

Knowledge Universe Education . and Subsidiaries

Consolidated Financial Statements as of and for the
Years Ended December 31, 2013 and 2012, and
Independent Auditors' Report

KNOWLEDGE UNIVERSE EDUCATION ■. AND SUBSIDIARIES

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors of
KUE Management Inc., General Partner of
Knowledge Universe Education [REDACTED] and Subsidiaries
Santa Monica, California

We have audited the accompanying consolidated financial statements of Knowledge Universe Education [REDACTED] and subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of operations, comprehensive income, partners' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

June 30, 2014

KNOWLEDGE UNIVERSE EDUCATION ■. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	2013	2012
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 396,757	\$ 259,391
Short-term marketable securities	755	1,015
Accounts receivable — net	60,323	60,681
Income tax receivable	2,474	3,864
Deferred income taxes	31,402	28,427
Assets held for sale	82	26,578
Prepaid expenses and other current assets	27,746	30,352
Assets related to discontinued operations		28
Total current assets	519,539	410,336
PROPERTY AND EQUIPMENT — Net	886,466	920,814
LONG-TERM INVESTMENTS	3,820	155,937
GOODWILL	383,336	384,702
OTHER INTANGIBLE ASSETS — Net	95,286	99,245
ASSETS HELD FOR SALE		250,642
DEFERRED INCOME TAXES	30,002	29,914
OTHER ASSETS	67,988	51,540
ASSETS RELATED TO DISCONTINUED OPERATIONS		2,025
TOTAL	<u>\$1,986,437</u>	<u>\$2,305,155</u>

(Continued)

KNOWLEDGE UNIVERSE EDUCATION ■. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS AS OF DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	2013	2012
LIABILITIES AND EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 23,076	\$ 21,157
Current portion of self-insurance	22,910	21,712
Income taxes payable	650	231
Accrued property and other taxes	16,178	12,810
Deferred revenue	65,607	61,941
Accrued interest	6,233	7,231
Accrued compensation and related expenses	55,619	49,249
Other accrued liabilities	30,626	34,737
Current portion of long-term debt	19,856	18,061
Current portion of capital lease obligations	3,031	3,840
Current portion of liabilities associated with assets held for sale	<u> </u>	<u>64,165</u>
Total current liabilities	243,786	295,134
LONG-TERM DEBT	885,437	910,207
CAPITAL LEASE OBLIGATIONS	8,027	10,903
DEFERRED INCOME TAXES	65,762	70,328
LIABILITIES ASSOCIATED WITH ASSETS HELD FOR SALE		154,663
OTHER LONG-TERM LIABILITIES	<u>64,910</u>	<u>60,419</u>
Total liabilities	<u>1,267,922</u>	<u>1,501,654</u>
EQUITY:		
Partners' equity:		
Common partner units — 2,239,551 units issued and outstanding	388,141	757,383
Accumulated other comprehensive income	6,812	53,119
Retained earnings (accumulated deficit)	<u>308,559</u>	<u>(20,344)</u>
Total partners' equity attributable to Knowledge Universe Education ■.	703,512	790,158
Noncontrolling interests	<u>15,003</u>	<u>13,343</u>
Total equity	<u>718,515</u>	<u>803,501</u>
TOTAL	<u>\$ 1,986,437</u>	<u>\$ 2,305,155</u>

See notes to consolidated financial statements.

(Concluded)

KNOWLEDGE UNIVERSE EDUCATION ■ AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	2013	2012
REVENUE	\$ 1,564,669	\$ 1,531,173
COST OF REVENUE	<u>1,113,640</u>	<u>1,104,494</u>
GROSS MARGIN	<u>451,029</u>	<u>426,679</u>
OPERATING EXPENSES:		
General and administrative	286,568	291,660
Depreciation	86,820	98,197
Amortization of intangibles	3,067	4,209
Loss on closure of centers and other expenses	<u>12,655</u>	<u>4,317</u>
Total operating expenses — net	<u>389,110</u>	<u>398,383</u>
INCOME FROM OPERATIONS	<u>61,919</u>	<u>28,296</u>
NONOPERATING EXPENSE (INCOME):		
Gain on investments	(166,598)	(1,446)
Gain on extinguishment of debt	(52)	(6,439)
Interest expense	62,817	64,507
Interest income	(697)	(3,353)
Other income (expense) — net	<u>4,352</u>	<u>(1,722)</u>
Nonoperating (income) expense — net	<u>(100,178)</u>	<u>51,547</u>
INCOME (LOSS) BEFORE INCOME TAXES	162,097	(23,251)
INCOME TAX BENEFIT	<u>4,416</u>	<u>18,318</u>
INCOME (LOSS) FROM CONTINUING OPERATIONS — Net of taxes	166,513	(4,933)
INCOME FROM DISCONTINUED OPERATIONS	<u>165,662</u>	<u>9,472</u>
NET INCOME	332,175	4,539
LESS NET INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS	<u>(3,272)</u>	<u>(2,503)</u>
NET INCOME ATTRIBUTABLE TO KNOWLEDGE UNIVERSE EDUCATION ■	<u>\$ 328,903</u>	<u>\$ 2,036</u>

See notes to consolidated financial statements.

KNOWLEDGE UNIVERSE EDUCATION ■. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

(Dollars in thousands)

	2013	2012
NET INCOME	\$ 332,175	\$ 4,539
OTHER COMPREHENSIVE INCOME (LOSS):		
Foreign currency translation adjustments	3,648	3,775
Unrealized gain on investment — K12, Inc.	117,695	18,380
Reclassification of unrealized gain on K-12 Inc. investment to income upon distribution to shareholders	<u>(167,708)</u>	<u> </u>
Comprehensive income	285,810	26,694
LESS COMPREHENSIVE INCOME ATTRIBUTABLE TO NONCONTROLLING INTERESTS:		
Noncontrolling interest in net income	3,272	2,503
Foreign currency translation adjustments	<u>(58)</u>	<u>50</u>
COMPREHENSIVE INCOME ATTRIBUTABLE TO KNOWLEDGE UNIVERSE EDUCATION ■.	<u>\$ 282,596</u>	<u>\$ 24,141</u>

See notes to consolidated financial statements.

KNOWLEDGE UNIVERSE EDUCATION ■ AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF PARTNERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	Knowledge Universe Education ■						
	Common Partner Units	Amount	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Income	Total Partners' Equity	Noncontrolling Interests	Total Equity
BALANCE — January 1, 2012	2,239,551	\$ 757,383	(22,380)	31,014	766,017	10,290	776,307
Net income			2,036		2,036	2,503	4,539
Contribution by noncontrolling interest in KUE US LLC						500	500
Other comprehensive income (loss):							
Foreign currency translation adjustments				3,725	3,725	50	3,775
Unrealized gain on investments — K12 Inc.				18,380	18,380		18,380
BALANCE — December 31, 2012	2,239,551	757,383	(20,344)	53,119	790,158	13,343	803,501
Net income			328,903		328,903	3,272	332,175
Other comprehensive income (loss):							
Foreign currency translation adjustments				3,706	3,706	(58)	3,648
Unrealized gain on investment — K12 Inc.				117,695	117,695		117,695
Reclassification of unrealized gain on K-12 Inc. investment to income upon distribution to shareholders				(167,708)	(167,708)		(167,708)
Noncontrolling interest related to sale of Busy Bees						(1,554)	(1,554)
Cash distribution to partners		(100,000)			(100,000)		(100,000)
Distribution of K12 Inc. shares to partners		(269,242)			(269,242)		(269,242)
BALANCE — December 31, 2013	<u>2,239,551</u>	<u>\$ 388,141</u>	<u>\$ 308,559</u>	<u>\$ 6,812</u>	<u>\$ 703,512</u>	<u>\$ 15,003</u>	<u>\$ 718,515</u>

See notes to consolidated financial statements.

