Ambow Education Holding Ltd.
Form 20-F
May 29, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 20-F

(Mark One)

o	**Registration Statement pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934**

OR

x	**Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2011

OR

o	**Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

OR

o	**Shell Company Report pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934**

Date of the event requiring this shell company report . . . .

Commission file number: 001-34824

AMBOW EDUCATION HOLDING LTD.
(Exact name of Registrant as specified in its charter)

Not Applicable
(Translation of Registrant s Name into English)

Cayman Islands
(Jurisdiction of Incorporation or Organization)

18th Floor, Building A, Chengjian Plaza, No. 18,

BeiTaiPingZhuang Road, Haidian District, Beijing

100088

People s Republic of China
(Address of Principal executive offices)

Gareth Kung, Chief Financial Officer

18th Floor, Building A, Chengjian Plaza, No. 18,

BeiTaiPingZhuang Road, Haidian District, Beijing

100088

People s Republic of China

Telephone: +86 (10) 6206-8007

Facsimile: +86 (10) 6206-8100
(Name, Telephone, E-mail and/or Facsimile Number and Address of Company Contact Person)

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

Title of Each Class	Name of Each Exchange on Which Registered
Class A Ordinary Shares	New York Stock Exchange*

* Not for trading, but only in connection with the listing on New York Stock Exchange of American depository shares representing the Class A ordinary shares. Each American depositary share represents two Class A ordinary shares.

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

None

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Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

Indicate the number of outstanding shares of each of the issuer s classes of capital stock as of the close of the period covered by this report.

49,088,096 Class A Ordinary Shares and 95,392,968 Class B Ordinary Shares, par value $0.0001 per share, as of December 31, 2011.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

o Yes x No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

o Yes x No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

o Yes x 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).

o Yes o No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o	Accelerated Filer x	Non-accelerated Filer o

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP x	International Financial Reporting Standards as issued by the International Accounting Standards Board o	Other o

If Other has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

o Item 17 o Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

o Yes x No

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CONVENTIONS THAT APPLY IN THIS ANNUAL REPORT ON FORM 20-F

Except where the context requires otherwise and for purposes of this annual report only:

- ***ADSs*** refers to our American depositary shares, each of which represents two Class A ordinary shares, and ***ADRs*** refers to the American depositary receipts that evidence our ADSs.

- ***Ambow***, ***we***, ***us*** or ***our*** refer to Ambow Education Holding Ltd. and its subsidiaries and, in the context of describing our operations and consolidated financial data, also include our VIEs and their respective subsidiaries.

- ***China*** or ***PRC*** refers to the People s Republic of China, excluding, for the purpose of this annual report, Hong Kong, Macau and Taiwan.

- ***GaoKao*** refers to university entrance exams administered in China.

- ***IPO*** refers to the initial public offering of our ADSs.

- ***RMB*** or ***Renminbi*** refers to the legal currency of China.

- ***U.S. GAAP*** refers to the Generally Accepted Accounting Principles in the United States.

- ***VIEs*** refers to our variable interest entities, which are certain domestic PRC companies in which we do not have direct or controlling equity interests but whose historical financial results have been consolidated in our financial statements in accordance with U.S. GAAP.

- ***ZhongKao*** refers to senior high school entrance exams administered in China.

- ***$*** , ***US$*** or ***U.S. dollars*** refers to the legal currency of the United States.

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FORWARD-LOOKING STATEMENTS

This annual report on Form 20-F includes forward-looking statements that relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Words such as, but not limited to, believe, expect, anticipate, estimate, intend, plan, likely, will, would, could, and expressions or phrases identify forward-looking statements. We have based these forward-looking statements largely on our current expectations and future events and financial trends that we believe may affect our financial condition, results of operation, business strategy and financial needs. Forward-looking statements include, but are not limited to, statements about:

- Anticipated trends and challenges in our business and the markets in which we operate;
- Our ability to anticipate market needs or develop new or enhanced services and products to meet those needs;
- Our ability to compete in our industry and innovation by our competitors;
- Our ability to protect our confidential information and intellectual property rights;
- Risks associated with opening new learning centers and other strategic plans;
- Our need to obtain additional funding and our ability to obtain funding in the future on acceptable terms;
- The impact on our business and results of operations arising from the defects in our real properties;
- Our planned capital expenditures in 2012;
- Our plan to make significant expenditures to create and maintain our positive brand awareness and brand loyalty;

- Our ability to manage growth; and

- Economic and business conditions in China.

All forward-looking statements involve risks, assumptions and uncertainties. You should not rely upon forward-looking statements as predictors of future events. The occurrence of the events described, and the achievement of the expected results, depend on many events, some or all of which are not predictable or within our control. Actual results may differ materially from expected results. See the information under Item 3.D Key Information Risk Factors and elsewhere in this annual report for a more complete discussion of these risks, assumptions and uncertainties and for other risks and uncertainties. These risks, assumptions and uncertainties are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could harm our results. We undertake no obligation, and specifically decline any obligation, to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this annual report might not occur.

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PART I

Item 1. Identity of Directors, Senior Management and Advisers

Not applicable.

Item 2. Offer Statistics and Expected Timetable

Not applicable.

Item 3. Key Information

A. Selected Financial Data

The selected consolidated financial data presented below for the three years ended December 31, 2009, 2010 and 2011 and as of December 31, 2010 and 2011 is derived from our audited consolidated financial statements included elsewhere in this annual report, which were prepared in accordance with U.S. GAAP. The selected consolidated financial data presented below for the years ended December 31, 2007 and 2008, and as of December 31, 2007, 2008 and 2009 is derived from our unaudited consolidated financial statements for those years that are not included in this annual report (which are unaudited as they have been revised from previously issued audited financial statements to reflect the classification of discontinued operations as a separate line item in the income statement), which were prepared in accordance with U.S. GAAP.

We have completed a number of acquisitions since January 1, 2008, including 7 acquisitions in 2011. We also disposed of several companies in December 2011 as well as initiated the disposal process for a college and K-12 school in December 2011. This has affected period-to-period comparisons of our selected consolidated financial data. The results presented in our financial statements reflect all of our continuing operations since January 1, 2007 or the subsequent date of acquisition. Any entities disposed of or in the process of being disposed of in December 2011 have been classified as discontinued operations, where applicable, and their financial results, together with any gain/loss arising on disposal, are reflected as a single line item below Income from Continuing Operations, for all periods presented, except for Beijing 21st Century International School, whose financial results were included as part of continuing operations because the Company will have significant continuing involvement with the school following the completion of the planned disposal.

	For the Year Ended December 31,					
	2007	2008	2009	2010	2011	2011
	RMB	RMB	RMB	RMB	RMB	US$

	(in thousands, except share, per share and per ADS information)					
Consolidated Statement of Operations Data:						
NET REVENUES:						
Educational programs and services	317,854	451,115	613,611	1,002,458	1,321,141	209,908
Software products	1,077	38,826	123,104	214,663	348,071	55,303
Total net revenues	318,931	489,941	736,715	1,217,121	1,669,212	265,211
Cost of revenues	(205,619)	(319,536)	(356,842)	(526,804)	(715,332)	(113,655)
GROSS PROFIT	113,312	170,405	379,873	690,317	953,880	151,556
Operating expenses:						
Selling and marketing (1)	(19,600)	(39,649)	(127,688)	(235,683)	(353,425)	(56,154)
General and administrative (1)	(33,828)	(52,747)	(136,466)	(220,602)	(329,913)	(52,418)
Research and development (1)	(3,754)	(11,696)	(16,968)	(27,553)	(39,541)	(6,282)
Impairment loss from continuing operations (1)					(25,336)	(4,025)
Total operating expenses	(57,182)	(104,092)	(281,122)	(483,838)	(748,215)	(118,879)
OPERATING INCOME	56,130	66,313	98,751	206,479	205,665	32,677
OTHER INCOME (EXPENSE)	(11,315)	5,577	(4,130)	(12,140)	(27,634)	(4,391)
INCOME BEFORE INCOME TAX, NON-CONTROLLING INTEREST, AND DISCONTINUED OPERATIONS	44,815	71,890	94,621	194,339	178,031	28,286
Income tax expense	(10,578)	(7,629)	(2,772)	(37,635)	(42,231)	(6,710)
INCOME FROM CONTINUING OPERATIONS	34,237	64,261	91,849	156,704	135,800	21,576
Income(loss) from and (loss) on sale of discontinued operations, net of income tax		3,099	46,172	54,995	(119,581)	(19,000)

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	For the Year Ended December 31,					
	2007 RMB	2008 RMB	2009 RMB	2010 RMB	2011 RMB	2011 US$
	(in thousands, except share, per share and per ADS information)					
NET INCOME	34,237	67,360	138,021	211,699	16,219	2,576
Non-controlling interest			215	4,333	4,966	789
NET INCOME ATTRIBUTABLE TO AMBOW EDUCATION HOLDING LTD.	34,237	67,360	138,236	216,032	21,185	3,365
Preferred shares redemption value accretion	(1,407)	(67,768)	(157,877)	(94,209)		
Allocation of net income to participating preferred shareholders	(20,837)	(53,949)	(93,611)	(55,534)		
NET INCOME (LOSS) ATTRIBUTABLE TO ORDINARY SHAREHOLDERS	11,993	(54,357)	(113,252)	66,289	21,185	3,365
Net income (loss) from continuing operations per ordinary share: (2)						
Basic	0.75	(2.49)	(4.07)	0.13	0.98	0.16
Diluted	0.33	(2.49)	(4.07)	0.14	0.94	0.15
Net income (loss) from discontinued operations per ordinary share: (2)						
Basic	0.00	0.13	1.18	0.64	(0.84)	(0.13)
Diluted	0.00	0.13	1.18	0.49	(0.79)	(0.13)
Net income (loss) from continuing operations per ADS: (2)						
Basic	1.50	(4.99)	(8.14)	0.26	1.96	0.32
Diluted	0.66	(4.99)	(8.14)	0.28	1.88	0.30
Net income (loss) from discontinued operations per ADS: (2)						
Basic	0.00	0.27	2.36	1.29	(1.67)	(0.27)
Diluted	0.00	0.27	2.36	0.98	(1.59)	(0.25)
Weighted average shares used in calculating net income (loss) per share (2)						
Basic	16,031,507	23,038,853	39,193,092	85,551,412	142,939,038	142,939,038
Diluted	37,622,476	23,038,853	39,193,092	112,122,045	150,432,812	150,432,812

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(1) Share-based compensation expense included in:

	For the Year Ended December 31,					
	2007	2008	2009	2010	2011	2011
	RMB	RMB	RMB	RMB	RMB	US$
	(in thousands, except share, per share and per ADS information)					
Selling and marketing	623	1,194	4,411	7,204	7,286	1,158
General and administrative	4,175	8,370	8,640	26,029	25,220	4,007
Research and development	353	426	480	981	842	134

(2) Basic and diluted net income from continuing operations per ordinary share is computed by dividing net income from continuing operations adjusted for the impact of any accretion/allocation of income relating to preferred shareholders by the weighted average number of shares outstanding for the period. Basic and diluted net income (loss) from discontinued operations per ordinary share is computed by dividing net income/(loss) from discontinued operations by the weighted average number of shares outstanding for the period. The potentially dilutive warrants, preferred shares and options were excluded from the calculation of diluted net income (loss) from continuing/discontinued operations per share in those periods where their inclusion would be anti-dilutive.

	As of December 31,					
	2007	2008	2009	2010	2011	2011
	(in thousands)					
	RMB	RMB	RMB	RMB	RMB	US$
Consolidated Balance Sheet Data:						
Cash and cash equivalents	416,094	778,824	409,926	869,300	470,682	74,784
Total current assets	1,006,011	1,578,712	1,133,515	1,663,782	1,669,505	265,258
Total assets	1,012,335	1,993,884	3,672,394	4,238,497	4,720,627	750,032
Total current liabilities	475,104	502,738	1,131,901	1,071,402	1,449,737	230,339
Total liabilities	475,104	525,626	1,582,625	1,505,504	1,954,164	310,485
Mezzanine equity	387,757	1,131,408	1,288,147			
Total shareholders equity	149,474	336,850	801,622	2,732,993	2,766,463	439,547

	For the Year Ended December 31,					
	2007	2008	2009	2010	2011	2011
	RMB	RMB	RMB	RMB	RMB	US$
	(in thousands)					
Consolidated Statement of Cash Flow Data:						
Net cash provided by/(used in) operating activities	88,613	(63,630)	523,094	456,914	296,705	47,142
Net cash used in investing activities	(118,430)	(261,831)	(802,365)	(392,364)	(494,558)	(78,577)
Net cash provided by/(used in) financing activities	388,754	700,041	(86,500)	406,598	(46,216)	(7,343)
Cash and cash equivalents included in assets held for sale					(139,099)	(22,101)

Exchange Rates

Our business is primarily conducted in China and substantially all of our revenues are denominated in RMB. This annual report contains translations of certain RMB amounts into U.S. dollars at specified rates solely for the convenience of the reader. All translations from RMB to U.S. dollars were made at the noon buying rate as set forth in the H.10 statistical release of the U.S. Federal Reserve Board. Unless otherwise stated, the translation of RMB into U.S. dollars has been made at the noon buying rate on December 30, 2011, which was RMB 6.2939 to US$1.00. We make no representation that the RMB or U.S. dollar amounts referred to in this annual report could have been converted into U.S. dollars or RMB, as the case may be, at any particular rate or at all. The PRC government imposes control over its foreign currency reserves in part through direct regulation of the conversion of RMB into foreign

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exchange and through restrictions on foreign trade. On May 18, 2012, the daily exchange rate reported by the Federal Reserve Board was RMB6.3245 to US$1.00.

The following table sets forth information concerning exchange rates between the RMB and the U.S. dollar for the periods indicated. These rates are provided solely for your convenience and are not necessarily the exchange rates that we used in this annual report or will use in the preparation of our periodic reports or any other information to be provided to you. The source of these rates is the Federal Reserve Board.

	Exchange Rate			
Period	**Period End**	**Average (1)**	**Low (2)**	**High (2)**
2007	7.2946	7.5806	7.2946	7.8127
2008	6.8225	6.9193	6.7800	7.2946
2009	6.8259	6.8295	6.8176	6.8470
2010	6.6000	6.7653	6.6000	6.8330
2011	6.2939	6.4475	6.2939	6.6364
October	6.3547	6.3710	6.3534	6.3825
November	6.3765	6.3564	6.3400	6.3839
December	6.2939	6.3482	6.2939	6.3733
2012				
January	6.3080	6.3119	6.2940	6.3330
February	6.2935	6.2997	6.2935	6.3120
March	6.2975	6.3125	6.2975	6.3315
April	6.2790	6.3043	6.2790	6.3150
May (through May 18, 2012)	6.3245	6.3133	6.3052	6.3247

(1) Annual averages are calculated from month-end noon buying rates in the city of New York as published by the Federal Reserve Bank. Monthly averages are calculated using the daily noon buying rates in the city of New York as set forth in the H.10 statistical release of the Federal Reserve Board during the relevant periods.

(2) Annual and monthly lows and highs are calculated from daily noon buying rates in the city of New York as published by the Federal Reserve Bank.

B. <u>Capitalization and Indebtedness</u>

Not applicable.

C. <u>Reasons for the Offer and Use of Proceeds</u>

Not applicable.

D. Risk Factors

Risks related to our business and industry

If we are not able to continue to attract students to enroll in our programs, our net revenues may decline and we may not be able to maintain profitability.

The success of our business largely depends on the number of student enrollments in our programs and the amount of course fees that our students are willing to pay. Therefore, our ability to continue to attract students to enroll in our programs without a significant decrease in course fees is critical to the continued success and growth of our business. This will depend on several factors, including our ability to develop new programs and enhance existing programs to respond to changes in market trends and student demands, expand our geographic reach, manage our growth while maintaining the consistency of our teaching quality, effectively market our programs to a broader base of prospective students, develop and license additional high-quality educational content and respond to competitive pressures. Our college is subject to the government imposed annual enrollment quota limit. If we were to violate requirements to which we are subject the Chinese Ministry of Education, or the MOE, could reduce the annual enrollment quota at our college or restrict the programs we offer at our college or the methods by which we recruit new students. If we are unable to continue to attract students to enroll in our programs without a significant decrease in course fees, our net revenues may decline and we may not be able to maintain profitability, either of which could result in a material adverse effect on our business, results of operations and financial condition.

