

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
  
FORM 20-F**

(Mark One)

☐ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

**OR**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the fiscal year ended December 31, 2013**

**OR**

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

**OR**

☐ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 001-34914

**Xueda Education Group**

(Exact name of Registrant as specified in its charter)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**A-4 Xibahe Beili, Chaoyang District  
Beijing 100028, People's Republic of China**

(Address of principal executive offices)

**Christine Lu-Wong, Chief Financial Officer**

**Telephone: +(86-10) 6427-8899**

**Facsimile: +(86-10) 6427-8899**

**A-4 Xibahe Beili, Chaoyang District  
Beijing 100028, People's Republic of China**

(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:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Ordinary Shares, par value \$0.0001 per share	New York Stock Exchange
American Depositary Shares, each representing two 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 or common stock as of the close of the period covered by the annual report:

133,610,982 Ordinary Shares

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

☐ Yes ☒ 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.

☐ Yes ☒ No

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

☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

☒ Yes ☐ No

Indicate by check mark 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. (Check one):

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

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

U.S. GAAP ☒

International Financial Reporting Standards as issued  
by the International Accounting Standards Board ☐

Other ☐

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.

☐ Item 17 ☐ 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 Securities Exchange Act of 1934).

☐ Yes ☒ No

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

☐ Yes ☐ No

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## CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT ON FORM 20-F

Unless otherwise indicated and except where the context otherwise requires, references in this annual report on Form 20-F to:

- “we,” “us,” “our company” and “our” refer to Xueda Education Group and its subsidiaries, and in the context of describing our operations and consolidated financial data, also to our VIE and its subsidiaries;
- “VIE” refers to Beijing Xueda Information Technology Co., Ltd., or Xueda Information, our variable interest entity, which is a domestic PRC company in which we do not have any equity interest but whose historical financial results have been consolidated in our financial statements in accordance with U.S. GAAP;
- “ADSs” refers to our American depositary shares, each of which represents two ordinary shares;
- “China” or “PRC” refers to the People’s Republic of China, excluding, for the purpose of this annual report only, Taiwan, Hong Kong and Macau;
- “provinces and municipalities” refers to provinces, autonomous regions and municipalities directly administered by the PRC central government; there are a total of 31 provinces, autonomous regions and municipalities directly administered by the PRC central government.
- “RMB” or “Renminbi” refers to the legal currency of China; “\$”, “dollars” or “U.S. dollars” refers to the legal currency of the United States; and
- “shares” or “ordinary shares” refers to our ordinary shares, par value \$0.0001 per share; “Series A1 preferred shares” refers to our Series A1 convertible redeemable preferred shares, par value \$0.0001 per share, and “Series A2 preferred shares” refers to our Series A2 convertible redeemable preferred shares, par value \$0.0001 per share. Series A1 preferred shares and Series A2 preferred shares have been converted into our ordinary shares upon completion of our initial public offering.

This annual report includes our audited consolidated financial statements for the years ended December 31, 2011, 2012 and 2013 and as of December 31, 2012 and 2013.

## FORWARD-LOOKING STATEMENTS

This annual report on Form 20-F contains statements of a forward-looking nature. All statements other than statements of historical facts are forward-looking statements. These forward-looking statements are made under the “safe harbor” provision under Section 21E of the Securities Exchange Act of 1934, as amended, and as defined in the Private Securities Litigation Reform Act of 1995. These statements involve known and unknown risks, uncertainties, and other factors that may cause our actual results, performance or achievements to be materially different from those expressed or implied by the forward-looking statements.

You can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “is expected to,” “intend,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “continue,” “is/are likely to” or the negative of these terms or other similar expressions. These forward-looking statements include, but are not limited to:

- our goals and strategies;
- our prospects, business development, growth of our operations, financial condition and results of operations;
- expected changes in our revenue and certain cost and expense items;
- our ability to expand our service network, attract more students, increase course fees and improve existing or offer new services;
- fluctuations in general economic and business conditions in China;
- competition in the education and tutoring markets in China;
- the expected increase in spending on education in China; and
- PRC laws, regulations and policies relating to private education and providers of private educational services.

We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our financial condition, results of operations, business strategy and financial needs.

You should read these statements in conjunction with the risks disclosed in “Item 3.D. Risk Factors” of this annual report and other risks outlined in our other filings with the Securities and Exchange Commission. Moreover, we operate in an emerging and evolving environment. New risks may emerge from time to time, and it is not possible for our management to predict all risks, nor can we assess the impact of such risks on our business or the extent to which any risk, or combination of risks, may cause actual results to differ materially from those contained in any forward-looking statements. Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

You should read thoroughly this annual report and the documents that we refer to herein with the understanding that our actual future results may be materially different from and/or worse than what we expect. We qualify all of our forward-looking statements by these cautionary statements.

## 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 following selected consolidated balance sheet data as of December 31, 2012 and 2013 and the selected consolidated statement of operations data for the years ended December 31, 2011, 2012 and 2013 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The following selected balance sheet data as of December 31, 2009, 2010 and 2011 and the following selected statement of operations data for the years ended December 31, 2009 and 2010 have been derived from our audited consolidated financial statements not included in this annual report.

The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by reference to our audited consolidated financial statements and related notes and “Item 5. Operating and Financial Review and Prospects” included elsewhere in this annual report. Our audited consolidated financial statements are prepared and presented in accordance with generally accepted accounting principles in the United States, or U.S. GAAP. Our historical results are not necessarily indicative of our results expected for any future periods.

	For the Year Ended December 31,				
	2009	2010	2011	2012	2013
	(in thousands of \$, except share and per share numbers)				
Consolidated Statement of Operations Data :					
Net revenue	77,188	154,144	221,738	293,157	347,047
Cost of revenue <sup>(1)</sup>	(57,326)	(103,504)	(156,222)	(219,655)	(239,948)
Gross profit	19,862	50,640	65,516	73,502	107,099
Operating expenses:					
General and administrative expenses <sup>(1)</sup>	(9,912)	(23,790)	(36,425)	(46,427)	(52,716)
Selling and marketing expenses <sup>(1)</sup>	(10,624)	(16,179)	(25,940)	(31,336)	(36,308)
Impairment loss on goodwill	—	—	—	—	(2,923)
Impairment loss on acquired intangible assets	—	—	—	—	(494)
Total operating expenses	(20,536)	(39,969)	(62,365)	(77,763)	(92,411)
Government subsidies	83	26	357	164	439
Other income	—	76	—	—	—
(Loss)/profit from operations	(591)	10,773	3,508	(4,097)	15,097
Interest income	220	510	3,766	6,722	7,279
(Loss)/profit before income tax expense	(371)	11,283	7,274	2,625	22,376
Income tax expenses					
Current	(1,320)	(3,455)	(4,562)	(3,179)	(8,302)
Deferred	83	2,465	2,078	2,303	820
Total income tax expenses	(1,237)	(990)	(2,484)	(876)	(7,482)
Net (loss)/income	(1,608)	10,293	4,790	1,749	14,894
Net loss attributable to the noncontrolling interests	—	—	—	216	1,257
Net (loss)/income attributable to Xueda Education Group shareholders	(2,585)	9,773	4,790	1,965	16,151
Net (loss)/income per share:					
Basic	(0.04)	0.09	0.03	0.01	0.12
Diluted	(0.04)	0.09	0.03	0.01	0.12
Net (loss)/income per ADS:					
Basic	(0.08)	0.18	0.07	0.03	0.25
Diluted	(0.08)	0.18	0.07	0.03	0.24
Weighted average shares used in calculating net (loss)/income per ordinary share:					
Basic	68,865,200	80,407,581	137,745,176	131,316,004	131,681,540
Diluted	68,865,200	82,776,366	142,268,913	131,776,207	134,466,868

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	As of December 31,				
	2009	2010	2011	2012	2013
	(in thousands of \$)				
Consolidated Balance Sheet Data:					
Current assets:					
Cash and cash equivalents	36,436	211,370	217,746	211,944	117,063
Short-term investments	—	21,212	7,944	26,126	129,619
Prepaid expenses and other current assets	4,587	8,398	18,645	12,911	16,642
Total current assets	42,593	242,910	247,996	256,908	272,094
Total assets	48,323	263,182	289,835	316,265	331,618
Current liabilities:					
Deferred revenue — current	41,529	61,161	79,095	105,027	103,871
Total current liabilities	48,809	77,470	105,246	157,525	148,876
Deferred revenue — non-current	16,454	25,020	22,309	28,765	29,983
Total liabilities	65,299	102,490	128,484	187,038	179,119
Net assets	(16,976)	160,692	161,351	129,227	152,499
Series A1 convertible redeemable preferred shares	3,037	—	—	—	—
Series A2 convertible redeemable preferred shares	1,103	—	—	—	—
Noncontrolling interests	—	—	—	1,363	112
Total Xueda Education Group shareholders' equity	(21,116)	160,692	161,351	127,864	152,387

	For the Year Ended December 31,				
	2009	2010	2011	2012	2013
Selected Operating Data:					
Number of learning centers (at period end)	131	207	295	383	408
Number of students served	54,130	88,761	116,900	138,688	149,882
Average hourly course fee (in \$) <sup>(2)</sup>	21	23	26	28	30

(1) Includes the following amounts of share-based compensation expenses for the periods indicated:

	For the Year Ended December 31,				
	2009	2010	2011	2012	2013
	(in thousands of \$)				
Cost of revenue	—	3	6	5	10
General and administrative expenses	—	1,895	4,092	3,156	5,368
Selling and marketing expenses	—	6	11	5	4
Total share-based compensation expenses	—	1,904	4,109	3,166	5,382

(2) Represents gross revenue, which is computed as net revenue plus business tax, divided by the total course hours delivered in the relevant period.

## Exchange Rate Information

For your convenience, this annual report also contains translations of certain amounts in RMB into U.S. dollars at the rate of RMB6.0537 to \$1.00, the noon buying rate for December 31, 2013, as set forth in the H.10 statistical release of the Federal Reserve Board.

We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated below, or at all. The PRC government imposes controls over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign exchange and through restrictions on foreign trade. On March 21, 2014, the exchange rate as set forth in the H.10 statistical release of the Federal Reserve Board was RMB6.2248 to \$1.00.

The following table sets forth information concerning exchange rates between the RMB and the U.S. dollar for the periods indicated.

	Noon Buying Rate			
	Period End	Average <sup>(1)</sup>	Low	High
2009	6.8259	6.8307	6.8176	6.8470
2010	6.6000	6.7671	6.6000	6.8330
2011	6.2939	6.4630	6.2939	6.6364
2012	6.2301	6.3093	6.2221	6.3879
2013	6.0537	6.1478	6.0537	6.2438
September	6.1200	6.1198	6.1178	6.1213
October	6.0943	6.1032	6.0815	6.1209
November	6.0922	6.0929	6.0903	6.0993
December	6.0537	6.0738	6.0537	6.0927
2014				
January	6.0590	6.0509	6.0402	6.0600
February	6.1448	6.0816	6.0591	6.1448
March (through March 21, 2014)	6.2248	6.1590	6.1183	6.2273

Source: Federal Reserve Bank of New York and Federal Reserve Board

- (1) Annual averages are calculated by using the average of the daily exchange rates during the relevant year. Monthly averages are calculated by using the average of the daily rates during the relevant month.

### B. Capitalization and Indebtedness

Not Applicable.

### C. Reasons for the Offer and Use of Proceeds

Not Applicable.

### D. Risk Factors

#### Risk Factors Relating to Our Business and Industry

*We may not be able to continue to attract students to enroll in our programs or retain our existing students. As a result, our net revenue may decline and we may not be able to maintain profitability.*

The success of our business largely depends on our ability to attract new students and retain existing students as well as the amount of course fees our students are willing to pay, which in turn depends on a variety of factors. These factors include our ability to refine our personalized service model, improve our services, 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 service quality, effectively market our programs to a broader base of prospective students and respond to competitive pressures. If we are unable to continue to attract students to enroll in our programs or retain existing students without a significant decrease in course fees or a significant increase in selling and marketing expenses, our net revenue 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.



***We may not be able to continue to attract and retain qualified service professionals. As a result, we may not be able to maintain consistent service quality throughout our service network, and our brand, business and results of operations may be materially and adversely affected.***

Our service professionals, including instructors, education consultants, study counselors and psychological counselors, are critical to maintaining the quality of our services and programs as well as our brand and reputation because they interact with our students on a regular basis and because our personalized tutoring service model requires significantly more service professionals per student than do other service models using class-based tutoring. We must continue to attract qualified service professionals who have the relevant experience, expertise and qualifications that meet our requirements, of which professionals there are a limited number. We must provide competitive compensation and benefits packages to attract and retain qualified service professionals. If we are unable to hire qualified service professionals without incurring significant incremental recruitment and compensation expenses, our business, results of operations and financial condition may be materially and adversely affected.

Historically, the attrition rates for our service professionals were 25.2%, 24.8% and 23.6% for 2011, 2012 and 2013, respectively. The attrition of our service professionals has generally resulted from our performance-driven salary structure that comprises of variable components, career development prospects perceived by our service professionals and our stringent performance evaluation process and is affected by seasonality associated with the academic calendar.

Under our service model, education consultants are the first group of service professionals with direct contact with prospective students. Our education consultants provide preliminary consultation and assessment of the students and help the students form a customized study plan. As such, education consultants are instrumental in both recruiting and retaining the students. Before the change to their compensation structure in the first half of 2011, our education consultants were paid immediately when students signed the service contracts and the course fees were collected. Under the changed compensation structure, a significant portion of our education consultants' compensation would be paid on a continuous basis and as the course hours are delivered. Our goal was to require the education consultants to make more efforts retaining their students, improve customer service and foster sustainable growth. Although we anticipated a short-term increase in the resignations of education consultants following such change, the actual number of resignations in mid to late 2011 was more significant than we had anticipated. As a result, the growth in students served and course hours delivered in the second half of 2011 slowed down, which, in turn, caused a slowdown in the revenue growth in the second half of 2011 compared to the previous periods.

The employment agreements we have entered into with all of our employees (including education consultants) contain non-competition provisions. Under the PRC law, to fully enforce a non-competition agreement, the employer must pay reasonable compensation to the terminated employee on a monthly basis throughout the non-competition period. Given the large number of education consultants and the small number of prospective students each education consultant can influence, we typically do not decide to enforce the non-competition provision against resigned education consultants and do not normally pay them the monthly non-competition compensation. We believe that our decision not to enforce the non-competition provisions against the resigned education consultants did not significantly affect our student retention, as the refund rate, defined as the percentage of course fee refunded in a period out of the total amount of course fees collected in such period, was 7.1% in 2011, 7.9% in 2012 and 8.6% in 2013, respectively.

We have taken the following measures to try to reverse such slowdown since 2012: (1) adopting a set of guidelines and autonomy framework for our local operations, which provides our regional management team with more flexibility in structuring the compensation of education consultants to better align with local market conditions; (2) vigorously recruiting new education consultants and (3) enhancing the training programs for our education consultants, with an emphasis on helping young education consultants advance in their career path and encouraging senior education consultants to be more proactive. As a general initiative, we also try to help our service professionals adapt to our business culture and enhance their internal career development opportunities in order to maintain a healthy level of attrition. In 2013, we continued to improve our employee incentive systems by enhancing training programs and improving recruitment quality. We also established an employee appeal system in order to facilitate efficient internal communication. As a result, the attrition rate for our service professionals decreased to 24.8% in 2012 and further decreased to 23.6% in 2013. However, we cannot assure you that the programs we have developed or may adopt to retain our service professionals (including the education consultants) will continue to be effective in allowing us to maintain our target service professional attrition levels. If we are unable to retain qualified service professionals and reduce their attrition rate without incurring significant retention expenses, our business, results of operations and financial condition may be materially and adversely affected.

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A small portion of our tutoring courses are delivered by instructors who are teachers at public schools and work at our learning centers on a contractual basis. The practice of paid tutoring by teachers of public schools has received increased regulatory scrutiny in recent years. Some provinces and municipalities where we have substantial business operations, such as Beijing, Tianjin, Jiangsu, Hunan, Guangdong, Anhui, Zhejiang, Hebei and Shaanxi, have promulgated local regulations prohibiting public school teachers from providing paid tutoring services. Similar regulations may be adopted in more provinces and municipalities where we have substantial business operations or plan to expand our service network. In 2012 and 2013, only a very small percentage of our total course hours were delivered by contract instructors who are teachers at public schools. If these instructors choose to, or are forced to, discontinue their employment relationship with us to comply with the relevant local regulations, we may need to seek new instructors to replace them. We cannot assure you we will be able to find replacements at a reasonable cost on a timely basis, if at all. In addition, we may experience a reduced supply of instructors in those provinces and municipalities, which may further increase the strain on and difficulty of our recruiting efforts. Furthermore, while none of the existing local regulations currently imposes any penalty on service providers like us for hiring full-time public school teachers, we cannot assure you that these regulations will not be amended, or that new regulations will not be adopted, to impose such penalties in the future.

There is an abundant supply of teachers in our resource pool, however, we may not be able to hire and retain enough qualified service professionals to keep pace with our anticipated growth at acceptable costs and on a timely basis while maintaining consistency in the quality of our services across our learning center network. Shortages of qualified service professionals, actual or perceived decreases in the quality of our services or increases in recruiting, compensation or retention costs in one or more of our current or future markets may impede our expansion efforts and may have a material adverse effect on our business prospects and results of operations.

***Our limited history of offering personalized tutoring services may not serve as an adequate basis for evaluating our future prospects, financial condition and results of operations.***

Although our founders were in the educational service business since as early as 2001, we only started our personalized tutoring services in 2004 and have experienced significant growth only since 2007. Our limited operating history may not provide a meaningful basis on which to evaluate our business. Despite the growth in our revenue in recent years, we incurred net losses for the fiscal years ended December 31, 2007, 2008 and 2009. Although we recorded net income since 2010, we cannot guarantee you that we will remain profitable or will not incur net losses in the future. We expect that both our cost and our operating expenses will increase as we continue our business expansions and that we may face difficulties maintaining profitability. Thus, our limited operating history may not provide you with a sufficient basis upon which to evaluate our future prospects, financial condition and results of operations.

***We have incurred losses in the past and may incur losses in the future.***

We incurred net losses attributable to our company of \$12.5 million and \$1.6 million in 2008 and 2009, respectively, and recorded an accumulated shareholders' deficit of \$12.3 million, \$8.5 million and \$7.0 million as of December 31, 2010, 2011 and 2012, respectively. As we expect our costs to increase as we continue to expand our business and operations, we may incur losses in the future. Our net income attributable to Xueda Education Group's ordinary shareholders decreased from \$10.3 million in 2010 to \$4.8 million in 2011 and further decreased to \$2.0 million in 2012. Although we generated net income of \$16.2 million in 2013, we cannot assure you that we will be able to sustain profitability in the future.

***We may not be able to manage our business expansion and increasingly complicated operations effectively, which could harm our business.***

We have expanded rapidly in recent years and plan to continue expanding our operations primarily through organic growth. The number of our learning centers increased from 108 as of December 31, 2008 to 408 as of December 31, 2013, and is expected to continue to grow. This expansion has resulted, and will continue to result, in substantial demands on our management, personnel, operational, technological and other resources. To manage the expected growth of our operations, we need to expand our existing operational, administrative, technological and financial systems, procedures and controls as well as expand, train and manage our employee base. In addition, the geographic dispersion of our operations requires significant management resources. We cannot assure you that our current and planned expansion of and upgrade in personnel, systems, procedures and controls will be adequate to support our future operations, or that we will be able to effectively and efficiently manage the growth of our operations, recruit and retain qualified personnel and integrate any entities we may acquire or any strategic alliances we may form 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 and to manage our existing operations, which in turn may have a material adverse effect on our financial condition and results of operations.

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In addition, we intend to form strategic alliances and make selective complementary acquisitions and investments to help drive future growth. For example, in June 2012, Xueda Information acquired a 60% equity interest in Beijing Weland International Education and Technology Corp., or Weland, for a consideration of RMB18.9 million. Weland is a company incorporated in China and organizes Chinese students to attend various model United Nations conferences and the relevant training in the United States and China. However, as a result of the increasingly competitive environment in the short-term overseas studies industry, Weland's estimated growth rates and profit margins for future periods were expected to be lower than that of prior years' forecast. Accordingly, we recognized a goodwill impairment loss of \$2,923 in the year ended December 31, 2013. In August 2012 and July 2013, we purchased, for a consideration of \$4.8 million and \$1.6 million, respectively, equity interests in the aggregate of 16.11% in Firstleap Education, a company incorporated in the Cayman Islands that provides English tutoring services to two- to ten-year-old children in China. We expect this investment in the long term to expand our service offerings, strengthen our position in the Chinese private tutoring sector and diversify our revenue streams. Our strategic alliances, acquisitions and investments involve substantial risks and uncertainties, including:

- our ability to form strategic alliances and identify and acquire targets in a cost-effective manner;
- our ability to obtain approval from relevant government authorities for the acquisitions and comply with applicable rules and regulations for such acquisitions;
- our ability to integrate new operations, services and personnel;
- potential ongoing financial obligations in connection with alliances and acquisitions;
- potential unforeseen or hidden liabilities, including litigation claims or tax liabilities, associated with acquired entities;
- the diversion of resources and management attention from our existing businesses;
- failure to achieve the intended revenue and other benefits expected from the alliances, acquisitions and investments;
- our ability to generate sufficient revenue to offset the costs and expenses of alliances, acquisitions and investments; and
- potential loss of, or harm to, employee or customer relationships as a result of ownership changes.

If any one or more of these risks or uncertainties materialize or if any of the strategic objectives we contemplated is not achieved, our strategic alliances, acquisitions or investments may not be beneficial to us and may have a material adverse effect on our business, financial condition and results of operations.

***If we are unable to achieve or maintain economies of scale with the expansion of our network of learning centers, our results of operations may be materially and adversely affected.***

The establishment of each new learning center involves an upfront investment in development of the facilities, hiring of service professionals, and incurs selling, marketing, administrative and other operating expenses. Our revenue and profitability depend on, among other things, the number of students we can attract to our new learning centers, the number of course hours they purchase, the amount of course fee they are willing to pay, as well as the cost savings we may be able to achieve by sharing administration, procurement and other resources among the various learning centers. If the new learning centers are unable to generate sufficient revenue to offset the development and operating costs, or if we are unable to effectively achieve resource sharing among the learning centers to reduce costs, our results of operations will be adversely affected.

***We may not be able to renew leases, control rent increases at our existing learning center locations or obtain leases at premium locations for new learning centers at reasonable prices.***

Except for four learning centers in Hefei, Anhui Province, Jinan, Shandong Province, Hangzhou, Zhejiang Province and Yancheng, Jiangsu Province, which own an aggregate space of 2,358 square meters, we currently lease all of the properties we use to operate our business. The term of our leases for the learning centers typically ranges from one to five years. Some of our learning centers have entered into multiple leases of multiple premises in the same building in order to obtain sufficient operational space. Some of our other learning centers operate in different buildings in the same geographic location, and therefore have multiple leases.