KNOWLEDGE UNIVERSE EDUCATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	2013	2012
OPERATING ACTIVITIES:		
Net income	\$ 332,175	\$ 4,539
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	83,508	90,471
Impairment of fixed assets	6,445	11,935
Impairment of goodwill	545	
Stock-based compensation	1,216	(182)
Loss on sale of property and equipment and software rights		1,169
Loss on sales of debt securities		1,574
Gain on extinguishment of debt	(52)	(6,439)
Gains on sale of investments	(167,708)	
Gain on sale of discontinued operations	(165,662)	(9,472)
Loss on liquidated discontinued operations		
Loss on sale of centers	41	
Unrealized gains on marketable securities and derivatives	(2,997)	(236)
Return on equity method investments		(836)
Amortization of deferred financing and other costs	3,468	4,964
Interest expense capitalized as long-term debt	(5)	
Foreign currency exchange gain (loss)	7,552	(10,790)
Changes in:		
Accounts receivable	1,120	12,270
Prepaid expenses and other current assets	15,653	3,855
Income tax receivable	2,992	6,956
Assets held for sale	(82)	117
Deferred income taxes	(9,153)	(11,827)
Other assets	(1,764)	2,897
Accounts payable	2,785	(19,310)
Accrued expenses and other liabilities	(358)	21,014
Net cash provided by discontinued operations	<u>29,883</u>	<u>20,798</u>
Net cash provided by operating activities	<u>139,602</u>	<u>123,467</u>
INVESTING ACTIVITIES:		
Purchases of property and equipment	(78,592)	(84,287)
Proceeds from sale of property and equipment	7,954	1,081
Proceeds from sale of investments	206,427	5,147
Increase in restricted cash	(17,365)	(14,642)
Proceeds from insurance recoveries	795	
Purchases of short-term marketable securities		(4,910)
Proceeds from sales of short-term marketable securities	250	44,220
Acquisitions of businesses		(95,977)
Investment in Open Realty Advisors	<u>609</u>	
Net cash provided by (used in) investing activities	<u>120,078</u>	<u>(149,368)</u>

(Continued)

KNOWLEDGE UNIVERSE EDUCATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012 (Dollars in thousands)

	2013	2012
FINANCING ACTIVITIES:		
Payments on long-term debt and capital leases	\$ (21,668)	\$ (108,242)
Proceeds from long-term debt		138,225
Contribution by noncontrolling interest		500
Distribution to partners	(100,000)	
Debt issuance costs	<u>(646)</u>	<u>(6,949)</u>
Net cash (used in) provided by financing activities	<u>(122,314)</u>	<u>23,534</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	137,366	(2,367)
CASH AND CASH EQUIVALENTS — Beginning of year	<u>259,391</u>	<u>261,758</u>
CASH AND CASH EQUIVALENTS — End of year	<u>\$ 396,757</u>	<u>\$ 259,391</u>
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for interest	<u>\$ 62,186</u>	<u>\$ 75,597</u>
Cash paid (refunded) for income taxes — net	<u>\$ 414</u>	<u>\$ (3,081)</u>
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Purchases of property and equipment included in current liabilities	<u>\$ 1,591</u>	<u>\$ 104</u>
Assets acquired under capital leases	<u>\$ 202</u>	<u>\$ 2,027</u>
Noncash distribution of K-12 shares to Partners	<u>\$ 269,242</u>	<u>\$ -</u>
See notes to consolidated financial statements.		(Concluded)

KNOWLEDGE UNIVERSE EDUCATION [REDACTED] AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

1. GENERAL

Knowledge Universe Education [REDACTED] was formed in April 2006 as a Cayman Islands exempted limited partnership. Knowledge Universe Education [REDACTED] is a holding company, whose subsidiaries specialize in education in the preschool to 12th grade segment, mainly in the United States and Asia (collectively, KUE [REDACTED] or the “Company”). The major subsidiaries are as follows:

KUE US LLC — KUE US LLC (“KUE US”) was formed in January 2012 as a holding company for the domestic early childhood education operations of the Company. Its main subsidiary is Knowledge Universe Education Holdings Inc.

Knowledge Universe Education Holdings Inc. — Knowledge Universe Education Holdings Inc. (KUEH) was formed in May 2011 as a holding company for the early childhood education operations of its wholly owned subsidiary, Knowledge Universe Education LLC (KUE LLC) and related subsidiaries and offers early childhood education programs to children ages six weeks through 12 years. The services provided include toddler care, preschool and kindergarten classes, and before- and after-school programs. KUE LLC provides education and care programs within the following three categories:

Early Childhood Education and Care — KUEH provides early childhood education and care services, primarily marketed under the names of KinderCare Learning Centers and Knowledge Beginnings. These services are provided through 1,506 community centers with a licensed capacity of 200,258 in 38 states.

Employer-Sponsored Early Childhood Education and Care — KUEH provides employer-sponsored early childhood education and care services, as well as back-up care, generally marketed under the name of Children’s Creative Learning Centers (CCLC), through 97 centers and four programs with a licensed capacity of 11,932 in 22 states and the District of Columbia. CCLC operates in partnership with employer sponsors under a variety of arrangements, such as discounted rent, enrollment guarantees, or an arrangement whereby the center is managed by CCLC in return for a management fee.

Before- and After-School Educational Enrichment Programs — KUEH provides customized before- and after-school educational enrichment programs for school-age children and preschool programs in connection with elementary schools under the name of Champions. Champions offers 386 educational enrichment programs in 16 states and the District of Columbia. These programs primarily operate at elementary school facilities.

Knowledge Universe Global Inc. — Knowledge Universe Global Inc. (“KU Global”) was formed in June 2012 as a holding company for the international early childhood education operations of the Company. Its main subsidiaries are:

Knowledge Universe Pte. Ltd — Knowledge Universe Pte. Ltd (KUPL) is a Singapore holding company for the early childhood education and international school operations of its wholly owned subsidiaries in Asia. Its primary operations include Pat’s Schoolhouse, Learning Vision @ Work, Asian International College, Learning Horizon, Global Educare, Odyssey The Global Preschool, Canadian International School Pte. Ltd., and Brighton Montessori Centres. It operates with a capacity of more than 6,105 children, excluding Canadian International School.

Global Educare Sdn Bhd — The Company acquired Global Educare Sdn Bhd (“Global”) on May 14, 2010. The principal activity of Global is providing child care and educational services in Malaysia. It operates with a capacity of 1,085 children.

Canadian International School Pte. Ltd. — The Company acquired a 60% joint venture interest in Canadian International School Pte. Ltd. (CIS) on June 5, 2010. CIS offers an International Baccalaureate program for students from early childhood education to K12. CIS has two campuses in Singapore with the new 463,000 square foot Lakeside campus in Jurong operating since October 2011. It operates with a capacity of more than 4,238 children (see Note 22).

Busy Bees Group Limited — The Company owned approximately 85% of Busy Bees Group Limited (“Busy Bees”). Busy Bees is the UK’s largest provider of care and education for children up to school age (five years of age). It operates more than 122 child care centers across the UK with a capacity of more than 11,000 children. The nurseries provide complete child care services with child development programs and curricula designed to develop creativity, individuality, and self-confidence in the children. Busy Bees was sold on October 31, 2013 (see Note 3).

Just Learning Group — The Company acquired 100% of Just Learning Group (JLG) on August 17, 2012 (see Note 4). JLG is a UK early childhood education provider with 71 centers and operates with a capacity of more than 6,664 children. JLG was sold on October 31, 2013, as part of Busy Bees (see Note 3).

KU Education Inc. — KU Education Inc. (KUE Inc.) was formed in March 2003 and is a holding company for the real estate operations of the Company. Its main subsidiary is KC Propco Holdings II LLC (“KC Propco”).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation — The consolidated financial statements include the accounts of KUE and its wholly owned subsidiaries, KUE US, KU Global, KUE Inc., and Learning Group LLC. All intercompany balances and transactions are eliminated in consolidation. The noncontrolling interests represent the 40% noncontrolling interest in CIS as of December 31, 2013 and 2012 (see Notes 15 and 22).

Use of Estimates — The consolidated financial statements are presented in conformity with accounting principles generally accepted in the United States of America. The preparation thereof requires management to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the consolidated financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Estimates have been prepared based on the most current and best available information, and actual results could differ from those estimates. The most significant estimates underlying the consolidated financial statements include the allowance for doubtful accounts; long-lived assets, other intangible assets, and goodwill valuations and any resulting impairment; self-insurance obligations; valuation of stock appreciation rights; and recognition and measurement of uncertain tax positions and valuation allowances against deferred tax assets.

Revenue Recognition — The recognition of revenues meets the following criteria: the existence of an arrangement through an enrollment agreement, the rendering of child care and tutoring services, an age-specific tuition rate and/or fees, and probable collection. Tuition, fees, and other income are recognized as the related services are provided. Payments for these types of services may be received in advance of services being rendered, in which case the revenue is deferred and recognized over the

appropriate service period. Deferred revenue for nonrefundable registration fees is recognized over the average enrollment period, not to exceed 12 months.

The Company's primary source of revenue is tuition paid by parents and supplemented, in some cases, by employer sponsors and government agencies. Revenues also include management fees paid by employer sponsors. In addition to tuition revenue and management fees, the Company receives fees for registration and other ancillary services.

Tuition revenue recognized pursuant to state and federal programs was approximately 24.0% and 23.7% of total revenue for 2013 and 2012, respectively.

