$4.6 million to acquired intangible assets and \$3.5 million to net liabilities assumed. The goodwill is not deductible for income tax purposes. Acquisition costs incurred by the Company related to this transaction included in selling, administrative and other operating expenses were \$0.4 million. Acquisition of LTS was not significant to our results of operations.

The following table summarizes the preliminary estimated fair values of considerations paid and identifiable assets acquired and liabilities assumed for LTS as of the date of acquisition (in millions):

	<u>June 30, 2016</u>
Acquisition consideration:	
Cash	\$20.3
Fair value of contingent consideration (earn-out liability)	<u>2.9</u>
Total consideration transferred	<u>\$23.2</u>
Identifiable assets acquired and liabilities assumed:	
Customer relationships	\$ 1.9
Developed technology	1.7
Other intangible assets	1.0
Goodwill	21.1
Deferred tax	(2.6)
Other net assets	0.1

The contingent consideration included in the table above represents the fair value of additional consideration payable to the seller, estimated using a discounted cash flow method. Consideration is to be distributed on the eighteen month and thirty month anniversaries of the closing date, and is contingent on the future performance of two key contracts. Each contract is to be assessed independently with an

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

12. Acquisitions and Investments (Continued)

aggregate potential payment of \$3.0 million. Performance metrics are based on the year-over-year maintenance of a total aggregate contract value in excess of 51%, with a greater than 90% success rate ensuring full payment.

13. Sale and Deconsolidation of Assets

On June 11, 2014, the Company sold an asset group comprised of certain domestic and international business and assets including Capital Education, LLC a post-secondary education product, a brick and mortar school named the International School of Berne, and the Company's 60% interest in the Middle East Joint Venture ("Middle East JV") to Safanad Education Ventures Limited ("Safanad"). Safanad is an affiliate of Safanad Limited, the Company's former partner in the Middle East JV. There was no retained interest in the disposed businesses and, as a result of the loss of control in the sale, the Company deconsolidated the assets recording a non-operating gain of approximately \$6.4 million. In aggregate, these businesses were responsible for \$16.9 million in revenue for the year ended June 30, 2014.

As part of the transaction, the Company entered into a services agreement to license, host and provide other related services to use its curriculum and technology for education services in limited territories and markets as defined by the agreement. In addition, the Company entered into a Transition Services Agreement (TSA) with Safanad to provide various administrative and support services.

14. Related Party Transactions

At June 30, 2016 and June 30, 2015, the Company had loaned a total of \$4.0 million to its 60% owned joint venture Middlebury Interactive Languages LLC ("MIL") in accordance with the terms of the original joint venture agreement. The loan was repayable under terms and conditions specified in the loan agreement. The loan balance and related interest are eliminated since MIL is consolidated in the Company's financial statements; however, repayment of the loan is dependent on the continued liquidity of MIL.

On September 11, 2013, the Company issued a mortgage note ("Mortgage") lending \$2.1 million to a managed school partner. The note bears interest at a fixed rate of 5.25% per year and has a term of five years. Monthly principal and interest payments began in October 2013 with a final balloon payment of \$1.8 million at the term of the loan. The Mortgage is primarily secured by the underlying property. The borrower has defaulted on the loan payment and we are in the foreclosure process. Also see Note 10.

During the fiscal year ended June 30, 2016, the Company contributed \$0.7 million to The Foundation for Online and Blended Learning ("Foundation"). The Foundation is a related party as an executive officer of the Company serves on the Board of the Foundation. No contributions were made during the fiscal years ended June 30, 2015 and June 30, 2014.

15. Employee Benefits

The Company maintains a 401(k) salary deferral plan (the "401(k) Plan") for its employees. Employees who have been employed for at least 30 days may voluntarily contribute to the 401(k) Plan on a pretax basis, up to the maximum allowed by the Internal Revenue Service. The 401(k) Plan provides for a matching Company contribution of 25% of the first 4% of each participant's compensation. The Company expensed \$1.5 million, \$1.8 million and \$3.7 million during each of the years ended June 30, 2016, 2015 and 2014, respectively under the 401(k) Plan.