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If we are not able to continue to attract and retain qualified education professionals, we may not be able to maintain consistent teaching quality throughout our school and learning center network and our brand, business and results of operations may be materially and adversely affected.

Our education professionals are critical to maintaining the quality of our services, software products and programs, and maintaining our brand and reputation, as they interact with our students on a regular basis. We must continue to attract qualified education professionals who have a strong command of the subject areas to be taught and meet our qualifications. There are a limited number of education professionals in China with the necessary experience to satisfy our qualifications, and we must provide competitive compensation packages to attract and retain qualified teachers and tutors. Some of our education professionals are teachers of public schools that are working at our tutoring centers on a part-time basis. Paid tutoring by teachers of public schools has received more regulatory scrutiny recently. Some of the provinces and cities where we have substantial business operations, such as Beijing, Tianjin, Chengdu, Jiangsu, Hunan and Hubei have promulgated local regulations prohibiting teachers of public schools from teaching, on a part-time basis, at private schools during the work week or at any time. We believe that some of our teachers also work in public schools. If these education professionals choose to leave, or are forced to leave, our learning centers to comply with relevant local regulations, we will need to seek new teachers to replace them which we cannot assure you that we will be able to do at a reasonable cost or at all. If these regulations become the trend and are adopted in more provinces and cities or become more restrictive, we may need to seek additional new teachers in more places, which will further increase the difficulty of our recruiting efforts. While none of the existing local regulations impose any penalty on private schools like ours for hiring teachers who also teach at public schools, we cannot assure you that such regulations will not be adopted in the future. In addition, we may not be able to hire and retain enough qualified education professionals to keep pace with our anticipated growth or at acceptable costs while maintaining consistent teaching quality across many different schools, learning centers and programs in different geographic locations. Shortages of qualified education professionals, or decreases in the quality of our instruction, whether actual or perceived in one or more of our markets, or an increase in hiring costs, may have a material and adverse effect on our business and our reputation. Further, our inability to retain our education professionals may hurt the brands we are trying to develop, and retaining qualified teachers at additional costs may have a material adverse effect on our business and results of operations.

Failure to effectively and efficiently manage the expansion of our service network may materially and adversely affect our ability to capitalize on new business opportunities.

We plan to expand our operations primarily through organic growth, which may result in substantial demands on our management personnel as well as our financial, operational, administrative, technological and other resources. Opening new tutoring and career enhancement centers requires us to incur substantial pre-opening costs and we may incur losses during the initial ramp-up stage since we incur rent, salary and other operating expenses for new learning centers regardless of any revenues we may generate. We expect that the fixed costs and other increased operating expenses that would result from opening new centers would exceed the revenue generated from those new centers during their initial establishment period. Consequently, if we open a significant number of new tutoring and career enhancement centers, our profit margins will decline substantially, at least in the near term, until such time as the new centers generate sufficient revenue to offset their fixed costs and other increased operating expenses. Furthermore, the expansion of our programs, services and geographic locations may not succeed due to competition, failure to efficiently market our new centers and maintain their quality and consistency, or other factors. We cannot assure you that we will be able to successfully integrate new learning centers into our operations. Any failure to effectively and efficiently manage our expansion may materially and adversely affect our ability to capitalize on new business opportunities, which in turn may have a material adverse effect on our future financial condition and results of operations. However, if we fail to expand our business in a timely fashion, we may lose market share and revenue and our future growth could be limited.

Our business depends on the strength of our brands in the marketplace. We may not be able to retain existing students or attract new students if we cannot continue to use, protect and enhance our brands successfully in the marketplace.

Our operational and financial performance and the successful growth of our business are highly dependent on market awareness of our Ambow brand and the regional brands that we have acquired. We believe that maintaining and enhancing the Ambow brand is critical to maintaining and enhancing our competitive advantage and growing our business. In order to retain existing students and attract new students, we plan to continue to make significant expenditures to create and maintain our positive brand awareness and brand loyalty. The diverse set of services and products that we offer to K-12 students, college students and other adults throughout many provinces in China places significant demands on us to maintain the consistency and quality of our services and products to ensure that our brands do not suffer from any actual or perceived decrease in the quality of our services and products. As we continue to grow in size, expand our services and products and extend our geographical reach, maintaining the quality and consistency of our services and products may be more difficult. Any negative publicity about our services, products, schools or learning centers, regardless of its veracity, could harm our brand image and have a material adverse effect on our business and results of operations.

We face significant competition in each major program we offer and each geographic market in which we operate, and if we fail to compete effectively, we may lose our market share and our profitability may be adversely affected.

The private education sector in China is rapidly evolving, highly fragmented and competitive, and we expect competition in this sector to persist and intensify. In addition, our K-12 schools compete with public schools in China, which are generally viewed to be superior to private schools within the Chinese market. We face competition in each major program we offer and each geographic

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market in which we operate. Moreover, competition is particularly intense in some of the key geographic markets in which we operate, such as Beijing and Shanghai.

We also face competition from many different companies that focus on one area of our business and are able to devote all of their resources to that business line, and these companies may be able to more quickly adapt to changing technology, student preferences and market conditions in these markets than we can. These companies may, therefore, have a competitive advantage over us with respect to these business areas.

The increasing use of the Internet and advances in Internet- and computer-related technologies are eliminating geographic and cost-entry barriers to providing private educational services. As a result, many international companies that offer online test preparation and language training courses may decide to expand their presence in China or to try to penetrate the China market. Many of these international companies have strong education brands, and students and parents in China may be attracted to the offerings based in the country that the student wishes to study in or in which the selected language is widely spoken. In addition, many Chinese and smaller companies are able to use the Internet to quickly and cost-effectively offer their services and products to a large number of students with less capital expenditure than previously required.

Competition could result in loss of market share and revenues, lower profit margins and limit our future growth. A number of our current and potential future competitors may have greater financial and other resources than we have. These competitors may be able to devote greater resources than we can to the development, promotion and sale of their services and products, and respond more quickly than we can to changes in student needs, testing materials, admissions standards, market needs or new technologies.

Our student enrollments may decrease due to intense competition, and we may be required to reduce course fees or increase spending in response to competition in order to retain or attract students or pursue new market opportunities. As a result, our net revenues and profitability may decrease. We cannot assure you that we will be able to compete successfully against current or future competitors. If we are unable to maintain our competitive position or otherwise respond to competitive pressures effectively, we may lose our market share and our profitability may be materially adversely affected.

We have completed a number of acquisitions, which involve risks and uncertainties, and if we don t manage those risks well, it may harm our business.

We have completed a number of acquisitions, and we intend to continue to make strategic acquisitions and investments as part of our growth strategy. In the future, we may also establish and maintain joint ventures and strategic relationships with third parties. Strategic acquisitions, investments and relationships with third parties involve substantial risks and uncertainties, including:

- Our ability to identify and acquire targets in a cost-effective manner;

- Our ability to obtain approval from relevant governmental authorities for the acquisitions and comply with applicable rules and regulations for such acquisitions;

- Potential ongoing financial obligations in connection with acquisitions;

- Potential unforeseen or hidden liabilities, including litigation claims or tax liabilities, associated with acquired companies or schools;

- The diversion of resources and management attention from our existing businesses;

- Failure to achieve the intended objectives, benefits or revenue-enhancing opportunities expected from the acquisitions;

- Our ability to generate sufficient revenues to offset the costs and expenses of strategic acquisitions, investments, joint venture formations, or other strategic relationships; and

- Potential loss of, or harm to, employee or customer relationships as a result of ownership changes.

In particular, while we have performed due diligence on each entity that we acquired before the acquisition, some of the acquired entities did not maintain their historical documents and records properly and a substantial amount of such documents and records were unavailable for our review. As such, there may be hidden liabilities and risks relating to the business and operation of such acquired entities that we failed to identify before the acquisition and of which we are still unaware. If any such hidden liability is found or any such risk materializes in the future, we may not have any remedy against the sellers and may have to assume the liabilities and losses as a result.

If any one or more of these risks or uncertainties were to occur or if any of the strategic objectives we contemplated is not achieved, our ability to manage our business could be impaired. It could result in our failure to derive the intended benefits of these strategic acquisitions, investments, joint ventures or strategic relationships, or otherwise have a material adverse effect on our business, financial condition and results of operations. In addition, if we fail to successfully pursue our future acquisition strategy, our plans for further market penetration, revenue growth and improved results of operations could be harmed.

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We may not be able to successfully integrate businesses that we acquire, which may cause us to lose anticipated benefits from such acquisitions and to incur significant additional expenses.

It is challenging to integrate business operations, infrastructure and management philosophies of acquired schools and companies. The benefits of our past and future acquisitions depend in significant part on our ability to integrate technology, operations and personnel. The integration of acquired schools and companies is a complex, time-consuming and expensive process that, without proper planning and implementation, could significantly disrupt our business and operations. The main challenges involved in integrating acquired entities include the following:

- Ensuring and demonstrating to our students that the acquisitions will not result in adverse changes in service standards or business focus;
- Consolidating and rationalizing corporate IT and administrative infrastructures;
- Retaining qualified education professionals of our acquired entities;
- Consolidating service and product offerings;
- Coordinating and rationalizing research and development activities to enhance introduction of new products and technologies with reduced cost;
- Preserving strategic, marketing or other important relationships of the acquired entity and resolving potential conflicts that may arise with our key relationships; and
- Minimizing the diversion of management attention from ongoing business concerns.

We may not successfully integrate our operations and the operations of entities we acquire in a timely manner, or at all, and we may not realize the anticipated benefits or synergies of the acquisitions to the extent, or in the timeframe, anticipated, which would have a material adverse effect on our results of operations. In the last quarter of 2011, we disposed four tutoring and career enhancement subdivisions and initiated the disposal of Beijing Century College and its 100% owned Beijing Siwa Century Facility Management Co. and Beijing 21st Century International School. In connection with these disposals, the Company recorded a total impairment loss of RMB152.6 million (US$24.2 million). This is done to sharpen our focus on the organic growth and business portfolio with stronger performance, greater capital efficiency and better asset turnover.

Our results of operations may fluctuate, which makes our financial results difficult to forecast, and could cause our results to fall short of expectations.

Our results of operations may fluctuate as a result of a number of factors, many of which are outside of our control. Our net revenues grew from RMB736.7 million in 2009 to RMB1,217.1 million in 2010 to RMB1,669.2 million (US$265.2 million) in 2011. Such growth may not be sustainable or indicative of our future results. In addition, comparing our results of operations on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. Our quarterly and annual net revenues and costs and expenses as a percentage of net revenues may be significantly different from our historical or projected rates. Our quarterly and annual net revenues and gross margins may fluctuate due to a number of factors, including:

- The mix of our net revenues across our operating segments;
- The increase of costs associated with our strategic expansion plans;
- The revenue and gross margin profiles of our acquisitions in a given period;
- Our ability to successfully integrate our acquisitions and the timing of our post-integration activities;
- Our ability to reduce our costs as a percentage of our net revenues;
- Increased competition; and
- Our ability to manage our financial resources, including administration of bank loans and bank accounts.

As a result of these and other factors, we may not sustain our past growth rates in future periods, and we may not sustain profitability on a quarterly or annual basis in the future.

Our business depends on the continuing efforts of our senior management team and other key personnel and our business may be harmed if we lose their services.

Our future success depends heavily upon the continuing services of the members of our senior management team and, in particular, upon our retaining the services of our founder, Chairman and Chief Executive Officer, Dr. Jin Huang. If one or more of our senior executives or other key personnel are unable or unwilling to continue in their present positions, we may not be able to replace them easily or at all, our business may be disrupted and our financial condition and results of operations may be materially and adversely affected. In addition, if any member of our senior management team or any of our other key personnel joins a competitor or forms a competing company, we may lose teachers, students, key professionals and staff members. Competition for experienced management personnel in the private education sector is intense, the pool of qualified candidates is very limited, and we may not be

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able to retain the services of our senior executives or key personnel, or attract and retain high-quality senior executives or key personnel in the future, which could have a material adverse effect on our business and results of operations.

Changes in our management may cause uncertainty in, or be disruptive to, our business.

We experienced certain changes in our senior management during 2011. Our Chief Financial Officer was appointed in December 2011, and we appointed a Chief Strategy Officer in November 2011. Although we will endeavor to implement management transition in as non-disruptive a manner as possible, any such transition might impact our business, and give rise to uncertainty among our customers, investors, vendors, employees and others concerning our future direction and performance. This could affect our business, financial condition, results of operations and cash flows, and our ability to execute our business model could be impaired.

The growth of our business is in part dependent on our relationships with our distributors and corporate partners. If we were to lose these relationships, or the benefits we derive from these relationships were to diminish, our growth rates and our business would be harmed.

We rely on our distributors and corporate partners to help drive our net revenues and profitability growth rates. We sell to distributors who then distribute our educational services and software products throughout China to additional schools and students and to expand our geographic reach to areas where we do not have a direct presence. Some of our distributors are small companies with limited resources and track records and there can be no assurance that they will be able to continue their operations or succeed in selling our products. If these distributors are unable to continue their operations or sell our products, we may be required to identify new distributors which may divert management resources from other matters and otherwise interrupt our sales cycle. We also have partnerships, both directly and through our distributors, with a number of K-12 schools and universities throughout China. We sell our services and software products to the students in these schools and universities and also teach students in our tutoring centers and career enhancement centers who are enrolled in these schools and universities. We have developed a number of strategic partnerships with significant national and multinational corporations who are expanding the business they do in China, including Cisco Systems, Inc., The McGraw-Hill Companies, Inc., Oracle (China) Software Systems Co. Ltd, Microsoft (China) Company Limited, Lenovo and Adobe Creative University. We derive both direct benefits, such as expanding and improving the curriculum in our career enhancement centers and helping to attract additional students to these centers, and indirect benefits, such as strengthening the Ambow brand, from these partnerships. If our relationships with any of these partners and distributors were to be damaged or lost, or the benefits we derive from these relationships were to be diminished, whether by our own actions, actions of one or more governmental entities or actions of our competitors, our growth rates and our business would be harmed.

If we are not able to continually enhance our online programs, services and products and adapt them to rapid technological changes and student needs, we may lose market share and our business could be adversely affected.

Our online programs, services and products are vital to the success of our business. The market for such programs, services and products is characterized by rapid technological changes and innovation, unpredictable product life cycles and user preferences. We must quickly modify our online programs, services and products to adapt to changing student needs and preferences, technological advances and evolving Internet practices. Ongoing enhancement of our online offerings and related technologies may entail significant expense and technical risk. We may use new technologies ineffectively or fail to adapt our online services or products and related technologies on a timely and cost-effective basis. If our improvements to our online offerings and the related technology are delayed, result in systems interruptions or are not aligned with market expectations or preferences, we may lose market share and our business could be materially adversely affected.

If we fail to successfully develop and introduce new services and products in time, our competitive position and ability to generate revenues could be harmed.

Our future success depends partly on our ability to develop new services and products. The planned timing or introduction of new services and products is subject to risks and uncertainties. Actual timing may differ materially from original plans. Unexpected technical, operational or other problems could delay or prevent the introduction of one or more of our new services or products. Moreover, we cannot assure you that any of our new services and products will achieve widespread market acceptance or generate incremental revenue. If our efforts to develop, market and sell new services and products to the market are not successful, our financial position, results of operations and cash flows could be materially adversely affected.

Failure to adequately and promptly respond to changes in curriculum, testing materials and standards could cause our services and products to be less attractive to our students.

There are continuous changes in the focus of the subjects and questions tested on ZhongKao and GaoKao in China, and the format of the tests and the manner in which the standardized tests are administered. These changes require us to continually update and enhance our curriculum, test preparation materials and our teaching methods. Any inability to track and respond to these changes in a timely and cost-effective manner would make our services and products less attractive to students, which may materially and adversely affect our reputation and ability to continue to attract students without a significant decrease in course fees. Further, we understand the MOE has been discussing reforms to curriculum of K-12 schools. Therefore, school curriculum will likely undergo changes and our tutoring and test preparation programs and materials will need to adapt to such changes. Failure to timely respond to such changes will adversely impact our tutoring services.

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Failure to respond to changes to the current assessment and testing systems and admission standards in China could have a material adverse effect on our business and results of operations.