Cash and Cash Equivalents — Cash and cash equivalents include interest-earning securities that mature within three months or less from the date purchased.

Restricted Cash — At December 31, 2013 and 2012, restricted cash of \$48.0 million and \$30.6 million, respectively, is included within other assets in the Company's consolidated balance sheets. Restricted cash of \$38.5 million and \$20.5 million at December 31, 2013 and 2012, respectively, is related to debt service requirements for properties sold that are held as collateral under the collateralized mortgaged-backed security (CMBS) facility; consisting of a \$650.0 million mortgage loan and \$50.0 million senior mezzanine loan (see Note 11). Restricted cash of \$5.1 million at December 31, 2013, is held under an agreement regarding the distributed K12 Inc. shares (see Note 17). Restricted cash of \$4.4 million and \$10.1 million at December 31, 2013 and 2012, respectively, is held as collateral on the Company's foreign currency hedge (see Note 13).

Concentration of Credit Risk — Financial instruments that subject the Company to credit risk consist primarily of cash and cash equivalents and trade receivables. Cash and cash equivalents are placed with high credit quality financial institutions. Concentration of credit risk with respect to trade receivables is generally diversified due to the large customer base and its geographic dispersion. The Company performs ongoing credit evaluations of its customers and maintains an allowance for doubtful accounts.

Accounts Receivable — Accounts receivable are composed primarily of tuition and reimbursable expenses due from government agencies, parents, and employers. Accounts receivable are presented at estimated net realizable value. The Company uses estimates in determining the ability to collect accounts receivable and must rely on its evaluation of historical experience, specific customer issues, governmental funding levels, and current economic trends to arrive at appropriate reserves.

Investments — The Company classifies investments in debt and equity securities as trading, held to maturity, or available for sale.

At December 31, 2013, available-for-sale securities include debt and equity securities, which the Company records at fair value, with unrealized gains and losses reported as part of accumulated other comprehensive income in the consolidated balance sheets. Trading securities include investments in short-term corporate debt securities. Unrealized gains and losses on these short-term marketable securities are included in nonoperating income in the consolidated statements of operations.

Investments at December 31, 2013 and 2012, consisted of the following (in thousands):

	2013	2012
Available-for-sale equity securities — K-12 Inc.	\$ -	\$ 151,565
Trading — short-term marketable securities	755	1,015
Equity method investments	<u>3,820</u>	<u>4,372</u>
Total investments	4,575	156,952
Less short-term marketable securities	<u>755</u>	<u>1,015</u>
Total long-term investments	<u>\$ 3,820</u>	<u>\$ 155,937</u>

Investments in available-for-sale equity securities and trading short-term marketable securities at December 31, 2013 and 2012, consisted of the following (in thousands):

	2013			2012		
	Cost	Gross Unrealized Gain	Estimated Fair Value	Cost	Gross Unrealized Gain	Estimated Fair Value
Available for sale — equity securities — K-12 Inc.	\$ -	\$ -	\$ -	\$101,465	\$ 50,100	\$151,565
Trading — short-term marketable securities	747	8	755	995	20	1,015

Property and Equipment — Property and equipment are stated at cost, less accumulated depreciation. Depreciation is computed on a straight-line basis over the useful lives of the assets or, in the case of leasehold improvements, the lesser of the term of the related lease or the useful lives of the improvements. A summary of estimated useful lives is as follows:

Buildings	5–50 years
Land improvements	2–15 years
Furniture, fixtures, and equipment	2–10 years
Building and leasehold improvements	2–60 years

Maintenance, repairs, and minor refurbishments are expensed as incurred.

Goodwill — Goodwill represents the excess of the cost over the fair value of the identifiable net assets of businesses acquired. The Company tests its goodwill for impairment on an annual basis, or more frequently, if circumstances indicate reporting unit carrying values exceed their fair values. Fair value is estimated by projecting future discounted cash flows from the applicable reporting unit in addition to other quantitative and qualitative analyses. If the carrying amount of goodwill exceeds the implied estimated fair value (based on discounted cash flows), an impairment charge to current operations is recorded to reduce the carrying value to the implied estimated fair value. In 2013, there was goodwill impairment of \$0.5 million. There was no impairment of goodwill in 2012.

Other Intangible Assets — Other intangible assets consist of customer lists, contract rights, accreditations, proprietary curricula, covenants not to compete, trade names, and trademarks. Other intangible assets subject to amortization are amortized on a straight-line basis over their estimated useful lives. The Company reviews and evaluates the remaining useful lives of such assets if events or changes in circumstances require impairment testing and/or a revision to the remaining period of amortization. Any such impairment analysis is based on a comparison of the carrying values to expected future cash flows.

Other intangible assets with indefinite useful lives are tested for impairment on an annual basis, or more frequently, if circumstances indicate the carrying values exceed their fair values. If the carrying amount exceeds the implied estimated fair value, an impairment charge to current operations is recorded to reduce the carrying value to the implied estimated fair value.

There was no impairment of other intangibles during 2013 or 2012.

Long-Lived Assets — The Company reviews and evaluates its long-lived assets, other than goodwill and indefinite-lived intangible assets, for impairment when events or changes in circumstances indicate that the carrying value of assets may not be recoverable through future undiscounted cash flows. Any impairment is measured as the amount by which the carrying values of such assets exceed their fair value (based on discounted cash flows). Impairment losses related to child care center property and equipment totaled \$6.4 million for 2013 and \$11.9 million for 2012. The impairment charges are included as a component of depreciation expense in the consolidated statements of operations.

Financial Instruments — The Company calculates the fair value of financial instruments and includes this information in the Company's notes to consolidated financial statements when the fair value is different than the book value of those financial instruments. When fair value is equal to book value, no disclosure is made.

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, accrued compensation, and related expenses and other accrued liabilities, excluding derivatives, approximate fair value due to the short-term nature of these assets and liabilities.

The Company's derivatives include an interest rate swap agreement, an interest rate cap agreement, and a four-year forward currency hedge based on the British pound. These instruments are recognized in the consolidated balance sheets at fair value. None of these instruments have been designated as a hedge of specific underlying interest rate exposure and therefore they are not subjected to hedge accounting. Rather, the interest rate swaps and caps are marked to market with the resulting gains or losses recognized as a component of interest expense in the consolidated statements of operations, and changes in the market value of the foreign currency hedge are included as a component of gains and losses on investments.

Deferred Financing Costs — Included in other assets are deferred financing costs incurred in connection with the issuance of debt. Deferred financing costs are amortized over the lives of the related debt facilities using a method that approximates the effective interest method (see Note 10).

Income Taxes — The Company accounts for income taxes under the asset and liability method. Under this method, deferred tax liabilities and assets are recognized for the expected future consequences of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. If it is more likely than not that some portion or all of a deferred tax asset will not be realized, a valuation allowance is established to reduce the amount

of that deferred tax asset to the amount, more likely than not, to be recognized. Uncertain tax positions and the related interest and penalties are recognized in other liabilities and income tax expense (see Note 19).

Other Comprehensive Income — Accounting Standards Codification (ASC) 320-10 requires that investment securities with readily determinable market values be marked to market at each reporting period. Accumulated other comprehensive income includes unrealized gains and losses on marketable securities classified as available for sale, net of the related tax effects, and adjustments to reclassify losses to the consolidated statements of operations for securities that have been determined to have other-than-temporary impairment — net of any related tax effects.

ASC 323-10, *Investments-Equity Method and Joint Ventures*, requires that a transaction of an investee of a capital nature should be recorded based on the investor's proportionate share of stockholder's equity of the investee. Therefore, the Company has recorded its proportionate share of the investee's adjustments to other comprehensive income.

Advertising Costs — Costs incurred to produce media advertising for seasonal campaigns are expensed when the advertising first takes place. All other advertising costs are expensed as incurred. Total advertising expense was \$13.8 million and \$10.9 million for 2013 and 2012, respectively, and is included in general and administrative expenses.

Self-Insurance — KUEH is self-insured for certain levels of general liability, workers' compensation, auto, property, and employee medical insurance coverage. Estimated costs of these self-insurance programs are accrued at the undiscounted value of projected settlements for known and anticipated claims incurred. The self-insurance reserves established and claims paid at December 31 are as follows (in thousands):

	2013	2012
Balance — beginning of year	\$ 42,084	\$ 43,207
Expense	109,458	102,473
Claims paid	<u>(107,881)</u>	<u>(103,596)</u>
Balance — end of year	<u>\$ 43,661</u>	<u>\$ 42,084</u>

Recent Accounting Pronouncements — In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (Topic 740)*. This ASU requires that liabilities related to unrecognized tax benefits offset deferred tax assets for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed. In situations in which a carryforward cannot be used or the deferred tax asset is not intended to be used for such purpose, the unrecognized tax benefit should be recorded as a liability and should not offset deferred tax assets. The guidance is effective for annual and interim reporting periods beginning after December 15, 2013, and permits early adoption. The Company has adopted the provisions of this new guidance for the tax year ended December 31, 2013.

