K12 INC
Form 10-Q
October 27, 2017
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2017

OR

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	95-4774688
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2300 Corporate Park Drive Herndon, VA	 20171
(Address of Principal Executive Offices)	(Zip Code)

(703) 483-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of October 19, 2017, the Registrant had 41,332,774 shares of common stock, $0.0001 par value per share outstanding.

Table of Contents

K12 Inc.

Form 10-Q

For the Quarterly Period Ended September 30, 2017

Index

		Page Number
PART I.	Financial Information	
Item 1.	Financial Statements (Unaudited)	3
Item 2.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	26
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	31
Item 4.	Controls and Procedures	32
PART II.	Other Information	
Item 1.	Legal Proceedings	33
Item 1A.	Risk Factors	33
Item 2.	Issuer Purchases of Equity Securities	33
Item 3.	Defaults Upon Senior Securities	33
Item 4.	Mine Safety Disclosures	33
Item 5.	Other Information	34
Item 6.	Exhibits	34
Signatures		35

Table of Contents

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited).

K12 INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2017	June 30, 2017
	(In thousands except share and per share data)	
ASSETS		
Current assets		
Cash and cash equivalents	$ 147,342	$ 230,864
Accounts receivable, net of allowance of $13,992 and $14,791 at September 30, 2017 and June 30, 2017, respectively	282,785	192,205
Inventories, net	18,588	30,503
Prepaid expenses	33,826	8,006
Other current assets	15,678	12,004
Total current assets	498,219	473,582
Property and equipment, net	32,468	26,297
Capitalized software, net	60,839	62,695
Capitalized curriculum development costs, net	57,056	59,213
Intangible assets, net	19,509	20,226
Goodwill	87,214	87,214
Deposits and other assets	7,134	6,057
Total assets	$ 762,439	$ 735,284
LIABILITIES, REDEEMABLE NONCONTROLLING INTEREST AND STOCKHOLDERS' EQUITY		
Current liabilities		
Current portion of capital lease obligations	$ 14,121	$ 11,880
Accounts payable	34,010	30,052
Accrued liabilities	11,509	21,622
Accrued compensation and benefits	14,281	29,367
Deferred revenue	65,769	24,830
Total current liabilities	139,690	117,751
Capital lease obligations, net of current portion	15,167	10,025
Deferred rent, net of current portion	3,939	4,157
Deferred tax liability	23,772	16,726
Other long-term liabilities	12,299	11,579
Total liabilities	194,867	160,238

Commitments and contingencies	—	—
Redeemable noncontrolling interest	700	700
Stockholders’ equity		
Common stock, par value $0.0001; 100,000,000 shares authorized; 44,837,066 and 44,325,772 shares issued and 41,334,468 and 40,823,174 shares outstanding at September 30, 2017 and June 30, 2017, respectively	4	4
Additional paid-in capital	691,294	690,488
Accumulated other comprehensive loss	(325)	(170)
Accumulated deficit	(49,101)	(40,976)
Treasury stock of 3,502,598 shares at cost at September 30, 2017 and June 30, 2017	(75,000)	(75,000)
Total stockholders’ equity	566,872	574,346
Total liabilities, redeemable noncontrolling interest and stockholders' equity	$ 762,439	$ 735,284

See accompanying summary of accounting policies and notes to unaudited condensed consolidated financial statements.

Table of Contents

K12 INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,	
	2017	2016
	(In thousands except share and per share data)	
Revenues	$ 228,785	$ 229,138
Cost and expenses		
Instructional costs and services	147,367	144,099
Selling, administrative, and other operating expenses	96,282	104,646
Product development expenses	2,898	3,062
Total costs and expenses	246,547	251,807
Loss from operations	(17,762)	(22,669)
Interest income, net	235	342
Loss before income taxes and noncontrolling interest	(17,527)	(22,327)
Income tax benefit	9,368	8,690
Net loss	(8,159)	(13,637)
Add net loss (income) attributable to noncontrolling interest	103	(196)
Net loss attributable to common stockholders	$ (8,056)	$ (13,833)
Net loss attributable to common stockholders per share:		
Basic and diluted	$ (0.21)	$ (0.36)
Weighted average shares used in computing per share amounts:		
Basic and diluted	39,108,172	37,938,705

See accompanying summary of accounting policies and notes to unaudited condensed consolidated financial statements.