K12 Inc.
Notes to Consolidated Financial Statements (Continued)

16. Supplemental Disclosure of Cash Flow Information

(In thousands)	Year Ended June 30,		
	2016	2015	2014
Cash paid for interest	\$ 790	\$ 1,051	\$ 1,054
Cash paid for taxes	\$ 1,125	\$19,390	\$ 9,134
Supplemental disclosure of non-cash investing and financing activities:			
Property and equipment financed by capital lease obligations, including student peripherals	\$10,878	\$14,654	\$24,132
Business Combinations			
—Current assets	\$ 419	\$ 27	\$ —
—Intangible assets	\$ 4,600	\$ —	\$ —
—Capitalized software development costs	\$ —	\$ 940	\$ —
—Goodwill	\$21,125	\$ 8,101	\$ —
—Assumed liabilities	\$ (5,780)	\$ (50)	\$ —
—Deferred revenue	\$ (400)	\$ (23)	\$ —

17. Common Stock Repurchases

On November 4, 2013, the Board of Directors authorized the repurchase of up to \$75.0 million of the Company's outstanding common stock over a two year period. Any purchases under the buyback are dependent upon business and market conditions and other factors. The stock purchases are made from time to time and may be made through a variety of methods including open market purchases and trading plans that may be adopted in accordance with the Rule 10b-18 of the Exchange Act. There were no stock repurchased during the fiscal year ended June 30, 2016.

18. Quarterly Results of Operations (Unaudited)

The unaudited consolidated interim financial information presented should be read in conjunction with other information included in the Company's consolidated financial statements. The following unaudited consolidated financial information reflects all adjustments necessary for the fair presentation of

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

18. Quarterly Results of Operations (Unaudited) (Continued)

the results of interim periods. The following tables set forth selected unaudited quarterly financial information for each of the Company's last eight quarters.

	2016			
	Jun 30, 2016	Mar 31, 2016	Dec 31, 2015	Sep 30, 2015
	(In thousands)			
Consolidated Quarterly Statements of Operations				
Revenues	\$ 221,319	\$ 221,340	\$ 208,811	\$ 221,230
Cost and expenses				
Instructional costs and services	143,136	134,755	129,616	139,003
Selling, administrative and other operating expenses	76,606	64,888	61,440	99,270
Product development expenses	1,067	2,563	3,028	3,413
Total costs and expenses	220,809	202,206	194,084	241,686
Income (loss) from operations	510	19,134	14,727	(20,456)
Interest expense, net and other	(21)	(101)	(190)	(305)
Income (loss) income before income tax expense and noncontrolling interest	489	19,033	14,537	(20,761)
Income tax benefit (expense)	(822)	(5,368)	(6,653)	8,097
Net income (loss)	(118)	13,665	7,884	(12,664)
Add net income (loss) attributable to noncontrolling interest	(649)	608	654	(129)
Net income (loss) attributable to common stockholders	\$ (982)	\$ 14,273	\$ 8,538	\$ (12,793)
Net income (loss) attributable to common stockholders per share:				
Basic	\$ (0.03)	\$ 0.38	\$ 0.23	\$ (0.34)
Diluted	\$ (0.03)	\$ 0.37	\$ 0.23	\$ (0.34)
Weighted average shares used in computing per share amounts:				
Basic	37,768,812	37,692,826	37,559,999	37,433,493
Diluted	37,768,812	38,999,871	37,680,876	37,433,493

K12 Inc.

Notes to Consolidated Financial Statements (Continued)

18. Quarterly Results of Operations (Unaudited) (Continued)

	2015			
	Jun 30, 2015	Mar 31, 2015	Dec 31, 2014	Sep 30, 2014
	(In thousands)			
Consolidated Quarterly Statements of Operations				
Revenues	\$ 235,655	\$ 244,623	\$ 231,304	\$ 236,712
Cost and expenses				
Instructional costs and services	166,900	148,985	145,029	146,842
Selling, administrative and other operating expenses	80,756	64,871	62,557	99,546
Product development expenses	4,317	3,337	3,245	3,482
Total costs and expenses	251,973	217,193	210,831	249,870
Income (loss) from operations	(16,318)	27,430	20,473	(13,158)
Interest expense, net and other	(3,158)	(315)	151	31
Income before income tax expense and noncontrolling interest	(19,476)	27,115	20,624	(13,127)
Income tax benefit (expense), net	6,901	(10,586)	(8,663)	6,538
Net income (loss)	(12,575)	16,529	11,961	(6,589)
Add net loss attributable to noncontrolling interest	995	484	370	(187)
Net income (loss) attributable to common stockholders	\$ (11,580)	\$ 17,013	\$ 12,331	\$ (6,776)
Net income (loss) attributable to common stockholders per share:				
Basic	\$ (0.31)	\$ 0.46	\$ 0.33	\$ 0.18
Diluted	\$ (0.31)	\$ 0.45	\$ 0.33	\$ 0.18
Weighted average shares used in computing per share amounts:				
Basic	37,318,085	37,211,634	37,096,480	37,695,681
Diluted	37,318,085	37,408,911	37,160,829	37,695,681