On September 13, 2013, the Internal Revenue Service released final tangible property regulations under Sections 162(a) and 263(a) of the Internal Revenue Code of 1986 (the "Code"), regarding the deduction and capitalization of expenditures related to tangible property. Also released were proposed regulations under Section 168 of the Code regarding dispositions of tangible property. These regulations replace

previously issued temporary regulations and are effective for tax years beginning January 1, 2014, or for the Company's fiscal year ending March 31, 2015, with optional adoption permitted in 2013. The Company is in the process of analyzing the impact of these new regulations but does not believe they will have a material impact on the Company's financial statements.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. For nonpublic entities, the standard is effective for fiscal years ending on or after December 15, 2017, which will be the Company's fiscal year ending December 31, 2017. The Company is in the process of evaluating the potential impacts adoption of the new standard will have on its financial position, results of operations, and cash flows.

3. DISCONTINUED OPERATIONS

On January 3, 2011, KUE Digital sold its wholly owned subsidiaries, KUE Digital Inc., ExLogica, and Excelsior, for approximately \$140 million, and recognized a gain of approximately \$110 million after consideration of noncontrolling interests. During 2012, an additional \$5.1 million of gain was recognized due to the release of escrow reserves.

On October 31, 2013, the Company sold its 85% interest in Busy Bees and its wholly owned subsidiary, Just Learning Group (collectively, the "UK Subsidiaries"), for approximately \$205.1 million, and recognized a gain of approximately \$169.2 million.

The table below discloses certain information regarding the UK Subsidiaries included in discontinued operations for 2013 and 2012 as follows (in thousands):

	2013	2012
Revenues	\$ 182,772	\$ 175,012
Cost of revenues	<u>132,577</u>	<u>100,169</u>
Gross margin	50,195	74,843
Operating expenses	<u>35,614</u>	<u>59,071</u>
Income from operations	14,581	15,772
Nonoperating income and expenses:		
Gain on sale of Busy Bees	169,198	
Nonoperating expenses	<u>(14,163)</u>	<u>(9,594)</u>
Gain before income taxes	169,616	6,178
Income tax expense	<u>(2,935)</u>	<u>(371)</u>
Net income	<u>\$ 166,681</u>	<u>\$ 5,807</u>

The consolidated balance sheet has been restated to present the assets and liabilities of the UK Subsidiaries as held for sale. Summarized assets and liabilities of the UK Subsidiaries included in assets held for sale and liabilities associated with assets held for sale as of December 31, 2012, were as follows (in thousands):

Assets held for sale:	
Cash and cash equivalents	\$ 12,266
Accounts receivable — net	1,631
Prepaid expenses and other current assets	<u>12,681</u>
Total current assets held for sale	<u>26,578</u>
Property and equipment — net	182,608
Goodwill	13,793
Other intangible assets — net	35,722
Deferred income taxes	11,545
Other assets	<u>6,974</u>
Total noncurrent assets held for sale	<u>250,642</u>
Total assets	<u>\$ 277,220</u>
Liabilities associated with assets held for sale:	
Accounts payable	\$ 5,576
Deferred revenue	8,119
Accrued compensation and related expenses	5,528
Other accrued liabilities	34,864
Current portion of long-term debt	<u>10,078</u>
Total current portion of liabilities associated with assets held for sale	<u>64,165</u>
Long-term debt	116,385
Deferred income taxes	14,318
Other long-term liabilities	<u>23,960</u>
Total noncurrent portion of liabilities associated with assets held for sale	<u>154,663</u>
Total liabilities	<u>\$ 218,828</u>

In December 2013, Knowledge Universe Online Services Inc. (KUOS) was liquidated and its assets sold. The table below discloses certain information regarding KUOS included in discontinued operations for 2013 and 2012 as follows (in thousands):

	2013	2012
Revenues	\$ -	\$ 7
Operating expenses	<u>893</u>	<u>1,101</u>
Loss from operations	(893)	(1,094)
Nonoperating expenses	<u>127</u>	<u>390</u>
Loss before income taxes	(1,020)	(1,484)
Income tax benefit	<u>1</u>	<u>2</u>
Net loss	<u><u>\$ (1,019)</u></u>	<u><u>\$ (1,482)</u></u>

The consolidated balance sheet has been restated to present the assets of KUOS as assets related to discontinued operations. The assets of KUOS included in discontinued operations as of December 31, 2012, were as follows (in thousands).

Current assets	\$ 13
Noncurrent assets	<u>2,025</u>
Total assets	<u><u>\$ 2,038</u></u>

A summary of income from discontinued operations at December 31, 2013 and 2012, is as follows (in thousands).

	2013	2012
Busy Bees	\$ 166,681	\$ 5,807
KUOS	(1,019)	(1,482)
KUE Digital	<u> </u>	<u>5,147</u>
Total	<u><u>\$ 165,662</u></u>	<u><u>\$ 9,472</u></u>

4. ACQUISITIONS

The following acquisition was accounted for by the purchase method of accounting, and accordingly, the results of operations have been included in the consolidated statements of operations since the acquisition date.

Acquisition of JLG — On August 17, 2012, KUHC acquired 100% of JLG for a total consideration of \$96.0 million, net of cash acquired of \$5.4 million. JLG is the holding company of seven subsidiaries, which are in the business of providing children day nurseries and operates 71 centers in the UK. JLG was sold as part of Busy Bees on October 31, 2013 (see Note 3).

The allocation of the purchase price for JLG is as follows:

Trade and other receivables	\$ 1,876
Property and equipment	98,666
Investment in joint venture	641
Trade, tax, and other payables	(10,668)
Intangible assets subject to amortization — customer lists (4.25 years)	8,996
Deferred tax liability	(7,936)
Goodwill	<u>4,402</u>
 Total purchase price	 <u>\$ 95,977</u>

5. ACCOUNTS RECEIVABLE — NET

Accounts receivable, net, at December 31 included the following (in thousands):

	2013	2012
Tuition	\$ 48,610	\$ 49,248
Other	13,490	14,200
Allowance for doubtful accounts	<u>(1,777)</u>	<u>(2,767)</u>
 Accounts receivable — net	 <u>\$ 60,323</u>	 <u>\$ 60,681</u>

6. PREPAID EXPENSES AND OTHER CURRENT ASSETS

Prepaid expenses and other current assets at December 31 included the following (in thousands):

	2013	2012
Prepaid rent	\$ 9,444	\$ 9,550
Deposits	2,263	1,383
Supplies and inventory	4,710	5,675
Prepaid maintenance	352	1,059
Prepaid insurance	1,702	2,240
Prepaid property taxes	4,818	3,015
Other	<u>4,457</u>	<u>7,430</u>
 Total prepaid expenses and other current assets	 <u>\$ 27,746</u>	 <u>\$ 30,352</u>

7. PROPERTY AND EQUIPMENT — NET

Property and equipment, net, at December 31 included the following (in thousands):

	2013	2012
Land and improvements	\$ 306,785	\$ 307,295
Buildings and improvements	601,863	605,852
Leasehold improvements	379,447	358,094
Furniture, fixtures, and equipment	<u>216,582</u>	<u>254,421</u>
Total property and equipment	1,504,677	1,525,662
Accumulated depreciation	<u>(618,211)</u>	<u>(604,848)</u>
Property and equipment — net	<u>\$ 886,466</u>	<u>\$ 920,814</u>

Construction in progress included in buildings and improvements was \$0.7 million as of December 31, 2013, and \$0.9 million as of December 31, 2012. Construction in progress included in furniture, fixtures, and equipment was \$1.1 million as of December 31, 2013, and \$4.6 million as of December 31, 2012.

Depreciation expense, not including impairment of long-lived assets, was \$80.4 million and \$97.8 million for 2013 and 2012, respectively.