A substantial majority of the net revenues generated in our tutoring segment in the year ended December 31, 2011 were generated from tutoring services focused on preparing for ZhongKao and GaoKao. There have been changes in some areas in the way ZhongKao is administered. For example, beginning in 2010, Yunnan Province stopped administering ZhongKao. Instead, high schools will admit students based on a combination of a comprehensive evaluation of the students aptitude (provided by their middle schools) and the students middle school academic performance. To ensure the success of the educational reform and cultivate students comprehensive abilities, Yunnan Province also prohibits subject competitions in elementary and middle schools, including Olympic math competitions, and standardizes admission policies regarding adding points to middle school test scores based on a student s extracurricular activities. As for GaoKao, some top universities such as Peking University have been allowed to recruit students through independently administered tests and admission procedures in recent years. The candidates still need to take GaoKao and their scores in GaoKao may not be lower than certain thresholds, but such GaoKao scores will not be the sole determining factor in the admission process. Students admitted in this manner generally should not exceed 5% of the annual enrollment quotas of these universities as approved by the MOE. In 2009, 76 universities and colleges were allowed to recruit students through independently administered tests and admission procedures according to a notice promulgated by the MOE on December 12, 2008. The number of such universities and colleges increased to 80 in 2011 and may increase further in the future. To the extent ZhongKao, or even GaoKao, becomes less prevalent throughout China, our business and results of operations may be materially adversely affected.

If we are unable to renew our existing loan facilities, or obtain new loans, at all or on terms that are acceptable to us, our growth pace will be impacted.

As of December 31, 2011, our total bank borrowings amounted to RMB180.6 million and our short-term bank loans outstanding totaled RMB118.1 million. We may seek to obtain additional bank loans in the future. We cannot assure you that we will be able to roll over our existing bank facilities, or obtain new loans or credit facilities, at all or on terms that are acceptable to us. Our ability to obtain financing may be affected by our financial position and leverage, our credit rating and investor perception of the education industry, as well as by prevailing economic conditions and the cost of financing in general. In addition, factors beyond our control, such as recent global market and economic conditions and the tightening of credit markets may result in a diminished availability of financing and increased volatility in credit and equity markets, which may materially adversely affect our ability to secure financing at reasonable costs or at all. As of the date of this annual report, all of our bank borrowing is from domestic banks in China. During 2011, the People s Bank of China (PBOC) significantly tightened liquidity among Chinese banks. Although on December 5, 2011, the PBOC reduced the reserve requirement ratio for Chinese banks to 21 percent from a record high of 21.5 percent, we cannot assure you that the PBOC will not in the future take actions that may result in a tightening of the credit market in China. Our ability to obtain bank loans from domestic Chinese banks will be significantly impacted by the PBOC s policies, over which we have no control. If we are unable to roll over our existing bank facilities or to obtain financing in the future on terms acceptable to us, our business operations and our growth plans would be materially harmed.

Our business is subject to seasonal fluctuations, which may cause our operating results to fluctuate from quarter to quarter. This may result in volatility and adversely affect the price of our ADSs.

We have experienced, and expect to continue to experience, seasonal fluctuations in our revenues and results of operations, primarily due to seasonal changes in service days and student enrollments. Historically, the number of days on which our students attend our courses is lower in the first and third quarters due to school closures for the celebration of the Chinese New Year and summer vacation. Because we recognize revenue in our K-12 schools and college segments based on the number of service days in the quarter, we expect our revenue in the first and third quarters to be negatively impacted. Our costs and expenses, however, vary significantly and do not necessarily correspond with changes in our student enrollments, service days and net revenues. We make investments in marketing and promotion, teacher recruitment and training, and product development throughout the year. We expect quarterly fluctuations in our revenues and results of operations to continue. These fluctuations could result in volatility and adversely affect the price of our ADSs. As our revenues grow in our K-12 schools and college segments, these seasonal fluctuations may become more pronounced.

We may not be able to adequately protect our intellectual property, which could cause us to be less competitive.

Our trademarks, trade names, copyrights, trade secrets and other intellectual property rights are important to our success. Unauthorized use of any of our intellectual property may adversely affect our business and reputation. We rely on a combination of copyright, trademark and trade secrets laws and confidentiality agreements with our employees, consultants and others, including our partner schools, to protect our intellectual property rights. Nevertheless, it may be possible for third parties to obtain and use our intellectual property without authorization. The unauthorized use of intellectual property is widespread in China, and enforcement of intellectual property rights by Chinese regulatory agencies is inconsistent. Moreover, litigation may be necessary in the future to enforce our intellectual property rights. Future litigation could result in substantial costs and diversion of our management s attention and resources and could disrupt our business. If we are unable to enforce our intellectual property rights, it could have a material adverse effect on our financial condition and results of operations. Given the relative unpredictability of China s legal system and potential difficulties enforcing a court judgment in China, we may be unable to halt the unauthorized use of our intellectual property

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through litigation. Failure to adequately protect our intellectual property could materially adversely affect our competitive position, our ability to attract students and our results of operations.

We may be exposed to infringement and misappropriation claims by third parties, which, if successful, could cause us to pay significant damage awards.

Third parties may initiate litigation against us alleging infringement upon their intellectual property rights. On May 13, 2009, the Intermediate Court in Beijing accepted a filing of an infringement claim by the Graduate Management Admission Council, or GMAC, regarding alleged copyright infringement arising from the unauthorized use of GMAT materials by Beijing Century Bosen Consulting Co., Ltd., or Beijing Century Tutoring, one of our tutoring centers. In November 2009, GMAC and Beijing Century Tutoring entered into a settlement agreement that provides, among other things, that Beijing Century Tutoring shall remove certain specified GMAT materials and hyperlinks from Beijing Century Tutoring s website, and RMB0.5 million was paid by Beijing Century Tutoring to GMAC for damages and losses incurred by the alleged infringing acts.

In August 2010, Beijing Kaidi Morning Light Education and Technology Development Co., Ltd., or Kaidi, initiated an action against Ambow Shida and Ambow Online in the Haidian District Court in Beijing, the People s Republic of China, alleging copyright infringement related to our Core Ebopo English and Ebopo English products. Kaidi applied to the court for an order that would require the defendants to stop the infringement, apologize publicly and pay the plaintiff damages in the amount of RMB 11,000,000. Ambow Shida and Ambow Online replied to the accusation, and Kaidi voluntarily withdrew the lawsuit after the first hearing for the preliminary evidence. In December 2010, Kaidi re-filed its claim for copyright infringement in the Haidian District Court in Beijing, the People s Republic of China, against Ambow Shida and Ambow Online. Ambow Shida and Ambow Online replied to the accusation. The court held a hearing to review the preliminary evidence in March 2011 and adjourned the case.

In March 2011, Mintel Learning Technology, Inc. (Mintel) filed a complaint against Ambow Education Holding Ltd. (Ambow) and Ambow s President and CEO, Dr. Jin Huang, in U.S. District Court for the Northern District of California, alleging a claim of trade secret misappropriation. On January 6, 2012, the Court granted Ambow s motion to dismiss the complaint for failure to state a claim. In an amended complaint filed on January 12, 2012, Mintel dropped its claim against Dr. Huang. Mintel maintained its claim against Ambow for trade secret misappropriation. In an order dated March 8, 2012, the Court denied Ambow s motion to dismiss the amended complaint. On March 22, 2012, Ambow filed an answer to the complaint, denying Mintel s claim. The parties are currently engaged in the early stages of discovery. Fact discovery will close on October 19, 2012, and expert discovery will close on December 14, 2012. The last day for the parties to file dispositive motions is January 11, 2013. The Court has set a preliminary pretrial conference for February 1, 2013.

Although we believe that these claims are not meritorious and intend to defend ourselves vigorously, in the event of a future successful claim of infringement or misappropriation and our failure or inability to develop non-infringing technology or license the infringed or misappropriated or similar technology on a timely basis, our business could be harmed. In addition, even if we are able to license the infringed or misappropriated or similar technology, license fees could be substantial and may adversely affect our results of operations.

We rely heavily on our information systems, and if we fail to further develop our technologies, or if our systems, software, applications, database or source code contain bugs or other undetected errors, our operations may be seriously disrupted.

The successful development and maintenance of our systems, software, applications and database, such as our school management software and system, learning engine and student database, is critical to the attractiveness of our online and offline programs and the management of our business operations. In order to achieve our strategic objectives and to remain competitive, we must continue to develop and enhance our technology. This may require us to acquire additional equipment and software and to develop new applications. In addition, our technology platform upon which our management systems and online programs operate, and our other databases, products, systems and source codes could contain undetected errors or bugs that could adversely affect their performance.

To date, our information systems have not encountered material errors or technical issues that have adversely affected or disrupted our operations. If we encounter errors or other service quality or reliability issues, or if we are unable to design, develop, implement and utilize information systems and the data derived from these systems, our ability to realize our strategic objectives and our profitability could be adversely affected, and this may cause us to lose market share, harm our reputation and brand names, and materially adversely affect our business and results of operations.

Unexpected network interruptions, security breaches or computer virus attacks and system failures could have a material adverse effect on our business, financial condition and results of operations.

Any failure to maintain satisfactory performance, reliability, security or availability of our network infrastructure may cause significant damage to our reputation and our ability to attract and maintain students. Major risks involving our network structure include:

- Breakdowns or system failures resulting in a prolonged shutdown of our servers, including failures attributable to power shutdowns, or attempts to gain unauthorized access to our systems, which may cause loss or corruption of data, including customer data, or malfunctions of software or hardware;

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- Disruption or failure in the national backbone network, which would make it impossible for visitors and students to log on to our websites;

- Damage from fire, flood, power loss and telecommunications failures; and

- Any infection by or spread of computer viruses.

Any network interruption or inadequacy that causes interruptions in the availability of our websites or deterioration in the quality of access to our websites could reduce customer satisfaction and result in a reduction in the number of students using our services. If sustained or repeated, these performance issues could reduce the attractiveness of our online and offline programs. In addition, we may be subject to a security breach caused by a computer hacker, which could involve attempts to gain unauthorized access to our systems or personal information stored in our systems, or to cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment. A user who circumvents our security measures could misappropriate proprietary information or cause interruptions or malfunctions in our operations. As a result, we may be required to expend significant resources to protect against the threat of these security breaches or to alleviate problems caused by these breaches.

Furthermore, increases in the volume of traffic on our websites could also strain the capacity of our existing computer systems, which could lead to slower response times or system failures. This would cause a disruption or suspension in our online course programs, which would hurt our brand and reputation, and thus negatively affect our net revenue growth. We may need to incur additional costs to upgrade our computer systems in order to accommodate increased demand if we anticipate that our systems cannot handle higher volumes of traffic in the future.

All of our servers and routers, including backup servers, are currently hosted by third-party service providers within China. We do not currently maintain any backup servers outside of China. To improve the performance and to prevent the disruption of our services, we may have to make substantial investments to deploy additional servers or one or more copies of our websites to mirror our online resources.

Our legal right to lease certain properties could be challenged by property owners or other third parties, which may cause interruptions to business operations of the affected schools, tutoring centers, college and career enhancement centers and adversely affect our financial results.

We lease most of the premises used for the operation of our schools, tutoring centers, college and career enhancement centers. As a result, we are dependent on the property rights of these properties held by their owners to enable us to use the premises. We cannot assure you that all lessors of our leased business premises have the relevant land use right certificates or building ownership certificates of the premises they lease to us or otherwise have the right to lease the premises to us.

As of December 31, 2011, we were unable to acquire copies of title certificates of buildings from lessors or registration or approval from competent authorities for properties to be obtained by lessors accounting for approximately 318,573 square meters, or approximately 42.2 % of the premises we lease based on the aggregate of 754,221 square meters of space we lease for our tutoring centers, K-12 schools, career enhancement centers and college as of such date. These leased buildings with defects, which represent 32.7% of all of the buildings we lease and own, generally are used for classrooms and dormitories for our students. Of the buildings we lease with defects, buildings covering approximately 94,212 square meters for schools or learning center space are leased from public schools and such buildings are prohibited from being leased to private schools.

In 2011, our net revenues were RMB1,669.2 million (US$265.2 million). If we are forced to vacate the premises at the properties that have defects where we lease buildings that house our classrooms and dormitories, it could impact schools and learning centers that generate approximately 23.6% of our net revenues, of which there was approximately 20.9% of our net revenues in 2011 that were generated by sales of software products and were not reliant on our physical properties. We believe, however, that it is highly unlikely that we would be impacted by all or most of these defects at the same time across numerous locations in various jurisdictions where these properties are located, and we believe that we would be able to find alternative locations quickly without incurring significant additional expenses for most of these locations; therefore, we believe that any impact from these defects on our net revenues would be significantly smaller than 23.6%.

As of December 31, 2011, certain land leased separately from the buildings discussed above covering 366,625 square meters, which represented approximately 78.0% of all our land leased as of that date and approximately 31.1% of all of our leased and owned land as of that date, are restricted to industrial and other uses, rather than for educational use, including one plot of land owned by villages and rural organizations, or collectively-owned land, which is not permitted to be leased for a non-agricultural use under PRC law. This portion of our leased land is used for recreational areas at certain of our tutoring centers, K-12 schools and college. As a result, if we were forced to vacate this portion of leased land, which is leased separately from our buildings, we do not believe it would have a direct impact on our net revenues. However, if we are regarded by a competent authority as using this leased land for a purpose other than the use approved by the government, we may be ordered to vacate the relevant land and subject to fines at a rate that we believe, based on our review of the applicable regulations, would be up to RMB30.0 (US$4.8) per square meter, and the total amount of the fines might be up to RMB11.1 million (US$1.8 million).

We are not aware of any actions, claims or investigations being contemplated by the competent governmental entities with respect to the defects in our leased real properties. However, if we are unable to use the existing properties, enter new leases or renew

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our current leases in a timely basis and on terms favorable to us, our business, results of operations and financial condition could be materially adversely affected.

We do not possess the relevant land use right certificates or building ownership certificates for some of the properties owned by us, and certain of the properties that we own have potential defects or issues that may not be easily remedied, which could cause us to incur significant additional expenses or could disrupt certain aspects of our business.

Some of the real properties that we own have defects or potential issues such as missing title certificates. As of December 31, 2011, we own and occupy land covering an aggregate of 681,634 square meters, of which one parcel of land covering 56,667 square meters, accounting for 8.3% of the land we own as of that date and 4.9% of the land we lease and own as of that date, do not have land use right certificates. As of December 31, 2011, we own an aggregate of 220,974 square meters of buildings. We have not acquired the building ownership certificates for buildings covering 83,069 square meters, accounting for 37.6% of the square meters of the buildings we own, including certain properties covering 54,864 square meters that have some of the required permits.

To the extent competent governmental entities were to detect these defects and we were found not to be in compliance with the applicable regulations, we may be subject to fines or incur significant additional expenses, our legal title to some of our properties may be challenged, and certain of the land we use to operate our business may be confiscated. If we are required to find alternative locations for our schools and learning centers, we may be required to pay increased rent for the new locations and the new locations, especially for our K-12 schools and college, may be less convenient and accessible to our students and teachers, which may materially adversely affect our business, results of operations and financial condition.

We are in the process of applying for the land use right for one parcel of land covering 56,667 square meters and building ownership certificates for buildings covering 53,726 square meters for which we do not yet hold effective title certificates, and are trying to remedy the defects and issues that prevent us from obtaining such certificates. We expect to complete the application process and obtain the certificates in a reasonable period of time, but do not have an exact time frame. However, we cannot assure you that these applications will be approved in a timely fashion or at all. If we are not able to remedy these defects in a timely manner, we may be required to find alternative locations for our schools and learning centers or may be subject to fines or penalties, either of which could have a material adverse effect on our business or results of operations.

We were aware of defects in the leased or owned real properties at target entities at the time we made acquisitions. As we continue to expand our business and acquire additional schools and learning centers, certain defects might exist in the leased or owned properties of the schools and learning centers we acquire in the future.

The defects in certain of the properties of our directly-operated schools and learning centers existed at the time we acquired these entities. Our mergers and acquisitions team has followed an internal procedure to identify and assess risks in connection with acquisitions. We were aware of the defects in the leased or owned properties of the acquired schools during our due diligence review, and a final business decision was made after our analysis of the likely impact of such real property defects. As we continue to expand our business and make acquisitions of additional schools and learning centers, we cannot assure you that all properties leased or owned by our acquisition targets will be fully in compliance with the relevant real property regulations. If the target schools fail to remedy the defects and issues in the leased or owned real properties prior to the time at which we complete the acquisitions, the schools or learning centers may be subject to fines or other penalties, which may adversely affect our operation of these schools and our operating results.