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As a result, as of December 31, 2013, we had a total of 408 learning centers established and operated by our VIE's subsidiaries or private schools, and 507 leases for these learning centers, representing all properties leased by our VIE, its subsidiaries and schools for the tutoring services we provide. Among these leases, 89 will expire by December 31, 2014 and 22 do not contain a priority renewal provision which provides the lessee with the right of first refusal to renew the lease on the terms and conditions offered by the lessor for renewal upon the expiration of the lease. At the end of the lease term, we may need to negotiate for a new lease or an extension of the existing lease and may be forced to find a new lease location, which could involve substantial rent increases and leasehold improvement costs. In addition, we compete with numerous other businesses for sites in a highly competitive market, and some landlords and developers may exclusively grant locations to our competitors. As a result, we may not be able to obtain new leases or renew existing ones on acceptable terms or at all, which could adversely affect our business, results of operations and financial condition.

### ***Certain of our leases may subject us to government penalties or may be challenged by property owners or other third parties.***

Some of the premises of our learning centers are located on 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. Certain other of our leased properties are located on land the use of which is restricted and not permitted for our current use. As of December 31, 2013, we operated a total of 408 learning centers. As of December 31, 2013, a total of approximately 4,919 square meters of our leased properties for these learning centers, representing 1.78% of the total size of our learning center leases, were located on land that cannot be used for our current purpose. Our lease of properties located on such land may subject us to government penalties at a rate we believe, based on our review of the applicable regulations, up to RMB30 (\$4.96) per square meter, or up to RMB14 7,570 (\$24,398) in total. As of the date of this annual report, we have not been subject to any penalty for leasing properties built on such land.

In addition, some lessors of premises we lease for the operation of learning centers have not provided us with evidence of their valid and enforceable building ownership or evidence of their rights or authority to lease or sub-lease such properties. As of December 31, 2013, leases for properties with such lease right deficiencies amounted to approximately 20,738 square meters, representing approximately 7.5% of the total size of all of our learning center leases.

We were aware of these deficiencies as a result of our due diligence investigation conducted by our local management teams prior to our entry into these leases. Our local management teams follow our procedure for identifying and assessing risks in connection with our leases, and report their findings to our management team at our corporate headquarters, who make a final business decision after assessing of the likely impact of the relevant deficiencies. Certain of these deficiencies are caused by the time required by the relevant government authorities to issue the title certificates after acquisition or change of ownership of the building, typically ranging from one to two years. Other deficiencies were outweighed by the business considerations, such as location and ease of access and rent.

As of the date of this annual report, no dispute has arisen as to the legal title of any of such leased properties or our right to occupy the properties. If any such dispute were to arise, we may be required to vacate such properties under dispute and relocate, which will disrupt our tutoring services and adversely affect our customer relationship. We may also be subject to administrative penalties for our lease of properties not permitted to be used for our current purpose. If we are not able to find desirable premises to relocate to, or if relocation cannot be completed with reasonable costs and on a timely basis, our business, financial condition and results of operations may be materially and adversely affected.

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

Our operational and financial performance and the successful growth of our business are highly dependent on our reputation and market awareness of our "Xueda" brand. We believe maintaining and enhancing our reputation and our "Xueda" brand is critical to maintaining and enhancing our competitive advantage and growing our business. The personalized tutoring services we offer to primary and secondary school students throughout many provinces and municipalities in China place significant demands on us to maintain the consistency and quality of our services to ensure our reputation and brand do not suffer from any actual or perceived deterioration in the quality of our services. As we continue to grow in size, expand our services and extend our geographical reach, maintaining the quality and consistency of our services may be more difficult. Any alleged deterioration in the quality of our services or any negative publicity about our services 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 the services we offer and in each geographic market in which we operate. If we fail to compete effectively, we may lose market share, and our results of operations and financial condition may be materially and adversely affected.***

In China, the educational services market, particularly the tutoring sector, is rapidly evolving, highly fragmented and intensely competitive. We expect competition in this sector to persist and further intensify. We face competition from other large market participants and a number of smaller, mostly local and regional players. 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 which focus on multiple areas related to our business and are able to cross-sell their services across their business lines. These companies may be able to more quickly adapt to changing technology, student preferences and market conditions in these markets than us and may, therefore, have a competitive advantage over us.

The increasing use of the Internet and advances in Internet- and computer- related technologies are eliminating geographic and cost-entry barriers to providing tutoring 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 these companies' programs for the perceived advantages these programs may offer. In addition, many smaller companies, both domestic and international, are able to use the Internet to quickly and cost-effectively offer their services to a large number of students with less capital expenditure than previously required.

Competition could result in loss of market share and revenue, higher expenses and lower profit margins; it could also limit our future growth. A number of our current and potential future competitors may have greater financial and other resources than we do. 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 or new technologies. They also compete with us in recruiting qualified service and management professionals and may attempt to solicit our employees.

In response to competition, we may have to reduce course fees or increase spending in order to retain or attract students or to pursue new market opportunities. We may also have to incur additional recruiting, compensation and retention expenses in order to attract and retain service professionals and management personnel. We cannot assure you that we will be able to compete successfully against current and future competitors. If we are unable to maintain our competitive position or otherwise respond to competitive pressures in a timely and effective manner, we may lose market share, and our results of operations and financial condition may be materially and adversely affected.

***We face risks related to severe weather conditions, natural disasters, health epidemics and other similar events, any of which could result in reduced attendance or temporary or long-term closure of our facilities.***

Our business could be disrupted or otherwise adversely affected by severe weather conditions, such as snow, storm or hurricane, natural disasters, such as earthquakes, health epidemics, such as an outbreak of avian influenza or severe acute respiratory syndrome, and other similar events. The occurrence of any such event could result in reduced attendance in, or even require the temporary or long-term closure of, our learning centers and other business facilities, and could severely disrupt our business operations and adversely affect our results of operations and financial condition.

***Our business depends on the continuing efforts of our senior management team, local management teams 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, as well as the local management teams that directly manage and operate our learning centers at the various locations throughout China. For example, Mr. Xin Jin, our co-founder and chief executive officer, and Ms. Christine Lu-Wong, our chief financial officer since November 2012, are key to our business. If one or more members of our senior management team or a substantial number of the members of our local management teams are unable or unwilling to continue in their present positions, we may not be able to replace them easily, if at all.

In 2011, 2012 and 2013, the attrition rates of our senior management team were 17%, 13% and 3%, respectively, and the attrition rates of our local management team were 20%, 14% and 14%, respectively, over the same period. In addition, although the employment agreement we enter into with each of our employees contains confidentiality and non-competition provisions and we pay the required compensation to resigned senior management team members in consideration for the non-competition provisions, if any resigned member of our senior management team or any resigned key member of our local management teams breaches such obligations and joins a competitor or forms a competing company, we may lose students, instructors, key professionals and staff members. Competition for experienced management personnel in the private education sector is intense, and the pool of qualified candidates is very limited. We may not be able to retain the services of our senior management team or key members of our local management teams, or attract and retain high-quality senior management team or key members of local management teams in the future, which could have a material adverse effect on our business and results of operations.

***If we are not able to continually enhance our services and adapt them to rapid pedagogical innovations and evolving student needs and preferences, we may lose market share, and our business could be adversely affected.***

Our services and customer satisfaction are vital to the success of our business. The market for such services is characterized by rapid pedagogical innovations and evolving user preferences. We must quickly identify areas for improvement and enhance our services to adapt to any pedagogical innovation, changes in curriculum and evolving student needs and preferences. However, we may not be able to continue to enhance our service offerings or adapt them to such innovation or changes in a timely and cost-effective manner or at all. If improvements to our services are delayed or are not aligned with market expectations, needs or preferences, we may lose market share, and our business could be materially and adversely affected.

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

Our future success depends in part on our ability to develop new services. The planned timing or introduction of new services 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. Moreover, we cannot assure you that any of our new services will achieve widespread market acceptance or generate incremental revenue. If our efforts to develop, market and sell new services to the market are not successful, our financial position, results of operations and cash flows could be materially and adversely affected.

***Failure to adequately and promptly respond to changes in curriculum, testing materials and standards or the current assessment and testing systems and admission standards in China could cause our services and products to be less attractive to our students.***

There have been continuous changes in the focus of the subjects and questions tested in high school and college entrance exams in China and the format of the tests and the manner in which the tests are administered. These changes require us to continually update and enhance our curriculum, test preparation materials and 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 Chinese Ministry of Education, or the MOE, has been discussing reforms of the curriculum of primary and secondary schools. Therefore, school curriculum will likely undergo changes, and our tutoring programs and materials will need to be adapted for such changes. Failure to respond in a timely manner to such changes will adversely impact the marketability of our services.





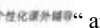

A substantial number of our students enroll in our tutoring programs to achieve better exam performance in school and in entrance exams. However, educational institutions and government authorities in China have initiated discussions and conducted some early experiments in China on school admissions. Generally, these discussions and experiments exhibit a trend of basing admissions decisions less on entrance exam scores and more on a combination of other factors, such as past academic record, extracurricular activities and comprehensive aptitude evaluations. There have been certain changes in some geographic areas in the way the high school entrance exam is administered. In 2013, 90 universities and colleges were allowed to recruit up to 5% of their students through independently administered tests according to a notice promulgated by the MOE, although students admitted in this manner still need to meet certain thresholds in the national college entrance exam. It has been reported that the number of such universities and colleges will further increase. If the use of admissions tests in China declines or falls out of favor with educational institutions and government authorities and if we fail to respond to these changes, the demand for our tutoring services may deteriorate, and our business will be materially and adversely affected.

***If we fail to maintain an effective system of internal control over financial reporting, we may be unable to accurately report our financial results or prevent fraud, and investor confidence in our company and the market price of our ADSs may be adversely affected.***

As a public company in the United States, we are subject to the Sarbanes-Oxley Act of 2002, or the SOX. As required by Section 404 of the SOX and related rules as promulgated by the Securities and Exchange Commission, or the SEC, we are required to include a report of management on the effectiveness of our internal control over financial reporting in our annual report. Under such rules, our independent registered public accounting firm is required to attest to the effectiveness of our internal controls over financial reporting. Our management conducted an evaluation of the effectiveness of our internal control over financial reporting and concluded that our internal control over financial reporting was effective as of December 31, 2013, and our independent registered public accounting firm also attested to the effectiveness of our internal control over financial reporting. However, we cannot assure you that we will maintain effective internal control over financial reporting on an ongoing basis. As effective internal control over financial reporting is necessary for us to produce reliable financial reports, any failure to maintain effective internal control over financial reporting could result in the loss of investor confidence in the reliability of our financial statements, which in turn could negatively impact the trading price of our ADSs. Furthermore, we may need to incur additional costs and use additional management and other resources in an effort to comply with Section 404 of the SOX and other requirements going forward.



***We may not be able to adequately protect our intellectual property, and our current or future competitors may independently develop intellectual property similar to ours, 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 secret laws and confidentiality agreements with our employees and others to protect our intellectual property rights. Our PRC subsidiary, Xuecheng Century (Beijing) Information Technology Co., Ltd., or Xuecheng Century, has registered various trademarks and logos, including “”, “”, “Xueda,” “”, “”, “”, and “”, with the Trademark Office of the State Administration for Industry and Commerce in China, or the SAIC. In addition, Xuecheng Century has submitted applications in several batches to the Trademark Office of SAIC for the registration of other trademarks and logos, including “prime learning,” for our small-group tutoring programs and other trademarks and logos which we believe are material for our operations. Normally it takes two to three years to obtain the registration after application. We expect the registration of these trademarks and logos to be completed during the period from 2014 to 2015 depending on the time each application was submitted. As our business grows and branding strategy develops, we may apply for the registration of additional trademarks and logos. Furthermore, Xuecheng Century has registered utility model and design patents with PRC Intellectual Property Bureau for certain teaching utilities it designed and developed, such as various kinds of multi-functional teaching desks.

Our main websites are [www.21edu.com](http://www.21edu.com) and [www.xueda.com](http://www.xueda.com). We have also registered certain other domain names, including [ejiajiao.com](http://ejiajiao.com), [exueda.com](http://exueda.com) and [xue.com](http://xue.com). In addition, we have successfully registered copyrights with respect to certain of our internally developed software and our course materials that we believe are material to our business operations, including our proprietary personalized teaching system, educational resource integration system, personalized performance testing system, enterprise resource planning system, or ERP system, office administration system and course materials for the subjects of English, Mathematics and Chinese.

Despite all our efforts to register our trademarks, logos, software and course materials, we may not be able to sufficiently protect all our data and course materials. To date, we are not aware of any unauthorized use of or infringement upon our intellectual property. 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. Given the relative unpredictability of China’s legal system and potential difficulties in enforcing a court judgment in China, we may be unable to halt the unauthorized use of our intellectual property through litigation. Failure to adequately protect our intellectual property could materially adversely affect our competitive position and our ability to attract students, which could in turn have a material adverse effect on our financial condition and results of operations.

***We may be exposed to infringement claims by third parties, which claims could cause us to pay significant damage awards or settlement payments.***

Third parties may initiate litigation against us alleging infringement upon their intellectual property rights. For example, our service professionals may use third-party copyrighted materials without proper authorization in providing tutoring services. We may incur liabilities for unauthorized use of third-party copyrighted materials, such as photos, videos or student-generated content, posted on our websites or used in our marketing materials. In the event we are required to pay significant damage awards or settlement payments, our results of operations and financial condition may be materially and adversely affected. To date, no material infringement claims have been brought against us. However, in the event that we are prevented from using certain intellectual property rights and fail to develop or license alternative intellectual property rights on a timely basis, our business could be harmed. In addition, even if we are able to license the infringed 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 the information technology infrastructure underlying our personalized service delivery model, is critical to the attractiveness of our tutoring programs and management of our business operations. In order to achieve our strategic objectives and remain competitive, we must continue to develop and enhance our technology. These efforts may require us to acquire additional equipment and software and 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.

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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, which 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 retain 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, 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;
- disruption or failure in the national backbone network;
- damage from fire, flood, power loss and telecommunications failures; and
- any infection by or spread of computer virus.

To date, we have not encountered any material unexpected network interruptions, security breaches, computer virus attacks or system failures. However, 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 decrease in the number of students using our services. In addition, we may be subject to 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 cause intentional malfunctions or loss or corruption of data, software, hardware or other computer equipment. 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 strain the capacity of our existing computer systems, which could lead to slower response times or system failures. This result would cause a disruption or suspension in our internal management or our online presence and programs, which would harm 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 our systems cannot handle higher volumes of traffic in the future.

All of our servers and routers, including backup servers, are currently hosted by us within China. We do not currently maintain any backup servers outside of China. To improve performance and prevent 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.

***Any significant interruption in the operations of our data storage center could cause a loss of data and adversely affect our ability to manage our network and technological infrastructure.***

We host most of our data relating to our services, learning centers and operations in our data storage center in Beijing and have contracted with an outside provider for data backup services. We have not experienced any significant interruption. However, our current data backup arrangements may not be adequate to prevent an interruption or loss of our operational data due to natural disasters, fire, power interruption, act of terrorism or other unanticipated catastrophic events. Any significant interruptions or loss of data as a result of these events or our failure to successfully expand or upgrade our systems could reduce our ability manage our network and technological infrastructure and have an adverse impact on our business operations.

***Any significant interruption in the operations of our call center could adversely affect our ability to respond to potential customers' inquiries and other service requests in a timely manner.***

We have a call center in Beijing which responds to inquiries from potential customers and provides customer service to our existing customers. We have not experienced any significant interruption in the operations of our call center. We do not currently have a risk mitigation plan for our call center to prevent an interruption of its operation due to natural disasters, accidents or other events. Any significant interruptions as a result of these events or our failure to successfully expand or upgrade our systems or manage the necessary expansions or upgrades in the call center could reduce our ability to respond to customer inquiries or service requests, which could in turn result in the loss of potential customers and damage our reputation.



***We do not have any liability or business disruption insurance, and liability claims against us such as those due to injuries suffered by our students or other people at our facilities could adversely affect our reputation and our financial results.***

We could be held liable for accidents that occur at our learning centers or otherwise arise out of our operations. In the event of personal injuries, fires or other accidents suffered by students or other people, we could face claims alleging that we were negligent, provided inadequate supervision or otherwise liable for the injuries. The business insurance industry in China is still at an early stage of development, and insurance companies in China offer limited business insurance products. We currently do not have any liability insurance or business disruption insurance. A successful liability claim against us due to injuries suffered by our students or other people at our facilities could adversely affect our reputation and our financial results. Even if unsuccessful, such a claim could cause unfavorable publicity and require substantial cost to defend and divert the time and attention of our management.

***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.***

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 generally based on the fair value of equity awards on the date of the grant, with compensation expense recognized over the period in which the recipient is required to provide service in exchange for the equity award. The expenses associated with share-based compensation may reduce the attractiveness of issuing share options, restricted shares or other stock-based awards under our 2009 share incentive plan. However, if we do not grant share options, restricted shares or other stock-based awards, or reduce the number of share options, restricted shares or other stock-based awards we grant, we may not be able to attract and retain key personnel. If we grant more share options, restricted shares or other stock-based awards to attract and retain key personnel, the expenses associated with share-based compensation may adversely affect our net income.

***The learning centers of some of our VIE's subsidiaries and schools may be deemed by government authorities to operate beyond their authorized business scope or without proper registration, which could expose us to certain risks.***

Based on the advice of our PRC counsel, Commerce & Finance Law Offices, we understand that under the framework and general principles of the *Education Law of the PRC*, which became effective on September 1, 1995 and was amended on August 27, 2009, the *Law for Promoting Private Education*, which became effective on September 1, 2003, and the *Implementation Rules for the Law for Promoting Private Education*, or the PE Implementation Rules, which became effective on April 1, 2004, the operation of after-school tutoring business is not in violation of PRC laws and regulations. Under the relevant PRC laws, regulations and administrative requirements, to provide tutoring services, a company may, in the capacity of a school sponsor, obtain a school permit from the education authorities above county level to establish a private tutoring school under Article 17 of the *Law for Promoting Private Education* as the first step. Such school can then establish and operate learning centers to provide tutoring services. It normally takes four to 12 months to obtain a school permit. In addition, all learning centers of a private school are required to be registered with the local educational authorities. Alternatively, a company may obtain approval from the industry and commerce administration authorities above county level to include the relevant services in the authorized scope of business as specified in its business licenses under Article 3 of the *Regulations on Administration of Enterprise Business Scope Registration*. A company with “education services” or “tutoring services” included in its approved scope of business can directly establish and operate learning centers to provide tutoring services.

However, many local government authorities have different views and understandings of the relevant rules and regulations and have adopted different practices in granting school permits or issuing licenses for businesses that provide tutoring services. When we applied for school permits or registration of learning centers, the local education authorities in many cities in China have either informed us that no school permits will be issued to new private schools in their jurisdictions or do not permit learning centers established by private schools to be registered if such learning centers are not located in the same district as the private schools. In addition, the industry and commerce administration authorities in certain areas have adopted regional regulations of not allowing “education services” or “tutoring services” to be included in the business scope of any company. These regional policies and practices adopted by local education authorities and industry and commerce administration authorities that vary from one geographic area to another in China have created significant obstacles for us to comply with all applicable rules and regulations for all of our local operations.

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Our VIE uses both ways discussed above to establish learning centers to provide tutoring services. As of December 31, 2013, we operated a total of 408 learning centers, 265 of which were established and operated by our VIE's 111 schools and 143 of which were established and operated by our VIE's subsidiaries. 261 of these 408 learning centers had been either established and operated by private schools with the prerequisite permits or by the subsidiaries of our VIE with "tutoring services" included in their approved business scope, and are therefore in full compliance under relevant laws and regulations. Among these 408 learning centers, 64 were established and operated by our VIE's subsidiaries that had included, among others, "education information" or "education technology related consultation," rather than "education services" or "tutoring services," in their respective approved business scope. The relevant PRC laws, regulations and administrative requirements do not clearly provide whether such companies also need to specifically include "tutoring services" in their authorized scope of business in order to operate private learning centers. We cannot assure you that these of our VIE's subsidiaries will not be deemed to have exceeded their authorized scope of business. These 64 learning centers contributed a total of 15.6% of our revenue for 2013. In addition, 83 of our 408 learning centers were either established by our VIE's subsidiaries that do not have any education related services in their approved scope of business, or were established by some of our VIE's schools but were not properly registered as required. These 83 learning centers contributed a total of 10.1% of our revenue for 2013.

As compared with the 146 learning centers with non-compliance issues among all the 383 learning centers as of December 31, 2012, we have, through our consistent efforts, improved the compliance status of such learning centers as evidenced by the fact that we only have 147 learning centers with non-compliance issues among all the 408 learning centers as of December 31, 2013.

For the current 147 learning centers discussed above, we have taken, or are in the process of taking the measures including but not limited to the establishment of new schools to take over the operations of the affected learning centers from the relevant VIE's subsidiaries or the transfer of their operations from the VIE's subsidiaries to some of our VIE's existing schools.

Despite our improved compliance and continuing efforts discussed above, we are uncertain of the time it may take to fully address the potential or existing compliance issues of all our learning centers, if at all.

Our VIE's subsidiaries engaging in services exceeding the authorized business scope stated in their business licenses may be ordered to complete the registration for change of business scope within a given period, failing which each company is subject to a one-time fine of RMB10,000 to RMB100,000. Under the PRC *Administrative Penalties Law*, which became effective on October 1, 1996 and was amended on August 27, 2009, these fines would not be assessed multiple times against the same entity for the same non-compliant act. In addition, under the PRC *Regulations on Company Registration*, which became effective on July 1, 1994 and was amended on December 18, 2005, and other relevant regulations, if a company conducts its business beyond its authorized business scope and in violation of other relevant regulations, it may be ordered to cease its operation. To date, none of our existing learning centers have been imposed any administrative penalties including fines.

As we continue to expand our tutoring network, the new learning centers we establish will be engaging in substantially identical business operations as those of our existing learning centers. As a result, our new learning centers will be subject to the same risks as our existing learning centers with respect to their operations outside their respective authorized scope of business.

***Rules and regulations issued by certain government authorities may restrict or prohibit after-school tutoring services. Similar or more stringent rules or regulations that limit our ability to offer our services may be introduced in the future and materially and adversely affect our business, results of operations and financial condition.***

Certain local government authorities had in the past issued notices or rules which prohibit private schools from offering after-school tutoring services by themselves or through cooperation with public schools. However, local government practices are inconsistent among the cities where we operate in implementing and enforcing such notices or rules. We have obtained the required education permits or business licenses for our tutoring services in most of these cities. None of our local operations has been subject to any penalties or other regulatory actions for violation of such notices or rules. In July 2010, the MOE issued the *National Guidance on Mid- to Long-term Education Reform and Development*, or the National Education Guidance, which expressly requires, among others, governments at various levels to subject private after-school tutoring service providers to appropriate regulation. We believe that the National Education Guidance reflects the latest developments of the PRC central government's policy, which supports an appropriately regulated after-school tutoring sector rather than prohibits the after-school tutoring business. Based on the above reasons, we do not believe that these prohibitive local notices and rules will likely have any material effect on our business operations or expansion. However, if the local government authorities in any of the relevant cities start strictly enforcing the existing prohibitive notices or rules, or if future government rules and regulations entirely prohibit us from offering after-school tutoring services or impose more stringent limitations on the type or range of after-school tutoring services that we may offer, our business, results of operations and financial condition will be materially and adversely affected.