SCHEDULE II
K12 INC
VALUATION AND QUALIFYING ACCOUNTS
YEARS ENDED June 30, 2016, 2015, and 2014

1. ALLOWANCE FOR DOUBTFUL ACCOUNTS

	<u>Balance at Beginning of Period</u>	<u>Additions Charged to Cost and Expenses</u>	<u>Deductions from Allowance</u>	<u>Balance at End of Period</u>
June 30, 2016	\$9,657,092	4,609,720	3,453,418	\$10,813,394
June 30, 2015	\$3,459,928	9,299,766	3,102,602	\$ 9,657,092
June 30, 2014	\$2,560,207	1,438,964	539,243	\$ 3,459,928

2. INVENTORY RESERVE

	<u>Balance at Beginning of Period</u>	<u>Charged to Cost and Expenses</u>	<u>Deductions, Shrinkage and Obsolescence</u>	<u>Balance at End of Period</u>
June 30, 2016	\$2,192,234	691,407	241,094	\$2,642,547
June 30, 2015	\$9,056,142	1,405,988	8,269,896	\$2,192,234
June 30, 2014	\$4,893,783	4,292,974	130,615	\$9,056,142

3. COMPUTER RESERVE(1)

	<u>Balance at Beginning of Period</u>	<u>Additions (Deductions) Charged to Cost and Expenses</u>	<u>Deductions, Shrinkage and Obsolescence</u>	<u>Balance at End of Period</u>
June 30, 2016	\$1,032,253	89,064	547,873	\$ 573,444
June 30, 2015	\$1,462,424	379,030	809,201	\$1,032,253
June 30, 2014	\$1,988,400	1,862,553	2,388,529	\$1,462,424

(1) A reserve account is maintained against potential obsolescence and unreturned computers provided to the Company's students. The reserve is calculated based upon several factors including historical percentages, the net book value and the remaining useful life. During fiscal years 2016, 2015 and 2014, certain computers were written off against the reserve.

4. INCOME TAX VALUATION ALLOWANCE

	<u>Balance at Beginning of Period</u>	<u>Additions to Net Deferred Tax Asset Allowance</u>	<u>Deductions in Net Deferred Tax Asset Allowance</u>	<u>Balance at End of Period</u>
June 30, 2016	\$2,791,033	1,594,174	46,554	\$4,338,653
June 30, 2015	\$1,968,482	1,352,231	529,680	\$2,791,033
June 30, 2014	\$1,268,966	699,516	—	\$1,968,482

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As required by Rules 13a-15(d) under the Securities Exchange Act of 1934, as amended) (the “Exchange Act”) management has evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Disclosure controls and procedures refer to controls and other procedures designed to ensure that information required to be disclosed in the reports the Company files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding our required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily applies its judgment in evaluating and implementing possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2016, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective.

Management’s Annual Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting.

Internal control over financial reporting refers to a process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and members of our board of directors; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our financial statements.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these

inherent limitations are known features of the financial reporting process, and it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Management evaluated the effectiveness of our internal control over financial reporting as of June 30, 2016 using the framework set forth in the report of the Treadway Commission's Committee of Sponsoring Organizations (COSO), "Internal Control—Integrated Framework (2013)." As a result of management's evaluation of our internal control over financial reporting, management concluded that as of June 30, 2016, our internal control over financial reporting was effective. The effectiveness of our internal control over financial reporting as of June 30, 2016 has been audited by BDO USA, LLP, an independent registered public accounting firm, as stated in its report which appears on page 103 of this Annual Report on Form 10-K.

Changes in Internal Control over Financial Reporting:

In addition, management carried out an evaluation, as required by Rule 13a-15(d) of the Exchange Act, under supervision of the Chief Executive Officer and Chief Financial Officer, of changes in the Company's internal control over financial reporting. Based on this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that there were no changes in the Company's internal control over financial reporting that occurred during the last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
K12 Inc.
Herndon, Virginia

We have audited K12 Inc. and subsidiaries' (the Company) internal control over financial reporting as of June 30, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). K12 Inc. and subsidiaries' management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Item 9A, Management's Annual Report on Internal Control Over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, K12 Inc. and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of June 30, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of K12 Inc. and subsidiaries as of June 30, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 2016 and our report dated August 9, 2016 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

McLean, Virginia
August 9, 2016

ITEM 9B. OTHER INFORMATION

NA

PART III

We will file a definitive Proxy Statement for our 2016 Annual Meeting of Stockholders (the “2016 Proxy Statement”) with the SEC, pursuant to Regulation 14A, not later than 120 days after the end of our fiscal year. Accordingly, certain information required by Part III has been omitted under General Instruction G(3) to Form 10-K. Only those sections of the 2016 Proxy Statement that specifically address the items set forth herein are incorporated by reference.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by Item 10 is hereby incorporated by reference to our 2016 Proxy Statement under the captions “Election of Directors” and “Section 16(a) Beneficial Ownership Reporting Compliance.”