Failure by our college to comply with regulatory requirements on land use rights and capital commitment may subject our colleges to penalties and adversely affect our business operations.

The Rules Relating to the Establishment and Regulation of Independent Colleges, or Independent College Rules, promulgated by the MOE on February 22, 2008 and effective as of April 1, 2008, provide that an independent college established thereafter shall hold the land use right certificate or construction planning permit for land covering at least 500 mu (333,334 square meters), and independent colleges established prior to April 1, 2008 are required to meet this land requirement within a grace period of five years, namely prior to March 31, 2013. Our college, the Applied Technology College, was established prior to April 1, 2008 and is subject to such minimum land requirements and does not currently comply. To satisfy such requirements would require us to incur significant expenses that we are not able to quantify, and we cannot assure you that we can satisfy these requirements in time. In addition, the Independent College Rules require that the capital commitment to an independent college established before the Rules came into effect shall be paid within one year after its effectiveness. As of the date of this annual report, the capital commitment to the Applied Technology College is fully paid in cash, but we still need to contribute land use rights. For the year ended December 31, 2011, net revenues from our independent college accounted for 7.0% of our net revenues. Our failure to comply with the land requirements before the deadline or the capital commitment requirement may subject us to penalties, including fines of an unknown amount, and the college s ability to recruit additional students may be limited or suspended, any of which may result in a material adverse effect on our reputation, business and results of operations.

We may need to record a significant charge to earnings if our goodwill or intangible assets arising from acquisitions become impaired, which would adversely affect our net income.

In accordance with U.S. GAAP, we account for our acquisitions using the purchase method of accounting, and such acquisitions have resulted in significant goodwill and intangible assets. These assets may become impaired in the future, which could have a material adverse effect on our results of operations following such acquisitions. We are required under U.S. GAAP to review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment annually, or more frequently, if facts and circumstances warrant a review. Factors that may be considered a change in circumstances indicating that the carrying value of our amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization and slower or declining growth rates in our industry. During 2011, we recorded an impairment loss of RMB152.6 million (US$24.2 million) in respect of continuing and discontinued operations. In the future, we may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, which could have a material adverse effect on our results of operations.

Our grant of employee share options, restricted shares or other share-based compensation and any future grants could have an adverse effect on our net income.

We adopted a stock option plan in 2005, or 2005 Stock Plan, as well as an equity incentive plan in 2010, or 2010 Equity Incentive Plan. We have granted options and restricted shares under these plans to our employees and consultants. U.S. GAAP prescribes how we account for share-based compensation, and may have an adverse or negative impact on our results of operations or the price of our ADSs. U.S. GAAP requires us to recognize share-based compensation as compensation expense in the statement of operations based on the fair value of equity awards on the date of the grant, with the compensation expense recognized over the period in which the recipient is required to provide service in exchange for the equity award. These statements also require us to adopt a fair value-based method for measuring the compensation expense related to share-based compensation. As of December 31, 2011, we had RMB 54.0 million (US$8.6 million) of unrecognized share-based compensation costs, adjusted for estimated forfeitures, related to unvested stock option awards granted prior to such date, which are expected to be recognized over a weighted-average period of 1.68 years. The expenses associated with share-based compensation may reduce the attractiveness of issuing share options or restricted shares under our equity incentive plan. However, if we do not grant share options or restricted shares, or reduce the number of share options or restricted shares that we grant, we may not be able to attract and retain key personnel. If we grant more share options or restricted shares to attract and retain key personnel, the expenses associated with share-based compensation may adversely affect our net income.

Changes to accounting pronouncements or taxation rules or practices or greater than anticipated tax liabilities may adversely affect our reported results of operations or how we conduct our business

A change in accounting pronouncements or taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements or taxation rules, such as FASB Interpretation No. 48 *Accounting for Uncertainty in Income Taxes*, or FIN 48 (now codified as ASC 740), the Corporate Income Tax Law in China which was effective January 1, 2008, or the CIT Law, and various interpretations of accounting pronouncements or taxation practice have been adopted and may be adopted in the future. These accounting standard and tax regulation changes, future changes and the uncertainties surrounding current practices and implementation procedures may adversely affect our reported financial results or the way we conduct our business. We are subject to income tax, business tax and other taxes in many provinces and cities in China and our tax structure is subject to review by various local tax authorities. The determination of our provision for income tax and other tax liabilities requires significant judgment and, in the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Although we believe our estimates are reasonable, the ultimate decisions by the relevant tax authorities may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made. Moreover, we may lose the tax benefits we are currently receiving or we may be forced to disgorge prior tax benefits we have enjoyed and pay additional taxes and possibly penalties for prior tax years, any of which would harm our results of operations.

For the years ended December 31, 2009, 2010 and 2011, we received the following preferential tax treatments: (i) Ambow Online was recognized as a Software Enterprise and was exempted from income tax on its profits for 2009, and is entitled to a 50% reduction in income tax rate from 2010 to 2012; and (ii) Tianjin Ambow Yuhua Software Co., Ltd., or Ambow Yuhua, was recognized as a Software Enterprise and is entitled to be exempted from income tax on its profits for 2011 and 2012, and is entitled to a 50% reduction in income tax rate from 2013 to 2015. In order to maintain the Software Enterprise status, each of these entities is required to obtain a Certificate of Software Enterprise issued by the provincial IT industry administration authorities through meeting the following conditions: (a) its primary business includes computer software development and production, system integration, application services and other related technical services because an enterprise which only engages in software trading is not qualified, (b) it has developed one or more software products or has intellectual property rights to such products, or provides such services as certified computer information system integration, (c) it has the technical equipment and business location required to engage in software development and related technical services, (d) it has the means and ability to control the quality of its software products and technical services, (e) its technicians engaging in product development and technical services make up no less than 50% of the staff, (f) its research and development expenses for software technology and products make up more than 6% of its software revenues, and (g) its annual software sales make up more than 35% of its total annual revenue and the sales of self-produced software make up more than 50% of the software sales. Pursuant to the Criteria for Recognition and Administrative Measures of Software Enterprises, Software Enterprises are subject to annual inspections by the local software industry associations or other relevant associations authorized by the Ministry of Industry and Information Technology, or the MIIT. Software Enterprises which fail such annual inspections may not, for the current year, enjoy the relevant incentive policies including the preferential tax treatment. Each of Ambow Online and Ambow Yuhua has obtained the Certificate of Software Enterprise. For the years ended December 31, 2009, 2010 and 2011, if our corporate

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subsidiaries in the PRC had not been awarded tax holidays or received preferential tax treatment, the increase in our tax expense would have been RMB25,523,000, RMB28,285,000 and RMB59,580,000, respectively.

For private schools or college operated for reasonable returns they were normally subject to income taxes at 33% prior to 2008 and 25% after January 1, 2008 but were, under certain circumstances, subject to deemed amounts or rates of income tax to be determined by the relevant tax authorities. According to the Implementing Rules of the Law for Promoting Private Education and other relevant tax rules, prior to January 1, 2008, had our schools and colleges been registered as not requiring reasonable returns, they would generally have been exempt from income taxes. To date, no separate regulations or guidelines have been released on how to define reasonable return for the purposes of assessing a school s tax status prior to January 1, 2008. Moreover, the CIT Law includes specific criteria that need to be met by an entity to qualify as a not-for-profit organization in order to be exempt from corporate income tax. An official circular was issued in November 2009 to set out further clarification of the requirements for not-for-profit organizations, and the circular stipulated that only not-for-profit organizations certified jointly by finance and taxation authorities are entitled to tax exemption and the circular shall go into effect retrospectively as of January 1, 2008. While we currently do not believe it is likely that our schools and college would qualify as not-for-profit organizations and therefore be exempt from corporate income tax under the CIT Law, the detailed implementation guidance has not been provided to local tax authorities on how to apply these changes to schools and colleges. We intend to engage an external tax consultant to conduct comprehensive tax planning once further guidance from the tax authorities is released. This consultant may be expensive and the results of the guidance may not be favorable on our tax rates in the future. If we lose the benefit of the preferential tax treatments some of our schools and companies are currently enjoying, we could be required to pay additional taxes, which could have a material adverse effect on our results of operations and financial condition.

If the slowdown in China s economy continues or worsens, it may adversely impact our business.

The growth rate of China s domestic product in 2011 was 9.2%, compared to a growth rate of 10.3% in 2010. A number of factors contributed to this slowdown in China s economy, including appreciation of the RMB, which adversely affected China s exports, and tightening macroeconomic measures and monetary policies adopted by the PRC government aimed at preventing overheating of China s economy and controlling China s high level of inflation. Since we derive substantially all of our revenues from students in China, any prolonged slowdown in the Chinese economy may have a negative impact on our business, results of operations and financial condition in a number of ways. For example, our students may decrease or delay spending with us, while we may have difficulty expanding our customer base fast enough, or at all, to offset the impact of decreased spending by our existing students. The adverse economic conditions, if they continue or worsen, will affect consumer spending generally, which could result in decreased demand for our services and products within our target markets.

If we fail to implement and maintain an effective system of internal controls, we may be unable to accurately report our results of operations or prevent fraud, and investor confidence and the market price of our ADSs may be materially and adversely affected.

As a public company in the United States, we are subject to the reporting obligations under the U.S. securities laws. The Securities and Exchange Commission, or the SEC, as required under Section 404 of the Sarbanes-Oxley Act of 2002, has adopted rules requiring every public company to include a report of management on the effectiveness of such company s internal control over financial reporting in its annual report. In addition, an independent registered public accounting firm must issue an attestation report on the effectiveness of our internal control over financial reporting. Our management and independent registered public accounting firm, as part of their audit of our consolidated financial statements for the year ended December 31, 2011, have performed an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2011 and reported to our board of directors the material weaknesses as of December 31, 2011. The material weaknesses identified in our internal control over financial reporting are related to both the inadequate oversight over complex transactions and insufficient personnel with appropriate levels of accounting knowledge and experience to address the high volume of U.S. GAAP accounting issues and to prepare and review financial statements and related disclosures under U.S. GAAP. See Item 15. Controls and Procedures.

In response to the material weaknesses described above, we have taken several measures designed to remediate the material weaknesses in our internal control over financial reporting, and we plan to continue to implement additional remedial measures. The measures we intend to take in the future may not be sufficient to remediate the material weaknesses noted by our management and our independent registered public accounting firm and to avoid potential future material weaknesses. See Item 15. Controls and Procedures.

We may require more resources and incur more costs than currently expected to remediate our identified material weaknesses or any additional significant deficiencies or material weaknesses that may be identified, which may adversely affect our results of operations.

If either of the material weaknesses is not remedied or recurs, or if we identify additional weaknesses or fail to timely and successfully implement new or improved controls, our ability to assure timely and accurate financial reporting may be adversely affected, and we could suffer a loss of investor confidence in the reliability of our financial statements, which in turn could negatively impact the trading price of our ADSs, result in lawsuits being filed against us by our shareholders, or otherwise harm our reputation.

Risks related to regulation of our business and our corporate structure

All aspects of our business are subject to extensive regulation in China, we may not be in full compliance with these regulations and our ability to conduct business is highly dependent on our compliance with this regulatory framework. If the PRC government finds that the agreements that establish the structure for operating our business do not comply with applicable PRC laws and regulations, we could be subject to severe penalties.

The Chinese government regulates all aspects of our business and operations, including licensing of parties to perform various services, pricing of tuition and other fees, curriculum content, standards for the operations of schools, tutoring centers, college and career enhancement centers and foreign investments in the education industry. The laws and regulations applicable to the education sector are subject to frequent change, and new laws and regulations may be adopted, some of which may have a negative effect on our business, either retroactively or prospectively.

PRC laws and regulations currently prohibit foreign ownership of elementary and middle schools for students in grades one to nine and foreign ownership of businesses that provide content over the Internet is restricted in the PRC. Accordingly, our wholly-owned subsidiaries in China, which are considered foreign-invested, are currently ineligible to apply for such education licenses and Internet content provider permits in China.

We conduct our K-12 school business and provide online services in China primarily through contractual arrangements between Ambow Online, our principal operating subsidiary in China, and our VIEs, and their respective shareholders. Our VIEs and their respective subsidiaries hold the required licenses and permits necessary to conduct our education business in China and to operate our K-12 schools, tutoring centers, college and career enhancement centers. We have been and expect to continue to be dependent on our VIEs and their respective subsidiaries to operate our business.

If our ownership structure and contractual arrangements are found to be in violation of any existing or future PRC laws or regulations or we fail to obtain any of the required permits or approvals, the relevant PRC regulatory authorities including the MOE, the Ministry of Commerce, or MOFCOM, and the MIIT, which regulate the education industry, foreign investment in China and Internet business, respectively, would have broad discretion in dealing with such violations, including:

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- Revoking the business and operating licenses of our PRC subsidiaries and affiliated entities;
- Discontinuing or restricting the operations of any related-party transactions among our PRC subsidiaries and affiliated entities;
- Imposing fines or other requirements with which we or our PRC subsidiaries and affiliated entities may not be able to comply;
- Revoking the preferential tax treatment enjoyed by our PRC subsidiaries and affiliated entities;
- Requiring us or our PRC subsidiaries and affiliated entities to restructure the relevant ownership structure or operations; or
- Restricting or prohibiting our use of the proceeds of our IPO to finance our business and operations in China, especially expansion of our business through strategic acquisitions.

As of the date of this annual report, similar ownership structure and contractual arrangements have been used by many China-based companies listed overseas, including in the United States. To our knowledge, none of the penalties listed above has been imposed on any of those public companies, including companies in the education industry. However, we cannot assure you that such penalties will not be imposed on any other companies or us in the future. If any of the above penalties is imposed on us, our business operations and expansion, financial condition and results of operations will be materially and adversely affected.

We rely on contractual arrangements with our VIEs and their respective shareholders for a substantial portion of our China operations, which may not be as effective in providing operational control as direct ownership.

We have relied and expect to continue to rely on contractual arrangements with our VIEs and their respective shareholders to operate a substantial portion of our education business. For a description of these contractual arrangements, see Item 4.C Information on the Company Organizational Structure and Item 7.B Related Party Transactions Contractual arrangements with our VIEs and their respective subsidiaries and shareholders. These contractual arrangements may not be as effective in providing us with control over our VIEs and their respective subsidiaries as direct ownership. If we had direct ownership of our VIEs and their respective subsidiaries, we would be able to exercise our rights as a shareholder to effect changes in the board of directors of our VIEs and their respective subsidiaries, which could effect changes, subject to any applicable fiduciary duties, at the management level. As a legal matter, if our VIEs or any of their respective shareholders fails to perform its or his or her respective obligations under these contractual arrangements, we may have to incur substantial costs and expend significant resources to enforce such arrangements. We may also rely on legal remedies under PRC law, including seeking specific performance or injunctive relief, and claiming damages, but these remedies may not be effective. For example, if the shareholders of any of our VIEs were to refuse to transfer their equity interest in such VIEs to us or our designee when we exercise the call option pursuant to these contractual arrangements, or if they were otherwise to act in bad faith toward us, then we may have to take legal action to compel them to fulfill their contractual obligations. In addition, we may not be able to renew these contracts with our VIEs and/or their respective shareholders.

In addition, these contractual arrangements are governed by PRC law and provide for the resolution of disputes through arbitration in the PRC. Accordingly, these contracts would be interpreted in accordance with PRC law and any disputes would be resolved in accordance with PRC legal procedures. The legal environment in the PRC may not be as developed as in some other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could limit our ability to enforce these contractual arrangements. In the event we are unable to enforce these contractual arrangements, we may not be able to exert effective control over our affiliated entities, and our ability to conduct our business would be materially adversely affected.

The shareholders of our VIEs may have potential conflicts of interest with us, which may harm our business and financial condition.

The shareholders of our VIEs are also employees of our company, and one of them, Xuejun Xie, is a director of certain of our VIEs as well as our company. Conflicts of interest between their dual roles may arise. We cannot assure you that when conflicts of interest arise, any or all of these individuals will act in the best interests of our company or that conflicts of interest will be resolved in our favor. In addition, these individuals may breach or cause our VIEs or their respective subsidiaries to breach or refuse to renew the existing contractual arrangements that allow us to effectively control our VIEs and their respective subsidiaries and to receive economic benefits from them. Currently, we do not have existing arrangements to address potential conflicts of interest between these individuals and our company. We rely on these individuals to abide by the laws of the Cayman Islands and China, both of which provide that directors owe a fiduciary duty to the company, which requires them to act in good faith and in the best interests of the company and not to use their positions for personal gain. If we cannot resolve any conflicts of interest or disputes between us and the beneficial owners of our VIEs, we would have to rely on legal proceedings, which could result in disruption of our business and substantial uncertainty as to the outcome of any such legal proceedings.