8. GOODWILL

Changes in the carrying amount of goodwill were as follows (in thousands):

Balance — January 1, 2012	\$ 382,775
Currency exchange difference	<u>1,927</u>
Balance — December 31, 2012	384,702
Impairment	(545)
Currency exchange difference	<u>(821)</u>
Balance — December 31, 2013	<u>\$ 383,336</u>

9. OTHER INTANGIBLE ASSETS — NET

The gross carrying amount and accumulated amortization of other intangible assets at December 31 were as follows (in thousands):

	Amortization Period	2013	2012
Amortizable intangible assets:			
Customer lists	2–7 years	\$ 20,806	\$ 32,931
Contracts	2–14 years	22,782	22,796
Accreditations	3–4 years	5,200	12,100
Intellectual property and proprietary curricula	3–14 years	2,203	6,237
Trade names and trademarks	1.5–10 years	1,500	1,500
Covenants not to compete	3–8 years	100	200
Favorable leases acquired	8 years	<u>850</u>	<u>850</u>
Gross carrying amount		53,441	76,614
Accumulated amortization		<u>(45,662)</u>	<u>(62,428)</u>
Net intangible assets subject to amortization		7,779	14,186
Intangible assets not subject to amortization — trade names and trademarks		<u>87,507</u>	<u>85,059</u>
Total other intangible assets — net		<u>\$ 95,286</u>	<u>\$ 99,245</u>

Amortization expense was \$4.0 million and \$4.2 million for 2013 and 2012, respectively. Estimated future amortization expense for finite-lived intangible assets at December 31, 2013, is as follows (in thousands):

2014	\$ 1,309
2015	1,571
2016	2,003
2017	1,455
2018	1,217
Thereafter	<u>224</u>
Total	<u>\$ 7,779</u>

10. OTHER ASSETS

Other assets at December 31 included the following (in thousands):

	2013	2012
Deferred financing costs — net of accumulated amortization	\$ 5,399	\$ 6,853
Restricted cash (Note 2)	47,989	30,624
Deferred compensation	6,992	6,601
Deposits	4,081	3,862
Long-term receivables	1,143	1,223
Other	<u>2,320</u>	<u>2,377</u>
Total other assets	<u>\$ 67,924</u>	<u>\$ 51,540</u>

11. LONG-TERM DEBT

Long-term debt at December 31 included the following (in thousands):

	2013	2012
Secured:		
CMBS loan	\$ 581,425	\$ 593,125
Senior mezzanine loan	44,725	45,625
Singapore construction loan	58,167	65,573
Unsecured:		
Senior subordinated notes	221,000	224,500
Other — net of discount of \$1 and \$6 in 2013 and 2012, respectively	1,158	1,337
Fair value adjustment	<u>(1,182)</u>	<u>(1,892)</u>
Total	905,293	928,268
Current portion	<u>(19,856)</u>	<u>(18,061)</u>
Long-term portion	<u>\$ 885,437</u>	<u>\$ 910,207</u>

Secured Loans — On November 9, 2005, KC Propco completed a refinancing of all of its senior debt that was assumed in connection with the KinderCare Learning Centers acquisition. The refinancing involved a 10-year fixed-rate \$650.0 million CMBS loan and a \$50.0 million senior mezzanine loan (collectively referred to as the “CMBS facility”). Under the CMBS loan agreement, all of the property and equipment of KC Propco are pledged as collateral.

The CMBS loan matures in December 2015. The weighted-average annual interest rate on the CMBS loan at December 31, 2013, was 5.46%.

Principal and interest payments on the CMBS loan are due in arrears on the first day of each month. The monthly principal amount due on the CMBS loan is approximately \$1.0 million through December 1, 2015.

The CMBS loan contains various customary nonfinancial covenants. The key nonfinancial covenants applicable to KC Propco restricts KC Propco’s ability to, among other things, amend lease provisions; impair the value of KUEH’s operating companies’ leasing arrangements; collect any rents more than one

month in advance; consent to assign or sublease arrangements under the KUEH lease; surrender, terminate, modify, or cancel the asset management agreement; establish liens on any of the original 713 CMBS properties; cancel or forgive any debt owed to KC Propco; initiate or consent to any rezoning of the CMBS properties; engage in any nonexempt transaction prohibited under the Employee Retirement Income Security Act of 1974; allow a joint assessment of any of the CMBS properties; enter into or modify any reciprocal easement agreement; or make any alterations or enter into any agreements that may have an adverse effect on the CMBS properties.

The CMBS loan also contains customary covenants that restrict KC Propco's ability to, among other things, engage in any other business other than the ownership, operation, and maintenance of the CMBS properties, acquire or own any other assets, merge into or consolidate with another entity or change its legal structure, own or invest in any subsidiary, commingle its assets, incur any additional debt, enter into any contract or agreement with any principal, assume or guarantee any debts, make any loans or advances, acquire obligations or securities, and make changes to name, identity, or structure.

Furthermore, the CMBS loan agreement includes a provision that requires KUEH to provide to the lender consolidated financial statements for the trailing 12 months to determine compliance with minimum thresholds of earnings before interest, taxes, depreciation, and amortization (EBITDA), which, if not maintained, could result in a sweep of 50% or 100% of excess cash flow, depending upon the amount of the shortfall. Any funds swept pursuant to these provisions would be held by the lender in a cash management account owned by KC Propco as additional loan collateral and would be available for distribution upon the lender determining that for the immediately preceding 12-month period, the EBITDA for KUEH was equal to or greater than \$108 million at the end of two consecutive calendar quarters.

The calculation of consolidated EBITDA for the trailing 12 months ended March 31, 2012, did not meet the threshold. In accordance with the terms of the loan agreement, beginning in June 2012, 50% of KC Propco's excess cash flow was swept into a cash management account. The cash management account balance as of December 31, 2013, and December 31, 2012, was \$30.8 million and \$12.8 million, respectively, and is recorded as restricted cash within other assets in the consolidated balance sheets.

KC Propco was in compliance with the other covenants of the CMBS loan as of December 31, 2013.

Singapore Construction Loan — In March 2010, CIS obtained a loan of \$68.7 million for the construction of a new school building in Singapore. The loan has been drawn down over two years and is repayable over 15 years. As of December 31, 2013, the amount of the loan outstanding was \$58.1 million. Total assets of CIS amounting to \$160.6 million were pledged as security against the bank loan. Monthly repayments began in June 2012 and continue for 13 years. The interest rate is the aggregate of a margin plus the Singapore Interbank Offered Rate, which was 2.7% and 3% at December 31, 2013 and 2012, respectively. The Company has not entered into any hedging arrangement to hedge the floating interest rate of the loan.

Unsecured Senior Subordinated Notes — In February 2005, the Unsecured Senior Subordinated Notes (the Notes) in the amount of \$260.0 million were issued to refinance certain indebtedness in connection with the acquisition of KinderCare Learning Centers. The Notes bear interest at 7.75%, payable semiannually in February and August of each year, and are due in February 2015. KUEH is a co-obligor under the indenture governing the Notes.

The Notes may be redeemed at any time, in whole or in part, after February 2013 at a redemption price equal to 100% of the principal amount of the Notes plus accrued and unpaid interest, if any, to the date of redemption.

Upon the occurrence of a change of control of either KUEH or KUE LLC, KUEH and KUE LLC will be required to make an offer to repurchase all Notes properly tendered at a price equal to 101.0% of the principal amount plus accrued and unpaid interest through the date of repurchase.

The indenture governing the Notes contains various nonfinancial covenants that limit KUEH and KUE LLC's ability to, among other things, enter into agreements that restrict KUEH's and KUE LLC's subsidiaries from paying dividends or other distributions, make loans or otherwise transfer assets to KUEH, KUE LLC, or to any other subsidiaries, incur additional debt or issue preferred stock, establish new liens on assets, make certain restricted payments and investments, sell assets or capital stock of subsidiaries in excess of established limits, engage in certain transactions with affiliates, and make certain fundamental changes to the business.

Credit Agreement — In October 2013, KUEH's subsidiary, KUE LLC, entered into an amendment (the "Amendment") to its amended and restated credit agreement with a group of syndicated lenders (the "Credit Agreement") that extended the expiration date from June 2014 to December 2015 and resulted in a reduction of the revolving line of credit from \$75.0 million to \$60.0 million. The Amendment also changed various other fees and interest rates on borrowings from a pricing grid to fixed rates and amended covenants.

At KUE LLC's discretion, borrowings under the revolving line of credit bear interest at either the base rate plus an annual rate of 2.50%, or the London InterBank Offered Rate (LIBOR) plus an annual rate of 3.50%. The base rate is the higher of the lender's prime rate or 0.50% in excess of the Federal Funds Effective Rate. In addition, the Credit Agreement allows for letters of credit against the current borrowing capacity and up to \$10.0 million for selected short-term borrowings. KUE LLC pays fees on the outstanding balance of letters of credit at an annual rate of 3.50% plus a fronting fee of 0.25%. KUE LLC is also required to pay fees of 0.70% on the unused portion of the revolving line of credit.