Table of Contents

K12 INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

	Three Months Ended September 30,	
	2017	2016
	(In thousands)	
Net loss	$ (8,159)	$ (13,637)
Other comprehensive income, net of tax:		
Foreign currency translation adjustment	(155)	152
Total other comprehensive loss, net of tax	(8,314)	(13,485)
Comprehensive loss (income) attributable to noncontrolling interest	103	(196)
Comprehensive loss attributable to common stockholders	$ (8,211)	$ (13,681)

See accompanying summary of accounting policies and notes to unaudited condensed consolidated financial statements.

Table of Contents

K12 INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	K12 Inc. Stockholders' Equity							
(In thousands except share data)	Common Stock		Additional Paid-in	Other Accumulated Comprehensive	Accumulated	Treasury Stock		
	Shares	Amount	Capital	Loss	Deficit	Shares	Amount	Total
Balance, June 30, 2017	44,325,772	$ 4	$ 690,488	$ (170)	$ (40,976)	(3,502,598)	$ (75,000)	$ 574,346
Adjustment related to new stock-based compensation guidance	—	—	112	—	(69)	—	—	43
Net loss (1)	—	—	—	—	(8,056)	—	—	(8,056)
Foreign currency translation adjustment	—	—	—	(155)	—	—	—	(155)
Stock-based compensation expense	—	—	4,832	—	—	—	—	4,832
Exercise of stock options	3,350	—	58	—	—	—	—	58
Issuance of restricted stock awards	867,388	—	—	—	—	—	—	—
Forfeiture of restricted stock awards	(129,286)	—	—	—	—	—	—	—
Adjustment to redeemable noncontrolling interest to estimated redemption value	—	—	(103)	—	—	—	—	(103)
Retirement of restricted stock for tax withholding	(230,158)	—	(4,093)	—	—	—	—	(4,093)
Balance, September 30, 2017	44,837,066	$ 4	$ 691,294	$ (325)	$ (49,101)	(3,502,598)	$ (75,000)	$ 566,872

(1) Net loss excludes $0.1 million due to the redeemable noncontrolling interest related to LearnBop, which is reported outside of permanent equity in the accompanying unaudited condensed consolidated balance sheets.

See accompanying summary of accounting policies and notes to unaudited condensed consolidated financial statements.

Table of Contents

K12 INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended September 30,	
	2017	2016
	(In thousands)	
Cash flows from operating activities		
Net loss	$ (8,159)	$ (13,637)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization expense	20,636	17,680
Stock-based compensation expense	3,079	4,694
Excess tax benefit from stock-based compensation	—	(103)
Deferred income taxes	7,765	8,291
Provision for doubtful accounts	120	239
Provision for excess and obsolete inventory	308	235
Provision for student computer shrinkage and obsolescence	23	224
Expensed computer peripherals	2,092	1,925
Changes in assets and liabilities:		
Accounts receivable	(90,704)	(94,871)
Inventories	11,607	14,067
Prepaid expenses	(25,820)	(21,901)
Other current assets	(3,674)	(3,077)
Deposits and other assets	(1,220)	2,447
Accounts payable	8,168	5,277
Accrued liabilities	(10,795)	(12,860)
Accrued compensation and benefits	(15,086)	(14,646)
Deferred revenue	40,939	45,790
Deferred rent and other liabilities	499	296
Net cash used in operating activities	(60,222)	(59,930)
Cash flows from investing activities		
Purchase of property and equipment	(5,143)	(960)
Capitalized software development costs	(7,934)	(7,222)
Capitalized curriculum development costs	(2,445)	(5,846)
Net cash used in investing activities	(15,522)	(14,028)
Cash flows from financing activities		
Repayments on capital lease obligations	(3,743)	(3,977)
Proceeds from exercise of stock options	58	437
Excess tax benefit from stock-based compensation	—	103
Repurchase of restricted stock for income tax withholding	(4,093)	(1,498)
Net cash used in financing activities	(7,778)	(4,935)
Effect of foreign exchange rate changes on cash and cash equivalents	—	(8)
Net change in cash and cash equivalents	(83,522)	(78,901)
Cash and cash equivalents, beginning of period	230,864	213,989
Cash and cash equivalents, end of period	$ 147,342	$ 135,088

See accompanying summary of accounting policies and notes to unaudited condensed consolidated financial statements.