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Our VIEs and their respective subsidiaries may be subject to significant limitations on their ability to operate private schools or make payments to related parties or otherwise be materially and adversely affected by changes in PRC laws and regulations.

The principal regulations governing private education in China are The Law for Promoting Private Education (2003) and The Implementing Rules for the Law for Promoting Private Education (2004), or 2004 Implementing Rules. Under these laws and regulations, a private school may elect to be a school that does not require reasonable returns or a school that requires reasonable returns. At the end of each fiscal year, every private school is required to allocate a certain amount to its development fund for the construction or maintenance of the school or procurement or upgrading of educational equipment. In the case of a private school that requires reasonable returns, this amount shall be no less than 25% of the annual net income of the schools, while in the case of a private school that does not require reasonable returns, this amount shall be equivalent to no less than 25% of the annual increase of net assets of the school (as determined under generally accepted accounting principles in the PRC). All of the private schools operated by our VIEs and their respective subsidiaries currently comply with the existing laws and regulations regarding the allocation of their development funds. A private school that requires reasonable returns must publicly disclose such election and additional information required under the regulations. A private school shall consider factors such as the school s tuition fees, ratio of the funds used for education-related activities to the course fees collected, admission standards and educational quality when determining the percentage of the school s net income that would be distributed to the investors as reasonable returns. However, none of the current PRC laws and regulations provides a formula or guidelines for determining reasonable returns. In addition, none of the current PRC laws and regulations sets forth different requirements or restrictions on a private school s ability to operate its education business based on such school s status as a school that requires reasonable returns or a school that does not require reasonable returns. New laws or regulations might be adopted to:

- Impose significant limitations on the ability of our schools to operate their business, charge course fees or make payments to related parties, such as Ambow Online, for services received; or

- Specify the formula for calculating reasonable returns.

We cannot predict the timing and effects of any such amendments or new laws and regulations. Changes in PRC laws and regulations governing private education or otherwise affecting our VIEs , and their respective subsidiaries , operations could have a material adverse effect on our business, prospects and results of operations.

Regulatory agencies may commence investigations of the tutoring centers, K-12 schools, career enhancement centers and college controlled and operated by our VIEs. If the results of the investigations are unfavorable to us, we may be subject to fines, penalties, injunctions or other censure that could have an adverse impact on our reputation and results of operations.

Our VIEs control and operate tutoring centers, K-12 schools, career enhancement centers and one college. As the provision of these services is heavily regulated in China, especially primary or secondary schools, these schools and companies that our VIEs or their respective subsidiaries currently own or operate or may acquire or establish in the future may be subject from time to time to inspections and investigations, claims of non-compliance or lawsuits by governmental agencies, which may allege statutory violations, regulatory infractions or other causes of action. For example, if an independent college is found unable to satisfy one or more conditions for running a college set by the MOE in such inspection or investigation, the MOE may impose limitation on the annual enrollment quota or even suspend the recruitment of the college. In 2006, the MOE, based on the result of an investigation into independent colleges, posted a notice of non-compliance on its website criticizing some independent colleges, including the two colleges that we subsequently acquired, for failure of their respective sponsors to transfer committed assets to the colleges. As of the date of this annual report, we have only one college and its sponsors have not had any fines imposed upon them or otherwise incurred a penalty from the MOE for the failure to pay committed capital, and its enrollment capacity has not been adversely affected for failure to satisfy conditions set by the MOE. If the results of any such investigations or lawsuits are unfavorable to us, we may be subject to fines, penalties, injunctions or other censure that could have an adverse impact on our reputation and results of operations. Even if we adequately address the issues raised by a government investigation, we may have to devote significant financial and management resources to resolve these issues, which could have a material adverse effect on our business.

Contractual arrangements we have entered into among our subsidiaries and our VIEs and their respective shareholders may result in adverse tax consequences to us; such arrangements may be subject to scrutiny by the PRC tax authorities and a finding that we or our VIEs and their respective shareholders owe additional taxes could substantially reduce our consolidated net income and the value of your investment.

Under PRC laws and regulations, arrangements and transactions among related parties should be priced on an arm s length basis and may be subject to audit or challenge by the PRC tax authorities. We could face material adverse tax consequences if the PRC tax authorities determine that the contractual arrangements between Ambow Online and our VIEs and their respective shareholders do not represent an arm s-length price and adjust our VIEs or any of their respective subsidiaries income in the form of a transfer pricing adjustment. A transfer pricing adjustment could, among other things, result in, for PRC tax purposes, increased tax liabilities for our VIEs or any of their respective subsidiaries. In addition, the PRC tax authorities may require us to disgorge our prior tax benefits, and require us to pay additional taxes for prior tax years and impose late payment fees and other penalties on our affiliated entities for underpayment of prior taxes. To date, similar contractual arrangements have been used by many other public companies and, to our knowledge, the PRC tax authorities have not imposed any material penalties on those companies. However, we cannot assure you that such penalties will not be imposed on any other companies or us in the future. Our consolidated net income may be

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harmed if our affiliated entities tax liabilities increase or if they are found to be subject to additional taxes, late payment fees or other penalties.

The tuition, accommodation and other fees charged by our degree programs and our K-12 schools and student enrollment at these schools are subject to regulation by the Chinese government, and our revenue is highly dependent on the level of these fees and our student enrollment.

Chinese regulators have broad powers to regulate the tuition, accommodation and other fees charged by primary, secondary and other schools and student enrollment levels at these schools. As a result, new regulations could adversely impact the fees we receive from the schools to which we provide course materials and software products and the student enrollments at our directly- operated schools and at our partner schools, as well as the returns from the K-12 schools operated by our Chinese affiliated entities. The tuition, accommodation and other fees charged by our degree programs and our K-12 schools are subject to various price controls administered by local price-control authorities and our student enrollment in our independent college is subject to annual enrollment quotas established by the MOE. In light of the substantial increase in tuitions and other education-related fees in China in recent years, China s price-control authorities may impose stricter price control on tuition changes in the future. As of the date of this annual report, there is no indication from the MOE or the relevant authorities that the government would significantly change the tuition charges or student annual enrollment quotas. If the tuition charges were to be decreased or if they were not allowed to increase in line with increases in our costs because of the actions of China s administrative price controls or if student enrollments at private schools were restricted, our net revenue and profitability would be materially adversely affected.

The discontinuation of any preferential tax treatments or deemed tax treatments currently available to us or the disgorgement of any benefits we enjoyed in the past could result in a decrease of our net income and harm our results of operations.

According to the 2004 Implementing Rules, private schools that do not require reasonable returns enjoy the same preferential tax treatment as public schools. While it is indicated in the 2004 Implementing Rules that the relevant authorities under the State Council may consider formulating separate preferential tax treatment policies applicable to private schools requiring reasonable returns, no such tax preferential policy has been promulgated yet. In March 2007, the Chinese government enacted the CIT Law, and promulgated the Implementing Regulations for the PRC Corporate Income Tax Law in December 2007, both of which came into effect on January 1, 2008. On February 22, 2008, the Ministry of Finance and State Taxation Administration issued a subsequent notice, or the 2008 Tax Notice, that effectively abolished our preferential tax treatment under the 2004 Implementing Rules. The CIT Law and 2008 Tax Notice, among other things, impose a unified income tax rate of 25% for all private schools regardless of whether they require a reasonable return or not unless the school qualifies as a not-for-profit organization as defined in the PRC tax regime effective January 1, 2008. If a school qualifies as a not-for-profit organization in accordance with the tax law, it will be exempt from corporate income tax for certain of its income qualified for exemption under the relevant laws and rules. In November 2009, the Ministry of Finance and State Taxation Administration further issued rules providing the criteria for a not-for-profit organization to qualify for exemption of corporate income tax. These rules are relatively new and contain many ambiguities. In practice, tax treatments for private schools vary across different cities in China. In some cities, private schools are subject to a 25% standard corporate income tax, while in other cities, private schools are subject to a 1.75% to 4.0% tax on gross receipts received by the schools or a deemed fixed tax amount or may be exempted from corporate income tax. These deemed tax rates and deemed fixed tax amount treatments granted to our schools by local tax authorities are subject to review and may be adjusted or revoked at any time. In addition, education services provided to students receiving degree-oriented education by private schools are also exempted from business tax in China so long as those schools are accredited to issue diplomas or degree certificates recognized by the MOE. The discontinuation of any of these tax treatments currently available to us or the determination of the tax authority that any of the preferential tax treatment we have enjoyed is not in compliance with the PRC laws, especially those schools in major cities, would cause our effective tax rate to increase, which would increase our income tax expenses and in turn decrease our net income or even subject us to supplementary payment of tax balance.

Under PRC laws and regulations, an enterprise that qualifies as a new and high-technology enterprise or a software enterprise may enjoy preferential tax benefits. An enterprise qualified as both a new and high-technology enterprise and as a software enterprise may choose one of the more preferential tax treatments. For example, Ambow Online is a certified new and high-technology enterprise and a software enterprise and has chosen to enjoy preferential tax treatments as a software enterprise. As a result, Ambow Online is entitled to a two-year exemption from the first year it generates taxable income and a 12.5% corporate income tax rate for another three years, which might be followed by a 15% tax rate so long as Ambow Online continues to qualify as a new or high-technology enterprise . If Ambow Online fails to maintain the status of a software enterprise or a new and high-technology enterprise , it will cease to enjoy the reduced tax rate and its tax rate will increase to 25% or the then current rate. Ambow Yuhua was also recognized as a software enterprise , and is entitled to a tax exemption from income tax on its profits for 2011. As a result, Ambow Yuhua will enjoy a two-year income tax exemption from 2011 and will be subject to 12.5% corporate income tax for another three years. If Ambow Yuhua ceases to qualify for the current preferential corporate income tax rate, it will cease to enjoy the reduced tax rate and its tax rate will increase to 25% or the then current rate. If PRC laws and regulations were to phase out preferential tax benefits currently granted to software enterprises or new and high-technology enterprises , each of Ambow Online and Ambow Yuhua would be subject to the standard corporate income tax rate, which currently is 25%. Loss of these preferential tax treatments could have a material adverse effect on our financial condition and results of operations.

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The regulation of Internet website operators in China is subject to interpretation, and our operation of online education programs could be harmed if we are deemed to have violated applicable laws and regulations.

The interpretation and application of existing Chinese laws and regulations, the stated positions of the main governing authority, the MIIT, and the possibility of adopting new laws or regulations have created significant uncertainties regarding the legality of the businesses and activities of Chinese companies with Internet operations. In particular, according to the Internet Information Services Administrative Measures promulgated by the State Council on September 25, 2000, the activities of Internet content providers are regulated by various Chinese governmental authorities, including, the MOE, the State Administration of Radio, Film and Television, the General Administration of Press and Publication, or GAPP, and the Ministry of Culture, or MOC, depending on the specific activities conducted by the Internet content provider. In addition, MIIT promulgated a notice titled Notice on Strengthening Management of Foreign Investment in Operating Value-Added Telecom Services on July 13, 2006, which prohibits PRC Internet content providers from leasing, transferring or selling their ICP licenses or providing facilities or other resources to illegal foreign investors. The notice states that PRC Internet content providers (or their shareholders) should directly own the trademarks and domain names for websites operated by them, as well as servers and other infrastructure used to support these websites and a PRC Internet content provider s failure to comply with the notice by November 1, 2006 may result in revocation of its ICP license.

Ambow Shida holds an ICP license issued by Beijing Communications Administration, the local counterpart of the MIIT. According to this ICP license, Ambow Shida is approved to provide internet information services, excluding services of press, publication, education, medicine and medical apparatus and instruments. Due to the uncertainties of implementation of relevant regulations by different authorities, we cannot assure you that Ambow Shida has satisfied or will be able to satisfy all the requirements for a PRC Internet content provider and the ICP license held by Ambow Shida will be deemed to be adequate for all of the online services that we provide. For example, Ambow Shida s ICP license does not cover educational content while most materials provided on our websites may be deemed educational content, including content related to our tutoring centers and career enhancement centers. According to our experience and our knowledge of other education providers in our industry, and as advised by our PRC counsel, based on their consultation with the competent authorities that the content provided by us does not exceed the scope of Ambow Shida s ICP License, we believe the content on, and use of, our website are in compliance with the requirement imposed by Chinese Internet Regulations on ICP Licenses. We cannot assure you, however, that the competent authorities will not adopt a different interpretation of this issue.

In 2011, we generated net revenues from our tutoring and career enhancement segments of RMB 778.0 million (US$123.6 million) and RMB 505.2 million (US$80.3 million), respectively. A portion of these net revenues were related to providing educational materials online. If the provision of these online services is deemed to have exceeded the scope of Ambow Shida s license, we may be required to cease providing these online materials, which would harm our net revenues and results of operations. As we are a foreign enterprise in China, Ambow Shida may also be deemed to have illegally leased its ICP license or provided facilities or other resources to foreign investors. If we are deemed to have violated applicable Chinese Internet regulations, we could be subject to severe penalties, including confiscation of illegal gains, fines ranging from three to five times the illegal gains, suspension of certain types of service or orders to shut down the relevant websites.

Risks related to doing business in China

PRC economic, political and social conditions, as well as changes in any government policies, laws and regulations, could adversely affect the overall economy in China or the education or career enhancement market, which could harm our business.

Substantially all of our operations are conducted in China, and substantially all of our net revenues are derived from China. Accordingly, our business, financial condition, results of operations, prospects and certain transactions we may undertake are subject, to a significant extent, to economic, political and legal developments in China.

The PRC economy differs from the economies of most developed countries in many respects, including the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the PRC economy has experienced significant growth in the past two to three decades, growth has been uneven, both geographically and among various sectors of the economy. Demand for our services and products depends, in large part, on economic conditions in China. Any slowdown in China s economic growth may cause our potential customers to delay or cancel their plans to purchase our services and products, which in turn could reduce our net revenues.

Although the PRC economy has been transitioning from a planned economy to a more market-oriented economy since the late 1970s, the PRC government continues to play a significant role in regulating industry development by imposing industrial policies. The PRC government also exercises significant control over China s economic growth through allocating resources, controlling the incurrence and payment of foreign currency-denominated obligations, setting monetary policy and providing preferential treatment to particular industries or companies. Changes in any of these policies, laws and regulations could adversely affect the economy in China or the education or career enhancement market, which could harm our business.

The PRC government has implemented various measures to encourage foreign investment and sustainable economic growth and to guide the allocation of financial and other resources, which have for the most part had a positive effect on our business and growth. However, we cannot assure you that the PRC government will not repeal or alter these measures or introduce new

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measures that will have a negative effect on us. China s social and political conditions may also not be as stable as those of the United States and other developed countries. Any sudden changes to China s political system or the occurrence of widespread social unrest could have a material adverse effect on our business and results of operations.

Uncertainties with respect to the PRC legal system could harm us.

Our operations in China are governed by PRC laws and regulations. The PRC legal system is a civil law system based on written statutes. Unlike common law systems, prior court decisions have limited precedential value. Ambow Online and our other wholly-owned subsidiaries in China are generally subject to laws and regulations applicable to foreign investments in China and, in particular, laws applicable to wholly foreign-owned enterprises.

Since 1979, PRC legislation and regulations have significantly enhanced the protections afforded to various forms of foreign investments in China. However, China has not developed a fully integrated legal system and recently-enacted laws and regulations may not sufficiently cover all aspects of economic activities in China. In particular, because these laws and regulations are relatively new, and because of the limited volume of published decisions and their nonbinding nature, the interpretation and enforcement of these laws and regulations involve uncertainties. In addition, the PRC legal system is based in part on government policies and internal rules (some of which are not published on a timely basis or at all) that may have a retroactive effect. As a result, we may not be aware of our violation of these policies and rules until sometime after the violation. Moreover, some regulatory requirements issued by certain PRC government authorities may not be consistently applied by other government authorities, including local government authorities, thus making strict compliance with all regulatory requirements impractical, or in some circumstances, impossible. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention.

If the chops of our subsidiaries and VIEs in China are not kept safely, are stolen or are used by unauthorized persons or for unauthorized purposes, the corporate governance of those entities could be severely and adversely compromised.