As of December 31, 2013 and 2012, KUE LLC had no borrowings under the Credit Agreement, and outstanding letters of credit totaled \$47.2 million and \$46.0 million, respectively.

The Credit Agreement contains various financial and nonfinancial loan covenants and provisions. The key financial loan covenants include a minimum interest coverage ratio and minimum consolidated EBITDA. Nonfinancial loan covenants restrict KUE LLC's ability to, among other things, incur additional debt, make fundamental changes to the business, open new learning centers in excess of established limits, make certain restricted payments and investments or enter into certain sale-leaseback transactions. When making a restricted payment, permitted acquisition, qualifying financing indebtedness, or revolving loan commitment increase, the Credit Agreement also requires a financial metrics test, which includes a minimum fixed charge ratio and maximum leverage ratio. KUEH is a guarantor under the Credit Agreement.

As of December 31, 2013, KUEH and KUE LLC were in compliance with the covenants of the Notes and KUE LLC was in compliance with the covenants of the Credit Agreement.

Debt Maturities — Principal payments on long-term debt during the next five years and thereafter at December 31, 2013, are as follows (in thousands):

2014	\$ 18,856
2015	839,645
2016	5,095
2017	5,095
2018	5,095
Thereafter	<u>32,689</u>
Total	<u>\$ 906,475</u>

2014 Debt Refinancing Transaction — In March 2014, KUEH's subsidiary, KUE LLC, entered into new \$370.0 million senior secured credit facilities. The proceeds from the new facilities were used primarily to refinance all of the existing indebtedness under the Credit Agreement and to redeem the Notes in full. The redemption date was April 17, 2014. Significant terms of the new senior secured credit facilities are as follows:

- \$300.0 million term loan facility with a maturity date in April 2021;
- \$70.0 million revolving credit facility with a termination date in April 2019;
- The applicable rates for the term loan facility are either the base rate plus 3.25% per annum or LIBOR (the Eurodollar rate) plus 4.25% per annum provided the base rate may not be lower than 2.0% and the Eurodollar rate may not be lower than 1.0%;
- The applicable rates for borrowings under the revolver are based on a pricing grid based on KUE LLC's consolidated net leverage ratio at either the base rate plus between 3.0% and 3.25% per annum or LIBOR (the Eurodollar rate) plus between 4.0% and 4.25% per annum; and
- Fees on the outstanding balance of letters of credit are between 4.0% and 4.25% per annum plus a fronting fee of 0.25% per annum.

Principal payments of \$0.8 million on the term loan are due quarterly and commence in June 2014, with the final payment of the remaining balance of the term loan due in April 2021.

12. OTHER LONG-TERM LIABILITIES

Other long-term liabilities at December 31 included the following (in thousands):

	2013	2012
Reserves for uncertain tax positions	4,936	\$ 3,086
Self-insurance reserves — long term	20,751	20,372
Deferred rent	12,508	13,492
Deferred compensation plan	6,992	6,601
Property taxes	2,006	4,157
Real estate obligation	9,054	9,336
Closed centers	2,324	4
Other	<u>6,339</u>	<u>3,371</u>
Total other long-term liabilities	<u>\$64,910</u>	<u>\$60,419</u>

13. DERIVATIVE CONTRACTS

In June 2009, the Company entered into a four-year forward currency hedge based on the British pound. The Company sold 25 million British pounds at a rate of 1.65205 on a forward leg maturing in June 2013. As the foreign currency hedge has not been designated as a hedge of specific underlying interest rate exposure, it has been marked to market with the resulting gains or losses recognized as a component of (gains) losses on investments in the consolidated statements of operations. The hedge closed in June 2013 with a gain of \$3.0 million, of which \$2.3 million has been recognized in 2013. The mark to market at December 31, 2012, resulted in an asset of \$0.7 million recorded in other assets in the accompanying consolidated balance sheets.

In August 2012, the Company entered into a five-year forward currency hedge on the British pound. The Company sold 14.6 million British pounds at a rate of 1.5677 on a forward leg maturing in August 2017. As the foreign currency hedge was not designated as a hedge of specific underlying interest rate exposure, it has been marked to market with the resulting gains or losses recognized as a component of (gains) losses on investments in the consolidated statements of operations. The mark to market at December 31, 2013, resulted in a liability of \$1.3 million recorded in other liabilities in the accompanying consolidated balance sheets (see Note 16).

14. LEASE OBLIGATIONS

The Company and its subsidiaries lease certain child care and office facilities, vehicles, and equipment under both capital and operating leases. Many of these operating leases contain renewal options and escalation clauses. For scheduled rent escalation clauses during the lease terms, the Company records minimum rental expenses on a straight-line basis over the terms of the leases in the consolidated statements of operations. Real estate obligations represent the Company's financing obligation for certain assets constructed under built-to-suit lease arrangements with lessors. The following represents future minimum fixed payments under operating and capital leases, not including unexercised renewal options, real estate taxes, insurance, and maintenance costs (in thousands):

	Capital Leases	Real Estate Obligations	Operating Leases	Total Leases
2014	\$ 3,676	\$ 5,181	\$ 110,168	\$ 119,025
2015	2,182	2,440	90,992	95,614
2016	1,795	1,352	69,029	72,176
2017	1,294	1,352	53,667	56,313
2018	773	1,352	36,122	38,247
Thereafter	<u>5,419</u>	<u>7,363</u>	<u>93,299</u>	<u>106,081</u>
Total minimum payments*	15,139	19,040	<u>\$ 453,277</u>	<u>\$ 487,456</u>
Less amounts representing interest	<u>(4,081)</u>	<u>(4,424)</u>		
	11,058	14,616		
Less current portion of lease obligations	<u>(3,031)</u>	<u>(645)</u>		
Long-term capital leases and real estate obligations	<u>\$ 8,027</u>	<u>\$ 13,971</u>		

*Minimum payments have not been reduced by minimum sublease rentals of \$0.8 million in the future under noncancelable subleases.

The majority of the vehicles in KUEH's subsidiary's (KUE LLC) fleet are leased pursuant to the terms of a 12-month noncancelable master lease that may be renewed on a month-to-month basis after the initial 12-month lease period. Payments under the vehicle leases vary with the number, type, model, and age of the vehicles leased. The vehicle leases require that KUE LLC guarantee specified residual values upon cancellation. As of December 31, 2013, KUE LLC's residual guarantee was \$16.8 million. In most cases, KUE LLC expects that substantially all of the leases will be renewed or replaced by other leases as part of the normal course of business. All such leases are classified as operating leases. Lease expense for vehicle leases, included in rent and general and administrative expenses on the consolidated statements of operations, was \$10.7 million and \$11.5 million for the years ended December 31, 2013 and 2012, respectively.

Assets related to capital leases and real estate obligations, net of accumulated depreciation, included within property and equipment totaled \$17.3 million as of December 31, 2013, and \$20.2 million as of December 31, 2012.

When the decision is made to close a center, KUEH records a closed center liability equal to the present value of the net future obligation. The net future obligation is determined as the remaining contractual rent obligation less the amount that KUEH estimates it would be able to sublease the property. KUEH estimates the amount for an expected sublease based on a review of real estate market conditions for comparable properties.

KUEH had closed center liabilities of \$3.6 million and \$0.1 million as of December 31, 2013, and December 31, 2012, respectively. Closed center liabilities are recorded within other accrued liabilities and other long-term liabilities on the consolidated balance sheets. Charges corresponding to the closed center liabilities are recorded in loss on closure of centers and other in the consolidated statements of operations.

15. NONCONTROLLING INTERESTS

Busy Bees had noncontrolling interest holders that had a combined ownership interest of approximately 15% at December 31, 2012. Through the date of sale, the Company had recorded the proportionate share of Busy Bees' net income as net income attributable to noncontrolling interests in the consolidated statements of operations (see Note 3).

CIS has noncontrolling interest holders that have a combined ownership interest of approximately 40% at December 31, 2013. In February 2014, the Company acquired the 40% noncontrolling interest for \$71.0 million (see Note 22).