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED 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 and third party curriculum, software systems and educational services designed to facilitate individualized learning for students primarily in kindergarten through 12th grade, or K-12. 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 products and services are provided primarily to three lines of business: Managed Public School Programs (curriculum and services sold to 75 managed public schools in a majority of states throughout the United States), 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 a partner with 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 courses and supplemental solutions. In addition to curriculum, systems and programs, the Company provides teacher training, teaching services, and other academic and technology support services.

2. Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2017, the condensed consolidated statements of operations and comprehensive loss for the three months ended September 30, 2017, the condensed consolidated statements of cash flows for the three months ended September 30, 2017 and 2016, and the condensed consolidated statement of stockholders' equity for the three months ended September 30, 2017 are unaudited. The unaudited interim financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to present fairly the Company's financial position and results of operations for the periods presented. The results for the three months ended September 30, 2017 are not necessarily indicative of the results to be expected for the year ending June 30, 2018 or for any other interim period or for any other future fiscal year. The condensed consolidated balance sheet as of June 30, 2017 has been derived from the audited consolidated financial statements at that date.

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Accordingly, the Company does not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, these statements include all adjustments (consisting of normal recurring adjustments) considered necessary to present a fair statement of the Company's condensed consolidated results of operations, financial position and cash flows. Preparation of the Company's financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts in the financial statements and footnotes. Actual results could differ from those estimates. This quarterly report on Form 10-Q should be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K filed with the Securities and Exchange Commission (the "SEC") on August 9, 2017, which contains the Company's audited financial statements for the fiscal year ended June 30, 2017.

The Company operates in one operating and reportable business segment as a technology-based education company providing proprietary and third party 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 on consolidated results.

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

3. Summary of Significant Accounting Policies

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 charter schools, traditional public schools, school districts, 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 development 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 revenue.

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 revenues received by the school from its state funding school district or from other sources up to the expenses incurred in accordance with Accounting Standards Codification (“ASC”) 605, Revenue Recognition (“ASC 605”). As a result of being the primary obligor, amounts recorded as revenues and school operating expenses for the three months ended September 30, 2017 and 2016 were $63.5 million and $62.5 million, respectively. For contracts where the Company is not the primary obligor, the Company records revenues 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 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, where required;

- internet access and technology support services;
- instruction by 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, revenues are 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. Revenues from certain managed schools are recognized ratably over the period services are performed.

To determine the pro rata amount of revenues to recognize in a fiscal quarter, the Company 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. The Company reviews its estimates of funding periodically, and revises 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

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 three months ended September 30, 2017 and 2016.

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 revenues 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 service contract revenues, 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 revenues, net of its estimated portion of school operating losses, to reflect the expected cash collections from such schools. Revenues are 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 expenses 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.

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 three months ended September 30, 2017 and 2016, the Company's revenues included a reduction for these school operating losses of $17.8 million and $15.7 million, respectively.

The Company provides certain online curriculum and services to schools and school districts under subscription and perpetual license agreements. Revenues under these agreements are recognized 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. Revenues from the licensing of curriculum under subscription arrangements are recognized on a ratable basis over the subscription period. Revenues from the licensing of curriculum under non-cancelable perpetual arrangements are recognized when all revenue recognition criteria have been met. Revenues from professional consulting, training and support services are deferred and recognized ratably over the service period.

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 three months ended September 30, 2017 and 2016, the Company had one contract that represented approximately 10% of revenues. Approximately 7% of accounts receivable was attributable to one contract as of September 30, 2017.

Consolidation

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

Inventories

Inventories consist primarily of textbooks and curriculum materials, a majority of which are supplied to virtual public schools and blended public schools and utilized directly by students. Inventories represent items that are purchased and held for sale and are recorded at the lower of cost (first-in, first-out method) or net realizable value. Provisions for excess and obsolete inventory are established based upon the evaluation of the quantity on hand relative to demand. The excess and obsolete inventory reserve was $2.6 million and $2.3 million at September 30, 2017 and June 30, 2017, 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 expense. Leasehold improvements are amortized over the lesser of the lease term or the estimated useful life of the asset. The Company determines the lease term in accordance with ASC 840, Leases ("ASC 840"), 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:

	Useful Life
Student and state testing computers	3 - 5 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. The Company recorded accelerated depreciation of $0.4 million and $0.5 million, for the three months ended September 30, 2017 and 2016, respectively related to unreturned student computers. Depreciation expense for property

and equipment, including accelerated depreciation for unreturned student computers, for the three months ended September 30, 2017 and 2016 was $4.4 million and $4.4 million, respectively.