***The discontinuation of any of the preferential tax treatments currently available to us in the PRC or imposition of any additional PRC taxes on us could adversely affect our financial condition and results of operations.***

China passed the *Enterprise Income Tax Law*, or the EIT Law, and the *Regulation on the Implementation of the Enterprise Income Tax Law* of the PRC, or the EIT Implementation Rules, both of which became effective on January 1, 2008. The EIT Law significantly curtails tax incentives previously granted to foreign-invested enterprises in China. The EIT Law (i) reduces the statutory rate of the enterprise income tax from 33% to 25%, (ii) permits companies established before March 16, 2007 to continue to enjoy their existing tax incentives, adjusted by certain transitional phase-out rules promulgated by the State Council on December 26, 2007, and (iii) introduces new tax incentives, subject to various qualification criteria.

Under PRC laws and regulations, an enterprise that qualifies as a software enterprise may enjoy preferential tax benefits. Xuecheng Century was certified as a software enterprise in April 2010 and as a result is eligible for a two-year exemption of income tax from the first year it generates taxable income, followed by a 12.5% income tax rate for another three years. Such preferential tax treatment must be filed with tax authorities and software enterprises are subject to annual assessment. Enterprises which have not passed the annual assessment are not entitled to the above preferential treatments. If Xuecheng Century fails to maintain the status of a software enterprise, it will not be able 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, Xuecheng Century would be subject to the standard enterprise income tax rate, which currently is 25%. Loss of this preferential tax treatment could have a material adverse effect on our financial condition and results of operations.

***Our business and results of operations may be adversely affected by a severe and prolonged global economic downturn and the corresponding slowdown of the Chinese economy.***

Recent global market and economic conditions have been unprecedented and challenging with recession in most major economies persisting in 2009 and significant market volatility since then. Continued concerns about the systemic impact of a potentially long-term and widespread recession, energy costs, geopolitical issues and the availability and cost of credit have contributed to increased market volatility and diminished expectations for economic growth around the world. The difficult economic outlook has negatively affected business and consumer confidence and contributed to unprecedented volatility levels. The Chinese economy also faces challenges. The stimulus plans and other measures implemented by the Chinese government may not work effectively or quickly enough to maintain economic growth in China or avert a severe economic downturn.

Since we derive all of our revenue from our operations in China, any prolonged slowdown in the Chinese economy may have a negative impact on our business and results of operations. Our revenue depend on our students' spending on tutoring services, which in turn depends on the level of current and expected household disposable income and willingness to spend of the students' families. As there are still substantial uncertainties in the current and future conditions of global and Chinese economies, our potential customers may reduce their spending on tutoring services or seek less expensive alternatives. Moreover, since we require prepayment of course fees, certain potential customers who prefer installment payments due to economic and other concerns may be or may become unwilling or unable to purchase our services. Further disruptions of the financial markets could also significantly restrict our ability to obtain financing in the capital markets or from financial institutions, if and when such financing is needed.

***We generate a substantial portion of our revenue from a small number of cities in China. Any event negatively affecting the private education industry in these cities could have a material adverse effect on our business and results of operations.***

For the fiscal year ended December 31, 2013, we generated approximately 11.0% of our net revenue from learning centers located in Beijing. The next five cities where we derived most revenue, including Xi'an, Shanghai, Guangzhou, Tianjin and Nanjing, collectively contributed approximately 29.4% of our net revenue for 2013. We expect these cities to continue to constitute important sources of our revenue. If any of these cities experiences an event negatively affecting its private education industry, such as a severe economic downturn, a natural disaster or outbreak of contagious disease, or if any of these cities adopts regulations relating to private education that place additional restrictions or burdens on us, our overall business and results of operations may be materially and adversely affected.

***Our business may be, directly or indirectly, affected by misconduct of other educational service providers.***

The tutoring sector in China is rapidly developing, and we, like all other participants in the sector, are still enhancing our brand awareness and building trust with students and their parents, which is critical to our business. Actual or perceived misconduct or bankruptcy of other similar service providers may lead to the distrust of tutoring by students and their parents, and we may suffer from reduced business as a result. Misconduct or bankruptcy of third parties, as well as any allegation or perception of such, is beyond our control, and if any such event occurs, it may have an adverse effect on our business.

***Our new courses and services may compete with our existing course offerings.***

We are constantly developing new courses and services to meet changes in student demands, testing materials, admission standards, market trends and evolving technologies. While some of the courses and services that we develop will expand our current course offerings and increase student enrollment, some may compete with or render obsolete our existing offerings without increasing our overall student enrollment. For example, our small-group tutoring service might attract students away from our one-on-one tutoring services. If we are unable to increase our overall student enrollment and profitability as we expand our course and service offerings, our business and growth may be adversely affected.

**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 the contractual arrangements that establish the structure for our business operations 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, standards for the operations of learning centers and foreign investments in the education industry. The laws and regulations applicable to the education sector are subject to amendments from time to time, and new laws and regulations may be adopted, some of which may negatively affect our business, either retroactively or prospectively.

We are a Cayman Islands company and, as such, we are classified as a foreign enterprise under Chinese laws, and our PRC subsidiary, Xuecheng Century, is a foreign-invested enterprise. PRC laws and regulations do not expressly impose limitations or restrictions on foreign investment in the tutoring service sector in China. However, many local government authorities have different views and understandings of the relevant rules and regulations and have adopted different practices in granting licenses and permits for entities (particularly, foreign-invested entities) providing tutoring services. As a result, we conduct our tutoring business in China primarily through a series of contractual arrangements between Xuecheng Century, and its affiliated entities and persons in China such as our VIE, Xueda Information, and its shareholders. Our VIE and its subsidiaries and schools are the entities that hold certain licenses and permits relating to our tutoring business in China. We have been and expect to continue to be dependent on our VIE and its subsidiaries and schools to operate our business.

In the opinion of our PRC legal counsel, Commerce & Finance Law Offices, (i) the ownership structures of our VIE and its subsidiaries and schools, and our PRC subsidiary, are in compliance with existing PRC laws and regulations; and (ii) the contractual arrangements among our PRC subsidiary, our VIE, and the shareholders of our VIE are valid, binding and enforceable under, and will not result in any violation of, PRC laws or regulations currently in effect.

However, there are substantial uncertainties regarding the interpretation of current and future PRC laws, regulations and rules; accordingly, the PRC regulatory authorities may take a view that is contrary to the above opinion of our PRC legal counsel.

For example, the Ministry of Commerce, or the MOFCOM, promulgated the *Rules of Ministry of Commerce on Implementation of Security Review System of Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* in August 2011, or the MOFCOM Security Review Rules, to implement the *Notice of the General Office of the State Council on Establishing the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* promulgated on February 3, 2011, or Circular No. 6. The MOFCOM Security Review Rules came into effect on September 1, 2011 and replaced the *Interim Provisions of the Ministry of Commerce on Matters Relating to the Implementation of the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors* promulgated by MOFCOM in March 2011. According to these circulars and rules, a security review is required for mergers and acquisitions by foreign investors having “national defense and security” concerns and mergers and acquisitions by which foreign investors may acquire the “*de facto* control” of domestic enterprises having “national security” concerns. In addition, when deciding whether a specific merger or acquisition of a domestic enterprise by foreign investors is subject to the security review, the MOFCOM will look into the substance and actual impact of the transaction. The MOFCOM Security Review Rules further prohibit foreign investors from bypassing the security review requirement by structuring transactions through proxies, trusts, indirect investments, leases, loans, control through contractual arrangements or offshore transactions. There is no explicit provision or official interpretation stating that our tutoring services fall into the scope subject to the security review, and there is no requirement for foreign investors in those mergers and acquisitions transactions already completed prior to the promulgation of Circular No. 6 to submit such transactions to MOFCOM for security review. As we have already obtained the “*de facto* control” over our VIE prior to the effectiveness of these circulars and rules, we do not believe we are required to submit our existing contractual arrangement to the MOFCOM for security review. However, we are advised by our PRC legal counsel that, as these circulars and rules are relatively new and there is a lack of clear statutory interpretation on the implementation of the same, there is no assurance that the MOFCOM will have the same view as we do when applying these national security review-related circulars and rules.

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In addition, various media sources reported in 2011 that the China Securities Regulatory Commission, or the CSRC, has prepared a report for the State Council suggesting regulating the use of the VIE structure, such as ours, in the context of foreign investment in China and overseas listings. However, it is unclear whether the CSRC has officially submitted such a report, what specific content such report contains and whether and when any further action will be taken by the State Council, the CSRC, the MOFCOM or any other PRC government authority regarding the use of the VIE structure.

Accordingly, we cannot assure you that we will not be found in violation of any current or future PRC laws and regulations. If our ownership structure and contractual arrangements are found to be in violation of any existing or future PRC laws or regulations, including the MOFCOM Security Review Rules and any future regulations regarding the use of the VIE structure promulgated by any PRC government authority, or we fail to obtain or maintain any of the required licenses or permits, the relevant PRC regulatory authorities including the MOE and the MOFCOM, which regulate the education industry and foreign investment in China, respectively, would have broad discretion in dealing with such violations, including:

- revoking the business and operating licenses of our PRC subsidiary and affiliated entities;
- discontinuing or restricting the operations of any related party transactions among our PRC subsidiary and affiliated entities;
- imposing fines or other requirements with which we or our PRC subsidiary and affiliated entities may not be able to comply;
- requiring us or our PRC subsidiary and affiliated entities to restructure or unwind the relevant ownership structure or operations; or
- restricting or prohibiting our use of the proceeds from our initial public offering to finance our business and operations in China.

The imposition of any of these penalties could materially and adversely affect our ability to conduct our business and our results of operations. If any of these penalties results in our inability (i) to direct the activities of Xueda Information and its subsidiaries and schools that most significantly impact their economic performance, and/or (ii) to receive the economic benefits from Xueda Information and its subsidiaries and schools, we may no longer be able to consolidate Xueda Information and its subsidiaries and schools in our consolidated financial statements in accordance with U.S. GAAP.

***We rely on contractual arrangements with our VIE and its shareholders for substantially all of our China operations, which may not be as effective as direct ownership in providing operational control.***

We have relied and expect to continue to rely on contractual arrangements with our VIE and its shareholders to operate our education business. For a description of these contractual arrangements, see “Item 4. Information on the Company — C. Organizational Structure.” These contractual arrangements may not be as effective as direct ownership in providing us with control over our VIE and its subsidiaries and schools. If we had direct ownership of our VIE and its subsidiaries and schools, we would be able to exercise our rights as a shareholder to effect changes in the board of directors or executive council of our VIE and its subsidiaries and schools, which could then effect changes, subject to any applicable fiduciary duties, at the management level.

***We may have to incur significant cost to enforce, or may not be able to effectively enforce, the contractual arrangements with our VIE and its shareholders in the event of a breach or non-compliance by our VIE or its shareholders.***

If our VIE or any of its shareholders fails to perform its, his or her respective obligations under the contractual arrangements with our VIE and its shareholders, we may have to incur substantial costs and expend significant resources to enforce such arrangements. We may also rely on legal remedies under PRC laws, including seeking specific performance or injunctive relief and claiming damages, but these remedies may not be effective. For example, provided that the then-applicable laws permit, if the shareholders of our VIE were to refuse to transfer their equity interest in the VIE 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, these contractual arrangements, including the Amended and Restated Exclusive Technology Consulting and Management Service Agreement, or the Exclusive Service Agreement, the Amended and Restated Pledge Agreement, or the Pledge Agreement, the Amended and Restated Exclusive Purchase Right Contract, or the Exclusive Purchase Right Contract, and the related Powers of Attorney, are governed by PRC law, and all but the Powers of Attorney provide for the resolution of disputes through arbitration before the China International Economic and Trade Arbitration Center, or CIETAC, in Beijing. Accordingly, these contracts would be interpreted in accordance with PRC law and any disputes arising from these arrangements would be resolved through arbitration before CIETAC or, in the case of disputes arising from the Powers of Attorney, through litigation in the PRC, in each case in accordance with PRC legal procedures. Furthermore, although CIETAC may award the same type of relief to the prevailing party in an arbitration proceeding as that granted by a court in a civil action, CIETAC does not have the authority to enforce arbitral awards. In the event that we prevail in an arbitration proceeding before CIETAC, we may nevertheless have to apply to a PRC court for the enforcement of the arbitral award relating to the contractual arrangements. The legal environment in the PRC may not be as developed as in some other jurisdictions, such as the United States. See “— Risk Factors Relating to Doing Business in China — The PRC legal system embodies uncertainties which could limit the legal protections available to you and us.” As a result, although the enforceability of the contractual arrangements is not affected, it might be less certain as to how these contractual arrangements would be enforced. In the event that we are unable to enforce these contractual arrangements to the fullest extent, we may not be able to exert effective control over our affiliated entities, and our ability to conduct our business would be materially and adversely affected.

***Certain shareholders of our VIE may have potential conflicts of interest with us, which may harm our business and financial condition.***

Currently, certain shareholders of our VIE, namely Xin Jin, Rubin Li, Jinbo Yao, Qiang Deng, Yafei Wang, Chaoming Chai and CDH Xueda Limited (through Junhong Piao, its designated holder) are also beneficial owners of our company. Certain shareholders of our VIE are also directors (namely, Xin Jin, Rubin Li, Jinbo Yao and Yafei Wang) or have appointed a director of our company (namely, CDH Xueda Limited) or are employees of our company (namely, Qiang Deng). In addition, Rubin Li, Xin Jin, Jinbo Yao, Yafei Wang and Junhong Piao are directors of our VIE, Xin Jin is the chairman of our VIE's board of directors and Rubin Li is the general manager of our VIE. Conflicts of interest between (i) their duties to our company and shareholders (including the holders of our ADSs who are not otherwise affiliated with our VIE) and (ii) those as the major shareholders, directors and officers of our VIE 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 and our shareholders, or that conflicts of interest will be resolved in our favor.

For example, these parties with dual roles may decide to transfer significant business or assets of the VIE to other legal entities they own or control but are not controlled by us, or opportunities may arise in the future for these individuals to sell the VIE or its significant business or assets to third parties at a premium. Under either circumstance, the consideration of such a transfer or sale would be paid to the shareholders of the VIE (including these parties), not to our company or our other shareholders, yet our company would lose all or a significant portion of our underlying business, which would be materially detrimental to our other shareholders. Decisions relating to the VIE like this would be controlled by our company under our contractual arrangements with the VIE and its shareholders. Two of our company's independent directors, Mr. Sean Shao and Mr. Cheung Kin Au-Yueng, do not own any equity interest or hold any office in the VIE and therefore are also independent of the parties with dual roles as discussed above. In situations such as the above discussed potential transactions, these two independent directors are the only fiduciaries our unaffiliated shareholders may rely on to safeguard their interests. However, due to the majority seats on our board of directors held by the parties with dual roles and their control over our company, there would be no effective way for the two independent directors or the other shareholders of our company to prevent the parties with dual roles from making decisions on behalf our company that only favor themselves as shareholders of the VIE.



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In addition, these individuals may breach or cause our VIE or its subsidiaries or schools to breach or refuse to renew existing contractual arrangements that allow us to effectively control our VIE and its subsidiaries and schools, and to receive economic benefits from them. Currently, we do not have existing arrangements to address such potential conflicts of interest between these individuals and our company. We rely on those of our VIE's shareholders who are also our directors to abide by the laws of the Cayman Islands and China, both of which provide that a company's directors and officers owe a fiduciary duty to such company, which requires them to act in good faith and in the best interests of our 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 VIE, 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.

***The contractual arrangements our PRC subsidiary has entered into with our VIE and its 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 VIE and its 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 PRC tax authorities. We could face material adverse tax consequences if the PRC tax authorities determine that the contractual arrangements between Xuecheng Century and our VIE and its shareholders do not represent an arm's-length price and adjust our VIE's 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 VIE and its subsidiaries and schools. In addition, the PRC tax authorities may require us to disgorge our prior tax benefits or pay additional taxes for prior tax years and impose late payment fees and other penalties on our VIE and its subsidiaries and schools for underpayment of prior taxes. Similar contractual arrangements have been used by many other overseas-listed China-based companies and, to our knowledge, the PRC tax authorities have not imposed any material penalties on those companies to date. However, we cannot assure you that such penalties will not be imposed on us or our VIE and its subsidiaries and schools in the future, nor are we able to assess with any degree of certainty the likelihood or remoteness of regulatory authorities implementing the relevant laws and regulations in a way that would materially and adversely affect our business. Our consolidated net income may be materially and adversely affected if our VIE's and its subsidiaries' and schools' tax liabilities increase or if our VIE or its subsidiaries or schools are found to be subject to additional taxes, late payment fees or other penalties.

***Our VIE and its subsidiaries may be subject to significant limitations on their ability to distribute economic returns of their private tutoring schools or otherwise be materially and adversely affected by changes in PRC laws and regulations.***

The principal laws and regulations governing private education in China are *The Law for Promoting Private Education* and the PE Implementation Rules. Under these laws and regulations, a private school may elect to be a school that does not distribute reasonable returns or a school that distributes reasonable returns. As of December 31, 2013, 106 of our VIE's 111 schools were registered as private schools that distribute reasonable returns, and the remaining five of our schools were registered as schools that do not distribute 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 distributes reasonable returns, this amount may not be less than 25% of the annual net income of the schools, while in the case of a private school that does not distribute reasonable returns, this amount should be equivalent to no less than 25% of the annual increase of net assets of the school as determined in accordance with generally accepted accounting principles in the PRC.

All of our VIE's private tutoring schools are controlled by our VIE or its respective subsidiaries or schools and are currently in compliance with the existing laws and regulations regarding the allocation of their development funds. A private school that distributes reasonable returns must publicly disclose such election and additional information required under the regulations. A private school should 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 its sponsors as reasonable returns. However, none of the current PRC laws and regulations provides a formula or guidelines for determining "reasonable returns." None of the current PRC laws and regulations sets forth sponsors' economic rights in schools that do not distribute reasonable returns. These requirements and the lack of clear guidance may limit the ability of the private tutoring schools established and operated by the VIE and its subsidiaries to distribute their economic 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:

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- impose significant limitations on the ability of our private tutoring schools to operate their business, charge course fees or make payments to related parties; or
- specify the formula for calculating reasonable returns.

We cannot predict the timing and effects or assess the likelihood or remoteness, of any such amendments or new laws and regulations. Changes in PRC laws and regulations governing private education or otherwise affecting our VIE's and its subsidiaries' operations of private tutoring schools could have a material adverse effect on our business, prospects and results of operations.

***If our VIE or any of its subsidiaries or schools becomes the subject of a bankruptcy or liquidation proceeding, or if we fail to prevent our VIE or any of its subsidiaries or schools from entering into third-party liens or assigning other rights to third parties without our permission and approval, we may lose the ability to use and enjoy assets held by our VIE or any of its subsidiaries or schools, which could reduce the size of our operations and materially and adversely affect our business, ability to generate revenue and the market price of our ADSs.***

We currently conduct our operations in China through contractual arrangements with our VIE and its shareholders. As part of these arrangements, our VIE and its subsidiaries and schools hold some of the assets that are important to the operation of our business. If any of these entities goes bankrupt and all or part of their assets become subject to liens or rights of third-party creditors, we may be unable to continue some or all of our business activities, which could materially and adversely affect our business, financial condition and results of operations. If our VIE or any of its subsidiaries or schools undergoes a voluntary or involuntary liquidation proceeding, its shareholders or unrelated third-party creditors may claim rights to some or all of these assets, which would hinder our ability to operate our business and could materially and adversely affect our business, our ability to generate revenue and the market price of our ADSs.

Under Section 2.1 of the Exclusive Purchase Right Contract, our VIE undertakes that, before the proposed purchase, (i) it will prudentially and effectively conduct its business, deal with its affairs and maintain its existence in accordance with good financial and commercial standards and practices; and (ii) it will at all times conduct all of its operations during the ordinary course of business so as to maintain the value of its assets and will refrain from any action or inaction sufficient to affect its operating conditions or asset value. Under Section 2.2 of the Exclusive Purchase Right Contract, each of our VIE's shareholders further undertakes that, other than the pledge created on the equity interest of our VIE under the Pledge Agreement, (i) without prior written consent of Xuecheng Century, such shareholder will not sell, transfer, mortgage or otherwise dispose of any legal or beneficial interest in our VIE or allow the creation of any encumbrance thereon; and (ii) such shareholder will cause the shareholders' meeting of our VIE not to approve, in the absence of Xuecheng Century's prior written consent, sale, transfer, mortgage or other disposal of any legal or beneficial interest in our VIE or creation of any encumbrance thereon. Under the above undertakings, our VIE and its shareholders cannot enter into any third-party lien on, or assign to third parties other rights relating to, any physical assets our VIE directly owns if such lien or assignment would cause them to breach these undertakings. In addition, as our VIE holds all the equity interest in its subsidiaries or all the sponsorship interest in its schools, and as such, has full control over its subsidiaries' and schools' decisions to make any such lien or assignment under both the PRC law and internal decision-making policies of the VIE's subsidiaries and schools, the above undertakings also prevent the VIE from permitting any of its subsidiaries or schools to enter into such lien or make such assignment if it would cause our VIE to breach these undertakings.

In addition, under Section 7.1.10 of the Pledge Agreement, it would constitute an event of default if the property of the pledgors (i.e., the shareholders of the VIE) is adversely affected, causing the pledgee (i.e., Xuecheng Century) to believe that the ability of the pledgors to perform under the Pledge Agreement has been adversely affected. As the executive director of each of our VIE's subsidiaries and the majority of the decision-making body of most of the schools are also the pledgors under the Pledge Agreement, the above event of default provision also prevents such director or member of the decision-making body from making any decision on behalf any of our VIE's subsidiaries or schools if such decision would adversely affect the pledgor's property.

Furthermore, pursuant to paragraph 2 of the Powers of Attorney executed by each of our VIE's shareholders, each such shareholder authorizes Xuecheng Century to exclusively exercise his or her shareholder's right in our VIE, including but not limited to the power to vote at shareholders' meetings and execute shareholders' resolutions, and the power to nominate and appoint board members and senior management of our VIE, thus granting Xuecheng Century effective control over the decision making process of our VIE. Therefore, in addition to the several contractual provisions that prevent our VIE and its shareholders to enter into liens or transfer other rights as discussed above, Xuecheng Century also directly controls the VIE and its subsidiaries and schools through its control over our VIE's board and management under the Powers of Attorney.



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Last but not least, the internal policies adopted by Xuecheng Century for the VIE and its subsidiaries and schools also provide that any disposition of properties or assets by any of our VIE's subsidiaries or schools, including then entry into any third-party liens or assigning other rights to third parties, requires either Xuecheng Century's approval if the amount is over RMB5,000, or approval by the Xuecheng Century-appointed manager at such subsidiary or school, if the amount is under RMB5,000.

Based on the foregoing, we believe that we have effectively eliminated the possibility that our VIE or its subsidiaries or schools would enter into third-party liens or assign other rights to third parties without our permission and approval. However, if due to any reason we fail to prevent our VIE or its subsidiaries or schools from entering into liens or assigning other rights relating to any assets or business that are material to our company as a whole, we may lose the control of those affected assets or business, which could reduce the size of our operations and materially and adversely affect our business, ability to generate revenue and the market price of our ADSs.