In China, a company chop or seal serves as the legal representation of the company towards third parties even when unaccompanied by a signature. Each legally registered company in China is required to have a company chop, which must be registered with the local Public Security Bureau. Our company chops, or chops, are kept securely at our President Office under the direction of Chief Executive Officer at the headquarters level or held securely by personnel designated and approved by the General Manager or Headmaster at subsidiaries or VIEs level. Use of chops requires proper approvals in accordance with our internal control procedures. The custodian at the President Office also maintains a log to keep detailed record of each use of the chops. Moreover, the President Office is always locked after office hours and only authorized persons have the access to the keys.

The Company believes it has sufficient controls in place over access to and use of the chops. We however cannot assure you that unauthorized access to or use of those chops can be totally precluded. To the extent those chops are stolen or are used by unauthorized persons or for unauthorized purposes, the corporate governance of these entities could be severely and adversely compromised and the operations of these entities could be significantly and adversely impacted.

Our subsidiaries and affiliated entities in China are subject to restrictions on making dividends and other payments to us or any other affiliated company.

We are a holding company and rely principally on dividends paid by our subsidiaries established in China for our cash needs, including the funds necessary to pay dividends and other cash distributions to our shareholders to the extent we choose to do so, to service any debt we may incur and to pay our operating expenses. Our PRC subsidiaries income in turn depends on the service and other fees paid by our VIEs. Current PRC regulations permit our subsidiaries in China to pay dividends to us only out of their accumulated profits, if any, determined in accordance with Chinese accounting standards and regulations. In addition, under the applicable requirements of PRC law, our PRC subsidiaries and affiliated entities incorporated as companies may only distribute dividends after they have made allowances to fund certain statutory reserves. These reserves are not distributable as cash dividends.

In addition, under the CIT Law, which became effective on January 1, 2008, dividends paid to us by our PRC subsidiaries are subject to withholding tax. The withholding tax on dividends may be exempted or reduced by the PRC State Council. Currently, the withholding tax rate is 10% unless reduced or exempted by treaty between the PRC and the tax residence of the holder of the PRC subsidiary.

Furthermore, if our subsidiaries and affiliated entities in China incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other payments to us. In addition, the PRC tax authorities may require us to adjust our taxable income under the contractual arrangements we currently have in place in a manner that would restrict our subsidiaries ability to pay dividends and make other distributions to us.

In addition, at the end of each fiscal year, each of our affiliated entities that are private schools in China is required to allocate a certain amount to its development fund for the construction or maintenance of the school or procurement or upgrade of educational equipment. In the case of a private school that requires reasonable returns, this amount shall be no less than 25% of the annual net income of the school, while in the case of a private school that does not require reasonable returns, this amount shall be equivalent to no less than 25% of the annual increase in the net assets of the school, if any.

As of December 31, 2011, we have across our four operating segments a total of 33 private schools of which three schools are registered as schools not requiring reasonable returns while other schools choose to be registered as schools requiring reasonable returns. Entities registered as schools not requiring reasonable returns are restricted from directly distributing to us any dividends or profits.

To date, our PRC subsidiaries have not paid dividends to us out of their accumulated profits. In the near future, we do not expect to receive dividends from our PRC subsidiaries because the accumulated profits of these PRC subsidiaries are expected to be used for their own business or expansions. If we are unable to extract the earnings and profits of some of our schools and learning centers, it could have a material adverse effect on our liquidity and financial condition.

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PRC regulation of loans and direct investment by offshore holding companies to PRC entities may delay or prevent us from making loans or additional capital contributions to our PRC operating subsidiaries and affiliated entities, which could harm our liquidity and our ability to fund and expand our business.

As an offshore holding company of our PRC operating subsidiaries and affiliated entities, we may make loans to our PRC subsidiaries and VIEs or we may make additional capital contributions to our PRC subsidiaries. Any loans to our PRC subsidiaries or consolidated PRC affiliated entities are subject to PRC regulations. For example:

- Loans by us to our wholly-owned subsidiaries in China, each of which is a foreign-invested enterprise, to finance their activities cannot exceed statutory limits and must be registered with the PRC State Administration of Foreign Exchange, or SAFE, or its local counterparts; and

- Loans by us to our VIEs and their respective subsidiaries, which are domestic PRC entities, must be approved by the relevant government authorities and must also be registered with SAFE or its local counterparts.

We may also decide to finance our wholly-owned subsidiaries by means of capital contributions. These capital contributions must be approved by the PRC Ministry of Commerce or its local counterparts. We are not likely, however, to finance the activities of our VIEs and their respective subsidiaries by means of capital contributions due to regulatory issues related to foreign investment in domestic PRC entities, as well as the licensing and other regulatory issues discussed in the Regulation section of this annual report. We cannot assure you that we will be able to obtain these government registrations or approvals on a timely basis, if at all, with respect to future loans or capital contributions by us to our subsidiaries or our VIEs or any of their respective subsidiaries. If we fail to receive such registrations or approvals, our ability to capitalize our PRC operations may be negatively affected, which could adversely affect our liquidity and our ability to fund and expand our business.

In addition, on August 29, 2008, SAFE promulgated Circular 142, a notice regulating the conversion by a foreign-invested company of its capital contribution in foreign currency into RMB. The notice requires that the capital of a foreign-invested company settled in RMB converted from foreign currencies shall be used only for purposes within the business scope as approved by the authorities in charge of foreign investment or by other competent authorities and as registered with the Administration for Industries and Commerce and, unless set forth in the business scope or in other regulations, may not be used for equity investments within the PRC. In addition, SAFE strengthened its oversight of the flow and use of the capital of a foreign-invested company settled in RMB converted from foreign currencies. The use of such RMB capital may not be changed without SAFE s approval, and may not in any case be used to repay RMB loans if the proceeds of such loans have not been used. Violations of Circular 142 will result in severe penalties, including heavy fines. As a result, Circular 142 may significantly limit our ability to transfer capital to our VIEs and their respective subsidiaries through our subsidiaries in the PRC, which may adversely affect our ability to expand our business, and we may not be able to convert capital into RMB to invest in or acquire any other PRC companies, or establish other VIEs in the PRC.

Presently none of Ambow Online or our other wholly-owned subsidiaries are registered as an investment company. We do not intend to turn these entities into investment companies because to do so these subsidiaries would have to satisfy criteria promulgated by MOFCOM and be approved by MOFCOM or its provincial counterparts before registration with the administration for industries and commerce, which is difficult to accomplish and time consuming. As a result, if capital is injected into Ambow Online and our other subsidiaries as increased registered capital, we could not convert such proceeds into RMB to fund acquisitions of the VIEs and their respective subsidiaries, and our ability to expand our business may be adversely affected.

While we may not transfer capital through our wholly-owned subsidiaries for the purpose of domestic acquisitions, we may use our capitals to acquire PRC companies or schools that do not include compulsory education through Wenjian Gongying, an RMB fund established in Suzhou as a venture capital joint venture, subject to the PRC industrial policy for foreign investment. If we use our capital to make acquisitions through Wenjian Gongying in entities that are in restricted industries, like high schools, without receiving proper approvals or in entities that are in prohibited industries, like schools that provide compulsory education, we may be subject to significant fines of unknown amounts or other sanctions. See Item 4.C Information on the Company Organizational Structure for a further description of the legal structure, joint venture participants identities and such participants respective percentage ownership interest in Wenjian Gongying and for a further description of the PRC rules and regulations that will be applicable to our planned investments through Wenjian Gongying.

If we use our capital for the business of Ambow Online or our other wholly-owned subsidiaries, we are also required to apply to the authority of commerce for approval for an increase of their respective registered capital given that the original registered capital of these subsidiaries have been fully paid. We cannot assure you our capital that we can obtain such approvals in a timely manner or at all. If we are unable to use our capital to fund our PRC operating entities or their subsidiaries or to make strategic acquisitions, it could have a material adverse effect on our expansion plans and future growth.

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It is unclear whether we will be considered a PRC resident enterprise under the CIT Law and, depending on the determination of our PRC resident enterprise status, dividends paid to us by our PRC subsidiaries may be subject to PRC withholding tax, we may be subject to 25% PRC income tax on our worldwide income, and holders of our ADSs or ordinary shares may be subject to PRC withholding tax on dividends paid by us and gains realized on their transfer of our ADSs or ordinary shares.

The CIT Law and its Implementing Regulations, which became effective on January 1, 2008, provide that enterprises established outside of China whose de facto management bodies are located in China are considered resident enterprises. Although the Implementing Regulations of the PRC CIT Law define the term de facto management bodies as a body which substantially manages, or has control over the business, personnel, finance and assets of an enterprise, currently there are no further detailed rules or precedents applicable to us governing the procedures and specific criteria for determining de facto management bodies and it is still unclear if the PRC tax authorities would determine that we should be classified as a PRC resident enterprise.

If we are treated as a PRC resident enterprise, however, we will be subject to PRC income tax on our worldwide income at the 25% uniform tax rate, which could have an impact on our effective tax rate and an adverse effect on our net income and results of operations and our income tax expenses will increase and the amount of dividends, if any, we may pay to our shareholders and ADS holders may be decreased, although dividends distributed from our PRC subsidiaries to us could be exempt from the PRC dividend withholding tax, since such income is exempted under the CIT Law and its Implementing Regulations to a PRC resident recipient.

In addition, if we are considered a PRC resident enterprise, dividends we pay with respect to our ADSs or ordinary shares and the gains realized from the transfer of our ADSs or ordinary shares may be considered income derived from sources within the PRC for PRC tax purposes and be subject to PRC withholding tax.

Restrictions on currency exchange may limit our ability to receive and use our revenue effectively.

Because substantially all of our revenue is denominated in RMB, restrictions on currency exchange may limit our ability to use revenue generated in RMB to fund any business activities we may have outside China or to make dividend payments to our shareholders and ADS holders in U.S. dollars. The principal regulation governing foreign currency exchange in China is the Foreign Currency Administration Rules (1996), as amended. Under these rules, RMB is freely convertible for trade and service-related foreign exchange transactions, but not for direct investment, loan or investment in securities outside China unless the prior approval of SAFE is obtained. Although the PRC government regulations now allow greater convertibility of RMB for current account transactions, significant restrictions still remain. For example, foreign exchange transactions under our subsidiaries capital accounts, including principal payments in respect of foreign currency-denominated obligations, remain subject to significant foreign exchange controls. These limitations could affect our ability to obtain foreign exchange for capital expenditures. We cannot be certain that the PRC regulatory authorities will not impose more stringent restrictions on the convertibility of RMB, especially with respect to foreign exchange transactions.

Fluctuations in the value of the RMB may have a material adverse effect on your investment.

The change in value of the RMB against the U.S. dollar and other currencies is affected by, among other things, changes in China s political and economic conditions. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the RMB to the U.S. dollar.

Under the policy, the RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. Between July 21, 2005 and April 30, 2012, the RMB appreciated by approximately 31.8% against the U.S. dollar, although the pace of appreciation was uneven during this period. It is difficult to predict how the RMB exchange rates may change in the future. There remains significant international pressure on the PRC government to adopt a more flexible currency policy, which could result in a further and more significant adjustment of the RMB against the U.S. dollar.

Any significant revaluation of the RMB may have a material adverse effect on the value of, and any dividends payable on, our ADSs in foreign currency terms. More specifically, if we decide to convert our RMB into U.S. dollars for the purpose of making payments for dividends on our ordinary shares or ADSs or for other business purposes, appreciation of the U.S. dollar against the RMB would have a negative effect on the U.S. dollar amount available to us. To the extent that we need to convert U.S. dollars denominated financial assets into RMB for our operations, appreciation of the RMB against the U.S. dollar would have an adverse effect on the RMB amount we would receive from the conversion. Consequently, appreciation or depreciation in the value of the RMB relative to the U.S. dollar could materially adversely affect our financial results reported in U.S. dollar terms without giving effect to any underlying change in our business or results of operations.

Recent PRC regulations relating to offshore investment activities by PRC residents and employee stock options granted by overseas-listed companies may increase our administrative burden, restrict our overseas and cross-border investment activity or otherwise adversely affect the implementation of our acquisition strategy. If our shareholders who are PRC residents, or our PRC employees who are granted or exercise stock options, fail to make any required registrations or filings under such regulations, we may be unable to distribute profits and may become subject to liability under PRC laws.

In 2005, SAFE promulgated regulations that require PRC residents and PRC corporate entities to register with local branches of SAFE in connection with their direct or indirect offshore investment activities. These regulations apply to our shareholders who are PRC residents and may apply to any offshore acquisitions that we make in the future.

Under the SAFE regulations, PRC residents who make, or have previously made, direct or indirect investments in offshore companies, will be required to register those investments. In addition, any PRC resident who is a direct or indirect shareholder of an offshore company is required to file or update the registration with the local branch of SAFE, with respect to that offshore company, any material change involving its round-trip investment, capital variation, such as an increase or decrease in capital, transfer or swap of shares, merger, division, long-term equity or debt investment or creation of any security interest. If any PRC shareholder fails to make the required SAFE registration, the PRC subsidiaries of that offshore parent company may be prohibited from distributing their profits and the proceeds from any reduction in capital, share transfer or liquidation, to their offshore parent company, and the offshore parent company may also be prohibited from injecting additional capital into their PRC subsidiaries. Moreover, failure to comply with the various SAFE registration requirements described above could result in liability under PRC laws for evasion of applicable foreign exchange restrictions.

We cannot provide any assurances that all of our shareholders who are PRC residents will make or obtain any applicable registrations or approvals required by these SAFE regulations. The failure or inability of our PRC resident shareholders to comply with the registration procedures set forth in the SAFE regulations may subject our PRC subsidiaries to fines and legal sanctions, restrict our cross-border investment activities, or limit our PRC subsidiaries ability to distribute dividends to or obtain foreign-exchange denominated loans from our company.

As it is uncertain how the SAFE regulations will be interpreted or implemented, we cannot predict how these regulations will affect our business operations or future strategy. For example, we may be subject to a more stringent review and approval process with respect to our foreign exchange activities, such as remittance of dividends and obtaining foreign currency denominated borrowings, which may harm our results of operations and financial condition. In addition, if we decide to acquire a PRC domestic company, we cannot assure you that we or the owners of such company, as the case may be, will be able to obtain the necessary approvals or complete the necessary filings and registrations required by the SAFE regulations. This may restrict our ability to implement our acquisition strategy and could adversely affect our business and prospects.

On February 15, 2012, SAFE promulgated the Notice of the State Administration of Foreign Exchange on Issues Related to Foreign Exchange Administration in Domestic Individuals Participation in Equity Incentive Plans of Companies Listed Abroad, or the No. 7 Notice, which supersedes the Operation Rules on Foreign Exchange Administration for Domestic Individuals Participating in Employee Stock Holding Plan or Stock Option Plan of Overseas-Listed Company, or the Stock Option Rule, in its entirety and immediately became effective upon circulation. According to the No. 7 Notice, domestic individuals, which include any directors, supervisors, senior managerial personnel or other employees of a domestic company who are Chinese citizens (including citizens of Hong Kong, Macao and Taiwan) or foreign individuals who consecutively reside in the territory of the PRC for one year, who participate in the same equity incentive plan of an overseas-listed company shall, through the domestic companies they serve, collectively entrust a domestic agency to handle issues like foreign exchange registration, account opening, funds transfer and remittance, and entrust an overseas institution to handle issues like exercise of options, purchasing and sale of related stocks or equity, and funds transfer. As an overseas publicly listed company, we and our employees who have been granted stock options or any type of equity awards may be subject to the No. 7 Notice. If we or our employees who are subject to the No. 7 Notice fail to comply with these regulations, we may be subject to fines and legal sanctions. See Item 4.B Information on the Company Business Overview

Regulation SAFE regulations on employee share options.

The M&A Rules establish more complex procedures for some acquisitions of Chinese companies by foreign investors, which could make it more difficult for us to pursue growth through acquisition in China.

The M&A Rules that became effective on September 8, 2006 established additional procedures and requirements that could make merger and acquisition activities by foreign investors more time-consuming and complex, including requirements in some instances that the Ministry of Commerce be notified in advance of any change-of-control transaction in which a foreign investor takes control of a PRC domestic enterprise. Complying with the requirements of the M&A Rules to complete such transactions could be time-consuming, and any required approval processes, including obtaining approval from the Ministry of Commerce, may delay or inhibit our ability to complete such transactions, which could materially adversely affect our ability to grow our business through acquisitions in China.