ITEM 11. EXECUTIVE COMPENSATION

The information required by Item 11 is hereby incorporated by reference to our 2016 Proxy Statement under the captions “Compensation Discussion and Analysis” and “Director Compensation for fiscal 2016.”

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS, MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by Item 12 is hereby incorporated by reference to our 2016 Proxy Statement under the caption “Security Ownership of Certain Beneficial Owners and Management.”

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

The information required by Item 13 is hereby incorporated by reference to our 2016 Proxy Statement under the captions “Certain Relationships and Related-Party Transactions” and “Director Independence.”

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by Item 14 is hereby incorporated by reference to our 2016 Proxy Statement under the caption “Fees Paid to Independent Registered Public Accounting Firm.”

PART IV

ITEM 15. *EXHIBITS AND FINANCIAL STATEMENT SCHEDULES*

(a)(1) *Financial Statements.*

The information required by this item is incorporated herein by reference to the financial statements and notes thereto listed in Item 8 of Part II and included in this Annual Report.

(a)(2) *Financial Statement Schedules.*

Except for Schedule II which was presented separately, all financial statement schedules are omitted because the required information is included in the financial statements and notes thereto listed in Item 8 of Part II and included in this Annual Report.

(c) *Exhibits.*

The following exhibits are incorporated by reference or filed herewith.

See Exhibit Index

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

K12 INC.

By: /s/ STUART J. UDELL

Name: Stuart J. Udell
Title: *Chief Executive Officer*
August 9, 2016

POWER OF ATTORNEY

Know all persons by these presents, that each person whose signature appears below constitutes and appoints Stuart J. Udell, James J. Rhyu and Howard D. Polsky, and each of them severally, his or her true and lawful attorney- in-fact with power of substitution and resubstitution to sign in his or her name, place and stead, in any and all capacities, to do any and all things and execute any and all instruments that such attorney may deem necessary or advisable under the Securities Exchange Act of 1934, as amended, and any rules, regulations and requirements of the U.S. Securities and Exchange Commission in connection with the Annual Report on Form 10-K and any and all amendments hereto, as fully for all intents and purposes as he or she might or could do in person, and hereby ratifies and confirms all said attorneys-in-fact and agents, each acting alone, and his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ STUART J. UDELL</u> Stuart J. Udell	Chief Executive Officer (Principal Executive Officer)	August 9, 2016
<u>/s/ JAMES J. RHYU</u> James J. Rhyu	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	August 9, 2016
<u>/s/ NATHANIEL A. DAVIS</u> Nathaniel A. Davis	Executive Chairman of the Board of Directors	August 9, 2016
<u>/s/ CRAIG R. BARRETT</u> Craig R. Barrett	Director	August 9, 2016

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ GUILLERMO BRON</u> Guillermo Bron	Director	August 9, 2016
<u>/s/ FREDDA J. CASSELL</u> Fredda J. Cassell	Director	August 9, 2016
<u>/s/ ADAM L. COHN</u> Adam L. Cohn	Director	August 9, 2016
<u>/s/ JOHN M. ENGLER</u> John M. Engler	Director	August 9, 2016
<u>/s/ STEVEN B. FINK</u> Steven B. Fink	Director	August 9, 2016
<u>/s/ JON Q. REYNOLDS</u> Jon Q. Reynolds	Director	August 9, 2016
<u>/s/ ANDREW H. TISCH</u> Andrew H. Tisch	Director	August 9, 2016