***If we lose control over controlling non-tangible assets of our VIE and its subsidiaries and schools, including their chops, seals and business licenses or non-corporate entity registration certificates, our business and operations could be materially and adversely affected.***

Our VIE and its subsidiaries and schools have certain controlling non-tangible assets, such as chops, seals and their business licenses (for our VIE and its subsidiaries) or non-corporate entity registration certificates (for our VIE's private schools), for entering into contracts, dealing with banks or taking certain official actions including registering any change to the composition of the board or senior management team with relevant PRC authorities.

Under the PRC law, legal documents for various transactions, including government filings, agreements and contracts, are executed using chops or seals of the signing entity or with the signature of the legal representative whose designation is registered and filed with the relevant industry and commerce administration authorities. We generally execute legal documents by affixing chops or seals, rather than having the designated legal representatives sign the documents. Our VIE and its subsidiaries and schools have four types of chops and seals: the entity chop, the contract chop, the legal representative seal and the finance chop. The entity chop is generally used for documents to be submitted to government agencies, such as applications for changing business scope, directors or entity name, and for other legal letters. The contract chop is used for executing leases and commercial contracts, including service contracts with our students. The legal representative seal is normally used for issuing checks. The finance chop is generally used for making and collecting payments, including, but not limited to issuing invoices. Our VIE's and its subsidiaries' business licenses and the schools' non-corporate entity registration certificates are required to be presented for (i) annual inspection by the industry and commerce administration authorities or the civil affairs administration authorities, as applicable, in order to maintain valid existence; (ii) application, registration and modification of other licenses and qualifications; (iii) opening bank accounts and (iv) purchase of real properties or motor vehicles.

Under the internal policies adopted by us for our VIE and its subsidiaries and schools, the use of chops and seals must be approved by specifically designated managers before the custodians of these assets may affix the chops and seals to legal documents for approved uses. Xuecheng Century's prior written approval is required before the business licenses of our VIE and its subsidiaries or the schools' non-corporate entity registration certificates can be taken offsite.

Similar to the other aspects of our VIE's business operations, we control our VIE's and its subsidiaries' and schools' controlling non-tangible assets through our control over our VIE and its subsidiaries and schools, which in turn is based on our contractual arrangements with our VIE and its shareholders, rather than through direct ownership. As one of the measures to maintain the control over local subsidiaries and schools of our VIE, we appoint the legal representatives and the senior management team for each of our VIE's subsidiaries and schools. To maintain the control over their chops and seals and business licenses or non-corporate entity registration certificates, we also appoint the designated manager, normally one of the top-ranking managers in each of our VIE's subsidiaries and schools, who approves the use of these assets, and appoints custodians of these assets. To maintain their physical security, we require all chops, seals, business licenses and non-corporate entity registration certificates to be stored in secured locations accessible only to the designated custodians.

Although we believe we have maintained effective control over our controlling nontangible assets through the procedure and measures described above, these procedures and measures may not be sufficient to prevent all instances of abuse or unauthorized actions. If we fail to maintain effective control over these controlling non-tangible assets for any reason, or if any of these controlling non-tangible assets were misused or misappropriated by the authorized users, whether as a result of labor disputes or other disputes, such persons' malfeasance or any other reason, these controlling non-tangible assets may be used to (i) transfer assets of the affected entities without our approval, (ii) bind the affected entities with obligations against our interest which we would be forced to fulfill, (iii) obstruct the affected entities' cash flow and financing, or (iv) prevent the affected entities from completing the required annual inspection or other administrative procedures, which will result in the loss of such entities' valid existence. If the legal representative or person designated with the responsibility to control the non-tangible assets of a local entity of our VIE misuses or misappropriates the controlling intangible assets in any manner, or otherwise acts against our instruction in an effort to seize control over such entity, we would need to have a shareholder or board resolution to designate a new legal representative and to take legal actions to seek the return of these assets, apply to the relevant authorities for new chops, seals, business licenses or non-corporate entity registration certificates, or otherwise seek legal remedies against such person, which may be time-consuming and may not be sufficient or timely to remedy all the harms caused. During any period in which we lose effective control of the activities as a result of such loss of control over or misuse or misappropriation of these non-tangible assets, the business activities of the affected entity may be severely disrupted and we could lose the economic benefits of that aspect of our VIE's business, which may materially and adversely affect our overall business operations, our financial position and results of operations.

### **Risk Factors Relating to Doing Business in China**

***Our operations may be adversely affected by changes in China's political, economic and social conditions.***

Currently, all of our operations are conducted in China, and all of our revenue is 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 political, economic and social 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, foreign exchange control and allocation of resources. 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 exercise 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. Our results of operations and financial condition may be materially and adversely affected by a tightening or other changes of these policies and controls.

China's social and political conditions are also not 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 material adverse effects on our business and results of operations.

In addition, while the Chinese economy has experienced significant growth in the past several decades, growth has been uneven, both geographically and among various sectors of the economy. Demand for our services 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, which in turn could reduce our revenue.

***There are significant uncertainties under the EIT Law relating to the withholding tax liabilities of our PRC subsidiary, and dividends payable by our PRC subsidiary to our Hong Kong subsidiary may not qualify to enjoy the treaty benefits.***

Under the EIT Law and the EIT Implementation Rules, the profits of a foreign invested enterprise generated in 2008 and onwards which are distributed to its immediate holding company outside the PRC will be subject to a withholding tax rate of 10%. Pursuant to a special arrangement between Hong Kong and the PRC, such rate may be lowered to 5% if a Hong Kong resident enterprise owns over 25% of a PRC company. Our PRC subsidiary is currently wholly-owned by our Hong Kong subsidiary, China Xueda Corporation Limited (Hong Kong), or Xueda Hong Kong. However, the 5% withholding tax rate does not automatically apply and approvals from competent local tax authorities are required before an enterprise can enjoy any benefits under the relevant taxation treaties. Moreover, according to the *Notice of the State Administration of Taxation on Issues Regarding the Administration of the Dividend Provision in Tax Treaties* promulgated on February 20, 2009, for a tax treaty to be applicable, certain requirements must be satisfied, including: (1) the taxpayer must be the beneficial owner of the relevant dividends; (2) for corporate recipients to enjoy the favorable tax treatment under the tax treaty as direct owners of a PRC enterprise, such corporate recipients must satisfy the direct ownership thresholds at all times during the 12 consecutive months preceding the receipt of the dividends. On August 24, 2009, the State Administration of Taxation, or the SAT, issued the *Administrative Measures for Non-resident Enterprises to Enjoy Treatments under Tax Treaties (For Trial Implementation)*, which became effective on October 1, 2009, requiring non-resident enterprises to obtain an approval from the competent tax authority in order to enjoy the treatments under tax treaties. Further, the State Administration of Taxation promulgated the *Notice on How to Understand and Recognize the "Beneficial Owner" in Tax Treaties* on October 27, 2009, which limits the "beneficial owner" to individuals, enterprises or other organizations normally engaged in substantive operations, and set forth certain adverse factors on the recognition of such "Beneficial Owner." Our PRC subsidiary has not yet applied for such approvals because it has not declared or paid dividends, and does not intend to declare or pay dividends. Our PRC subsidiary will apply for such approvals when it intends to declare and pay dividends. There is no assurance that the PRC tax authorities will approve the 5% withholding tax rate on dividends received by our Hong Kong subsidiary from our PRC subsidiary.

***Under the EIT Law, we may be classified as a “resident enterprise” of China. Such classification would likely result in unfavorable tax consequences to us and our non-PRC shareholders.***

Under the EIT Law and the EIT Implementation Rules, an enterprise established outside of the PRC with “*de facto* management bodies” within the PRC is considered a resident enterprise and is subject to enterprise income tax at the rate of 25% on its global income. The EIT Implementation Rules define the term “*de facto* management bodies” as “establishments that carry out substantial and overall management and control over the manufacturing and business operations, personnel, accounting, properties, etc. of an enterprise.” The SAT issued the Notice Regarding the Determination of Chinese-Controlled Offshore Incorporated Enterprises as PRC Tax Resident Enterprises on the Basis of De Facto Management Bodies, or Circular 82, on April 22, 2009. Circular 82 provides certain specific criteria for determining whether the “*de facto* management body” of a Chinese-controlled offshore incorporated enterprise is located in China. Following Circular 82, on August 3, 2011, the SAT issued *Administrative Measures on Income Taxes of Resident Enterprises Incorporated outside Mainland China and Are Controlled by Chinese Enterprises (Trial Implementation)*, or Resident Enterprise Administrative Measures, which was effective as of September 1, 2011. This Resident Enterprise Administrative Measures provides clarification of resident status determination, post-determination administration, as well as competent tax authorities. However, Circular 82 and Resident Enterprise Administrative Measures apply only to offshore enterprises controlled by PRC enterprises, not those invested in by PRC individuals, like our company. Currently there are no further detailed rules or precedents applicable to us governing the procedures and specific criteria for determining “*de facto* management body” for the company of our type. We do not believe we are a resident enterprise defined and regulated by the aforesaid regulations as none of our shareholders is a PRC company or PRC corporate group. However, it remains unclear how PRC tax authorities will determine the tax residency status of companies like us. If the PRC authorities were to subsequently determine, or any future regulation provides, that we should be treated as a PRC resident enterprise, we would be subject to a 25% enterprise income tax on our global income, which will significantly increase our tax burden and could materially and adversely affect our financial condition and results of operations.

Therefore, if we are regarded as a PRC resident enterprise, the amount of dividends, if any, we may pay to our shareholders and ADS holders may be decreased, although dividends distributed from our PRC subsidiary, Xuecheng Century, to us could be exempted from the PRC dividend withholding tax, since such income is exempted under the EIT Law and the EIT Implementation Rules to a PRC resident recipient. If the PRC tax authorities determine we are a PRC resident enterprise for EIT purposes, we may be required to withhold a PRC withholding tax of 10% from dividends we pay to our non-PRC enterprise shareholders and a 20% withholding tax from dividends we pay to our non-PRC individual shareholders, including the holders of our ADSs. In addition, non-PRC shareholders may be subject to PRC tax on gains realized on the sale or other disposition of ADSs or ordinary shares, if such income is treated as sourced from within the PRC. It is unclear whether our non-PRC shareholders would be able to claim the benefits of any tax treaties between their tax residence and the PRC in the event that we are considered as a PRC resident enterprise.

***The enforcement of the Labor Contract Law and other labor-related regulations in China may adversely affect our business and our results of operations.***

On June 29, 2007, the National People’s Congress of China enacted the *Labor Contract Law*, which became effective on January 1, 2008. Compared to the laws that it replaced, the *Labor Contract Law* establishes more restrictions and increases costs for employers to dismiss employees under certain circumstances, including specific provisions related to fixed-term employment contracts, non-fixed-term employment contracts, task-based employment, contract-based employment, probation, consultation with the labor union and employee representative’s council, employment without a contract, dismissal of employees, compensation upon termination and for overtime work and collective bargaining. According to the *Labor Contract Law*, unless otherwise provided by law, an employer is obliged to sign a labor contract with a non-fixed term with an employee if the employer continues to hire the employee after the expiration of two consecutive fixed-term labor contracts or if the employee has worked for the employer for ten consecutive years. Severance pay is required if a labor contract expires without renewal because the employer refuses to renew the labor contract or provides less favorable terms for renewal. In addition, under the *Regulations on Paid Annual Leave for Employees*, which became effective on January 1, 2008, employees who have served more than one year for an employer are entitled to a paid vacation ranging from five to 15 days, depending on the number of years the employee has worked for the employer. Employees who waive such vacation time at the request of employers are entitled to compensation equal to three times their regular daily salary for each waived vacation day. As a result of these new measures designed to enhance labor protection, our labor costs have increased and could further increase, which may adversely affect our business and our results of operations. In addition, the PRC government in the future may enact further labor-related legislation that increases our labor costs and restricts our operations.

***The PRC legal system embodies uncertainties which could limit the legal protections available to you and us.***

As our main operating entities and a substantial majority of our assets are located in China, PRC laws and the PRC legal system in general may have a significant impact on our business operations. Although China's legal system has developed over the last several decades, PRC laws, regulations and legal requirements remain underdeveloped relative to those of the United States. Moreover, PRC laws and regulations change frequently and their interpretation and enforcement involve uncertainties. For example, the interpretation or enforcement of PRC laws and regulations may be subject to government rules or policies, some of which are not published on a timely basis or at all. In addition, the relative inexperience of China's judiciary in some cases may add to the uncertainty as to the outcome of litigation. These uncertainties could limit our ability to enforce our legal or contractual rights or otherwise adversely affect our business and operations. Furthermore, due to the existence of unpublished rules and policies, and since newly issued PRC laws and regulations may have a retroactive effect, we may not be aware of our violation of certain PRC laws, regulations, policies or rules until after the fact.

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

Because currently all of our revenue is denominated in RMB, restrictions on currency exchange may limit our ability to use net income generated in RMB to fund any business activities we may have outside China in the future. The principal regulation governing foreign currency exchange in China is the *Foreign Exchange Administration Rules* (1996), as amended. Under these rules, RMB is freely convertible for current account items, such as trade and service-related foreign exchange transactions and dividend distributions, but not for direct investment, or loan or investment in securities outside China unless the prior approval of China's State Administration of Foreign Exchange, or 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 subsidiary's capital account, including principal payments in respect of foreign currency-denominated obligations, remain subject to significant foreign exchange controls and the approval of SAFE. These limitations could affect our ability to obtain foreign exchange for capital expenditures.

Our VIE and its subsidiaries and schools generate revenue in RMB. We receive substantially all of our VIE's and its subsidiaries' and schools' economic benefits in the form of service fees they pay to our PRC subsidiary in RMB pursuant to a series of contractual arrangements. As we do not own any equity interest in our VIE, its subsidiaries or schools, we do not receive any dividends or other direct distributions from them. If and when our PRC subsidiary declares and pays dividends to Xueda Hong Kong, by virtue of its status as a wholly foreign-owned enterprise, it will be permitted under applicable regulations to convert the RMB dividends into a foreign currency and remit to its shareholder outside of the PRC. See "Item 4. Information on the Company — B. Business Overview — Regulation — Regulations on Dividend Distribution" for additional requirements for distribution of dividends by a wholly foreign-owned enterprise. In addition, in the event that our PRC subsidiary liquidates, proceeds from the liquidation may be converted into foreign currency and distributed outside of China to Xueda Hong Kong. The shareholders of our VIE have undertaken to distribute the proceeds from liquidation of our VIE, if any, to our PRC subsidiary. Our PRC subsidiary then may distribute such proceeds to us after converting them into foreign currency and remit them outside of China in the form of dividends or other distributions to us. Once remitted outside of the PRC, dividends and proceeds from liquidation paid to us will not be subject to further restrictions under PRC regulations with respect to its further transfer or use.

Other than the above distributions by and through our PRC subsidiary expressly permitted to be made without the necessity to obtain further approvals, any direct conversion of the RMB-denominated revenue generated by our VIE and its subsidiaries and schools for direct investment, loan or investment in securities outside China will be subject to the limitations discussed above. We do not anticipate the need to directly convert other RMB-denominated revenue for these purposes as we expect to rely on such permitted dividend distributions by and through our PRC subsidiary to meet our future cash needs. However, we cannot assure you that such a need will not arise in the future as a result of unexpected future circumstances. To the extent we need to convert and use any RMB-denominated revenue generated by our VIE and its subsidiaries and schools not paid to our PRC subsidiary, or by our PRC subsidiary not declared and paid as dividends, the limitations discussed above will restrict the convertibility of, and our ability to directly receive and use such revenue. As a result, our business and financial condition may be adversely affected.

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.

***Public shareholders of China-based, U.S.-listed companies and other market participants may no longer have access to a wide array of corporate records of such listed companies' PRC entities filed with industry and commerce administration authorities in China. Loss of, or limit in, the access to such information may adversely affect overall investor confidence in China-based, U.S.-listed companies' reported results or other disclosures, including those of our company, and may cause the trading price of our ADSs to decline .***

All PRC corporate entities, including Xuecheng Century, our VIE and its subsidiaries, maintain corporate records and filings with industry and commerce administration authorities in the cities where such PRC entities are registered. Information contained in such corporate records and filings includes, among others, business address, registered capital, business scope, articles of association, equity interest holders, legal representative, changes to the above information, annual financial reports, matters relating to termination or dissolution, information relating to penalties imposed, and annual inspection records.

There have been regulations promulgated by various government authorities in China that govern the public access to corporate records and filings. Under the *Measures for Accessing Corporate Records and Filings* promulgated on December 16, 1996 by the SAIC, or the SAIC measures, a wide range of basic corporate records, except for such restricted information as business results and financial reports, can be inspected by the public without restrictions. Under these SAIC measures, a company's restricted information can only be inspected by authorized government officers and officials from judicial authorities or lawyers involved in pending litigation relating to such company and with court-issued proof of such litigation. In practice, local industry and commerce administration authorities in different cities have adopted various regional regulations which impose more stringent restrictions than the SAIC measures by expanding the scope of restricted information that the public cannot freely access. Many local industry and commerce administration authorities only allow unrestricted public access to such basic corporate information as name, legal representative, registered capital and business scope of a company. Under these local regulations, access to the other corporate records and filings (many of which are not restricted information under the SAIC measures) is only granted to authorized government officers and officials from judicial authorities or lawyers involved in pending litigation relating to such company and with court-issued proof of such litigation.

However, neither the SAIC nor the local industry and commerce administration authorities were reported to have strictly implemented the restrictions under either the SAIC measures or the various regional regulations before early 2012. As a result, before early 2012, the public, including public shareholders of China-based, U.S.-listed companies and other market participants, such as lawyers and research firms, were reported to be able to access all or most corporate records and filings of these listed companies' PRC entities maintained with the industry and commerce administration authorities. Such records and filings were reported to have formed important components of research on certain China-based, U.S.-listed companies, which researches claimed to have uncovered wrongdoings and fraud committed by these companies on the basis of (i) the disparities found between the listed companies' reported results and their PRC entities' financial reports filed with industry and commerce administration authorities, and (ii) information on material changes of the PRC entities, such as transfers of equity interests of significant PRC subsidiaries, that were filed with the industry and commerce administration authorities but not properly disclosed by such listed companies as required under the U.S. securities law and the SEC's disclosure requirements. The significant disparities found between (i) certain China-based, U.S.-listed companies' reported results and other disclosure and (ii) their PRC entities' financial reports and other records filed with industry and commerce administration authorities were also reported to have formed the basis of several class actions against such listed companies in the United States.

It was reported that, since the first half of 2012, local industry and commerce administration authorities in a number of cities in China had started strictly implementing the above restrictions and had significantly curtailed public access to corporate records and filings. There have also been reports saying that only the limited scope of basic corporate records and filings are still accessible by the public, and much of the previously publically accessible information, such as financial reports and changes to equity interests, now can only be accessed by the parties specified in, and in strict accordance with the restrictions under, the various regional regulations. Such reported limitation on the public access to corporate records and filings and the resulting concerns over the loss of, or limit in, an otherwise available source of information to verify and evaluate the soundness of China-based, U.S.-listed companies' business operations in China may have a significant adverse effect on the overall investor confidence in China-based, U.S.-listed companies' reported results or other disclosures, including those of our company, and may cause the trading price of our ADSs to decline.



***A failure by our shareholders or beneficial owners who are PRC citizens or residents to comply with certain PRC foreign exchange regulations could restrict our ability to distribute profits, restrict our overseas and cross -border investment activities or subject us to liability under PRC laws, which could adversely affect our business and financial condition.***

In October 2005, SAFE issued the *Notice on Relevant Issues Concerning Foreign Exchange Administration for PRC Residents Engaging in Financing and Roundtrip Investments via Overseas Special Purpose Vehicles*, or SAFE Circular 75. SAFE Circular 75 states that PRC citizens or residents must register with the relevant local SAFE branch or central SAFE in connection with their establishment or control of an offshore entity established for the purpose of overseas equity financing involving a roundtrip investment whereby the offshore entity acquires or controls onshore assets or equity interests held by the PRC citizens or residents. In addition, such PRC citizens or residents must amend their SAFE registrations when the offshore special purpose company undergoes material changes relating to increases or decreases in investment amount, transfers or exchanges of shares, mergers or divisions, long-term equity or debt investments, external guarantees or other material events. Although our beneficial owners who are known to us to be PRC residents have registered with SAFE and have completed their current amendment registrations under SAFE Circular 75, if any of them or our future beneficial owners who are PRC residents fails to complete any applicable registration or amend previously filed registrations as required under SAFE Circular 75, our onshore subsidiary, Xuecheng Century, is required to report the non-compliance to the local branch of SAFE. Failure or inability to comply with the registration procedures may restrict our cross-border investment activities and result in restrictions on the relevant onshore entity, including restrictions on the payment of dividends and other distributions to its offshore parent or affiliate and restrictions on the capital inflow from the offshore entity, and may also subject relevant PRC residents to penalties under the PRC foreign exchange administration regulations.

***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 revised policy, which was suspended in 2008 due to the worldwide financial crisis, the RMB is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. In June 2010, the PRC government announced its intentions to again allow the RMB to fluctuate within the 2005 parameters. Since July 21, 2005, there has been a more than 20% appreciation of the RMB against the U.S. dollar. 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. Consequently, appreciation or depreciation in the value of the RMB relative to the U.S. dollar would affect our financial results reported in U.S. dollar terms without giving effect to any underlying change in our business or results of operations.

***A failure to comply with PRC regulations regarding the registration of shares and share options held by our employees who are PRC citizens may subject such employees or us to fines and legal or administrative sanctions.***

Pursuant to the *Implementation Rules of the Administrative Measures on Individual Foreign Exchange*, or the Individual Foreign Exchange Rules promulgated by SAFE on January 5, 2007, and the *Circular on Relevant Issues Relating to the Administration of Foreign Exchange Regarding PRC Individuals' Participation in Employee Share Incentive Plans and Employee Stock Option Plans of Overseas Listed Companies* issued by SAFE on February 15, 2012 and effective as of the same date, which replaced the *Operating Procedures on Administration of Foreign Exchange regarding PRC Individuals' Participation in Employee Share Incentive Plans and Employee Stock Option Plans of Overseas Listed Companies* issued by SAFE on March 28, 2007, PRC citizens who are granted shares or share options by an overseas-listed company according to its employee share option or share incentive plan are required, through the PRC subsidiary of such overseas-listed company or other qualified PRC agents, to file with the applicable local branch of SAFE and complete certain other procedures related to the share option or other share incentive plan. In addition, the overseas-listed company or its PRC subsidiary or other qualified PRC agent is required to appoint an asset manager or administrator and a custodian bank, and open special foreign currency accounts to handle transactions relating to the share option or other share incentive plan. Under the *Foreign Exchange Administration Rules* (1996), as amended, the foreign exchange proceeds of domestic entities and individuals can be remitted into China or deposited abroad, subject to the terms and conditions to be issued by SAFE. However, the implementation rules in respect of depositing the foreign exchange proceeds abroad have not been issued by SAFE. Currently, the foreign exchange proceeds from the sales of stock or dividends distributed by the overseas-listed company can be converted into RMB or transferred to such individuals' foreign exchange savings account after the proceeds have been remitted back to the special foreign currency account opened at a PRC domestic bank. In the case of an exercise of the options on a non-cash basis, PRC citizens are required to remit the proceeds to special foreign currency accounts. We and our PRC citizen employees are subject to these rules. If we or our PRC option holders fail to comply with these rules, we or our PRC option holders may be subject to fines and legal or administrative sanctions. See "Item 4. Information on the Company — B. Business Overview — Regulation — Regulations on Foreign Exchange."