The Company fully expenses computer peripheral equipment (e.g. keyboards, mouses) upon shipment as recovery has been determined to be uneconomical. These expenses totaled $2.1 million and $1.9 million for the three months ended September 30, 2017 and 2016, respectively, and are recorded as instructional costs and services.

Capitalized Software Costs

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 (“ASC 350”). 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 additions totaled $7.9 million and $7.2 million for the three months ended September 30, 2017 and 2016, respectively. Amortization expense for the three months ended September 30, 2017 and 2016 was $10.3 million and $8.0 million, respectively.

During the three months ended September 30, 2017, the Company recorded an out of period adjustment related to the capitalization of software and curriculum development. The adjustment increased capitalized software development costs and capitalized curriculum development costs by $2.3 million and $0.6 million, respectively, and decreased net loss by $1.4 million for the period. The Company assessed the materiality of these errors on its prior quarterly and annual financial statements, assessing materiality both quantitatively and qualitatively, in accordance with the SEC’s Staff Accounting Bulletin (“SAB”) No. 99 and SAB No. 108 and concluded that the errors were not material to any of its previously issued financial statements.

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. 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 are amortized is generally five years.

Total capitalized curriculum development additions were $2.4 million and $5.8 million for the three months ended September 30, 2017 and 2016, respectively. These amounts are recorded on the accompanying condensed consolidated balance sheets net of amortization charges. Amortization is recorded in instructional costs and services on the accompanying condensed consolidated statements of operations. Amortization expense for the three months ended September 30, 2017 and 2016 was $5.2 million and $4.6 million, respectively. As mentioned above, capitalized curriculum development additions included an out of period adjustment of $0.6 million.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740, Income Taxes ("ASC 740"). 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.

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

Redeemable Noncontrolling Interests

Earnings or losses attributable to minority shareholders of a consolidated affiliated company are classified separately as “noncontrolling interest” in the Company’s condensed consolidated statements of operations. 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. 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.

Goodwill and Intangible Assets

The Company records as goodwill the excess of the 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. Amortization expense for the three months ended September 30, 2017 and 2016 was $0.7 million and $0.7 million, respectively. Future amortization of intangible assets is $2.1 million, $2.8 million, $2.7 million, $2.3 million and $2.2 million in the fiscal years ending June 30, 2018 through June 30, 2022, respectively, and $7.1 million thereafter. At both September 30, 2017 and June 30, 2017, the goodwill balance was $87.2 million.

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. During the three months ended September 30, 2017 and 2016, there were no events or changes in circumstances that would indicate that the carrying amount of the goodwill was impaired.

ASC 350 prescribes a two-step process for impairment testing of goodwill and intangible assets 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”. The Company performs its annual assessment on May 31st. 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. During the year ended June 30, 2017, the Company performed “Step 0” of the impairment test and determined that there were no facts and circumstances that indicated that the fair value of the reporting unit may be less than its carrying amount and as a result, the Company determined that no impairment was required. During the three months ended September 30, 2017 and 2016, there were no events or changes in circumstances that would indicate that the carrying amount of the goodwill was impaired.

The following table represents the balance of the Company’s intangible assets as of September 30, 2017 and June 30, 2017:

	September 30, 2017			June 30, 2017		
($ in millions)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value	Gross Carrying Amount	Accumulated Amortization	Net Carrying Value
Trade names	$ 17.6	$ (7.8)	$ 9.8	$ 17.6	$ (7.6)	$ 10.0
Customer and distributor relationships	20.1	(12.4)	7.7	20.1	(12.0)	8.1
Developed technology	2.9	(1.8)	1.1	2.9	(1.7)	1.2
Other	1.4	(0.5)	0.9	1.4	(0.5)	0.9
Total	$ 42.0	$ (22.5)	$ 19.5	$ 42.0	$ (21.8)	$ 20.2

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

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 (“ASC 360”), 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 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. During the three months ended September 30, 2017 and 2016, there was no such impairment charge.