The audit report included in this annual report is prepared by an auditor who is not inspected by the Public Company Accounting Oversight Board and, as such, you are deprived of the benefits of such inspection.

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Auditors of companies that are registered with the Securities and Exchange Commission and traded publicly in the United States, including our independent registered public accounting firm, must be registered with the US Public Company Accounting Oversight Board (United States) (the PCAOB) and are required by the laws of the United States to undergo regular inspections by the PCAOB to assess their compliance with the laws of the United States and professional standards. Because our auditors are located in the People s Republic of China, a jurisdiction where the PCAOB is currently unable to conduct inspections without the approval of the Chinese authorities, our auditors are not currently inspected by the PCAOB.

This lack of PCAOB inspections in China prevents the PCAOB from regularly evaluating audits and quality control procedures of any auditors operating in China, including our auditors. As a result, investors may be deprived of the benefits of PCAOB inspections.

The inability of the PCAOB to conduct inspections of auditors in China makes it more difficult to evaluate the effectiveness of our auditor s audit procedures or quality control procedures as compared to auditors outside of China that are subject to PCAOB inspections. Investors may lose confidence in our reported financial information and procedures and the quality of our financial statements.

We do not have business insurance coverage in China, which could harm our business.

We could be held liable for accidents that occur at our learning centers and other facilities. In the event of on-site food poisoning, personal injuries, fires or other accidents suffered by students or other people, we could face claims alleging that we were negligent, provided insufficient supervision or instruments or were otherwise liable for the injuries. Such accidents may adversely affect our reputation and financial results. The insurance industry in China is still at an early stage of development. Insurance companies in China offer limited business insurance products. As a result, we do not have any business liability or disruption insurance coverage for our operations. Any business disruption, litigation or natural disaster would result in substantial costs and diversion of our resources.

We face risks related to natural disasters and health epidemics in China, which could have a material adverse effect on our business and results of operations.

Our business could be severely disrupted and materially adversely affected by natural disasters or the outbreak of health epidemics in China. For example, in May 2008, Sichuan Province suffered a strong earthquake measuring approximately 8.0 on the Richter scale that caused widespread damage and casualties. In addition, in the last decade, the PRC has suffered health epidemics related to the outbreak of avian influenza and severe acute respiratory syndrome, or SARS. In April 2009, an outbreak of the H1N1 virus, also commonly referred to as swine flu, occurred in Mexico and spread to other countries, including Hong Kong and mainland China. The Chinese government and certain regional governments within China, have enacted regulations to address the H1N1 virus specifically within the education services market, which may have an effect on our business. Any future natural disasters or health epidemics in the PRC could also severely disrupt our business operations and have a material adverse effect on our business and results of operations.

1,433

Assets

	12,628	16,523	2,571	11,808	30,902	43,530
Capital expenditures	117	116	25	37	178	295
Depreciation and amortization	48	81	14	79	174	222

Profit (loss) from operations consists of sales less cost of sales, engineering and development, selling, general and administrative expenses but is not affected by either non-operating charges/income or by income taxes. Non-operating charges/income consists principally of investment income and interest expense. All intercompany transactions have been eliminated.

The following table lists customers from which the Company derived revenues in excess of 10% of total revenues for the three and six-month periods ended March 31, 2013, and 2012.

	For the three months ended,				For the six months ended			
	March 31, 2013		March 31, 2012		March 31, 2013		March 31, 2012	
	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues	Amount	% of Revenues
	(dollars in millions)							
Customer A	$4.8	18 %	$5.8	30 %	$7.4	16 %	$10.3	26 %
Customer B	$5.9	23 %	$1.5	8 %	$11.0	23 %	$6.7	17 %
Customer C	$0.2	1 %	$2.2	12 %	$1.0	2 %	$3.4	9 %
Customer D	$3.0	12 %	$0.2	1 %	$4.2	9 %	$0.8	2 %

8. Fair Value Measures

Assets and Liabilities measured at fair value on a recurring basis are as follows:

	Fair Value Measurements Using				
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Balance	Gain or (loss)
	As of March 31, 2013 (Amounts in thousands)				
Assets:					
Money Market funds	$3,500	$ —	$ —	$3,500	$—
Total assets measured at fair value	$3,500	$ —	$ —	$3,500	$—
	As of September 30, 2012 (Amounts in thousands)				
Assets:					
Money Market funds	$3,498	$—	$—	$3,498	$—
Total assets measured at fair value	$3,498	$—	$—	$3,498	$—

These assets are included in cash and cash equivalents in the accompanying consolidated balance sheets. All other monetary assets and liabilities are short-term in nature and approximate their fair value. The Company did not have any transfers between Level 1, Level 2 or Level 3 measurements.

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The Company had no liabilities measured at fair value as of March 31, 2013 or September 30, 2012. The Company had no assets or liabilities measured at fair value on a non recurring basis as of March 31, 2013 or September 30, 2012.

9. Dividend

On December 10, 2012, the Company's board of directors declared a cash dividend of $0.20 per share which was paid on December 28, 2012 to stockholders of record as of December 20, 2012, the record date.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

The discussion below contains certain forward-looking statements related to, among others, but not limited to, statements concerning future revenues and future business plans. In addition, forward-looking statements include statements in which we use words such as “expect,” “believe,” “anticipate,” “intend,” or similar expressions. Although we believe the expectations reflected in such forward-looking statements are based on reasonable assumptions, we cannot assure you that these expectations will prove to have been correct, and actual results may vary from those contained in such forward-looking statements.

Markets for our products and services are characterized by rapidly changing technology, new product introductions and short product life cycles. These changes can adversely affect our business and operating results. Our success will depend on our ability to enhance our existing products and services and to develop and introduce, on a timely and cost effective basis, new products that keep pace with technological developments and address increasing customer requirements. The inability to meet these demands could adversely affect our business and operating results.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, income taxes, deferred compensation and retirement plans, estimated selling prices used for revenue recognition and contingencies. We base our estimates on historical performance and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. A description of our critical accounting policies is contained in our Annual Report on Form 10-K for the fiscal year ended September 30, 2012 in the “Critical Accounting Policies” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Results of Operations

Overview of the six months ended March 31, 2013 Results of Operations

Overview:

Revenue increased by approximately \$6.6 million, or 16%, to \$46.7 million for the six months ended March 31, 2013 versus \$40.1 million for the six months ended March 31, 2012. This increase in sales volume resulted in our operating income and net income being consistent with the prior-year six-month period, despite a decrease in overall gross profit margin, which decreased from 24% for the six months ended March 31, 2012 to 21% for the six months ended March 31, 2013. Operating profit was approximately \$1.4 million for both six-month periods ended March 31 in fiscal 2013 and 2012. Net income was \$0.9 million for both six-month periods. The decrease in gross profit margin was due to the company having realized approximately \$3.0 million in royalty revenue in the prior year six-month period compared to \$0.8 million in the current year six-month period.

The following table details our results of operations in dollars and as a percentage of sales for the six months ended March 31, 2013 and 2012:

	March 31, 2013	% of sales	March 31, 2012	% of sales
	(Dollar amounts in thousands)			
Sales	$46,693	100 %	$40,122	100 %
Costs and expenses:				
Cost of sales	36,749	79 %	30,584	76 %
Engineering and development	824	2 %	857	2 %
Selling, general and administrative	7,725	16 %	7,248	19 %
Total costs and expenses	45,298	97 %	38,689	97 %
Operating income	1,395	3 %	1,433	3 %
Other income (expense)	34	— %	(70)	— %
Income before income taxes	1,429	3 %	1,363	3 %
Income tax expense	574	1 %	460	1 %
Net income	$855	2 %	$903	2 %

Sales

The following table details our sales by operating segment for the six months ended March 31, 2013 and 2012:

	Systems	Service and System Integration	Total	% of Total
	(Dollar amounts in thousands)			
For the Six Months Ended March 31, 2013:				
Product	$2,590	$32,252	$34,842	75 %
Services	1,100	10,751	11,851	25 %
Total	$3,690	$43,003	$46,693	100 %
% of Total	8 %	92 %	100 %	

	Systems	Service and System Integration	Total	% of Total
For the Six Months Ended March 31, 2012:				
Product	$1,462	$25,817	$27,279	68 %
Services	3,248	9,595	12,843	32 %
Total	$4,710	$35,412	$40,122	100 %
% of Total	12 %	88 %	100 %	

	Systems	Service and System Integration	Total	% increase (decrease)

Increase (Decrease)				
Product	$1,128	$6,435	$7,563	28 %
Services	(2,148)	1,156	(992)	(8)%
Total	$(1,020)	$7,591	$6,571	16 %
% increase (decrease)	(22)%	21 %	16 %	

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As shown above, total revenues increased by approximately $6.6 million, or 16%, for the six months ended March 31, 2013 compared to the six months ended March 31, 2012. Revenue in the Systems segment decreased for the current year six- month period versus the prior year six-month period by approximately $1.0 million, while revenues in the Service and System Integration segment increased by approximately $7.6 million.

Product revenues increased by approximately $7.6 million, or 28%, for the six months ended March 31, 2013 compared to the comparable period of the prior fiscal year. Product revenues in the Service and System Integration segment increased by approximately $6.4 million while in the Systems segment product revenue increased by approximately $1.1 million for the six-month period ended March 31, 2013 versus the six month period ended March 31, 2012.

In the US division of the Service and System Integration segment, product sales increased by approximately $9.2 million, offset by decreases in the German division of approximately $2.0 million and in the UK division of approximately $0.8 million.

In the US division, the increase was due in part to sales to new customers (customers to which no sales were made in the prior year), which totaled approximately $3.7 million for the six months ended March 31, 2013. In addition, sales increased to three large existing customers in the IT hosting vertical by an aggregate of approximately $5.7 million.

In Germany, the $2.0 million decrease in product revenue included an unfavorable foreign currency impact of approximately $0.2 million, therefore on a volume basis in constant dollars the decrease was approximately $1.8 million. This sales volume decrease was driven by decreased sales to the division’s largest customer, a large UK-based wireless carrier. The decrease in product sales in the UK division was the result of weaker demand from our UK customer base in the current-year six month period versus the prior year six month period.

The increase in product revenues in the Systems segment of approximately $1.1 million was due largely to an increase in sales to our Japanese defense department customer of approximately $1.3 million, and a decrease of $0.4 million in sales of parts, components and spares to existing US defense department customers.

As shown in the table above, service revenues decreased by approximately $1.0 million, or 8%. This decrease was made up of an decrease in the Systems segment of $2.1 million and an increase in the Service and System Integration segment of approximately $1.2 million. The decrease in the Systems segment service revenue was due to lower royalty income recorded in the six months ended March 31, 2013 which was approximately $0.8 million versus $3.0 million for the six months ended March 31, 2012. The increase in service revenues in the Service and System Integration segment was due to an increase in the German division, where service revenue increased by approximately $0.5 million, and an increase in service revenues of approximately $0.5 million in the US division. In Germany, the increase in sales volume was driven by increased service revenues to the German division's largest customer, a UK-based wireless carrier. The increase in service revenue in the US division of the segment was primarily from higher third party maintenance revenue for the six months ended March 31, 2013 versus the six months ended March 31, 2012.

Our sales by geographic area, based on the location to which the products were shipped or services rendered, are as follows:

	For the six months ended,					
	March 31, 2013	%	March 31, 2012	%	$ Increase (Decrease)	% Increase (Decrease)

	(Dollar amounts in thousands)											
Americas	$	29,689	64	%	$	21,918	55	%	$	7,771	35	%
Europe		14,673	31	%		17,321	43	%		(2,648)	(15	)%
Asia		2,331	5	%		883	2	%		1,448	164	%
Totals	$	46,693	100	%	$	40,122	100	%	$	6,571	16	%

The increase in Americas revenue for the six months ended March 31, 2013 versus the six months ended March 31, 2012 was primarily the result of the fluctuations described above in the Systems segment where combined product and service sales to US customers decreased by an aggregate $2.6 million while in the US division of the Service and System Integration segment, sales to customers in the Americas were greater by approximately $10.2 million.

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The decrease in sales in Europe was primarily the result of the lower sales described above from the German and UK divisions of the Service and System Integration segment, which made up $2.1 million of the decrease, while Europe sales from the US division of the Service and System Integration segment decreased by approximately $0.5 million. The increase in Asia sales was the result of the increase in sales to our existing customer that supplies a large Japanese defense program (see discussion above).

Cost of Sales and Gross Margins

The following table details our cost of sales and gross profit margins by operating segment for the six months ended March 31, 2013 and 2012:

	Systems	Service and System Integration	Total	% of Total
		(Dollar amounts in thousands)		
For the Six Months Ended March 31, 2013:				
Product	$979	$27,921	$28,900	79%
Services	127	7,722	7,849	21%
Total	$1,106	$35,643	$36,749	100%
% of Total	3%	97%	100%	
% of Sales	30%	83%	79%	
Gross Margins:				
Product	62%	13%	17%	
Services	88%	28%	34%	
Total	70%	17%	21%	
For the Six Months Ended March 31, 2012:				
Product	$1,077	$22,298	$23,375	76%
Services	127	7,082	7,209	24%
Total	$1,204	$29,380	$30,584	100%
% of Total	4%	96%	100%	
% of Sales	26%	83%	76%	
Gross Margins:				
Product	26%	14%	14%	
Services	96%	26%	44%	
Total	74%	17%	24%	
Increase (decrease)				
Product	$(98)	$5,623	$5,525	24%
Services	—	640	640	9%
Total	$(98)	$6,263	$6,165	20%
% Increase (decrease)	(8)%	21%	20%	
% of Sales	4%	—%	3%	
Gross Margins:				
Product	36%	(1)%	3%	
Services	(8)%	2%	(10)%	
Total	(4)%	—%	(3)%	

Total cost of sales increased by approximately $6.2 million when comparing the six months ended March 31, 2013 versus the six months ended March 31, 2012. This increase in cost of sales was due to the overall increase in sales as discussed previously, however whereas sales increased by 16% , cost of sales increased by 20%. The resulting lower gross profit margin ("GPM") of 21% for the six months ended March 31, 2013 versus 24% for 2012 was primarily attributable to a greater proportion of Systems segment revenue (12%) for the six months ended March 31, 2012 versus the six months ended March 31, 2013 (8%).

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In the Service and System Integration segment, the overall GPM was 17% for the six months ended March 31, 2013 and also 17% for the prior year six-month period. Product GPM in the segment decreased from 14% for the six months ended March 31, 2012, to 13% for the six months ended March 31, 2013, while the segment's service GPM increased from 26% to 28% . The product GPM decrease was due to a less favorable product mix in the current year six-month period versus the prior year. Prior year product sales included more networking and data security products as opposed to sales of servers and other lower margin products in the current year six-month period particularly in the German division. The increase in service GPM in the Service and System Integration segment from 26% for the six-month period ended March 31, 2012 to 28% for the six months ended March 31, 2013 was due primarily to higher utilization of in-house service engineers in providing billable services in Germany, and higher third-party maintenance revenue for the current year six-month period versus that of the prior year.

In the Systems segment, the overall GPM decreased from 74% to 70% as shown in the table above. This was because in the current year six month period, royalty revenue, which carries a 100% GPM, made up a much lower percentage (22%) of total Systems segment revenue versus the prior year six-month period, wherein royalty revenue was 64% of total Systems segment revenue.

Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the six months ended March 31, 2013 and 2012:

	For the six months ended,					
	March 31, 2013	% of Total	March 31, 2012	% of Total	$ Decrease	% Decrease
	(Dollar amounts in thousands)					
By Operating Segment:						
Systems	$824	100 %	$857	100 %	$(33)	(4)%
Service and System Integration	—	—	—	—	—	—
Total	$824	100 %	$857	100 %	$(33)	(4)%

As shown in the table above, engineering and development expenses did not vary significantly for the for the six months ended March 31, 2013 versus the six-month period ended March 31, 2012, as approximately the same amount of resources were expended in both six-month periods.