***PRC regulation of loans and direct investment by offshore holding companies to PRC entities may delay or prevent us from using the proceeds we received from our initial public offering, which could materially and adversely affect our liquidity and our ability to fund and expand our business.***

In utilizing the proceeds we received from our initial public offering, as an offshore holding company of our PRC subsidiary, we may make loans to our PRC subsidiary, or we may make additional capital contributions to our PRC subsidiary. Any loans to our PRC subsidiary or consolidated PRC affiliated entities are subject to PRC regulations and approvals or registration. For example, loans by us to our PRC subsidiary to finance its activities cannot exceed statutory limits and must be registered with SAFE or its local counterparts. In addition, loans by us to our VIE and its subsidiaries and schools, which are domestic PRC entities, must be approved by the relevant government authorities and must also be registered with SAFE or its local counterparts. Any capital contribution to our PRC subsidiary and VIE are subject to the approvals of MOFCOM or its local counterparts. 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 PRC subsidiary. If we fail to receive such registrations or approvals, our ability to use the proceeds of our initial public offering and to capitalize our PRC operations may be negatively affected, which could adversely affect our liquidity and our ability to fund and expand our business.

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 and converted from foreign currencies may be used only for purposes within the business scope stated on the business license of the company and, unless otherwise permitted by other regulations, may not be used for equity investments within the PRC. SAFE also strengthened its oversight of the flow and use of the capital of a foreign-invested company settled in RMB and 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 the substantial fines set forth in the *Foreign Exchange Administration Rules*. In addition, SAFE promulgated a circular on November 19, 2010, or Circular 59, which requires the authenticity of settlement of net proceeds from offshore offerings to be closely examined and the net proceeds to be settled in the manner described in the offering documents. Furthermore, SAFE issued an internal guideline to its local counterparts, referred to as Circular 45, in November 2011. Circular 45 has never been formally announced by SAFE to the public or posted on SAFE's website. Based on the version of Circular 45 made publicly available by certain local governmental authorities on their websites, we understand that Circular 45 requires SAFE's local counterparts to strengthen the control imposed by Circulars 142 and 59 over the conversion of a foreign-invested company's capital contributed in foreign currency into RMB. Circular 45 stipulates that a foreign-invested company's RMB funds, if converted from such company's capital contributed in foreign currency, may not be used by such company to (i) extend loans (in the form of entrusted loans), (ii) repay borrowings between enterprises, or (iii) repay bank loans it has obtained and on-lent to third parties.

As stated on its business license, Xuecheng Century's scope of business is the research, development and design of computer software and hardware, network technologies, communication technologies and products; the provision of technology transfer, technology services, technology consulting, training in computer technologies related to these products; as well as the sale of proprietary products. We currently expect that a substantial portion of the proceeds of our initial public offering we received will be used by Xuecheng Century to meet its working capital needs and for general corporate expenses in connection with its business expansion through providing better support to the operations of our VIE and its subsidiaries and schools. Specifically, Xuecheng Century will make substantial investments to improve our operating platform and technology infrastructure. Xuecheng Century will also make significant investments in developing and offering new services and products to our students through our VIE and its subsidiaries and schools to enhance our tutoring services. In addition, Xuecheng Century will enhance its services to our VIE and subsidiaries and schools through establishing operations in selected locations where our VIE and its subsidiaries and schools operate their business and providing other services as needed. These uses of proceeds are for purposes within the business scope of Xuecheng Century. Meanwhile, we believe that our VIE will have adequate cash from its operations to support its own operation and expansion. Therefore, we do not expect to transfer any significant amount of the proceeds of our initial public offering we received to our VIE, its subsidiaries or schools in any manner that would result in any violation of Circulars 142, 59 or 45. However, to the extent we need to transfer any proceeds of our initial public offering to our VIE, its subsidiaries or schools through our PRC subsidiary, Circulars 142, 59 and 45 may significantly limit our ability to do so. In such an event, we may have to obtain external financing for our VIE, its subsidiaries or schools, or use our PRC subsidiary's cash generated from its operations (primarily the service fees to be paid by our VIE under the Exclusive Service Agreement) to extend entrusted loans to our VIE, its subsidiaries and schools. We cannot assure you that we will have timely access to such funding on reasonable terms, in a sufficient amount, or at all.

***Restrictions under PRC law on our PRC subsidiary's ability to make dividend payments and other distributions could materially and adversely affect our ability to make investments or acquisitions, pay dividends or other distributions to you, and otherwise fund and conduct our other businesses.***

We are a holding company incorporated in the Cayman Islands. In order for us to distribute any dividends to our shareholders and ADS holders or meet other potential future cash needs, we will rely on dividend payment and other distributions made by our PRC subsidiary. As of the date of this annual report, our PRC subsidiary has not paid any dividend to us. Although we believe our PRC subsidiary has the ability to pay dividends to us upon our request, we do not expect to request dividends from our PRC subsidiary in the near future because we plan to have our PRC subsidiary retain all its accumulated profits for its own business operation and expansion. Furthermore, PRC regulations restrict the ability of our PRC subsidiary to make dividends and other payments to its offshore parent company. PRC legal restrictions permit payments of dividends by our PRC subsidiary only out of its accumulated after-tax profits, if any, determined in accordance with PRC accounting standards and regulations. Our PRC subsidiary is also required under PRC laws and regulations to allocate at least 10% of its annual after-tax profits determined in accordance with PRC accounting standards to a statutory reserve fund until the cumulative amount in such fund reaches 50% of the company's registered capital. From early 2013, our PRC subsidiary has increased its registered capital from \$420,000 to \$30.0 million (approximately 20.1% of the increased registered capital has been contributed and the remaining portion is required to be contributed no later than May 2014 under the relevant PRC laws and regulations) and is in compliance with all applicable PRC laws and regulations relating to the allocation of statutory funds. Allocations to this statutory fund can only be used for specific purposes and are not transferable to us in the form of loans, advances or dividends. As of December 31, 2013, our PRC subsidiary had allocated \$ 0.6 million to these statutory reserve funds. As a result, not all funds of our PRC subsidiary are available to us and our access to such funds is restricted. These and any other limitations on the ability of our PRC subsidiary to transfer funds to us could materially and adversely limit our ability to grow, make investments or acquisitions that could be beneficial to our business, pay dividends and otherwise fund and conduct our business.

***We may have been required to obtain prior approval of the CSRC of the listing and trading of our ADSs on the NYSE.***

On August 8, 2006, six PRC regulatory authorities, including MOFCOM, the State Assets Supervision and Administration Commission, the State Administration of Taxation, the SAIC, the CSRC and the SAFE, jointly issued the *Regulations on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, or the M&A Regulations, which became effective on September 8, 2006 and were amended on June 22, 2009. These regulations, among other things, include provisions that purport to require that an offshore special purpose vehicle, or SPV, formed for listing purposes and controlled directly or indirectly by PRC companies or individuals, must obtain the approval of the CSRC prior to the listing and trading of such SPV's securities on an overseas stock exchange, including the case where the SPV acquires shares of or equity interests in the PRC companies in exchange for the shares of offshore companies. The application of the M&A Regulations is subject to interpretation. On December 14, 2006, the CSRC published procedures regarding its approval of overseas listings by SPVs. The CSRC approval procedures require the filing of a number of documents with the CSRC, and it would take several months to complete the approval process.

Under the M&A Regulations, "mergers and acquisitions of domestic enterprises by foreign investors" refers to a situation where a foreign investor purchases by agreement the equity interests of a domestic non-foreign-invested enterprise, or a domestic company, or subscribes to the increased capital of a domestic company, and thus changes the domestic company into a foreign-invested enterprise; where a foreign investor establishes a foreign-funded enterprise, through which the foreign investor purchases by agreement the assets of a domestic enterprise and operates its assets; or where a foreign investor purchases by agreement the assets of a domestic enterprise, and then invests such assets to establish a foreign-funded enterprise to operate the assets.

While the exact perimeters of the M&A Regulations remain unclear, based on the advice of our PRC counsel, because the M&A Regulations only apply to transactions involving "mergers and acquisitions of domestic enterprises by foreign investors," we believe that (i) the M&A Regulations were not applicable to our corporate restructuring in 2009 and 2010 and (ii) CSRC approval was not required in the context of our initial public offering in 2010, for the following reasons: (a) we established our PRC subsidiary by means of direct investment, not through merger or acquisition of any PRC domestic companies and (b) we control our VIE and its subsidiaries through contractual arrangements, not through "mergers and acquisitions of domestic enterprises by foreign investors" as defined under the M&A Regulations. However, we cannot assure you that the relevant PRC government agencies, including the CSRC, would reach the same conclusion as our PRC counsel did. If the CSRC or another PRC regulatory body subsequently determines that we should have obtained the CSRC's approval for our initial public offering either by interpretation, clarification or amendment of the M&A Regulations or by any new rules, regulations or directives or in any other ways promulgated after the issuance date of the legal opinion of our PRC counsel, we may face sanctions by the CSRC or other PRC regulatory agencies. In such an event, these regulatory agencies may impose fines and penalties on our operations in the PRC, limit our operations in the PRC, delay or restrict the repatriation of the proceeds from our initial public offering into the PRC or take other actions that could have a material adverse effect on our business, financial condition, results of operations, reputation and prospects, as well as the trading price of our ADSs.



***The M&A Regulations established 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 Regulations 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 MOFCOM 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 Regulations in such transactions could be time-consuming, and any required approval processes, including obtaining approval from the MOFCOM, may delay or inhibit our ability to complete such transactions, which could adversely affect our ability to grow our business through acquisitions in China.

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

Our independent registered public accounting firm that issues the audit reports included in our annual reports filed with the SEC, as auditors of companies that are traded publicly in the United States and a firm registered with the U.S. Public Company Accounting Oversight Board (United States), or the “PCAOB”, is required by the laws of the United States to undergo regular inspections by the PCAOB to assess its compliance with the laws of the United States and professional standards. Because our auditors are located in the Peoples’ 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.

Inspections of other firms that the PCAOB has conducted outside China have identified deficiencies in those firms’ audit procedures and quality control procedures, which may be addressed as part of the inspection process to improve future audit quality. This lack of PCAOB inspections in China prevents the PCAOB from regularly evaluating our auditor’s audits and its quality control procedures. 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.

***Proceedings instituted by the SEC against five PRC-based accounting firms, including our independent registered public accounting firm, could result in financial statements being determined to not be in compliance with the requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act.***

In late 2012, the SEC commenced administrative proceedings under Rule 102(e) of its Rules of Practice and also under the Sarbanes-Oxley Act of 2002 against the Chinese affiliates of the “big four” accounting firms, (including our auditors) and also against Dahua (the former BDO affiliate in China). The Rule 102(e) proceedings initiated by the SEC relate to these firms’ inability to produce documents, including audit work papers, in response to the request of the SEC pursuant to Section 106 of the Sarbanes-Oxley Act of 2002, as the auditors located in the PRC are not in a position lawfully to produce documents directly to the SEC because of restrictions under PRC law and specific directives issued by the China Securities Regulatory Commission. The issues raised by the proceedings are not specific to our auditors or to us, but affect equally all audit firms based in China and all China-based businesses with securities listed in the United States.

In January 2014, the administrative judge reached an initial decision that the “big four” accounting firms should be barred from practicing before the SEC for six months. However, it is currently impossible to determine the ultimate outcome of this matter as the accounting firms have filed a petition for review of the initial decision and pending that review the effect of the initial decision is suspended. The SEC commissioners will review the initial decision, determine whether there has been any violation and, if so, determine the appropriate remedy to be placed on these audit firms. Once such an order was made, the accounting firms would have a further right to appeal to the US Federal courts, and the effect of the order might be further stayed pending the outcome of that appeal.

Depending upon the final outcome, listed companies in the United States with major PRC operations may find it difficult or impossible to retain auditors in respect of their operations in the PRC, which could result in financial statements being determined to not be in compliance with the requirements of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including possible delisting. Moreover, any negative news about the proceedings against these audit firms may cause investor uncertainty regarding China-based, United States-listed companies and the market price of our ADSs may be adversely affected.

## **Risks Relating to Our ADSs**

### ***The trading price for our ADSs may fluctuate significantly.***

The market price for our ADSs has been and may continue to be subject to wide fluctuations in response to factors such as actual or anticipated fluctuations in our quarterly operating results, changes in financial estimates by securities research analysts, changes in the economic performance or market valuations of other education companies, announcements by us or our competitors of material acquisitions, strategic partnerships, joint ventures or capital commitments, fluctuations of exchange rates between the RMB and the U.S. dollar, intellectual property litigation, announcements of new business initiatives by us or by our competitors, recruitment or departure of key personnel, changes in the estimates of our financial results or changes in the recommendations of any securities analysts electing to follow our securities or the securities of our competitors, changes in the economic or political conditions in China and the impact of global macroeconomic conditions. For example, the global financial crisis and the ensuing economic recessions in many countries have contributed and may continue to contribute to extreme volatility in the global stock markets, such as the large decline in share prices in the United States, China and other jurisdictions in late 2008, early 2009 and the second half of 2011. These broad market fluctuations may also adversely affect the market price of our ADSs.

In addition, the performance and fluctuation of the market prices of other companies with business operations located mainly in China that have listed their securities in the United States may affect the volatility in the price of and trading volumes for our ADSs regardless of our actual operating performance. In recent years, a number of PRC companies have listed their securities, or are in the process of preparing for listing their securities, on the U.S. stock markets. Some of these companies have experienced significant volatility in the prices of their securities, including significant price declines in connection with and following their initial public offerings, due to various reasons, including actual or perceived inadequacy in corporate governance, accounting or business practices or financial reporting. The trading performances of these PRC companies' securities at the time of or after their offerings may affect the overall investor sentiment towards PRC companies listed in the United States and consequently may impact the trading performance of our ADSs, regardless of whether we have engaged in any inappropriate activities. These broad market and industry factors may significantly affect the market price and volatility of our ADSs, regardless of our actual operating performance. Any of these factors may result in large and sudden changes in the trading volume and price for our ADSs.

### ***Future sales or perceived sales of our ADSs or ordinary shares by existing shareholders or option holders could cause our ADSs' price to decline.***

If our existing shareholders sell, indicate an intention to sell, or are perceived to intend to sell, substantial amounts of our ordinary shares in the public market and other legal restrictions on resale lapse, the trading price of our ADSs could decline. As of December 31, 2013, we had 133,610,982 outstanding ordinary shares. Of these shares, only 35,401,906 ordinary shares represented by ADSs were freely tradable without restriction in the public market. The other 98,209,076 outstanding ordinary shares were eligible for sale in the public market, subject to limitations under Rule 144 under the Securities Act. In addition, an additional 4,570,380 ordinary shares subject to outstanding options and the 7,567,784 unvested restricted shares granted under our 2009 share incentive plan will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements and Rules 144 and 701 under the Securities Act. If these additional shares are sold, or if it is perceived that they will be sold in the public market, the trading price of our ADSs could decline.

### ***We may need additional capital, and the sale of additional ADSs or other equity securities would result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations, and the related covenants could restrict our operations and business activities.***

We believe that our current cash and cash equivalents and anticipated cash flow from operations will be sufficient to meet our anticipated cash needs for the near future. We may, however, require additional cash resources due to changed business conditions or other future developments. If our internal resources are insufficient to satisfy our cash requirements, we may seek to sell additional equity or debt securities or obtain a credit facility. The sale of additional equity securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations and may result in operating and financing covenants that would restrict our operations or our ability to pay dividends. Our ability to raise additional funds in the future is subject to a variety of uncertainties, including:

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- investors' perception of, and demand for, securities of educational service providers;
- conditions of the U.S. and other capital markets in which we may seek to raise funds;
- our future results of operations, financial condition and cash flows;
- PRC governmental regulation of foreign investment in education in China;
- economic, political and other conditions in China; and
- PRC governmental policies relating to foreign currency borrowings.

We cannot assure you that, if we need additional cash, financing will be available in amounts or on terms acceptable to us, if at all, especially in the event of a severe and prolonged global economic recession. If we fail to raise additional funds, we may need to reduce our growth to a level that can be supported by our cash flow. Without additional capital, we may not be able to open additional schools and learning centers, acquire necessary technologies, products or business, hire, train and retain teachers and other employees, market our programs, services and products, or respond to competitive pressures or unanticipated capital requirements.

***Many of the corporate governance rules promulgated by the NYSE do not apply to us so long as we qualify as a foreign private issuer, and there may be significant differences between our corporate governance practices and the corporate governance standards applicable to U.S. domestic companies listed on the NYSE.***

As a foreign private issuer, we are permitted to follow corporate governance practices in accordance with Cayman Islands law in lieu of most of the NYSE corporate governance rules in the NYSE Listed Company Manual, or the NYSE Standards. For example, the NYSE Standards require U.S. domestic issuers to have a compensation committee and a nominating/corporate governance committee, each composed entirely of independent directors. We are not subject to these requirements under the Cayman Islands law. Currently, we have a compensation committee composed of one independent director and two non-independent directors. We do not have, nor do we intend to establish, a nominating/corporate governance committee. We believe that the composition of our board and its committees and their respective duties and responsibilities are otherwise generally responsive to the relevant NYSE Standards applicable to U.S. domestic issuers. However, the charters for our audit and compensation committees may not address all aspects of the NYSE Standards applicable to U.S. domestic issuers. For example, the NYSE Standards require compensation committees of U.S. domestic issuers to produce a compensation committee report annually and include such report in their annual proxy statements or annual reports on Form 10-K. We are not subject to this requirement, and we have not addressed this in our compensation committee charter. The NYSE Standards require shareholder approval for certain matters, such as requiring that shareholders must be given the opportunity to vote on all equity compensation plans and material revisions to those plans. We intend to comply with the requirements of Cayman Islands law in determining whether shareholder approval is required.

***We may be classified as a passive foreign investment company, or PFIC, which could result in adverse U.S. tax consequences to U.S. holders.***

Based on the nature of our business and the composition of our income and valuation of our assets, including goodwill, we believe that we were a passive foreign investment company, or PFIC, for 2013 and may be a PFIC in 2014 or the future. If we are a PFIC for any taxable year during which a United States Holder, as defined under "Item 10. Additional Information — E. Taxation— United States Federal Income Taxation," holds our ordinary shares or ADSs, such United States Holder may be subject to increased tax liabilities under United States federal income tax laws and regulations and will be subject to burdensome reporting requirements. The determination of whether or not we are a PFIC is made on an annual basis and will depend on the composition of our income and assets from time to time. Specifically, for any taxable year we will be classified as a PFIC for United States federal income tax purposes if either (i) 75% or more of our gross income in that taxable year is passive income or (ii) the average percentage of our assets (which includes cash) by value (determined on a quarterly average) in that taxable year which produce or are held for the production of passive income is at least 50%. The calculation of the value of our assets will be based, in part, on the quarterly market value of our ADSs, which is subject to change. See "Item 10. Additional Information — E. Taxation — United States Federal Income Taxation — Passive Foreign Investment Company." We cannot assure you that we will not be a PFIC for 2014 or in future taxable year. As the determination of PFIC status is based on an annual determination that cannot be made until the close of a taxable year, our U.S. counsel expresses no opinion with respect to our PFIC status.

***You may not be able to participate in rights offerings and may experience dilution of your holdings in relation to any such offerings.***

We may, from time to time, distribute rights to our shareholders, including rights to acquire securities. Under the deposit agreement, the depositary may not make the rights available to holders of ADSs unless the distribution and sale of rights and the securities to which these rights relate are either exempt from registration under the Securities Act with respect to all holders of ADSs, or are registered under the provisions of the Securities Act. The depositary may, but is not required to, attempt to sell these undistributed rights to third parties and may allow the rights to lapse. We may be unable to establish an exemption from registration under the Securities Act, and we are under no obligation to file a registration statement with respect to these rights or underlying securities or to endeavor to have a registration statement declared effective. Accordingly, holders of ADSs may be unable to participate in our rights offerings and may experience dilution of their holdings as a result.

***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. As a result, 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 revenue and costs and expenses as a percentage of net revenue may be significantly different from our historical or projected rates. Our quarterly and annual net revenue and gross margins may fluctuate due to a number of factors, including:

- expansion and related costs in a given period;
- seasonality associated with the academic calendar with decreased net revenue specifically during Chinese New Year and over the summer;
- our ability to reduce our costs as a percentage of our net revenue;
- our ability to attract and retain qualified service professionals; and
- increased competition.

Our ADSs could be subject to significant price volatility should our earnings fail to meet the expectations of the investment community. Any of these events could cause the price of our ADSs to fall.

***Anti-takeover provisions in our charter documents may discourage a third party from acquiring us, which could limit our shareholders' opportunities to sell their shares at a premium.***

Our third amended and restated memorandum and articles of association include provisions that could limit the ability of others to acquire control of us, modify our structure or cause us to engage in change-of-control transactions. For example, our board of directors will have the authority, without further action by our shareholders, to issue preferred shares in one or more series and to fix the powers and rights of these shares, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, any or all of which may be greater than the rights associated with our ordinary shares. Preferred shares could thus be issued quickly with terms calculated to delay or prevent a change in control or make removal of management more difficult. In addition, if our board of directors issues preferred shares, the market price of our ordinary shares may fall and the voting and other rights of the holders of our ordinary shares may be adversely affected. These provisions could have the effect of depriving our shareholders of an opportunity to sell their shares at a premium over prevailing market prices by discouraging third parties from seeking to obtain control of us in a tender offer or similar transaction.

***We are a Cayman Islands company and, because judicial precedent regarding the rights of shareholders is more limited under Cayman Islands law than under U.S. law, you may have less protection of your shareholder rights than you would under U.S. law.***

Our corporate affairs are governed by our memorandum and articles of association, as amended from time to time, the Cayman Islands Companies Law (as amended) and the common law of the Cayman Islands. The rights of shareholders to take action against the directors, actions by minority shareholders and the fiduciary responsibilities of our directors to us under Cayman Islands law are to a large extent governed by the common law of the Cayman Islands. The common law of the Cayman Islands is derived in part from comparatively limited judicial precedent in the Cayman Islands as well as from English common law, which has persuasive, but not binding, authority on a court in the Cayman Islands. The rights of our shareholders and the fiduciary responsibilities of our directors under Cayman Islands law are not as clearly established as they would be under statutes or judicial precedent in some jurisdictions in the United States. In particular, the Cayman Islands has a less developed body of securities laws than the United States. In addition, some U.S. states, such as Delaware, have more fully developed and judicially interpreted bodies of corporate law than the Cayman Islands.

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The Cayman Islands courts are unlikely:

- to recognize or enforce judgments of U.S. courts obtained against us or our directors or officers predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States; or
- to entertain original actions brought against us or our directors or officers predicated upon the securities laws of the United States or any state in the United States.

There is no statutory recognition in the Cayman Islands of judgments obtained in the United States, although the Cayman Islands will generally recognize as a valid judgment, a final and conclusive judgment *in personam* obtained in the federal or state courts in the United States under which a sum of money is payable (other than a sum of money payable in respect of multiple damages, taxes or other charges of a like nature or in respect of a fine or other penalty) and would give a judgment based thereon provided that (i) such courts had proper jurisdiction over the parties subject to such judgment; (ii) such courts did not contravene the rules of natural justice of the Cayman Islands; (iii) such judgment was not obtained by fraud; (iv) the enforcement of the judgment would not be contrary to the public policy of the Cayman Islands; (v) no new admissible evidence relevant to the action is submitted prior to the rendering of the judgment by the courts of the Cayman Islands; and (vi) there is due compliance with the correct procedures under the laws of the Cayman Islands.