Exhibit Index

Exhibit No.	Description of Exhibit
3.1	Third Amended and Restated Certificate of Incorporation of K12 Inc. (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2007, filed with the SEC on February 14, 2008, File No. 001-33883).
3.2	Second Amended and Restated Bylaws of K12 Inc. (incorporated by reference to Exhibit 3.2 to the Registrant's Current Report on Form 8-K, filed with the SEC on February 9, 2016, File No. 001-33883).
4.1	Form of stock certificate of common stock (incorporated by reference to Exhibit 4.1 to the Registrant's Amendment No. 4 to Registration Statement on Form S-1, filed with the SEC on November 8, 2007, File No. 333-144894).
4.2*	Amended and Restated Stock Option Plan and Amendment thereto (incorporated by reference to Exhibit 4.2 to the Registrant's Registration Statement on Form S-1, filed with the SEC on July 27, 2007, File No. 333-144894).
4.3*	Form of Stock Option Agreement—Employee (incorporated by reference to Exhibit 4.3 to the Registrant's Registration Statement on Form S-1, filed with the SEC on July 27, 2007, File No. 333-144894).
4.4	Form of Stock Option Agreement—Director (incorporated by reference to Exhibit 4.4 to the Registrant's Registration Statement on Form S-1, filed with the SEC on July 27, 2007, File No. 333-144894).
4.5*	K12 Inc. 2007 Equity Incentive Award Plan, as amended (incorporated by reference to Appendix A to the Registrant's Definitive Proxy Statement on Schedule 14A, filed on October 28, 2015, File No. 001-33883).
4.6*	Form of Indemnification Agreement for Non-Management Directors and for Officers of K12 Inc. (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008, filed with the SEC on November 14, 2008, File No. 001-33883).
4.7	Form of Director's Indemnification Agreement (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed with the SEC on October 22, 2008, File No. 001-33883).
4.8	Form of Second Amended and Restated Stockholders Agreement (incorporated by reference to Exhibit 4.5 to the Registrant's Registration Statement on Form S-1, filed with the SEC on July 27, 2007, File No. 333- 144894).
10.1*	Amendment to Amended and Restated Stock Option Agreement, dated December 23, 2010 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2010, filed with the SEC on February 9, 2011, File No. 001-33883).
10.2*	Employment Agreement for Nathaniel A. Davis, effective January 7, 2013 (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2012, filed with the SEC on February 5, 2013, File No. 001-33883).
10.3*	First Amendment to Employment Agreement for Nathaniel A. Davis, effective January 7, 2013 (incorporated by reference to Exhibit 10.28 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2013, filed with the SEC on August 29, 2013, File No. 001-33883).

Exhibit No.	Description of Exhibit
10.4*	Amended and Restated Employment Agreement for Nathaniel A. Davis, effective March 10, 2014 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, filed with the SEC on April 29, 2014, File No. 001- 33883).
10.5	Second Amended and Restated Employment Agreement of Nathaniel A. Davis, dated January 27, 2016. (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2015, filed with the SEC on January 28, 2016, File No. 001- 33883).
10.6	Employment Agreement of Stuart J. Udell ("Agreement"), dated January 7, 2016. (incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2015, filed with the SEC on January 28, 2016, File No. 001- 33883).
10.7	Form of Performance Share Unit Agreement under the 2007 Equity Incentive Award Plan, as amended (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2015, filed with the SEC on October 27, 2015, File No. 001-33883).
10.8*	Employment Agreement of Timothy L. Murray, dated March 7, 2012 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, filed with the SEC on May 9, 2012, File No. 001-33883).
10.9*	First Amendment to Employment Agreement of Timothy L. Murray, effective December 19, 2013 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2013, filed with the SEC on February 4, 2014, File No. 001-33883).
10.10*	Second Amendment to Employment Agreement of Timothy L. Murray, effective November 24, 2014 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2014, filed with the SEC on January 29, 2015, File No. 001-33883).
10.11*	Employment Agreement of James J. Rhyu, dated May 1, 2013 (incorporated by reference to Exhibit 10.29 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2013, filed with the SEC on August 29, 2013, File No. 001-33883).
10.12*	Employment Agreement of Howard D. Polsky, dated June 1, 2004 (incorporated by reference to Exhibit 10.16 to the Registrant's Amendment No. 1 to Registration Statement on Form S-1, filed with the SEC on September 26, 2007, File No. 333-144894).
10.13*	First Amendment to Employment Agreement of Howard D. Polsky, dated June 1, 2004 (incorporated by reference to Exhibit 10.18 to the Registrant's Amendment No. 4 to Registration Statement on Form S-1, filed with the SEC on November 8, 2007, File No. 333-144894).
10.14	Second Amended and Restated Educational Products and, Administrative, and Technology Services Agreement between the Ohio Virtual Academy and K12 Ohio L.L.C., dated April 19, 2007 (incorporated by reference to Exhibit 10.21 to Amendment No. 4 to the Registrant's Registration Statement on Form S-1, filed with the SEC on November 8, 2007, File No. 333- 144894).
10.15	Deed of Lease by and between ACP/2300 Corporate Park Drive, LLC and K12 Inc., dated December 7, 2005 (incorporated by reference to Exhibit 10.13 to the Registrant's Amendment No. 1 to Registration Statement on Form S-1, filed with the SEC on September 26, 2007, File No. 333-144894).