Selling, General and Administrative

The following table details our selling, general and administrative ("SG&A") expense by operating segment for the six months ended March 31, 2013 and 2012:

	For the six months ended,					
	March 31, 2013	% of Total	March 31, 2012	% of Total	$ Increase (Decrease)	% Increase (Decrease)
	(Dollar amounts in thousands)					
By Operating Segment:						
Systems	$1,984	26 %	$2,178	30 %	$(194)	(9)%
Service and System Integration	5,741	74 %	5,070	70 %	671	13 %

Total	$7,725	100 %	$7,248	100 %	$477	7 %

SG&A expenses increased in the Service and System Integration segment by approximately $0.7 million as shown above, due primarily to higher commissions and bonus expense, primarily due to the higher GP, and operating profit, plus higher sales salary expenses for additional headcount and promotions within the US division. In the Systems segment, SG&A expenses decreased by approximately $0.2 million from lower retirement plan expenses of $0.2 million and lower bonus of $0.3 million offset by expenses incurred for legal and consulting expenses in connection with a proxy contest initiated by a shareholder, of $0.3 million.

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Other Income/Expenses

The following table details our other income (expense) for the six months ended March 31, 2013 and 2012:

	For the six months ended, March 31, 2013	March 31, 2012	Increase
	(Amounts in thousands)		
Interest expense	$(43)	$(43)	$—
Interest income	18	16	2
Foreign exchange gain	5	(26)	31
Gain on sale of fixed assets	17	—	17
Other income (expense), net	37	(17)	54
Total other income (expense), net	$34	$(70)	$104

Other income (expense), net, for the six month periods ended March 31, 2013 and 2012 was not significant nor was the change from the prior year six month period to that of the current year.

Overview of the three months ended March 31, 2013 Results of Operations

Overview:

Revenue increased by approximately $6.8 million, or 36%, to $25.8 million for the three months ended March 31, 2013 versus $19.0 million for the three months ended March 31, 2012. This increase in sales volume resulted in our operating income and net income increasing significantly compared with the prior-year three-month period, despite a decrease in overall gross profit margin, which decreased from 25% for the three months ended March 31, 2012 to 22% for the three months ended March 31, 2013. The decrease in gross profit margin was due to the company having realized approximately $2.0 million in royalty revenue in the prior year three-month period compared to no royalty revenue in the current year three-month period.

For the three months ended March 31, 2013, we had an operating profit of approximately $1.2 million versus an operating profit of approximately $0.7 million for the three months ended March 31, 2012, for an increase of approximately $0.6 million. For the three months ended March 31, 2013, net income was approximately $0.7 million versus net income of approximately $0.4 million for the three months ended March 31, 2012, for an increase of approximately $0.3 million.

The following table details our results of operations in dollars and as a percentage of sales for the three months ended March 31, 2013 and 2012:

	March 31, 2013	% of sales	March 31, 2012	% of sales
	(Dollar amounts in thousands)			
Sales	$25,823	100%	$19,029	100%
Costs and expenses:				
Cost of sales	20,056	78%	14,314	75%
Engineering and development	380	1%	474	3%
Selling, general and administrative	4,165	16%	3,572	19%
Total costs and expenses	24,601	95%	18,360	97%
Operating income	1,222	5%	669	3%
Other income (expense)	(25)	—%	(36)	—%
Income before income taxes	1,197	5%	633	3%
Income tax expense	457	2%	191	1%
Net income	$740	3%	$442	2%

Sales

The following table details our sales by operating segment for the three months ended March 31, 2013 and 2012:

	Systems	Service and System Integration	Total	% of Total
	(Dollar amounts in thousands)			
For the Three Months Ended March 31, 2013:				
Product	$2,494	$17,043	$19,537	76%
Services	143	6,143	6,286	24%
Total	$2,637	$23,186	$25,823	100%
% of Total	10%	90%	100%	

	Systems	Service and System Integration	Total	% of Total
For the Three Months Ended March 31, 2012:				
Product	$223	$11,902	$12,125	64%
Services	2,141	4,763	6,904	36%
Total	$2,364	$16,665	$19,029	100%
% of Total	12%	88%	100%	

	Systems	Service and System Integration	Total	% increase (decrease)
Increase (Decrease)				

Product	$2,271		$5,141		$7,412		61		%
Services	(1,998	)	1,380		(618	)	(9		)%
Total	$273		$6,521		$6,794		36		%
% increase	12	%	39	%	36	%			

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As shown above, total revenues increased by approximately $6.8 million, or 36%, for the three months ended March 31, 2013 compared to the three months ended March 31, 2012. Revenue in the Systems segment increased for the current year three-month period versus the prior year three-month period by approximately $0.3 million, while revenues in the Service and System Integration segment increased by approximately $6.5 million.

Product revenues increased by approximately $7.4 million, or 61%, for the three months ended March 31, 2013 compared to the comparable period of the prior fiscal year. Product revenues in the Service and System Integration segment increased by approximately $5.1 million while in the Systems segment product revenue increased by approximately $2.3 million for the three-month period ended March 31, 2013 versus the three-month period ended March 31, 2012.

In the US division of the Service and System Integration segment, product sales increased by approximately $5.9 million, offset by decreases in sales in this segment's German division of approximately $0.2 million and in the UK division of approximately $0.6 million.

In the US division, sales increased to three large existing customers in the IT hosting vertical by an aggregate of approximately $5.2 million and by approximately $1.0 million to one of the largest customers in the education vertical.

In Germany, the $0.2 million decrease in product revenue was due to slightly lower shipments among the existing large customer base. The decrease in product sales in the UK division was the result of weaker demand from our UK customer base in the current-year quarter versus the prior-year quarter.

The increase in product revenues in the Systems segment of approximately $2.3 million was due to increased sales to our Japanese defense department customer.

As shown in the table above, service revenues decreased by approximately $0.6 million, or 9%. This decrease was made up of a decrease in the Systems segment of $2.0 million and an increase in the Service and System Integration segment of approximately $1.4 million. The decrease in the Systems segment service revenue was due to the absence of royalty revenue recorded in the three months ended March 31, 2013 while for the three months ended March 31, 2012, royalty revenue was $2.0 million. The increase in service revenues in the Service and System Integration segment was due to an increase in the German division, of approximately $0.9 million, an increase in the US division of approximately $0.4 million and an increase in the UK division of approximately $0.1 million. In Germany, the increase in sales volume was driven by increased service revenues to the German division's largest customer, a UK-based wireless carrier. The increase in service revenue in the US division of the segment was from higher third party maintenance revenue for the quarter ended March 31, 2013 versus the quarter ended March 31, 2012 and an increase in professional service contract revenue.

Our sales by geographic area, based on the location to which the products were shipped or services rendered, are as follows:

	For the three months ended,								
	March 31, 2013	%		March 31, 2012	%		$ Increase	% Increase	
	(Dollar amounts in thousands)								
Americas	$14,747	57	%	$10,104	53	%	$4,643	46	%
Europe	8,922	35	%	8,856	47	%	66	1	%
Asia	2,154	8	%	69	—	%	2,085	3,022	%
Totals	$25,823	100	%	$19,029	100	%	$6,794	36	%

The increase in Americas revenue for the three months ended March 31, 2013 versus the three months ended March 31, 2012 was primarily the result of the fluctuations described above in the US division of the Service and System Integration segment, sales to customers in the Americas were greater by approximately $6.5 million, while in the Systems segment combined product and service sales to US customers decreased by an aggregate 2.0 million.

The increase in Asia sales was the result of the increase in sales to our existing customer that supplies a large Japanese defense program (see discussion above).

Cost of Sales and Gross Margins

The following table details our cost of sales and gross profit margins by operating segment for the three months ended March 31, 2013 and 2012:

	Systems	Service and System Integration	Total	% of Total
		(Dollar amounts in thousands)		
For the Three Months Ended March 31, 2013:				
Product	$962	$14,714	$15,676	78 %
Services	40	4,340	4,380	22 %
Total	$1,002	$19,054	$20,056	100 %
% of Total	5 %	95 %	100 %	
% of Sales	38 %	82 %	78 %	
Gross Margins:				
Product	61 %	14 %	20 %	
Services	72 %	29 %	30 %	
Total	62 %	18 %	22 %	
For the Three Months Ended March 31, 2012:				
Product	$248	$10,362	$10,610	74 %
Services	72	3,632	3,704	26 %
Total	$320	$13,994	$14,314	100 %
% of Total	2 %	98 %	100 %	
% of Sales	14 %	84 %	75 %	
Gross Margins:				
Product	(11)%	13 %	12 %	
Services	97 %	24 %	46 %	
Total	86 %	16 %	25 %	
Increase (decrease)				
Product	$714	$4,352	$5,066	48 %
Services	(32)	708	676	18 %
Total	$682	$5,060	$5,742	40 %
% Increase (decrease)	213 %	36 %	40 %	
% of Sales	24 %	(2)%	3 %	
Gross Margins:				
Product	72 %	1 %	8 %	
Services	(25)%	5 %	(16)%	
Total	(24)%	2 %	(3)%	

Total cost of sales increased by approximately $5.7 million when comparing the three months ended March 31, 2013 versus the three months ended March 31, 2012. This increase in cost of sales was due to the overall increase in sales as discussed previously, however whereas sales increased by 36% , cost of sales increased by 40%. The resulting lower GPM of 22% for the three months ended March 31, 2013 versus 25% for the three months ended March 31, 2012, was primarily attributable to a greater proportion of Systems Segment revenue (12%) for the three months ended March 31, 2012 versus the three months ended March 31, 2013 (10%). Also, within the Systems segment, the GPM was 86% for the three months ended March 31, 2012, versus 62% for the three months ended March 31, 2012. This was because in the prior year quarter, we realized approximately $2.0 million in royalty revenue which carries a 100% GPM, versus no royalty revenue in the current year quarter.

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In the Service and System Integration segment, the overall GPM was 18% for the three months ended March 31, 2013 versus 16% for the prior year three-month period. Product GPM in the segment increased from 13% for the three months ended March 31, 2012, to 14% for the three months ended March 31, 2013, while the segment's service GPM increased from 24% to 29% . The product GPM increase was due to a more favorable product mix in the current year three-month period versus the prior year. The increase in service GPM in the Service and System Integration segment was due primarily to higher utilization of in-house service engineers in providing billable services in Germany and higher TPM revenue in the US..

Engineering and Development Expenses

The following table details our engineering and development expenses by operating segment for the three months ended March 31, 2013 and 2012:

	For the three months ended,					
	March 31, 2013	% of Total	March 31, 2012	% of Total	$ Decrease	% Decrease
	(Dollar amounts in thousands)					
By Operating Segment:						
Systems	$380	100 %	$474	100 %	$(94)	(20)%
Service and System Integration	—	—	—	—	—	—
Total	$380	100 %	$474	100 %	$(94)	(20)%

The $0.1 million decrease in engineering and development expenses displayed above was due to lower engineering consulting and materials expenditures in connection with the development of the next generation of products in the Systems segment.

Selling, General and Administrative

The following table details our selling, general and administrative ("SG&A") expense by operating segment for the three months ended March 31, 2013 and 2012:

	For the three months ended,					
	March 31, 2013	% of Total	March 31, 2012	% of Total	$ Increase (Decrease)	% Increase (Decrease)
	(Dollar amounts in thousands)					
By Operating Segment:						
Systems	$1,106	27 %	$1,126	32 %	$ (20)	(2)%
Service and System Integration	3,059	73 %	2,446	68 %	613	25 %
Total	$4,165	100 %	$3,572	100 %	$ 593	17 %

The increase in SG&A expense in the Service & System Integration segment was the result of an increase in commission expense of approximately $0.3 million, due to the higher gross profit in the current-year period versus the prior year, higher salary and fringe expense of approximately $0.1 million a due to headcount increases, and higher bad debt expense of approximately $0.1 million. These increase were all within the US division of the segment.

Other Income/Expenses

The following table details our other income (expense) for the three months ended March 31, 2013 and 2012:

	For the three months ended, March 31, 2013	March 31, 2012	Increase (Decrease)
	(Amounts in thousands)		
Interest expense	$(21)	$(21)	$—
Interest income	4	11	(7)
Foreign exchange gain (loss)	(7)	(12)	5
Other income (expense), net	(1)	(14)	$13
Total other income (expense), net	$(25)	$(36)	11

Other income (expense), net, for the three month periods ended March 31, 2013 and 2012 was not significant nor was the change from the prior year three-month period to that of the current year.

Income Taxes

Income Tax Provision

The Company recorded income tax expense of approximately $0.5 million for the quarter ended March 31, 2013, reflecting an effective income tax rate of 38% for the period compared to income tax expense of approximately $0.2 million for the quarter ended March 31, 2012, which reflected an effective tax rate of 30%. For the six months ended March 31, 2013 the Company recorded income tax expense of approximately $0.6 million reflecting an effective income tax rate of 40% versus income tax expense of $0.5 million for the six months ended March 31, 2012, which reflected an effective tax rates of 34% .

In assessing the realizability of deferred tax assets, we considered our taxable future earnings and the expected timing of the reversal of temporary differences. Accordingly, we have recorded a valuation allowance which reduces the gross deferred tax asset to an amount that we believe will more likely than not be realized. We maintained a substantial valuation allowance against our United Kingdom deferred tax assets as we have experienced cumulative losses and do not have any indication that the operation will be profitable in the future to an extent that will allow us to utilize much of our net operating loss carryforwards. To the extent that actual experience deviates from our assumptions, our projections would be affected and hence our assessment of realizability of our deferred tax assets may change.

Liquidity and Capital Resources

Our primary source of liquidity is our cash and cash equivalents, which decreased by $5.2 million to $15.3 million as of March 31, 2013 from $20.5 million as of September 30, 2012. At March 31, 2013, cash equivalents consisted of money market funds which totaled $3.5 million.

Significant uses of cash for the six months ended March 31, 2013 included an increase in accounts receivable of approximately $8.3 million, payment of dividends of approximately $0.7 million and an increase in other assets of approximately $0.8 million. Significant sources of cash included net income of approximately $0.9 million, collection of officer's life insurance receivable of approximately $2.2 million and reduction in inventories of approximately $1.7 million.

Cash held by our foreign subsidiaries located in Germany and the United Kingdom totaled approximately $5.1 million as of March 31, 2013 and $9.8 million as of September 30, 2012. This cash is included in our total cash and cash equivalents reported above. We consider this cash to be permanently reinvested into these foreign locations because repatriating it would result in unfavorable tax consequences. Consequently, it is not available for activities that would require it to be repatriated to the U.S.

If cash generated from operations is insufficient to satisfy working capital requirements, we may need to access funds through bank loans or other means. There is no assurance that we will be able to raise any such capital on terms acceptable to us, on a timely basis or at all. If we are unable to secure additional financing, we may not be able to complete development or enhancement of products, take advantage of future opportunities, respond to competition or continue to effectively operate our business.

Based on our current plans and business conditions, management believes that the Company's available cash and cash equivalents, the cash generated from operations and availability on our lines of credit will be sufficient to provide for the Company's working capital and capital expenditure requirements for the foreseeable future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of March 31, 2013. Our chief executive officer, our chief financial officer, and other members of our senior management team supervised and participated in this evaluation. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company’s management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2013, the Company’s chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Controls over Financial Reporting

During the period covered by this report, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Number	Description
31.1*	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101*	Interactive Data Files regarding (a) our Consolidated Balance Sheets as of March 31, 2013 and September 30, 2012, (b) our Consolidated Statements of Operations for the three and six months ended March 31, 2013 and 2012, (c) our Consolidated Statements of Comprehensive Income for the three and six months ended March 31, 2013 and 2012, (d) our Consolidated Statement of Shareholders' Equity for the six months ended March 31, 2013, (e) our Consolidated Statements of Cash Flows for the six months ended March 31, 2013 and 2012 and (f) the Notes to such Consolidated Financial Statements.

*Filed Herewith

SIGNATURES

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

	CSP INC.	
Date: May 13, 2013	By:	/s/ Victor Dellovo Victor Dellovo Chief Executive Officer, President and Director
Date: May 13, 2013	By:	/s/ Gary W. Levine Gary W. Levine Chief Financial Officer

Exhibit Index

Number	Description
31.1*	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2*	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1*	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101*	Interactive Data Files regarding (a) our Consolidated Balance Sheets as of March 31, 2013 and September 30, 2012, (b) our Consolidated Statements of Operations for the three and six months ended March 31, 2013 and 2012, (c) our Consolidated Statements of Comprehensive Income for the three and six months ended March 31, 2013 and 2012, (d) our Consolidated Statement of Shareholders' Equity for the six months ended March 31, 2013, (e) our Consolidated Statements of Cash Flows for the six months ended March 31, 2013 and 2012 and (f) the Notes to such Consolidated Financial Statements.

*Filed Herewith