Fair Value Measurements

ASC 820, Fair Value Measurements and Disclosures (“ASC 820”), 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 instrument's valuation.

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

The held for sale asset is discussed in more detail in Note 11, "Investments." The lease exit liability is discussed in more detail in Note 10, "Restructuring." The redeemable noncontrolling interest includes the Company's joint venture with Middlebury College to form Middlebury Interactive Languages ("MIL"). Under the agreement, Middlebury College had an irrevocable election to sell all of its membership interest to the Company (put right). Middlebury College exercised its put right on May 4, 2015 and a transaction to acquire the remaining 40% noncontrolling interest for $9.1 million in cash was consummated on December 27, 2016.

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table summarizes certain fair value information at September 30, 2017 for assets or liabilities measured at fair value on a nonrecurring basis:

	Fair Value Measurements Using:			
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Held for sale asset	$ 1,200	$ —	$ —	$ 1,200
Lease exit liability	4,423	—	—	4,423
Total	$ 5,623	$ —	$ —	$ 5,623

The following table summarizes certain fair value information at June 30, 2017 for assets and liabilities measured at fair value on a nonrecurring basis:

	Fair Value Measurements Using:			
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Held for sale asset	$ 1,200	$ —	$ —	$ 1,200
Lease exit liability	4,841	—	—	4,841
Total	$ 6,041	$ —	$ —	$ 6,041

The following table summarizes certain fair value information at September 30, 2017 for assets or liabilities measured at fair value on a recurring basis:

Description	Fair Value Measurements Using:			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Contingent consideration associated with acquisition of LTS Education Systems	$ 838	$ —	$ —	$ 838
Total	$ 838	$ —	$ —	$ 838

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following table summarizes certain fair value information at June 30, 2017 for assets and liabilities measured at fair value on a recurring basis:

	Fair Value Measurements Using:			
Description	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Input (Level 2)	Significant Unobservable Inputs (Level 3)
	(In thousands)			
Contingent consideration associated with acquisition of LTS Education Systems	$ 2,806	$ —	$ —	$ 2,806
Total	$ 2,806	$ —	$ —	$ 2,806

The following tables summarize the activity during the three months ended September 30, 2017 and 2016 for assets and liabilities measured at fair value on a recurring basis:

	Three Months Ended September 30, 2017			
Description	Fair Value June 30, 2017	Purchases, Issuances, and Settlements	Realized Gains/(Losses)	Fair Value September 30, 2017
	(In thousands)			
Contingent consideration associated with acquisition of LTS Education Systems	$ 2,806	$ (1,819)	$ (149)	$ 838
Total	$ 2,806	$ (1,819)	$ (149)	$ 838

	Three Months Ended September 30, 2016			
Description	Fair Value June 30, 2016	Purchases, Issuances, and Settlements	Unrealized Gains (Losses)	Fair Value September 30, 2016
	(In thousands)			
	$ 6,801	$ —	$ 2,400	$ 9,201

Redeemable Noncontrolling Interest in Middlebury Interactive Learning				
Contingent consideration associated with acquisition of LTS Education Systems	2,947	—	8	2,955
Total	$ 9,748	$ —	$ 2,408	$ 12,156

Net Income (Loss) Per Common Share

The Company calculates net income (loss) per share in accordance with ASC 260, Earnings Per Share ("ASC 260"). 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") reflects 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 as income tax expense 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 condensed consolidated balance sheets includes restricted stock awards

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

outstanding. Securities that may participate in undistributed net income with common stock are considered participating securities.

	Three Months Ended September 30,	
	2017	2016
	(In thousands except share and per share data)	
Basic and diluted net loss per share computation:		
Net loss attributable to common stockholders	$ (8,056)	$ (13,833)
Weighted average common shares — basic	39,108,172	37,938,705
Weighted average common shares — diluted	39,108,172	37,938,705
Basic and diluted net loss per share	$ (0.21)	$ (0.36)

For the three months ended September 30, 2017 and 2016 shares issuable in connection with stock options and restricted stock of 2,645,987 and 4,100,953 respectively, were excluded from the diluted earnings per share calculation because the effect would have been antidilutive. As of September 30, 2017, the Company had 44,837,066 shares issued and 41,334,468 shares outstanding.