***You will have limited ability to bring an action against us or against our directors and officers, or to enforce a judgment against us or them, because we are incorporated in the Cayman Islands, because we conduct a majority of our operations in China and because the majority of our directors and officers reside outside the United States.***

We are incorporated in the Cayman Islands and conduct our operations primarily in China. A substantial majority of our assets are located outside the United States and most of our directors and officers reside outside the United States. As a result, it may be difficult or impossible for you to bring an action against us or against these individuals in the Cayman Islands or in China in the event that you believe your rights have been infringed under the applicable securities laws or otherwise. Even if you are successful in bringing an action of this kind, the laws of the Cayman Islands and of China may render you unable to enforce a judgment against our assets or the assets of our directors and officers. Unlike many jurisdictions in the United States, Cayman Islands law does not specifically provide for shareholder appraisal rights on a merger or consolidation of a company. This may make it more difficult for you to assess the value of any consideration you may receive in a merger or consolidation or to require that the offeror give you additional consideration if you believe the consideration offered is insufficient.

Shareholders of Cayman Islands exempted companies such as us have no general rights under Cayman Islands law to inspect corporate records and accounts or to obtain copies of lists of shareholders of these companies. Our directors have discretion under our amended and restated articles of association to determine whether or not, and under what conditions, our corporate records may be inspected by our shareholders but are not obliged to make them available to our shareholders. This may make it more difficult for you to obtain the information needed to establish any facts necessary for a shareholder motion or to solicit proxies from other shareholders in connection with a proxy contest.

As a result of all of the above, public shareholders may have more difficulty in protecting their interests in the face of actions taken by management, members of the board of directors or controlling shareholders than they would as public shareholders of a U.S. company.

***Your ability to protect your rights as shareholders through the U.S. federal courts may be limited because we are incorporated under Cayman Islands law.***

Cayman Islands companies may not have standing to initiate a derivative action in a federal court of the United States. As a result, your ability to protect your interests if you are harmed in a manner that would otherwise enable you to sue in a U.S. federal court may be limited to direct shareholder lawsuits.

***The voting rights of holders of ADSs are limited in several significant ways by the terms of the deposit agreement.***

Holders of our ADSs may only exercise their voting rights with respect to the underlying ordinary shares in accordance with the provisions of the deposit agreement. Upon receipt of voting instructions from a holder of ADSs in the manner set forth in the deposit agreement, the depositary will endeavor to vote the underlying ordinary shares in accordance with these instructions. Under our third amended and restated memorandum and articles of association, the minimum notice period required for convening a general meeting is seven days. When a general meeting is convened, you may not receive sufficient notice of a shareholders' meeting to permit you to withdraw your ordinary shares to allow you to cast your vote with respect to any specific matter at the meeting. In addition, the depositary and its agents may not be able to send voting instructions to you or carry out your voting instructions in a timely manner. We will make all reasonable efforts to cause the depositary to extend voting rights to you in a timely manner, but we cannot assure you that you will receive the voting materials in time to ensure that you can instruct the depositary to vote your shares. Furthermore, the depositary and its agents will not be responsible for any failure to carry out any instructions to vote, for the manner in which any vote is cast or for the effect of any such vote. As a result, you may not be able to exercise your right to vote, and you may lack recourse if your ordinary shares are not voted as you requested.

***The depositary of our ADSs will, except in limited circumstances, grant to us a discretionary proxy to vote the ordinary shares underlying your ADSs if you do not instruct the depositary how to vote at shareholders' meetings, which could adversely affect your interests and the ability of our shareholders as a group to influence the management of our company.***

Under the deposit agreement for the ADSs, the depositary will give us a discretionary proxy to vote our ordinary shares underlying your ADSs at shareholders' meetings if you do not instruct the depositary how to vote, unless:

- we have failed to timely provide the depositary with our notice of meeting and related voting materials;
- we have instructed the depositary that we do not wish a discretionary proxy to be given;
- a matter to be voted on at the meeting would have a material adverse impact on shareholders; or
- voting at the meeting is made on a show of hands.

The effect of this discretionary proxy is that you cannot prevent our ordinary shares underlying your ADSs from being voted, absent the situations described above, and it may make it more difficult for holders of ADSs to influence the management of our company. Holders of our ordinary shares are not subject to this discretionary proxy.

***You may not receive distributions on our ordinary shares or any value for them if it is unlawful or impractical for us to make them available to you.***

The depositary of our ADSs has agreed to pay you the cash dividends or other distributions it or the custodian for our ADSs receives on our ordinary shares or other deposited securities after deducting its fees and expenses. You will receive these distributions in proportion to the number of our ordinary shares your ADSs represent. However, the depositary is not responsible if it is unlawful or impractical to make a distribution available to any holders of ADSs. For example, it would be unlawful to make a distribution to a holder of ADSs if it consists of securities that require registration under the Securities Act but that are not properly registered or distributed pursuant to an applicable exemption from registration. The depositary is not responsible for making a distribution available to any holders of ADSs if any government approval or registration is required for such distribution. We have no obligation to take any other action to permit the distribution of our ADSs, ordinary shares, rights or anything else to holders of our ADSs. This means that you may not receive the distributions we make on our ordinary shares or any value for them if it is unlawful or impractical for us to make them available to you. These restrictions may have a material and adverse effect on the value of your ADSs.

***You may be subject to limitations on the transfer of your ADSs.***

Your ADSs, represented by American depositary receipts, are transferable on the books of the depositary. However, the depositary may close its books at any time or from time to time when it deems expedient in connection with the performance of its duties. The depositary may close its books from time to time for a number of reasons, including in connection with corporate events such as a rights offering, during which time the depositary needs to maintain an exact number of ADS holders on its books for a specified period. The depositary may also close its books in emergencies and on weekends and public holidays. The depositary may refuse to deliver, transfer or register transfers of our ADSs generally when our books or the books of the depositary are closed, or at any time if we think or the depositary thinks it is necessary or advisable to do so in connection with the performance of its duty under the deposit agreement, including due to any requirement of law or any government or governmental body or under any provision of the deposit agreement.



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We are a Cayman Islands company and substantially all of our assets are located outside of the United States. Substantially all of our current operations are conducted in the PRC. As a result, it may be difficult for you to effect service of process within the United States upon these persons. It may also be difficult for you to enforce judgments obtained in U.S. courts based on the civil liability provisions of the U.S. federal securities laws against us and our officers and directors, most of whom are not nationals or residents in the United States and the substantial majority of whose assets are located outside of the United States. In addition, there is uncertainty as to whether the courts of the Cayman Islands or the PRC would recognize or enforce judgments of U.S. courts against us or such persons predicated upon the civil liability provisions of the securities laws of the United States or any state. In addition, it is uncertain whether such Cayman Islands or PRC courts would be competent to hear original actions brought in the Cayman Islands or the PRC against us or such persons predicated upon the securities laws of the United States or any state.

### **ITEM 4. INFORMATION ON THE COMPANY**

#### **A. History and Development of the Company**

We commenced our business in September 2001 to initially operate an online tutoring portal as Beijing Wanwei Xinhua Technology Development Co. Ltd. We changed our name to Beijing Xueda Century Education Technology Co. Ltd. in November 2004 and to Xueda Education Technology (Beijing) Co. Ltd., or Xueda Technology, in September 2007. In March 2008, CDH Xueda Education Limited, a company incorporated in Hong Kong, and Beijing Century Hui Ce Investment Consultancy Co., Ltd, a PRC company, subscribed for equity interest in Xueda Technology. As a result, Xueda Technology became a Sino-foreign equity joint venture company.

From 2004 to 2006, we started developing our personalized service model, based on which we delivered personalized tutoring services and established learning centers in Beijing and a number of other pilot cities in China. Building on our success in these pilot cities, from 2007 and 2008, we expanded our tutoring service network to more than 100 learning centers in 28 cities in China. Since 2009, we have devoted significant resources to improving our operating platform and technology infrastructure and developing new services and products while continuing to expand into new geographic locations.

Since its inception, Xueda Technology had been our primary operating entity, through which, along with its branches, we conducted all of our operations in the PRC, until the restructuring described below.

#### *Restructuring*

PRC laws and regulations do not expressly impose limitations or restrictions on foreign investment in the tutoring service sector in China. Under the relevant PRC national laws, regulations and administrative requirements, a company may either (i) in the capacity of a school sponsor, obtain a permit from the relevant education authorities to establish private tutoring schools, and use such schools to establish and operate learning centers to provide tutoring services or (ii) obtain approval from industry and commerce administration authorities to include the relevant services in the authorized scope of business as specified in its business licenses, and directly establish and operate learning centers to provide tutoring services. However, many local government authorities have different views and understandings of the relevant national rules and regulations and have adopted different practices in granting licenses and permits to entities (particularly, foreign-invested entities) providing tutoring services. The local education authorities in many geographic areas have long maintained a local policy of not granting school permits to foreign invested entities. For instance, in response to Xueda Technology's inquiries, the local education authorities in Beijing and Shanghai, two of Xueda Technology's key markets, advised Xueda Technology that such local authorities normally would not issue school permits to private schools to be established by Sino-foreign equity joint venture companies. In addition, the industry and commerce administration authorities in certain areas have adopted regional regulations of not allowing "education services" or "tutoring services" to be included in the business scope of any company. As a result, Xueda Technology, as a Sino-foreign equity joint venture company, was not able to obtain school permits to establish and operate private schools, nor could it obtain approval to include education or tutoring service in the authorized scope of business of its subsidiaries, in all geographic areas where it operated.

As Xueda Technology planned on further expanding its business, it became increasingly uncertain whether Xueda Technology could address the then existing compliance issues or obtain the requisite licenses and permits to provide tutoring services in new geographic areas. In addition, we may decide to expand our business into business areas in which foreign ownership and investment are expressly restricted, such as online education services.

To address the uncertainties in our business expansion and to build a national tutoring service network and to minimize regulatory risks relating to restrictions on foreign ownership and investment in business areas we may expand into in the future, we undertook a restructuring during 2009 and 2010. Under this restructuring, we established Xueda Hong Kong, our Hong Kong holding company, and Xuecheng Century, our PRC subsidiary. Our VIE, Xueda Information, was also established by shareholders of Xueda Technology or their designated parties. We control Xueda Information through a series of contractual arrangements, and provide our tutoring services through Xueda Information, its subsidiaries and schools, all of which are PRC domestic entities.

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### *Xueda Hong Kong*

We hold 100% of the equity interest of Xuecheng Century through our wholly-owned subsidiary, Xueda Hong Kong. Xueda Hong Kong may qualify for the preferential PRC tax treatment for dividend payments from PRC companies to certain shareholders that are Hong Kong resident enterprises. See “Item 5. Operating and Financial Review and Prospects — A. Operating Results — Taxation — Income tax” for information on the preferential PRC tax treatment for certain Hong Kong resident enterprises. In addition, while we do not currently have plans to do so, Xueda Hong Kong would allow us to pursue future business expansion opportunities in Hong Kong.

### *Xuecheng Century*

Xuecheng Century was established on August 17, 2009 with a business term of 20 years from August 17, 2009 to August 16, 2029. Xuecheng Century does not provide any tutoring services or educational services and therefore is not required to have an authorized business scope that covers such services. As stated on its business license, Xuecheng Century’s scope of business is the research, development and design of computer software and hardware, network technologies, communication technologies and products; the provision of technology transfer, technology services, technology consulting, training in computer technologies related to these products; as well as the sale of proprietary products. Xuecheng Century provides a wide range of technology consulting and management services to our VIE and VIE’s subsidiaries and schools within this business scope.

### *Xueda Information*

On July 13, 2009, the shareholders of Xueda Technology, by themselves or through their respective designated parties, established Xueda Information to replace Xueda Technology as our primary operating entity. Starting from November 2009, Xueda Information and its subsidiaries and schools began to assume substantially all of Xueda Technology’s business, assets and personnel.

For the historical periods in which Xueda Technology and its learning centers provided tutoring services, they were reflected in the description of our business and their results of operations and financial position were consolidated in our historical financial statements. The business, assets and personnel of Xueda Technology and the legal entities through which the businesses of its learning centers were conducted have been completely transferred to and assumed by Xueda Information, and the relevant physical facilities continue to operate under Xueda Information with the same infrastructure, resources and geographical coverage as before.

Currently, all of our tutoring services are provided by Xueda Information and its subsidiaries and schools, through their learning centers. In August 2009, we entered into a series of contractual arrangements with Xueda Information and its shareholders, which provide us with effective control over Xueda Information and enable us to receive substantially all of the economic benefits from Xueda Information and its subsidiaries and schools. Therefore, we treat Xueda Information as our variable interest entity under U.S. GAAP and consolidate Xueda Information and its subsidiaries and schools in China, in which we do not hold any equity or sponsorship interest.

As of December 31, 2013, we operated 408 learning centers in the PRC through Xueda Information’s 49 wholly-owned PRC subsidiaries and 111 tutoring schools.

### **Initial Public Offering and Warburg Pincus Investment**

In November 2010, we completed our initial public offering, in which we offered and sold 30,889,000 ordinary shares in the form of ADSs, raising \$136.5 million in proceeds before expenses to us.

In conjunction with our initial public offering, WP X Investments IV Ltd., a company incorporated in the Cayman Islands and affiliated with Warburg Pincus LLC, or Warburg Pincus, purchased 7,124,000 ordinary shares for an aggregate purchase price of \$32.8 million from us and 3,000,000 ordinary shares from Goodor Corporation, one of our principal shareholders, which is 100% beneficially owned by the family trust of Mr. Rubin Li, chairman of our board of directors.

### **ADS Repurchases**

On September 27, 2011, we announced the implementation of a share repurchase program of up to \$30 million worth of our outstanding ADSs representing our ordinary shares on the open market at prevailing market prices, in block trades or otherwise. Pursuant to this program, we had repurchased an aggregate of 4,683,016 of our ADSs at an average price of \$ 3.42 per ADS on the open market for approximately \$ 16.0 million by November 2012, excluding commissions paid to brokers. The share repurchase program was concluded in November 2012.



## B. Business Overview

### Overview

We are the leading national provider of tutoring services for primary and secondary school students in China. We are the largest provider of primary and secondary school tutoring services in China in terms of revenue for the year of 2013, based on publicly available information as of December 31, 2013. We believe our leadership position and the fragmentation of the market provide us with significant growth opportunities. Since opening our first learning center in 2004, we have organically built a national network of 408 learning centers and approximately 11,200 full-time service professionals, serving customers located in 77 cities across 28 of China's 31 provinces and municipalities, as of December 31, 2013.

We have established “Xueda” as a leading brand in China's tutoring sector. In 2011, *Sina.com*, one of the most visited Internet portals in China, named us one of the “2010 A-List After-School Education Institutions,” “2010 Most Influential ‘Word-of-Mouth’ Reputation in After-School Tutoring,” and “2011 Leading Education Institution in China,” and *Sohu.com*, another most visited Internet portal in China, named us one of the “China's Top 10 Brands in After-School Tutoring.” In recognition of our leading role in personalized education, we were selected in August 2011 to serve as the organizer of the “2011 International Conference on Personalized Education” in Beijing, China, jointly presented by the Chinese Society of Education and the Chinese Association for Non-Government Education. In 2012, *Sina.com* named us a “2012 Leading Educational Institution In China,” “2012 ‘Five-Star Gold Medal’ After-School Tutoring Team” and “2012 Most Influential ‘Word-of-Mouth’ Reputation in After-School Tutoring.” In the same year, NetEase, Inc., operator of *163.com*, another popular Internet portal in China, named us one of the “2012 Top 10 Brands in After-School Education,” *www.eol.cn*, the largest online education portal in China, named us one of the “2012 Most Influential After-School Tutoring Institutions,” and *China.com.cn*, authorized Internet portal established by the Chinese government, named us one of the “2012 Most Recognized Brand In After-School Tutoring by Parents.” In 2013, *Sina.com* named us the “Education Company with Most Comprehensive Strength” and “Most Influential After-School Tutoring Brand,” and *Xinhuanet.com*, an important central news service-oriented website, named us one of the “2013 Leading After-School Tutoring Institutions.” We believe our strong brand helps us reach a broad customer base and has contributed to our rapid growth.

As a pioneer in providing personalized tutoring services in China, we strive to help students improve their academic performance and reach their potential by building on their strengths, filling in knowledge gaps, inspiring interest in learning, cultivating good study habits and fostering self-confidence. We have developed and implemented a results-oriented, student-centric service delivery model. Compared to the conventional, class-based tutoring, our service model features personalized tutoring services tailored to each of our students' needs and preferences and delivered by a dedicated team of full-time service professionals primarily through one-on-one tutoring. As such, we believe we are a provider of premium tutoring services. By helping students improve academic performance and become motivated and well-rounded learners, we have won the trust of tens of thousands of students and parents, which has in turn helped us further enhance our brand awareness and customer loyalty.

As a result of our strong brand and effective service model, our business has experienced rapid growth:

- *Service Network.* We expanded our tutoring service network from 295 learning centers in 63 cities in 2011 to 408 learning centers in 77 cities in 2013, including cities such as Beijing, Guangzhou, Shanghai, Tianjin, Shenzhen, Chongqing, Nanjing and Wuhan.
- *Students Served.* We increased the number of students served each year from approximately 117,000 in 2011 to approximately 150,000 in 2013.
- *Financial Performance.* Our net revenue increased significantly from \$221.7 million in 2011 to \$347.0 million in 2013, representing a compound annual growth rate, or CAGR, of 25%. For 2011, 2012 and 2013, we recorded net income attributable to Xueda Education Group's ordinary shareholders of \$4.8 million, \$2.0 million and \$16.2 million, respectively. For the reasons of the decrease in net income from 2011 to 2012 and the increase from 2012 to 2013, see “Item 5. Operating and Financial Review and Prospects — A. Operating Results — Results of Operations.”

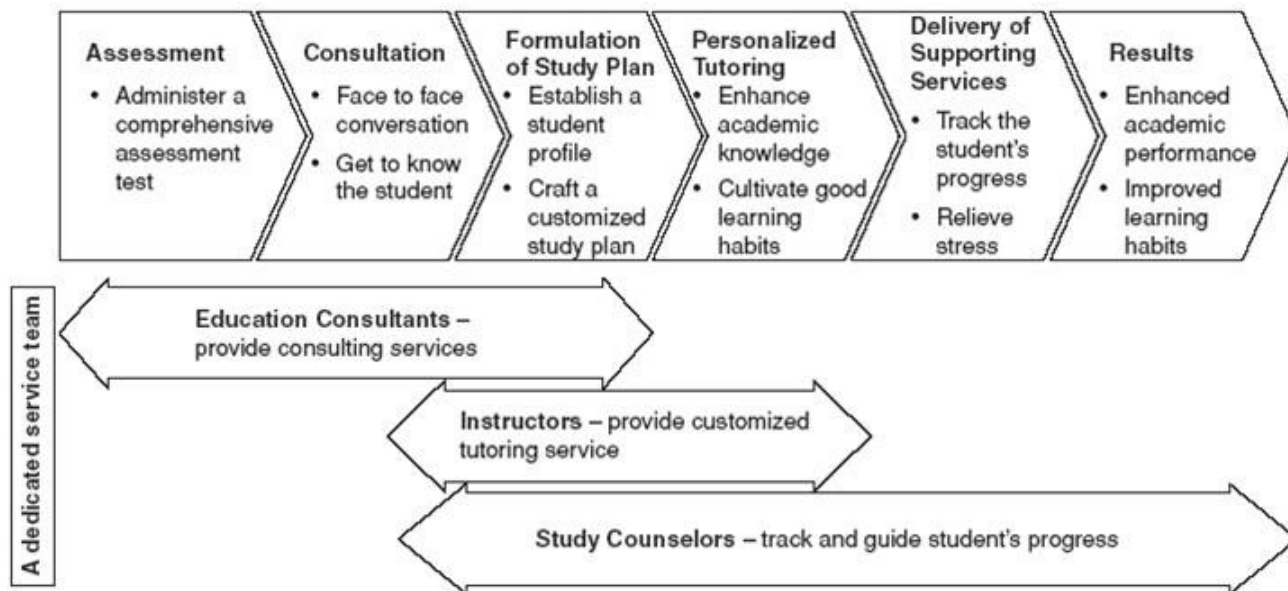
We conduct our tutoring business through our variable interest entity, or VIE, and its subsidiaries and schools located in 77 cities in China as of December 31, 2013. Although we do not hold any equity interest in our VIE, we exercise effective control over and receive substantially all of the economic benefits from our VIE and its subsidiaries and schools through a series of contractual arrangements with our VIE and its shareholders.

### Our Services

We offer personalized tutoring services to primary and secondary school students in China. We believe that many factors affect a student's academic performance and that our customized tutoring service can improve our students' academic performance by, among other things, selectively targeting each student's weak areas of academic knowledge and test-taking skills and building self-confidence.

## Our Service Model

Our personalized service model consists of six main components: assessment, consultation, formulation of a customized study plan, personalized tutoring, delivery of student-oriented supporting services and results. We also seek to involve the parents of our students in each of these components.



**Assessment.** For each new student, we commence our services with an assessment by one of our education consultants. A comprehensive assessment test is administered, which consists of questions designed to evaluate the student's existing academic knowledge, test-taking skills and psychological and behavioral patterns. Our education consultants use the results of the assessment test to analyze the student's academic strengths and weaknesses, establish a profile of the student's study preferences and habits, and help the student set or refine his or her academic objectives.

**Consultation.** During the consultation, we discuss with the student and his or her parents the student's past and current academic performance, future academic goals, specific subject and grade level tutoring needs, and any pertinent personal circumstances such as scheduling constraints. We also provide the student with an overview of our personalized service model and explain how we can design a study plan tailor-made to help the student improve his or her academic performance and achieve academic goals.

**Formulation of a customized study plan.** Based on a student's individual needs and their parents' input, our education consultants, instructors and study counselors jointly craft a customized study plan specifically designed for each student. The study plan includes identifying the subject areas in which the student needs tutoring, assembling a team of instructors who have a solid command of the relevant subject areas and whose styles of instruction are likely to be most effective for this student, establishing a timeline to reach key milestones and developing a weekly tutoring schedule that complements the student's regular school schedule.

**Personalized tutoring.** Guided by the customized study plan, our instructors work with our students primarily on a one-on-one basis to deliver personalized content, optimized exercises and customized study guidance to help student fill knowledge gaps, inspire academic interest and cultivate good learning habits. In executing the customized study plan, our instructors seek to enhance a student's understanding of a specific academic subject, problem-solving techniques and test-taking skills through a combination of pedagogical tools including one-one-one lectures, discussions, experiments, problem sets and tests. In addition, our instructors conduct small group tutoring in circumstances where group interaction and peer-inspired learning are conducive to the best results.