Exhibit No.	Description of Exhibit
10.16	First Amendment to Deed of Lease by and between ACP/2300 Corporate Park Owner, LLC and K12 Inc., dated November 30, 2006 (incorporated by reference to Exhibit 10.21 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2008, filed with the SEC on September 26, 2008, File No. 001-33883).
10.17	Second Amendment to Deed of Lease by and between ACP/2300 Corporate Park Owner, LLC and K12 Inc., dated March 26, 2007 (incorporated by reference to Exhibit 10.22 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2008, filed with the SEC on September 26, 2008, File No. 001-33883).
10.18	Credit Agreement, dated January 31, 2014, by and among K12 Inc., certain of K12's subsidiaries, Bank of America, N.A., and the other lenders party thereto (incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 2013, filed with the SEC on February 4, 2014, File No. 001-33883).
10.19*	Form of Stock Option Agreement under the 2007 Equity Incentive Award Plan, as amended (incorporated by reference to Exhibit 10.18 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2015, filed with the SEC on August 4, 2015, File No. 001-33883).
10.20*	Form of Restricted Stock Award Agreement under the 2007 Equity Incentive Award Plan, as amended (incorporated by reference to Exhibit 10.19 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 2008, filed with the SEC on September 26, 2008, File No. 001-33883).
21.1	Subsidiaries of K12 Inc.
23.1	Consent of BDO USA, LLP.
24.1	Power of Attorney (included in signature pages).
31.1	Certification of Principal Executive Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Principal Financial Officer Required Under Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Principal Executive Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
32.2	Certification of Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
101.INS#	XBRL Instance Document
101.SCH#	XBRL Taxonomy Extension Schema
101.CAL#	XBRL Taxonomy Extension Calculation
101.LAB#	XBRL Taxonomy Extension Labels
101.PRE#	XBRL Taxonomy Extension Presentation
101.DEF#	XBRL Taxonomy Extension Definition

* Denotes management compensation plan or arrangement.

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files included in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those Sections.

Subsidiaries of Registrant

<u>Name</u>	<u>Jurisdiction</u>
K12 Management Inc.	Delaware
K12 Services Inc.	Delaware
Power-Glide Language Courses, Inc.	Utah
K12 International Holdings B.V.	Netherlands
LearnBop, Inc.	Delaware
Disguise the Learning, Inc.	Tennessee

Subsidiaries of K12 Management Inc.

<u>Name</u>	<u>Jurisdiction</u>
Disguise the Learning, Inc.	Tennessee
K12 Virtual Schools LLC	Delaware
K12 Classroom LLC	Delaware
K12 Classroom Delaware LLC	Delaware
K12 California LLC	Delaware
K12 Florida LLC	Delaware
K12 Washington LLC	Delaware

Subsidiary of Power-Glide Language Courses, Inc.

<u>Name</u>	<u>Jurisdiction</u>
Middlebury Interactive Languages LLC	Delaware

Subsidiaries of K12 International Holdings B.V.

<u>Name</u>	<u>Jurisdiction</u>
K12 International Academy B.V.	Netherlands
K12 International Ltd.	Cayman Islands
K12 International GmbH	Switzerland
K12 Education (UK) Ltd.	United Kingdom
Web International Education Group Ltd.	Cayman Islands

Consent of Independent Registered Public Accounting Firm

K12 Inc.
Herndon, Virginia

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 333-148436, No. 333-198608 and No. 333- 206083) of K12 Inc. and subsidiaries of our reports dated August 9, 2016, relating to the consolidated financial statements and financial statement schedule and the effectiveness of K12 Inc. and subsidiaries' internal control over financial reporting, which appear in this Annual Report on Form 10-K.

/s/ BDO USA, LLP

McLean, Virginia
August 9, 2016

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICERS

I, Stuart J.Udell, certify that:

- (1) I have reviewed this Annual Report on Form 10-K of K12 Inc.;
- (2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- (4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 9, 2016

/s/ STUART J.UDELL

Stuart J.Udell
Chief Executive Officer (Principal Executive Officer)

CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER

I, James J. Rhyu, certify that:

- (1) I have reviewed this Annual Report on Form 10-K of K12 Inc.;
- (2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- (3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- (4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- (5) The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 9, 2016

/s/ JAMES J. RHYU

James J. Rhyu
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

Exhibit 32.1

The following certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350 and in accordance with SEC Release No. 33-8238. This certification shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, nor shall it be incorporated by reference in any filing of the Company under the Securities Act of 1933, as amended, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

Section 906 Certification

Pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of K12 Inc., a Delaware corporation (the “Company”), hereby certifies, to such officer’s knowledge, that:

- (1) the accompanying Annual Report of the Company on Form 10-K for the fiscal year ended June 30, 2016 (the “Report”) fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 9, 2016

/s/ STUART J. UDELL

Stuart J. Udell

Chief Executive Officer (Principal Executive Officer)