Recent Accounting Pronouncements

Accounting Standards Adopted

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-09, Compensation - Stock Compensation (Topic 718) ("ASU 2016 09"). 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 and an accounting policy election for forfeitures. As part of the new guidance:

- Excess tax benefits or deficiencies arising from share-based awards will be reflected in the condensed consolidated statements of operations as income tax expense rather than within stockholders' equity. The adoption of this guidance may result in volatility within a company's results of operations, primarily due to changes in the stock price.
- Excess tax benefits will be presented as an operating activity on the statement of cash flows rather than as a financing activity.

- A forfeiture election will be made to either estimate forfeitures (similar to today's requirement) or recognize actual forfeitures as they occur. Entities will apply the forfeiture election provision using a modified retrospective transition approach, with a cumulative effect adjustment recorded to retained earnings as of the beginning of the period of adoption.
- Statutory tax withholding requirements for employers who withhold shares upon settlement of an award on behalf of an employee to cover tax obligations are broadened to allow for a range of withholding from the minimum to the maximum statutory allowable amounts.

The Company adopted this guidance during the first quarter of fiscal 2018. As part of its adoption of ASU 2016 09, the Company made an accounting policy election to change the way in which it accounts for forfeitures of share-based awards. Specifically, beginning in the first quarter of fiscal 2018, the Company recognizes forfeitures of share-based awards as they occur in the period of forfeiture rather than estimating the number of awards expected to be forfeited at the grant date and subsequently adjusting the estimate when awards are actually forfeited. The change in accounting policy resulted in an adjustment to retained earnings as of July 1, 2017 of $0.1 million.

The Company has adopted the remaining provisions as follows:

- Excess tax benefits arising from share-based awards are reflected within the condensed consolidated statements of operations as income tax expense; adopted prospectively;
- Excess tax benefits are presented as an operating activity on the statement of cash flows; adopted

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

prospectively; and

- The Company is now permitted to withhold shares beyond the minimum statutory tax withholding requirements upon settlement of an award; adopted prospectively.

Accounting Standards Not Yet Adopted

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), which supersedes most existing revenue recognition guidance under 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 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. The Company is currently evaluating the impact this standard will have on its consolidated financial statements which includes performing a detailed review of each of its revenue streams and comparing historical accounting policies and practices to the new standard. The Company will provide expanded disclosures pertaining to revenue recognition in our annual and quarterly filings beginning in the first quarter of fiscal 2019. The Company expects to complete its assessment of the cumulative effect of adopting ASU 2014-09 as well as the expected impact of adoption during fiscal 2018.

4. Income Taxes

The provision for income taxes is based on earnings reported in the condensed consolidated financial statements. A deferred income tax asset or liability is determined by applying currently enacted tax laws and rates to 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 period. For the three months ended September 30, 2017 and 2016, the Company’s effective income tax rate was 53.4% and 38.9%, respectively. The effective income tax rate differs from the statutory federal income tax rate primarily due to the tax impact of the adoption of ASU 2016-09 related to stock compensation, state taxes, current year permanent differences between book and tax treatment, effects of foreign operations, and noncontrolling interests.

5. Long-term Obligations

Capital Leases

The Company incurs capital lease obligations for student computers under a non-revolving lease line of credit with PNC Equipment Finance, LLC. As of September 30, 2017 and June 30, 2017, the outstanding balance of capital leases under the current and former lease lines of credit (as discussed in more detail below) was $29.3 million and $21.9 million, respectively, with lease interest rates ranging from 1.95% to 2.84%. Individual leases under the lease lines 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 gross carrying value of leased student computers as of September 30, 2017 and June 30, 2017 was $45.6 million and $39.1 million, respectively. The accumulated depreciation of leased student computers as of September 30, 2017 and June 30, 2017 was $25.2 million and $25.1 million, respectively.

The Company had $24.2 million and $31.9 million of remaining availability under its lease line of credit as of September 30, 2017 and June 30, 2017, respectively. Interest on unpaid principal under the lease line of credit is at a fluctuating rate of LIBOR plus 1.2%.

Table of Contents

K12 INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - Continued

The following is a summary as of September 30, 2017 of the present value of the net minimum lease payments on capital leases under the Company’s commitments:

As of June 30,