Changes in the balance of the noncontrolling interests for 2013 and 2012 are as follows (in thousands):

	2013	2012
Balance — January 1	\$ 13,343	\$ 10,290
Contribution by noncontrolling interest in KUE US		500
Allocation of income	3,272	2,503
Noncontrolling interest related to sale of Busy Bees	(1,555)	
Other	<u>(57)</u>	<u>50</u>
Balance — December 31	<u>\$ 15,003</u>	<u>\$ 13,343</u>

16. FAIR VALUE MEASUREMENTS

Fair value guidance defines fair value as the exchange 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 on the measurement date. Fair value guidance also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels are described as follows:

- *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 fair value hierarchy for those assets and liabilities measured at fair value at December 31 is as follows (in thousands):

	2013 Fair Value				Balance Sheet Classification
	Level 1	Level 2	Level 3	Total	
Assets:					
Cash equivalents	\$ 15,557	\$ -	\$ -	\$ 15,557	Cash and cash equivalents
Short-term marketable securities		755		755	Short-term marketable securities
Impaired long-lived assets		537		537	Property and equipment, net
Investments in deferred compensation plan		6,992		6,992	Other assets
Liabilities —					
Foreign currency hedge		1,285		1,285	Other long-term liabilities

	2012 Fair Value				Balance Sheet Classification
	Level 1	Level 2	Level 3	Total	
Assets:					
Cash equivalents	\$ 78,560	\$ -	\$ -	\$ 78,560	Cash and cash equivalents
Short-term marketable securities		1,015		1,015	Short-term marketable securities
Impaired long-lived assets		3,223		3,223	Property and equipment, net
Investments	95,355	60,582		155,937	Long-term investments
Foreign currency hedge		664		664	Prepaid expenses and other current assets
Foreign currency hedge		847		847	Other long-term liabilities
Investments in deferred compensation plan		6,601		6,601	Other assets
Liabilities —					
Interest rate swaps		1,855		1,855	Other accrued liabilities

Cash Equivalents — The Company has invested in short-term marketable money market funds and commercial paper with maturity dates less than three months at date of purchase.

Short-Term Marketable Securities — The Company has invested in corporate debt securities, which it generally holds for periods of less than six months from date of purchase.

Derivatives — Derivative assets and liabilities within the scope of ASC 815, *Derivatives and Hedging*, are required to be recorded at fair value. The Company has two interest rate swaps that are marked to market based on observable rates at commonly quoted intervals for the full term of the swaps and, therefore, are considered to be Level 2 financial instruments. The Company also has one forward currency hedge based on the British pound. The hedge is marked to market based on observable daily quotes in the currency markets for the British pound and are, therefore, considered Level 2 financial instruments (see Note 13).

Long-Lived Assets, Purchase Price Allocation Adjustment of Property, and Equipment and Assets Held for Sale — In accordance with guidance related to the impairment of long-lived assets, the Company performs an impairment test whenever events and changes in circumstances indicate that impairment might have occurred.

As of December 31, 2013, these tests revealed that certain long-lived assets, with a carrying amount of \$7.0 million, needed to be written down to an estimated fair value of \$0.5 million, resulting in an impairment charge of \$6.5 million, which was included in depreciation expense for the fiscal year ended December 31, 2013.

As of December 31, 2012, these tests revealed that certain long-lived assets, with a carrying amount of \$15.2 million, needed to be written down to an estimated fair value of \$3.2 million, resulting in an impairment charge of \$12.0 million, which was included in depreciation expense for the fiscal year ended December 31, 2012.

The estimation of fair value required quoted prices for similar assets and liabilities in active markets, quoted prices for similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Long-Term Debt — For the CMBS loan and the senior subordinated notes, management's estimate of fair value was determined with assistance from an external valuation firm. The carrying value of the Singapore construction loan and the UK bank loan approximates its fair value. For the senior mezzanine loan, it is not practicable to estimate fair value due to limited market activity. These estimated fair values at December 31 are as follows (in thousands):

	2013	2012
	Fair Value	Fair Value
CMBS loan	\$ 549,000	\$ 526,000
Senior subordinated notes	216,100	209,300

17. PARTNERS' EQUITY

Common Partner Units — At December 31, 2013 and 2012, the Company had 2,239,551 common partner units outstanding, of which KUE Management Inc., the Company's general partner, held 1,464 units, and limited partners held the remaining units.

Profits Participation Limited Partner Units — The Company had a profits participation limited partner units plan under which PPUs were issued in conjunction with the sale of units to investors. The plan was terminated during 2013 with no amounts due.

Distribution to Partners — On September 3, 2013, the Company made a cash distribution in the sum of \$100 million to its partners on a pro rata basis. In addition, on the same date, the Company distributed all 7,415,083 shares of K12 Inc. common stock that it held to its partners on a pro rata basis. The distribution of the K12 Inc. shares was recorded at a fair market value of \$269.2 million. The Company recognized a gain of \$167 million, which is recorded in gains (losses) on investments on the consolidated statements of operations.

18. EMPLOYEE BENEFIT PLANS

Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, with the cost measured based on the estimated fair value of the equity or liability instruments issued. Costs attributable to stock appreciation rights and unit appreciation rights granted are recognized in accordance with the graded vesting attribution method.

KUE US Unit Appreciation Rights — KUE [REDACTED]'s subsidiary, KUE US, adopted a unit appreciation rights plan ("UARS Plan") in May 2012. The UARS Plan provides KUE US with the authority to grant unit appreciation rights (UARS) to members of senior management of KUE US and its subsidiaries. The UARS vest annually over a period of up to four years from the grant date and are redeemable upon a liquidity event such as a sale of KUE US or an underwritten public offering.

As of December 31, 2013, KUE U.S. LLC had 27,623,000 UARS outstanding, of which 9,247,800 were vested. During 2013, KUE US and its subsidiaries did not recognize any compensation expense related to the UARS because the UARS outstanding and exercisable at December 31, 2013, had no intrinsic value.

KUE US Profits Participation Units — KUE US issued profit participation units (PPUS) to a senior executive officer of subsidiaries of KUE US in conjunction with his employment. The PPUS entitle the holder to share in increases in value of KUE US from the date of issuance, upon distributions, liquidation, or sale of KUE US, based on the number of vested PPUS held divided by the total number of PPUS vested and outstanding. The PPUS vest over a two-year period and will result in compensation expense to the extent that KUE US's value increases to a level where amounts are due to the holder.

At December 31, 2013 and 2012, KUE U.S. LLC had 26,258,333 PPUS outstanding, of which 13,129,167 were vested. At December 31, 2013, no amounts were due in respect of the PPUS.

KUE [REDACTED]. UARS — KUE [REDACTED] has a UARS Plan. KUE [REDACTED]'s UARS Plan has been approved by the board of directors of KUE Management Inc., the Company's general partner, and provides the Company with the authority to grant UARS to directors, officers, and key employees of the Company. The UARS vest annually over a period of up to five years from the grant date, have an expiration date of 10 years from the grant date, and are redeemable in cash at the holder's discretion. Fifty percent of the UARS that vest during a year are exercisable upon vesting, and the remaining balance is exercisable upon occurrence of certain conditions, such as termination of employment.

At December 31, 2013 and 2012, KUE [REDACTED] had 1,226 and 3,607 UARS outstanding, respectively, of which 1,226 and 2,464 UARS, respectively, were fully vested. During 2013, the Company canceled 2,381 UARS. No compensation expense has been recorded for 2013 and 2012 as the exercise price of the UARS was higher than the approximate fair values at December 31, 2013 and 2012.

KS Stock Appreciation Rights — KUEH's subsidiary, KS, adopted a stock appreciation rights plan ("SARS Plan") in April 2004. The SARS Plan has been approved by KS' Board of Directors and provides KS with the authority to grant stock appreciation rights (SARS) to directors and certain key employees of KS and its subsidiaries. The SARS vest annually over a period of up to five years from the grant date, have an expiration date of up to 10 years from the grant date, and are redeemable in cash at the holder's discretion. KS recognizes a liability for the vested portion, and compensation expense is charged for the change in the intrinsic value of the vested awards during the year. The intrinsic value is

the estimated fair value at the end of the reporting period. KS and its subsidiaries recognize compensation expense, included within general and administrative expense, for the change in the intrinsic value of the SARS granted.

As of December 31, 2013, and December 31, 2012, KS had 3,629 SARS outstanding, all of which were fully vested. No SARS were issued or exercised during either of the fiscal years 2013 or 2012. During fiscal year 2013, KS and its subsidiaries recognized \$1.2 million in compensation expense related to SARS. A reduction in compensation expense related to SARS of \$0.2 million was recognized for fiscal year 2012. The intrinsic values of the SARS outstanding and exercisable were both \$3.3 million as of December 31, 2013, and \$2.1 million as of December 31, 2012.

The weighted-average remaining contractual term for SARS outstanding and exercisable was 0.6 years as of December 31, 2013.

401(k) Plan — Certain employees are eligible to enroll in the Knowledge Universe Education LLC Savings and Investment Plan (the “401(k) Plan”) on January 1, April 1, July 1, or October 1 following their date of hire and can contribute between 1% and 100% of pay up to the Internal Revenue Service maximum allowable. KUEH will match 40 cents for each dollar contributed on the first 5% of compensation.