Exhibit 32.2

The following certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350 and in accordance with SEC Release No. 33-8238. This certification shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, nor shall it be incorporated by reference in any filing of the Company under the Securities Act of 1933, as amended, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

Section 906 Certification

Pursuant to 18 U.S.C. Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of K12 Inc., a Delaware corporation (the “Company”), hereby certifies, to such officer’s knowledge, that:

- (1) the accompanying Annual Report of the Company on Form 10-K for the fiscal year ended June 30, 2016 (the “Report”) fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 9, 2016

/s/ JAMES J. RHYU

James J. Rhyu
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

OPERATING INCOME AND EBITDA

From 2014–2016, K12 incurred various charges, including:

- \$32.2 million relating to additional reserves, accelerated amortization and severance costs, and the \$6.4 million realized gain on sale of assets for the year ended June 30, 2014;
- \$28.4 million relating to reserves and write downs related to end-of-life products, software and inventory, incremental accounts receivable reserves, and severance costs for the year ended June 30, 2015; and
- \$7.1 million relating to a settlement with the State of California resolving all claims related to an Attorney General inquiry with no admission of liability or wrongdoing, and no fines or penalties in the year ended June 30, 2016.

A reconciliation of GAAP Operating Income to the Operating Income presented on pages V–VI inclusive of the aforementioned charges is as follows:

(\$ million)	2014	2015	2016
Operating Income (GAAP)	22.9	18.4	13.9
Impact to Operating Income of aforementioned charges	32.2	25.3	7.1
Operating Income (as presented)	55.1	43.7	21.0

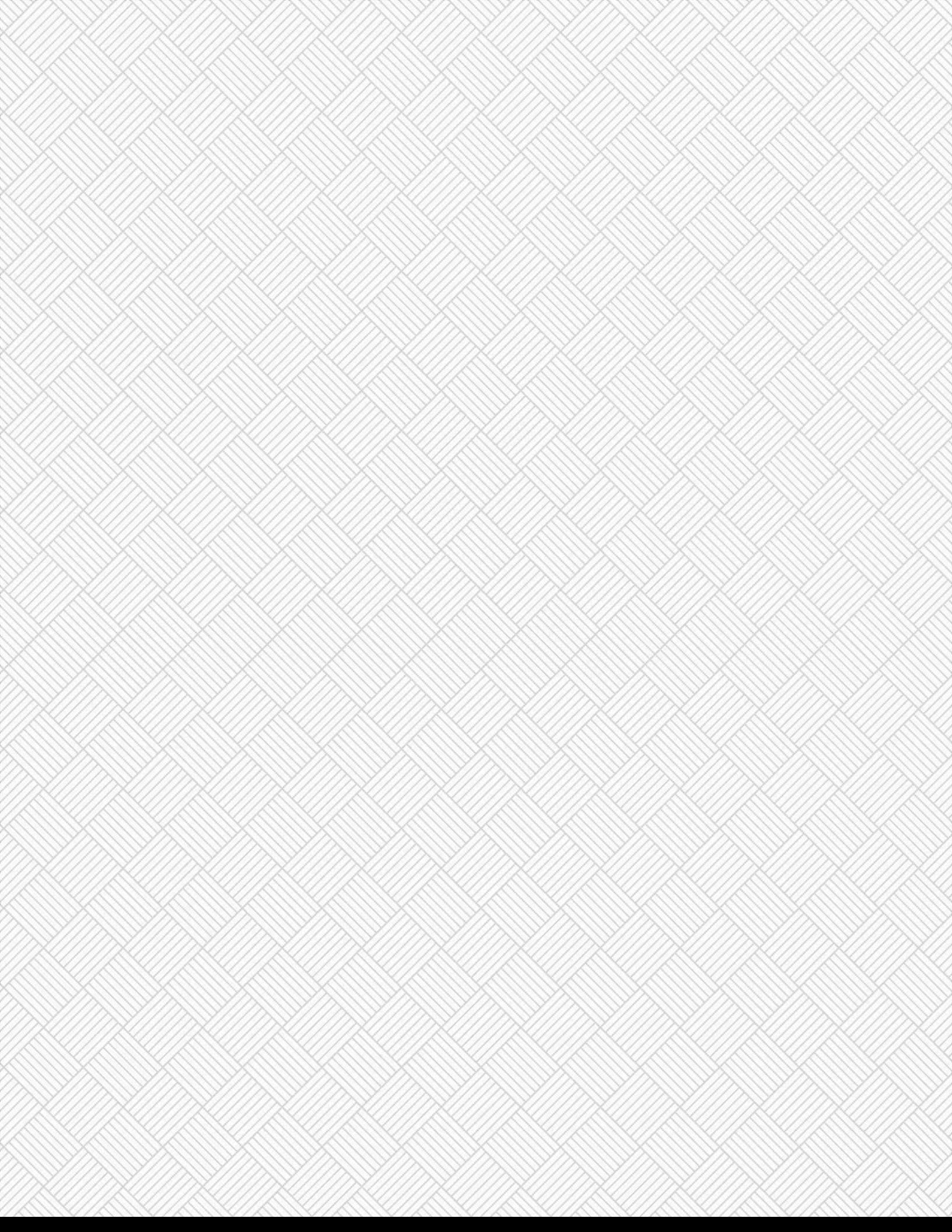
A reconciliation of GAAP Net Income to the EBITDA presented on pages V–VI inclusive of the aforementioned charges is as follows:

(\$ million)	2014	2015	2016
Net Income	19.6	11.0	9.0
Interest expense (income), net	-	3.3	0.6
Income tax expense	11.1	5.8	4.8
Depreciation and amortization	86.3	83.8	68.2
Noncontrolling interest	(1.5)	(1.7)	(0.5)
Net impact to EBITDA of aforementioned charges	8.1	11.4	7.1
EBITDA	123.6	113.6	89.2

FREE CASH FLOW

The following is a reconciliation of GAAP Net Cash Provided by Operating Activities to Free Cash Flow.

(\$ million)	2014	2015	2016
Net Cash Provided by Operating Activities	122.9	120.1	121.8
Purchases of property and equipment	(7.4)	(9.9)	(5.0)
Capitalized software development costs	(26.6)	(33.8)	(36.3)
Capitalized curriculum development costs	(15.4)	(18.1)	(21.6)
Free Cash Flow	(73.5)	58.3	58.9





Executive Management

Nathaniel A. Davis
Executive Chairman

Stuart J. Udell
Chief Executive Officer

James J. Rhyu
*Executive Vice President
and Chief Financial Officer*

Howard D. Polsky
*Executive Vice President,
General Counsel, and Secretary*

Allison B. Cleveland
*Executive Vice President,
School Management and Services*

Lynda B. Cloud
*Executive Vice President,
Products*

Joseph P. Zarella
*Executive Vice President,
Business Operations*

Jarayam “Bala” Balachander
*Senior Vice President,
Software Product Development
and Chief Technology Officer*

Robert W. Banwarth
*Senior Vice President
and Chief Information Officer*

Bryan W. Flood
Senior Vice President, Public Affairs

Mary F. Gifford
*Senior Vice President,
Academic Policy and External Relations*

Sameer S. Kasargod
*Senior Vice President
and Chief Marketing Officer*

Valerie A. Maddy
*Senior Vice President,
Human Resources*

Peter G. Stewart
*Senior Vice President,
School Development*

Board of Directors

Nathaniel A. Davis
*Executive Chairman,
K12 Inc.*

Craig R. Barrett
*Retired Chairman and CEO,
Intel Corporation*

Guillermo Bron
*Managing Director,
Pine Brook Road Partners, LLC*

Fredda J. Cassell
*Retired Partner,
PricewaterhouseCoopers LLP*

Adam L. Cohn
Co-CEO, Stone Canyon Industries LLC

John M. Engler
President, Business Roundtable

Steven B. Fink
Deputy Chairman, Heron International

Jon Q. Reynolds, Jr.
*General Partner,
Technology Crossover Ventures*

Andrew H. Tisch
*Co-Chairman of the Board and
Chairman of Executive Committee,
Loews Corporation*

Stuart J. Udell
*Chief Executive Officer,
K12 Inc.*

Company Directory

Transfer Agent
*Computershare
P.O. Box 30170
College Station, TX 77842
800.368.5948
Corporate website: computershare.com*

Independent Auditor
*BDO USA, LLP
Bethesda, MD*

Legal Counsel
*Latham & Watkins, LLP
Washington, DC*

Stock Exchange Listing
*Listed on the New York Stock
Exchange under the symbol LRN*

Annual Meeting
*The annual meeting of K12 Inc.
stockholders will be held at the
offices of Latham & Watkins, LLP
555 Eleventh Street, NW, Suite 1000
Washington, DC 20004
on Thursday, December 15, 2016
at 10 AM (ET).*

Investor Inquiries
*Michael S. Kraft
Vice President, Finance
571.353.7778
mkraft@K12.com*

Online Information
*For corporate reports and
company news, visit K12.com.*



***“K12 online school curriculum is challenging
to young minds and gives them the eagerness
to learn and crave education.”***

—KASSYLENA L., 2016, PARENT OF A K12 STUDENT

VISIT US: K12.com
TALK WITH US: 866.968.7512