**Delivery of supporting services.** Our customized tutoring services also include a comprehensive package of student-oriented supporting services that complements one-on-one tutoring. In addition to the education consultants who provide the initial consultation and our instructors who deliver our educational content, our professional team also consists of study counselors and psychological counselors. Each of our students is assigned to a study counselor, who tracks the student's progress and achievements throughout his or her learning process and adjusts his or her study plan from time to time to match the student's progress. Each student also has unrestricted access to optional, free Q&A sessions in study rooms at our learning center, where an instructor is present and available to answer questions and provide additional guidance on study material and general study methods. Our students also have access to our team of psychological counselors, who work with our students to help relieve anxiety, maintain motivation and build self-confidence. We do not include any hours relating to these supporting services in the calculation of our total course hours delivered. Each of our students also benefits from the services of our dedicated team of educational research specialists, who continually monitor the progress of our tutoring programs, develop and update tutoring and training materials based on curricular changes and trends in students' needs, and fine-tune our service model.

**Results.** Throughout the previous several steps, we keep updating the students' profile and crafting tailor-made study plans for our students on a timely manner. With the joint efforts of our professional team and students' parents, we target to enhance students' academic performance and cultivate their good learning habits.

We also seek to involve the parents of our students in each component of the tutoring process. Prior to, or in conjunction with, the consultation and assessment test, we discuss with the parents their observations of the student's academic performance, study habits and behavioral patterns to supplement the consultation and assessment test results and to formulate a more complete and accurate profile of the student. In our customized study plan, we consult with the parents on their objectives and expectations, and encourage the parents to provide additional input to optimize the study plan's fit given the student's and the parents' unique circumstances. During the tutoring sessions and throughout our service period, we periodically communicate with the parents to provide them with updates on the progress of their children in our tutoring program and seek additional input from them regarding any potential adjustments to the study plan. Parents also have the opportunity to interact with members of our professional team, including instructors and study counselors, on an *ad hoc* basis in addition to the regularly scheduled meetings. We also host seminars on parenting skills for parents from time to time.

### ***Our Course Offerings and Course Materials***

**Course Offerings.** Our personalized service model enables us to respond to the unique circumstances and serve the diverse needs of our students. We offer a customized study plan to each of our students, tailored to fit the student's aptitude, grade level, study habits, past academic performance, future academic goals and other pertinent factors, and assemble a team of service professionals that we deem to be best suited to effectively execute the study plan and deliver our services. Our course offerings cover all academic subjects taught in primary and secondary schools in the markets where we operate, such as Mathematics, English, Physics, Chinese and Chemistry. We also offer self-designed courses beyond the standard curriculum in certain subjects, as well as in subjects not usually taught at public primary and secondary schools. In addition to academic subjects, we started to design and offer extensive interest and personal development courses in 2013, such as personalized study abroad consulting courses, art training courses, psychology courses and attention skills training courses, catering to the evolving students' needs. We believe that such extensive courses will also provide us with synergy opportunities by leveraging our existing large number of students served.

**Course Materials.** We take a personalized approach with respect to the course materials we use in our tutoring services. For each of our students, we work with standard text books and course materials adopted by the school in which the student is enrolled or is expected to enroll as well as commercially available study aids, and supplement them with selected materials from our educational resources database that we deem to be the best fit for the student's needs and circumstances. Prior to each tutoring session, our instructors prepare an instruction outline of the course materials to be used at that session, including key knowledge points, examples and illustrations, and questions and exercises. We have built a sizable database that contains these outlines and other course materials and as a result, may not be able to effectively protect this database and course materials. We have registered copyrights with respect to our course materials for the subjects of English, Mathematics and Chinese, which we believe are material to our business operations. We rely on trade secret laws and confidentiality agreements with our employees, contractors and others to protect our copyrights in these proprietary database and course materials. In addition, since 2013, we have also commenced to offer our students tablet devices to better facilitate their study.

We currently have 73 employees focused on the research and development of course content and delivery method at our headquarters. In addition, we have research and development personnel in all of our subsidiaries to coordinate the efforts of many of our instructors who regularly participate in research and development projects. We regularly update our educational resources database and supplement it with feedback from our instructors and students. Leveraging this consolidated educational resource database, our content research and development team develops course materials based on students' needs and preferences.

## ***Service Pricing and Course Fees***

We charge for our services by tutoring hours and adjust the hourly rates for the students' grade levels, the number of course hours purchased, the experience levels of the instructors and local market conditions. Historically, we have observed a certain level of inelasticity in demand for our services and have been able to steadily raise our course fees.

We typically price our services based on an agreed-upon number of tutoring hours over a period of two to eight months and require all of our students to pay the total course fees in full within seven days from the date they enter into a service contract with us. In addition to course fees, each of our new students is required to pay a non-refundable registration fee at the time such student enters into the first service contract with us. The registration fee varies from location to location and normally ranges from RMB300 (\$49.6) to RMB 1,000 (\$165.2). Students who are unable or unwilling to complete all of the prepaid tutoring hours and wish to terminate the services may be eligible to receive a partial refund, subject to the terms of the agreement they have entered into with us that restrict refunds under certain circumstances and depending on our practice of whether to seek enforcement of these restrictive terms.

## **Service Professionals**

We help our students enhance their academic performance and become well-rounded learners through a combination of services and pedagogical methods. To that end, we assemble for each of our students a team of service professionals consisting of instructors, education consultants, study counselors and psychological counselors.

As of December 31, 2013, our team of full-time service professionals consisted of the following :

Instructors	8,080
Education consultants	1,693
Study counselors	1,391
Psychological counselors	75
Total	<u>11,239</u>

These service professionals are critical to maintaining the quality of our services and to protecting and enhancing our brand and reputation.

Our instructors play a key role in delivering our premium, personalized tutoring services by interacting with students on a regular basis. We seek to attract and retain qualified instructors with solid academic qualifications and teaching experience who are enthusiastic about working with students and can adapt to each of our students' unique circumstances. In particular, we target new or recent college graduates because they are more likely to adapt to our personalized service model, bond with our students and effectively deliver personalized tutoring services than are long-time teachers more familiar with traditional classroom settings. Over time, we have organically built up a young, energetic and well-qualified team of instructors. As of December 31, 2013, 71.1% of our full-time instructors were under the age of 30. Based on our track record of recruiting from this demographic group, we are developing collaborative programs with a number of teacher's colleges in China, at which we conduct early campus recruitment and provide pre-graduation training for prospective instructors.

All of our instructors are required to undergo an initial training program when they first join us, covering tutoring skills and techniques, subject matter for relevant courses, corporate culture and our educational philosophy. Our training includes not only teaching methods but also basic psychology lessons to help our instructors better understand our students. We also provide ongoing pedagogical training to our instructors to further enhance their skills and understandings of student demands, entrance exams, admissions standards and other key trends necessary to effectively render our services. These training programs are developed with the assistance of our research and development team.

Some of our instructors are more advanced in their teaching career. While we do not directly compete with other service providers in recruiting the limited number of star teachers from elite schools for our team of instructors, we have attracted a team of veteran teachers with extensive experience at leading primary and secondary schools that help us monitor our tutoring programs and participate in the training of our younger instructors.

By drawing upon decades of experience and insights from our more experienced instructors, as well as the enthusiasm and adaptability of our younger team of instructors located throughout the country, we are able to deliver high-quality personalized tutoring services cost-effectively and at scale. This combination of a smaller team of highly experienced instructors and a larger team of younger instructors also allows us to largely avoid the intense competition for hiring star teachers from elite schools as instructors, and enables us to primarily rely on a candidate pool where supply is far less limited.

Our study counselors are also instrumental to our service model. Our study counselors track the students' progress and achievements and adjust study plans from time to time. They also serve as a helpful resource to students and parents and provide them with advice on study methods and learning habits. In addition, our study counselors act as a conduit for students and parents to provide feedback on our services. Their services distinguish us from many providers of tutoring services who do not have service professionals dedicated to similar functions.

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Our education consultants and psychological counselors round out our team of service professionals. Education consultants provide initial assessment and consultation services to potential students; and psychological counselors help our students relieve anxiety, maintain motivation and build self-confidence. These service professionals are recruited because of their experience and skills in the relevant areas and because they have an interest in providing personalized tutoring services.

We are taking measures in order to maintain a healthy attrition level of our target service professionals. For example, we are in the process of enhancing our compensation schemes to make them more competitive in the market while enhancing the efficiency and utilization of our service professionals, refining our recruitment standards, developing training programs to help our service professionals adapt to our business and offering them better internal career development opportunities.

### **Our Service Network**

We deliver our services to students through a national network, consisting of 408 learning centers as of December 31, 2013, all of which are operated by us, in 77 cities in China. We select new locations based on a variety of factors, including the income level and trend, demographics (in particular, primary and secondary school enrollment), local regulations, rules and implementations relating to after-school tutoring, as well as the presence of competing offerings in the area. We expect to continue to open new learning centers in cities in which we currently have a presence and which exhibit strong enrollment potential. We also expect to continue our expansion into to new geographic locations.

All of our learning centers are directly operated by us under our “Xueda” brand. The following table sets forth the locations of our learning centers and the number of our learning centers at each location as of December 31, 2013.

City	Number of Learning Centers
Beijing	34
Shanghai	29
Tianjin	21
Guangzhou	18
Shenzhen	16
Xi'an	15
Suzhou	13
Changchun	10
Nanjing	10
Ningbo	10
Hangzhou	9
Wuhan	9
Dalian	9
Taiyuan	8
Chengdu	8
Changsha	8
Shenyang	8
Hohhot	8
Qingdao	8
Nanchang	7
Hefei	7
Fuzhou	6
Zhengzhou	6
Jinan	5
Wenzhou	5
Harbin	5
Kunming	5
Dongguan	5
Nanning	5
Shijiazhuang	5
Taizhou (Zhejiang Province)	5
Chongqing	4
Wuxi	4
Foshan	4
Lanzhou	4
Nantong	3
Daqing	3
Huizhou	3
Baotou	3
Changzhou	3
Guiyang	3
Langfang	3

Tangshan	3
Xiamen	3
Yinchuan	3
Baoding	2
Yantai	2
Jilin	2
Luoyang	2
Yangzhou	2
Baoji	2
Anshan	2
Dongying	2
Taizhou (Jiangsu Province)	2
Datong	2
Huainan	2
Jinhua	2
Wuhu	2
Fushun	1
Fuxin	1
Ma'anshan	1
Shaoxing	1
Xianyang	1
Yibin	1
Yichang	1
Yuxi	1
Zhenjiang	1
Zhuzhou	1
Yancheng	1
Qiqihar	1
Qujing	1
Weinan	1
Yulin	1
Jinzhong	1
Dali	1
Hanzhong	1
Xining	1
<b>Total</b>	<b>408</b>



Our tutoring service network has experienced a rapid growth during the recent years. However, we have not historically fully developed adequate controls and procedures regarding due diligence and screening process to cope with our rapid business expansion. In addition, there still exist significant uncertainties in local governments' practice in issuing relevant regulatory approvals and permits, as evidenced by our experience of obtaining relevant approvals and permits for learning centers with similar facilities and other conditions in most , but not all of the cities where we operate. As a result, certain of our learning centers commenced operations without education permits or "tutoring services" or any other education related services in their authorized business scope or prerequisite education permits. See "Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Our Business and Industry — The learning centers of some of our VIE's subsidiaries and schools may be deemed by government authorities to operate beyond their authorized business scope or without proper registration, which could expose us to certain risks." We have been undertaking measures to rectify the potential non-compliance issues and strengthen our risk management relating to the lack of relevant business scope or permits. In order to further control risks relating to potential non-compliance by our existing learning centers, we are in the process of transferring a majority of the non-compliant learning centers to our existing tutoring schools or to new tutoring schools to be established. In addition, we are strengthening the implementation of the following controls and procedures for the establishment of new learning centers. We require our local management teams to follow more stringent screening procedures and conduct thorough due diligence in connection with opening new learning centers. In order to identify potential non-compliance risks, the management teams are required to further enhance communications with relevant government authorities to gauge local compliance requirements and regulatory practices. Under our reporting and assessment system, the local management teams are required to report their findings to the senior management team at our headquarters in a timely manner. The senior management team then makes final decisions after consulting our legal counsel and assessing all relevant potential risks and available compliance options.

## **Marketing and Student Recruitment**

We selectively and systematically market our services and build our brand through a number of different marketing programs. By doing so, we intend to continue fostering a standard corporate identity across our learning centers network.

We believe prospective students are attracted to our services due to our excellent brand name, our personalized service model and the quality of our programs. We employ the following marketing methods to attract new students and retain existing students:

*Referrals.* Our student enrollments have also benefited from, and are expected to continue to benefit from, word-of-mouth referrals by our current and former customers.

*Media advertising.* We advertise in a number of local newspapers, television channels and other traditional media, as well as on leading Web portals in China such as *Baidu.com* and *Google.com*.

*Speeches and seminars.* We regularly organize promotional speeches and seminars on study habits, review methods and similar topics of interest to our prospective customers.

*Neighborhood promotions.* Our marketing representatives visit schools, supermarkets, bookstores and other community locations with a high concentration of potential customers and distribute promotional materials such as informational brochures, flyers and magazines.

## **Student Enrollment and Service Period**

With our premium, personalized service model, we are able to cater to a broad range of student needs and goals. Many students come to us because they feel that they are lagging in academic performance in certain subject areas and that classroom format instruction is inadequate to help them catch up with their peers. Many other students use our personalized services to maintain a competitive edge and continue to push ahead in subjects in which they already perform well. Some students also utilize our services primarily for exam preparation purposes.

For the year ended December 31, 2013, we delivered tutoring services to approximately 150,000 students. Of these students, approximately 16% were at the primary school level, 41% were at the middle school level, and 43% were at the high school level.

## **Competition**

We are uniquely positioned in the tutoring services market in China. We offer premium, personalized tutoring services through our national network of 408 learning centers located in 77 cities across China as of December 31, 2013. Our course offerings cover the full range of academic subjects taught at primary and secondary schools in markets where we operate. Although we compete with many other tutoring service providers for the same customer base, currently we are the only national service provider to offer personalized tutoring services across a broad range of academic subjects. Our competitors include educational service providers who offer tutoring services in multiple academic subjects in a limited number of geographic locations, such as TAL Education Group as well as personalized tutoring services, such as New Oriental Education & Technology Group, Inc.

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We believe the principal competitive factors in our market include the following:

- brand recognition and reputation of service providers;
- a service model that aligns personalized services to specific needs of students and parents;
- overall customer satisfaction;
- size and coverage of service network and proximity of services to customers;
- quality of the service team and scope, quality and consistency of service; and
- effectiveness of service as measured by improvements in academic performance.

We believe that our primary competitive advantages are our well-known “Xueda” brand, our personalized service model, our ability to deliver personalized curriculum with consistent, high quality across our national network of learning centers, and our team of experienced service and management professionals. However, some of our existing and potential competitors may have more programs, services and products than we do or have more resources than we do. These competitors may be able to devote greater resources than we can to the development, promotion and sale of their programs, services and products and respond more quickly than we can to changes in customer demands, market needs or new technologies. They also compete with us in recruiting qualified service and management professionals and may attempt to solicit our employees. In addition, we face competition from many different organizations that focus on some of our targeted markets, which may be able to respond more promptly to changes in student preferences in these markets.

## **Strategic Investment**

As part of our growth strategy, we intend to form strategic alliances and make selective complementary acquisitions and investments to help drive future growth. In March 2012, Xueda Information and two individuals, one of whom is the wife of Mr. Xin Jin, our co-founder and chief executive officer, and Mr. Junbo Song, one of the shareholders of our VIE, entered into a share transfer framework agreement with the selling shareholders of Beijing Weland International Education and Technology Corp., or Weland, a company incorporated in China that organizes Chinese students to attend various model United Nations conferences and the relevant training in the United States and China. Pursuant to this agreement, in June 2012, Xueda Information acquired 60% of the equity interest in Weland for a consideration of RMB18.9 million. The two individuals acquired an aggregate of 10% of the equity interest in Weland for an aggregate consideration of RMB3.1 million. We expect this acquisition to diversify our services. In August 2012 and July 2013, we purchased, for a consideration of \$4.8 million and \$1.6 million, respectively, equity interests in the aggregate of 16.11% in Firstleap Education, a company incorporated in the Cayman Islands that provides English tutoring services to two- to ten-year-old children in China. We expect this investment in the long term to expand our service offerings, strengthen our position in the Chinese private tutoring sector and diversify our revenue streams.

## **Regulation**

We operate our business in China under a legal regime consisting of the State Council, which is the highest authority of the executive branch of the PRC central government, and several ministries and agencies under the State Council’s authority, including the MOE, the MIIT, SAIC, the Ministry of Civil Affairs, or the MCA, the MOFCOM, the SAFE, and their respective authorized local counterparts. This section summarizes principal PRC regulations related to our business.

### **Regulations on Private Education**

The principal regulations governing private education in China consist of the *Education Law of the PRC*, the *Law for Promoting Private Education* and the PE Implementation Rules.

#### ***Education Law of the PRC***

On March 18, 1995, the National People’s Congress enacted the *Education Law of the PRC*. The *Education Law of the PRC* sets forth provisions relating to the fundamental education systems of the PRC, including a school system of pre-school education, primary education, secondary education and higher education, a system of nine-year compulsory education and a system of education certificates. The *Education Law of the PRC* provides that the government formulates plans for the development of education and establishes and operates schools and other institutions of education. It also provides that enterprises, social organizations and individuals are generally encouraged to operate schools and other types of educational organizations in accordance with PRC laws and regulations. Although no organization or individual may establish or operate a school or any other institution of education for profit-making purposes, investors are permitted to receive “reasonable returns” on their investment in private schools, as described in more detail below.

## ***The Law for Promoting Private Education and the PE Implementation Rules***

The *Law for Promoting Private Education* became effective on September 1, 2003, and the PE Implementation Rules became effective on April 1, 2004. Under these regulations, “private schools” are defined as schools established by social organizations or individuals using non-government funds.

Under relevant PRC laws and regulations, entities and individuals who establish private schools are commonly referred to as “sponsors” instead of “owners” or “shareholders.” Accordingly, a sponsor holds “sponsorship interest” in a school, as opposed to “equity interest” an owner holds in a company. The economic substance of “sponsorship” with respect of private schools is substantially similar to that of ownership with respect to legal, regulatory and tax matters. The major differences between sponsorship and ownership are as follows:

- *Right to receive return on investment.* The portion of after-tax profits that can be distributed by a company to its owner is different from that distributed by a school to its sponsor. Under the PRC *Company Law*, which became effective on January 1, 2006, a company is required to allocate 10% of its after-tax profits to statutory reserve funds, while under the *Law for Promoting Private Education*, a school that distributes reasonable returns is required to allocate no less than 25% of its annual net profit to its development fund as well as make allocation for mandatory expenses as required by applicable laws and regulations. In addition, although the decision-making body of the school has the power to determine what constitutes “reasonable returns,” none of the current PRC laws and regulations provides a formula or guidelines for such determination.
- *Right to the distribution of residual properties upon termination and liquidation.* Under the PRC *Company Law*, properties that remain upon termination and liquidation of a company after payment of relevant fees and compensations are distributed to its owners. With respect to a school, the *Law for Promoting Private Education* provides that such distribution be made in accordance with other relevant laws and regulations. However, there have been no other relevant laws and regulations addressing the distribution of residual properties upon termination and liquidation of a private school.

Despite the above differences between sponsorship and ownership, the sponsor of a private school has effective control over such private school under the *Law for Promoting Private Education* through controlling the executive council or board of directors of such school, which is the decision-making body of the school, in the same manner as a shareholder controls a company’s board of directors. Through the school’s decision-making body, the sponsor exercises a broad range of powers, including (i) the appointment and dismissal of the school principal, (ii) the amendment of articles of association of the school and formulation of rules and regulations of the school, (iii) the adoption of development plans and approval of annual work plans, (iv) raising funds for school operations and adoption of budgets and final accounts, (v) making decisions on the size and compensation of the staff, (vi) making decisions on the division, merger or termination of the school, and (vii) making decisions on other important matters of the school. In addition, through controlling the decision-making body, the sponsor also has the power to use and manage the properties of the school in accordance with relevant laws and regulations.

Private schools providing certifications, pre-school education, education for self-study aid and other academic education are subject to approval by the education authorities, while private vocational schools are subject to approvals from the authorities in charge of labor and social welfare. A duly-approved private school will be granted a permit for operating a private school, and must be registered with the MCA or its local counterparts as a privately-run non-corporate entity. These regulations also provide that, with respect to for-profit, private training centers registered at SAIC or its local counterparts, separate administration measures will be formulated by PRC State Council. However, as of the date of this annual report, no such administrative measures have been promulgated by PRC State Council or other competent authorities.

Under the above regulations, private schools have the same legal status as public schools in most respects, although private schools are prohibited from providing military, police, political and other kinds of education of a sensitive nature. Public schools that provide compulsory education are not permitted to be converted into private schools. In addition, the operation of private schools is highly regulated. For example, tuition and fees private schools may charge their degree-seeking students are subject to approval by the governmental pricing authority and are required to be publicly disclosed.

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As of December 31, 2013, 109 of our 111 schools were solely sponsored and established either directly by our VIE or by one of our VIE's subsidiaries, and two of our 111 schools were sponsored and established directly by one of our VIE's schools. The sole sponsors of 107 of the 111 schools are either our VIE or one of its wholly-owned subsidiaries or schools in China. The sole sponsors of the remaining four schools are Rubin Li, chairman of our board of directors, Xin Jin, our chief executive officer, and another individual who is a manager of one of the subsidiaries of the VIE, respectively. These individuals hold the sponsorship interests of these four schools on behalf of our VIE under certain nominee agreements between our VIE and these individuals, as the local education authorities in certain districts of these the cities where these three schools are located require that (i) the sponsor of a private school must be an individual (not an enterprise) or (ii) the sponsor of a private school must be a local resident, which makes it impossible for our VIE or any of its subsidiaries to serve as a sponsor of these schools.

Private schools are divided into three categories: (i) private schools established with donated funds, (ii) private schools that distribute reasonable returns and (iii) private schools that do not distribute reasonable returns. As of December 31, 2013, 106 of our 111 schools were registered as private schools that distribute reasonable returns, and the remaining five schools were registered as schools that do not distribute reasonable returns.

As none of our schools were established with donated funds, we discuss the major differences between private schools that distribute reasonable returns and those that do not as follows:

- *Economic rights.*

In the case of private schools that distribute reasonable returns, sponsors of these schools have the right to seek the distribution of reasonable returns from the annual net balance of the school after deduction of costs, donations received, government subsidies, if any, the reserved development fund and other expenses as required by the regulations. A private school that distributes reasonable returns to its sponsors must be permitted to do so by explicit provisions of its articles of association. The percentage of the school's annual net balance that can be distributed as reasonable returns should be determined by the school's board of directors or executive council, taking into consideration the following factors: (i) the school's tuition and fees, (ii) the ratio of the school's expenses used for educational activities and improvement of the educational conditions to the total tuition and fees collected; and (iii) the admission standards and educational quality. Certain information relating to the factors discussed above is required to be publicly disclosed before the board of the school may determine the amount of reasonable returns for distribution. Such information and the decision to distribute reasonable returns is also required to be filed with the approval authorities within 15 days of the board's decision. However, none of the current PRC laws and regulations provides a formula for or clear guidelines on determining what constitutes reasonable returns.

Currently, none of the PRC laws or regulations sets forth sponsors' economic rights in schools that do not distribute reasonable returns.

- *Allocation of development fund.* 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 upgrade of educational equipment. As of December 31, 2013, all of our 408 schools were in compliance with the existing laws and regulations regarding the allocation of their development funds.