Nonqualified Deferred Compensation Plan — KUEH offers highly compensated employees, who are excluded from participating in the 401(k) Plan, the ability to participate in the Knowledge Universe Education LLC Non-Qualified Deferred Compensation Plan (the “Non-Qualified Deferred Compensation Plan”). This plan allows employees to defer between 1% and 100% of base and bonus compensation. KUEH will match 40 cents for each dollar contributed on the first 5% of compensation.

Employer matching contribution expense for the 401(k) Plan and the Non-Qualified Deferred Compensation Plan totaled \$2.5 million and \$2.4 million in 2013 and 2012, respectively.

19. INCOME TAXES

The provision for income taxes at December 31 included the following (in thousands)

	2013	2012
Continuing operations:		
Current:		
Federal	\$ 514	\$(12,631)
State	(996)	768
Foreign	114	(46)
Total current expense	<u>(368)</u>	<u>(11,909)</u>
Deferred:		
Federal	5,079	30,417
State	(341)	(329)
Foreign	46	139
Total deferred benefit	<u>4,784</u>	<u>30,227</u>
Income tax benefit from continuing operations	<u>\$4,416</u>	<u>\$ 18,318</u>

Under ASC 740, *Income Taxes*, deferred taxes are recorded to give recognition to temporary differences between the tax basis of assets or liabilities and their reported amounts in the consolidated balance sheets. The tax effects of these temporary differences are recorded as deferred tax assets or deferred tax liabilities. Deferred tax assets generally represent items that can be used as a tax deduction or credit in future years. Deferred tax liabilities generally represent items that have been deducted for tax purposes, but have not yet been recorded in the consolidated statements of operations.

Deferred tax assets and liabilities as of December 31 included the following (in thousands):

	2013	2012
Deferred tax assets:		
Tax credits	\$ 18,132	\$ 28,265
Compensation payments	12,782	9,178
Net operating loss carryforwards	53,875	42,673
Self-insurance reserves	17,195	16,567
Capital lease obligations	13,793	12,578
Other	<u>13,827</u>	<u>17,704</u>
Total deferred tax assets	129,604	126,965
Valuation allowance	<u>(3,189)</u>	<u>(10,094)</u>
Net deferred tax assets	126,415	116,871
Deferred tax liabilities:		
Fixed assets/intangibles	(127,290)	(126,404)
Other	<u>(3,483)</u>	<u>(2,454)</u>
Total deferred tax liabilities	<u>(130,773)</u>	<u>(128,858)</u>
Net deferred tax liability	<u>\$ (4,358)</u>	<u>\$ (11,987)</u>

The Company had federal net operating loss carryforwards of \$123.3 million as of December 31, 2013, and \$96.2 million as of December 31, 2012, which start expiring in 2031. The Company had state net operating loss carryforwards of \$172.7 million as of December 31, 2013, and \$143.2 million as of December 31, 2012, which start expiring in 2015. The Company had federal tax general business, foreign tax, and alternative minimum tax credit carryforwards of \$11.3 million as of December 31, 2013, and \$13.4 million as of December 31, 2012, which start expiring in 2017. The Company had state credit carryforwards of \$6.9 million as of December 31, 2013, and \$3.1 million as of December 31, 2012, which start expiring in 2014. The Company also operates in several foreign jurisdictions.

The Company has evaluated whether it is more likely than not that its deferred tax assets will be utilized in the foreseeable future. The Company has evaluated all available evidence, including potential tax planning strategies that management considers prudent and feasible. The Company had valuation allowance of \$3.2 million as of December 31, 2013, and \$10.1 million as of December 31, 2012. During 2013, the Company's valuation allowance decreased by \$6.9 million primarily related to its foreign operations. The remaining valuation allowance of approximately \$3.2 million relates to certain state net operating losses, transaction cost, and tax credits that it cannot assert will be utilized on a more-likely-than-not basis.

The Company or any one of its subsidiaries files income tax returns in the United States, various states, the United Kingdom, Singapore, and various other foreign jurisdictions. With few exceptions, all domestic subsidiaries of the Company are no longer subject to examinations by tax authorities for years before 2010. The United Kingdom tax years remain open from 2012. All other foreign statutes remain open from 2010.

The Company's total uncertain tax liability as of December 31, 2013, is \$6.5 million, which included interest and penalties of \$0.3 million. As of December 31, 2012, the total uncertain tax liability was \$3.4 million, which included interest and penalties of \$0.4 million. The Company recognizes accrued interest and penalties related to uncertain tax positions in federal, state, and foreign income tax expense. If the Company's positions were sustained by the taxing authority in favor of the Company, approximately \$5.1 million for December 31, 2013, and approximately \$3.4 million for December 31, 2012, would be recognized as a reduction in the tax provision, which would reduce the Company's effective tax rate.

The Company believes it is reasonably possible that, within the next 12 months, \$0.3 million of previously unrecognized tax benefits related to certain federal, state, and foreign filing positions, all of which would reduce the Company's effective tax rate, will be recorded primarily as a result of the expiration of federal, state, and foreign statutes of limitation.

A reconciliation of the beginning and ending amount of unrecognized tax benefits for 2013 and 2012 is as follows:

	2013	2012
Gross unrecognized tax benefits — beginning of year	\$ 3,000	\$ 5,387
Gross increase in tax positions for prior years	3,770	9
Gross increase in tax positions for current years	60	744
Lapse of statute of limitations	<u>(682)</u>	<u>(3,140)</u>
Gross unrecognized tax benefits — end of year	<u>\$ 6,148</u>	<u>\$ 3,000</u>

KU Education, Inc. received a notice on March 4, 2014 indicating that they would be subject to an IRS audit for the year ended December 31, 2012. At this time the Entity has received and responded to an initial information document request which typically includes a request for general information about the Entity for the tax year. They have not received a response back from the IRS and are not aware of any additional areas of focus or proposed adjustments at this time.

20. RELATED-PARTY TRANSACTIONS

Fixed Overhead Payment Agreement — KUE Inc. and KUE LLC are required to pay annually to related parties, KULG and Knowledge Universe Limited LLC, \$17.5 million and \$2.5 million, respectively, for services provided to the Company and its subsidiaries. The payments are made in quarterly installments and cover salaries and bonuses of the affiliates' employees providing services to the Company and its subsidiaries, fees, and expenses related to financing transactions and acquisitions, professional fees, and other administrative expenses. These expenses are included within general and administrative expenses in the consolidated statements of operations. These agreements were amended in October 2013, reducing the annual fees to \$12.5 million. Total fees paid during 2013 by KUE Inc. and KUE LLC were \$15.7 million and \$1.9 million, respectively.

Real Estate Services — One of KUE [REDACTED]'s affiliates, Greenstreet Real Estate Partners, [REDACTED], provides real estate asset management and consulting services to KC Propco for an annual management fee of \$8.3 million. Effective January 1, 2014, this fee was reduced to an annual rate of \$4.8 million.

KUEH's subsidiary, KUE LLC, had leases for six early childhood education and care facilities owned by subsidiaries of Greenstreet Real Estate Holdings, [REDACTED], as of December 31, 2013, and seven as of December 31, 2012. These leases have an average duration of 15 years from their respective lease commencement dates.

21. COMMITMENTS AND CONTINGENCIES

On June 17, 2013, a lawsuit was filed against the Company and certain affiliates alleging misrepresentations and fraud relating to the sale of a subsidiary in 2011. The plaintiffs are seeking recovery of the \$135 million purchase price plus damages and other remedies. The sale transaction was completed pursuant to an extensively negotiated purchase agreement after comprehensive due diligence by the plaintiffs. The plaintiffs' allegations are inconsistent with the terms of the purchase agreement, and the Company believes they are completely baseless and without merit and intends to vigorously defend against the lawsuit. On September 11, 2013, the action was dismissed without prejudice against KUE [REDACTED] and KUEH, but continues against a director of the General Partner of KUE [REDACTED] and a former officer and director of the subsidiary that was sold.

The Company is subject to claims and litigation arising in the ordinary course of business. The Company believes that none of the claims or litigation of which it is aware will materially affect its consolidated financial statements, although assurance cannot be given with respect to the ultimate outcome of any such actions.

22. SUBSEQUENT EVENTS

In March 2014, KUEH's subsidiary, KUE LLC, entered into new \$370.0 million senior secured credit facilities to refinance all of the existing indebtedness under the Credit Agreement and redeemed the Notes in full in April 2014.

In February 2014, a subsidiary of KUPL acquired the 40% noncontrolling interest in CIS for \$71.0 million.

The Company had no other subsequent events to report as evaluated through June 30, 2014, the date the consolidated financial statements were available to be issued.

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