In the case of a private school that distributes reasonable returns, this amount must be at least 25% of the annual net income of the school, as determined in accordance with generally accepted accounting principles in the PRC.

In the case of a private school that does not distribute reasonable returns, this amount must be at least 25% of the annual increase in the net assets of the school, if any, as determined in accordance with generally accepted accounting principles in the PRC.

- *Tax status.*

The PE Implementation Rules provide that the preferential tax treatment policies applicable to private schools that distribute reasonable returns are to be formulated by the finance, tax and administration departments of the State Council. However, to date, no such regulations have been promulgated.

The PE Implementation Rules provide that private schools that do not distribute reasonable returns are entitled to the same preferential tax treatment as public schools. According to the *Notice of the Ministry of Finance and the State Administration of Taxation on Education Tax Policies* issued in 2004, public schools are exempt from business tax, income tax and other taxes. However, the above mentioned preferential tax treatments applicable to public schools are not part of the preferential tax treatments stipulated in the EIT Law, resulting in different interpretations and implementations of these laws and regulations by local tax authorities in practice.

Due to the uncertainties as to what preferential tax treatments are applicable to our schools discussed above, we do not adopt any preferential tax treatment in our tax policy. Instead, all of our schools, including our schools that distribute reasonable returns and those that do not, have accrued and paid all taxes that are applicable to an enterprise.

- *Right to the distribution of residual properties.*

Regardless of whether distributing reasonable return or not, the *Law for Promoting Private Education* provides that properties that remain upon termination and liquidation of a school after payment of relevant fees and compensations shall be made in accordance with other relevant laws and regulations. However, there have been no other relevant national laws and regulations addressing the distribution of residual properties upon termination and liquidation of a private school.

- *Business operations.*

None of the current PRC laws and regulations regulates the business operations of private schools that distribute reasonable returns any differently than those that do not.

## **Regulations on Internet Information Services**

Subsequent to the State Council's promulgation of the *Telecom Regulations and the Internet Information Services Administrative Measures* on September 25, 2000, or the Internet Information Measures, the MIIT and other regulatory authorities formulated and implemented a number of Internet-related regulations.

The Internet Information Measures require that commercial Internet content providers, or ICP providers, obtain a license for Internet information services, or ICP license, from the appropriate telecommunications regulatory authorities in order to provide any commercial Internet information services in the PRC. ICP providers are required to display their ICP license number in a conspicuous location on their homepage. In addition, the Internet Information Measures also provide that ICP providers that operate in sensitive and strategic sectors, including news, publishing, education, health care, medicine and medical devices, must also obtain additional approvals from the relevant authorities in charge of those sectors. Under the Internet Information Measures, non-commercial Internet information services, referring to information services generally available to the public free of charge, do not require prior approval and may be provided upon completion of record filing with the appropriate telecommunications regulatory authorities.

In July 2006, the MIIT posted on its website the *Notice on Strengthening Management of Foreign Investment in Operating Value-added Telecom Services*. The notice prohibits PRC ICP providers from leasing, transferring or selling their ICP licenses or providing facilities or other resources to any foreign investors. The notice states that PRC ICP 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.

The information we currently provide via Internet is non-commercial Internet information services. We have completed the required record filing for such services. We do not currently conduct commercial online education business and will obtain the relevant approvals and licenses as required by relevant PRC laws and regulations when we intend to conduct such business.

## **Regulations on Information Security**

The PRC government regulates Internet content in China to protect state security. Anyone who: (i) gains improper entry into a computer or system of strategic importance; (ii) disseminates politically disruptive information; (iii) leaks state secrets; (iv) spreads false commercial information; or (v) infringes intellectual property rights may be subject to criminal penalty.

The Ministry of Public Security has promulgated measures that prohibit use of the Internet in ways that, among other things, result in a leakage of state secrets or a spread of socially destabilizing content. The Ministry of Public Security has supervision and inspection rights in this regard, and we are subject to the jurisdiction of the local security bureaus. If an ICP license holder violates these measures, the PRC government may revoke its ICP license and shut down its websites.

We have been in compliance with these regulations in connection with the information provided on our corporate website.



## Regulations on Dividend Distribution

The *PRC Wholly Foreign-owned Enterprise Law* (1986), as amended, and the *Implementing Rules of the Wholly Foreign-owned Enterprise Law* (1990), as amended, are the principal regulations governing the distribution of dividends of wholly foreign-owned enterprises in China. Under these regulations, wholly foreign-owned enterprises, such as our PRC subsidiary, in China may, subject to the ongoing compliance with the applicable foreign exchange regulations, distribute dividends only out of their accumulated after-tax profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, each wholly foreign-owned enterprise in China is required to contribute at least 10% of its annual after-tax profits each year, if any, determined in accordance with PRC accounting standards to its general reserves fund until the cumulative amount in the reserve fund reaches 50% of the enterprise's registered capital, and to set aside a certain amount of its after-tax profits each year, if any, to fund its employee welfare fund. These reserve funds can only be used for the specified purposes and are not transferable to the company's shareholders in the form of loans, advances, dividends or otherwise. As discussed below, under the *Foreign Exchange Administration Rules* (1996), as amended, RMB is freely convertible into foreign exchange for dividend distribution.

## Regulations on Foreign Exchange

Under the *Foreign Exchange Administration Rules* (1996), as amended, and various regulations issued by SAFE and other relevant PRC government authorities, Renminbi is freely convertible only to the extent of current account items, such as trade related receipts and payments, interest payments and dividend distributions. Capital account items, such as direct equity investments, loans and repatriation of investment, require the prior approval from SAFE or its local counterpart for conversion of Renminbi from or into a foreign currency, such as U.S. dollars, and remittance of the foreign currency into or out of the PRC.

Under current PRC regulations, foreign-invested enterprise such as our PRC subsidiary is required to apply to SAFE for a Foreign Exchange Registration Certificate for Foreign-invested Enterprise. With such a certificate, which is subject to review and renewal by SAFE on an annual basis, a foreign-invested enterprise may open foreign exchange bank accounts at banks authorized to conduct foreign exchange business by SAFE and may buy, sell and remit foreign exchange through such banks, subject to documentation and approval requirements. Foreign-invested enterprises are required to open and maintain separate foreign exchange accounts for capital account transactions and current account transactions.

On August 29, 2008, SAFE promulgated Circular 142, a notice regulating the conversion by a foreign-invested company of foreign currency into Renminbi by restricting how the converted Renminbi may be used. The notice requires that Renminbi converted from the foreign currency denominated capital of a foreign-invested company may only be used for purposes within the business scope stated on the business license of the company and may not be used for equity investments within the PRC unless specifically provided for otherwise. SAFE also strengthened its oversight over the flow and use of Renminbi converted from the foreign currency denominated capital of a foreign-invested company. The use of such Renminbi may not be changed without approval from SAFE, and such Renminbi may not be used to repay Renminbi loans if the proceeds of such loans have not yet been used. Violations of Circular 142 may result in severe penalties, including substantial fines as set forth in the *Foreign Exchange Administration Rules*. In addition, SAFE promulgated a circular on November 19, 2010, or Circular 59, which tightens the regulation over settlement of net proceeds from overseas offerings like our initial public offering and requires that the settlement or net proceeds must be consistent with the description in the prospectus for the initial public offering. Furthermore, it has recently come to our attention that SAFE issued an internal guideline to its local counterparts, referred to as Circular 45, in November 2011. Circular 45 has never been formally announced by SAFE to the public or posted on SAFE's website. Based on the version made publicly available by certain local governmental authorities on their websites, we understand that Circular 45 requires SAFE's local counterparts to strengthen the control imposed by Circulars 142 and 59 over the conversion of a foreign-invested company's capital contributed in foreign currency into RMB. Circular 45 stipulates that a foreign-invested company's RMB funds, if converted from such company's capital contributed in foreign currency, may not be used by such company to (i) extend loans (in the form of entrusted loans), (ii) repay borrowings between enterprises, or (iii) repay bank loans it has obtained and on-lent to third parties. On November 19, 2012, SAFE promulgated the *Circular on Further Improvement and Adjustment of the Foreign Exchange Administration Policy for Foreign Direct Investments*, or Circular 59. Although Circular 59 deepens the reform of the foreign exchange administration system and simplifies the foreign exchange approval procedure for foreign direct investments in China, the restrictions imposed by Circulars 142, 59 and 45 regarding the conversion by a foreign-invested company of foreign currencies into Renminbi remain unchanged. In addition, SAFE promulgated the *Circular on Printing and Distributing the Provisions on Foreign Exchange Administration over Domestic Direct Investment by Foreign Investors and the Supporting Documents* in May 2013, which specifies that the administration by SAFE or its local counterparts over direct investment by foreign investors in the PRC are to be conducted by way of registration and banks are to process foreign exchange business relating to the direct investment in the PRC based on the registration information provided by SAFE and its local counterparts.

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We expected that a substantial portion of the proceeds of our initial public offering will be used by our PRC subsidiary to meet its working capital needs and for general corporate expenses in connection with its business expansion. Meanwhile, we believe that our VIE will have adequate cash from its operations to support its own operation and expansion. Therefore, we do not expect to transfer any significant amount of the proceeds of our initial public offering to our VIE or its subsidiaries or schools. However, to the extent we need to transfer any proceeds of our initial public offering to our VIE, its subsidiaries or schools through our PRC subsidiary, Circulars 142, 59 and 45 may significantly limit our ability to do so. In such an event, we may have to obtain external financing for our VIE, its subsidiaries or schools or use our PRC subsidiary's cash generated from its operations (primarily the service fees to be paid by our VIE under the Exclusive Service Agreement) to extend entrusted loans to our VIE, its subsidiaries and schools, and we cannot assure you that we will have timely access to such funding on reasonable terms, in a sufficient amount, or at all.

### **SAFE Circular 75**

SAFE Circular 75, issued in October 2005, states that PRC citizens or residents must register with SAFE or the relevant local SAFE branch in connection with their establishment or control of an offshore company established for the purpose of overseas equity financing involving a roundtrip investment whereby the offshore company acquires or controls onshore assets or equity interests held by the PRC citizens or residents. In addition, such PRC citizens or residents must amend their SAFE registrations when the offshore special purpose company undergoes material events relating to increases or decreases in investment amount, transfers or exchanges of shares, mergers or divisions, long-term equity or debt investments, external guarantees, or other material events.

Our beneficial owners who are known to us to be PRC residents have registered with SAFE and have completed their amendment registrations under SAFE Circular 75 with regard to our initial public offering.

### **Employee Stock Option Plans**

In December 2006, the People's Bank of China promulgated the *Administrative Measures on Individual Foreign Exchange*, or the Individual Foreign Exchange Regulations, setting forth the requirements for foreign exchange transactions by individuals (both PRC and non-PRC citizens) under the current account and the capital account. In January 2007, SAFE issued the *Implementation Rules for the Individual Foreign Exchange Regulations*, which, among other things, specified the approval and registration requirement for certain capital account transactions such as a PRC citizen's participation in employee share ownership and share option plans of overseas-listed companies.

On March 28, 2007, SAFE promulgated the *Operating Procedures on Administration of Foreign Exchange for PRC Individuals' Participation in Employee Share Ownership Plans and Employee Share Option Plans of Overseas Listed Companies*, or the Share Option Rules. Under the Share Option Rules, PRC citizens who are granted shares or share options by an overseas-listed company according to its employee share option or share incentive plan are required, through the PRC subsidiary of such overseas-listed company or other qualified PRC agents, to file with the applicable local branch of SAFE and complete certain other procedures related to the share option or other share incentive plan. In addition, the overseas-listed company or its PRC subsidiary or a qualified PRC agent is required to appoint an asset manager or administrator and a custodian bank, and open special foreign currency accounts to handle transactions relating to the share option or other share incentive plan. Under the *Foreign Exchange Administration Rules* (1996), as amended, the foreign exchange proceeds of domestic entities and individuals can be remitted into China or deposited abroad, subject to the terms and conditions to be issued by SAFE. However, to date, SAFE has not issued any implementation rules in respect of depositing the foreign exchange proceeds abroad. Currently, the foreign exchange proceeds from the sales of shares or dividends distributed by the overseas-listed company can be converted into RMB or transferred to such individuals' foreign exchange savings account after the proceeds have been remitted back to the special foreign currency account maintained at a PRC domestic bank. In the case of an exercise of the options on a non-cash basis, PRC citizens are required to remit the proceeds to special foreign currency accounts. On February 15, 2012, SAFE promulgated the *Circular on Relevant Issues Relating to the Administration of Foreign Exchange Regarding PRC Individuals' Participation in Employee Share Incentive Plans and Employee Stock Option Plans of Overseas Listed Companies*, or the Share Option Circular, which replaced the Share Option Rules. We believe that we and our PRC citizen employees are subject to these rules. If we and/or our PRC citizen employees fail to comply with the Share Option Circular, we and/or our PRC citizen employees may face sanctions imposed by SAFE or any other PRC government authorities.

### **Regulation on Overseas Listings**

On August 8, 2006, six PRC regulatory agencies, including the CSRC, jointly promulgated the M&A Regulations. Under the M&A Regulations, the prior approval of the CSRC is required for the overseas listing of offshore SPVs that are directly or indirectly controlled by PRC companies or individuals and used for the purpose of listing PRC onshore interests on an overseas stock exchange.

Under the M&A Regulations, "mergers and acquisitions of domestic enterprises by foreign investors" refers to a situation where a foreign investor purchases by agreement the equity interests of a domestic company or subscribes to the increased capital of a domestic company, and thus changes the domestic company into a foreign-invested enterprise; or where a foreign investor establishes a foreign-funded enterprise, and through which the foreign investor purchases by agreement the assets of a domestic company and operates its assets; or where a foreign investor purchases by agreement the assets of a domestic company, and then invests such assets to establish a foreign-funded enterprise to operate the assets.

While the exact perimeters of the M&A Regulations remain unclear, based on the advice of our PRC counsel, because the M&A Regulations only apply to transactions involving “mergers and acquisitions of domestic enterprises by foreign investors,” we believe that (a) the M&A Regulations are not applicable to our corporate restructuring in 2009 and 2010 and (b) CSRC approval is not required in the context of our initial public offering, for the following reasons: (i) we established our PRC subsidiary by means of direct investment, not through merger or acquisition of any PRC domestic companies and (ii) we control our VIE and its subsidiaries through contractual arrangements, not through “mergers and acquisitions of domestic enterprises by foreign investors” as defined under the M&A Regulations. However, we cannot assure you that the relevant PRC government agencies, including the CSRC, would reach the same conclusion as our PRC counsel did. If the CSRC or another PRC regulatory body subsequently determines that we should have obtained the CSRC’s approval for our initial public offering either by interpretation, clarification or amendment of the M&A Regulations or by any new rules, regulations or directives or in any other ways promulgated in the future, we may face sanctions by the CSRC or other PRC regulatory agencies. In such an event, these regulatory agencies may impose fines and penalties on our operations in the PRC, limit our operations in the PRC, delay or restrict the repatriation of the proceeds from our initial public offering into the PRC, or take other actions that could have a material adverse effect on our business, financial condition, results of operations, reputation and prospects, as well as the trading price of our ADSs.

## **Regulation of the Software Industry**

### ***Policies to Encourage the Development of Software***

On June 24, 2000, the State Council issued *Certain Policies to Encourage the Development of Software and Integrated Circuit Industries*, or the Policies, to encourage the development of software and integrated circuit industries in China and to enhance the ability of PRC information technology companies to compete in the international market. The Policies facilitate the development of software and integrated circuit industries in China through various methods, including:

- encouraging venture capital investments in software industry and providing capital to software enterprises or assisting such software enterprises to raise capital overseas;
  - providing tax incentives, including an immediate tax rebate for taxpayers who sell self-developed software products before 2010 in the amount of the statutory value-added tax that exceeds 3% and a number of exemptions and reduced corporate income tax rates;
  - providing government support, such as government funding in the development of software technology;
  - providing preferential treatments, such as credit facilities with low interest rates to enterprises that export software products;
  - taking various strategies to ensure that the software industry has sufficient expertise; and
  - implementing measures to enhance intellectual property protection in China.
- To qualify for preferential treatments, an enterprise must be recognized as a software enterprise by governmental authorities. A software enterprise is subject to annual inspection, failure to pass such inspection in a given year would cause the enterprise to lose the relevant benefits. Xuecheng Century, our PRC subsidiary, was qualified as a software enterprise in April 2010 and is entitled to enjoy these preferential treatments including tax incentives. If Xuecheng Century fails to pass the annual inspection in any year, it will not be able to enjoy these preferential treatments.

### ***Software Products Administration***

On October 27, 2000, the MIIT issued and enforced the *Measures Concerning Software Products Administration* to regulate and administer software products and facilitate the development of software industry in China. Pursuant to the *Measures Concerning Software Products Administration*, all software products operated or sold in China must be duly registered with and recorded by the relevant authorities, and no entity or individual is allowed to sell or distribute any unregistered and unrecorded software products. In order to produce software products in China, a software producer is required to have:

- the status of an enterprise legal person, which scope of operations must include computer software business (including technology development of software or production of software products);
- a fixed production site;
- necessary conditions and technologies for producing software products; and
- quality control measures and capabilities for the production of software products.

Software developers or producers are allowed to sell their registered and recorded software products independently or through agents, or by way of licensing. Software products developed in China must be registered with local provincial governmental authorities in charge of information industry and subsequently filed with the taxation authority at the same level and the MIIT. Imported software products, *i.e.*, software developed overseas and sold or distributed into China, must be registered with the MIIT. Upon registration, the software products will be granted registration certificates. Each registration certificate is valid for five years from the issuance date and may be renewed upon expiry. The MIIT and other relevant authorities may carry out supervision and inspection over the development, production, operation and import/export of software products in and out of China.

On March 5, 2009, the MIIT promulgated the new *Measures Concerning Software Products Administration*, or the New Measures, which became effective on April 10, 2009. Under the New Measures, software products operated or sold in China are not required to be registered or recorded by relevant authorities, and software products developed in China (including those developed in China on the basis of imported software) can enjoy certain favorable policies when they have been registered and recorded. The New Measures also eliminated the previous requirements set forth above.

### ***Software Copyright***

The State Council promulgated the *Regulations on the Protection of Computer Software*, or the Software Protection Regulations, on December 20, 2001, which became effective on January 1, 2002. The Software Protection Regulations were promulgated, among other things, to protect the copyright of computer software in China. According to the Software Protection Regulations, computer software that is independently developed and attached to physical goods will be protected. However, such protection does not apply to any ideas, mathematical concepts, processing and operation methods used in the development of software solutions. Under the Software Protection Regulations, PRC citizens, legal persons and organizations will enjoy copyright protection for computer software that they have developed, regardless of whether the software has been published. Foreigners or any person without a nationality will enjoy copyright protection over computer software that they have developed, as long as such computer software was first distributed in China. Software of foreigners or any person without a nationality will enjoy copyright protection in China under these regulations in accordance with a bilateral agreement, if any, executed by and between China and the country to which the developer is a citizen of or in which the developer resides, or in accordance with an international treaty to which China is a party. Under the Software Protection Regulations, owners of software copyright will enjoy the rights of publication, authorship, modification, duplication, issuance, lease, transmission on the information network, translation, licensing and transfer. Software copyright protection takes effect on the day of completion of the software's development. The protection period for software developed by legal persons and other organizations is fifty years and ends on December 31 of the fiftieth year from the date the software solution was first published. However, the Software Protection Regulations will not protect the software if it is not published within fifty years from the date of the completion of its development. Civil remedies available under the Software Protection Regulations against copyright infringements include cessation of the infringement, elimination of the effects, apology and monetary compensation. The copyright administrative authorities may order the infringer to stop all infringing acts, confiscate illegal gains, confiscate and destroy infringing copies, and may impose a fine on the offender under certain circumstances.

### ***Software Copyright Registration***

On February 20, 2002, the State Copyright Administration of the PRC promulgated and enforced the *Measures Concerning Registration of Computer Software Copyright Procedures*, or the Registration Procedures, to implement the Software Protection Regulations and to facilitate the development of China's software industry. The Registration Procedures apply to the registration of software copyrights and software copyright exclusive licensing contracts and assignment contracts. The registrant of a software copyright will either be the copyright owner or another person (a natural person, legal person or an organization) in whom the software copyright becomes vested through succession, assignment or inheritance. Upon registration, the registrant should be granted a registration certificate by the China Copyright Protection Center. As of the date of this annual report, we had obtained ten registration certificates for computer software copyrights.

We have completed the registration of the software programs developed by us in accordance with the above-stated software-related regulations and have obtained from relevant government agencies the Software Product Certificates for these software programs.

### ***Regulation of Domain Names***

PRC laws require owners of Internet domain names to register their domain names with qualified domain name registrars approved by the MIIT and obtain registration certificates from such registration agencies. A registered domain name owner has the exclusive right to use its domain name. Unregistered domain names may not receive proper legal protections and may be misappropriated by unauthorized third parties.

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We have registered certain domain names, including *21edu.com*, *xueda.com*, *ejiajiao.com*, *exueda.com* and *xue.com* in accordance with such regulations relating to domain names and website names.






### **Regulation of Copyright and Trademark Protection**

China has enacted legislation governing intellectual property rights, including copyrights and trademarks. China is a signatory to the main international conventions on intellectual property rights and became a member of the Agreement on Trade Related Aspects of Intellectual Property Rights upon its accession to the World Trade Organization in December 2001.

#### **Regulation of Copyright Protection**

The National People's Congress amended the Copyright Law in 2001 to widen the scope of works and rights eligible for copyright protection and to extend copyright protection to Internet activities, products disseminated over the Internet and software products. In addition, there is a voluntary registration system administered by the China Copyright Protection Center. In February 2010, the National People's Congress further amended the Copyright Law to regulate the registration of pledge of copyright, which amendment came into force on April 1, 2010.

#### **Regulation of Trademark Protection**

The PRC Trademark Law, adopted in 1982 and amended in 2001, protects the proprietary rights to registered trademarks. The Trademark Office of SAIC handles trademark registrations and grants a term of ten years to registered trademarks and another ten years if requested upon expiry of the prior term. Trademark license agreements must be filed with the Trademark Office for record. Our PRC subsidiary, Xuecheng Century, has registered various trademarks and logos, including “ 学大教育”, “ 学大教育”, “Xueda,” “ 学大教育”, “ 学大教育 个性化课外辅导” and “”, with the Trademark Office of SAIC. In addition, Xuecheng Century has submitted applications in several batches to the Trademark Office of SAIC for the registration of certain other trademarks and logos, including “prime learning,” for our small-group tutoring programs and other trademarks and logos for our operations. Furthermore, Xuecheng Century has registered utility model and design patents with PRC Intellectual Property Bureau for certain teaching utilities it designed and developed, such as various kinds of multi-functional teaching desks.

#### **Regulation of Employment**

On June 29, 2007, the National People's Congress promulgated the *Employment Contract Law of the People's Republic of China*, or ECL, which became effective on January 1, 2008. On September 18, 2008, the State Council issued the *People's Republic of China Employment Contract Law Implementation Rules*, or ECL Implementation Rules, which became effective on September 18, 2008, the date of issuance. The ECL and ECL Implementation Rules require employers to enter into written contracts with their employees, restrict the use of temporary workers and aim to give employees long-term job security.

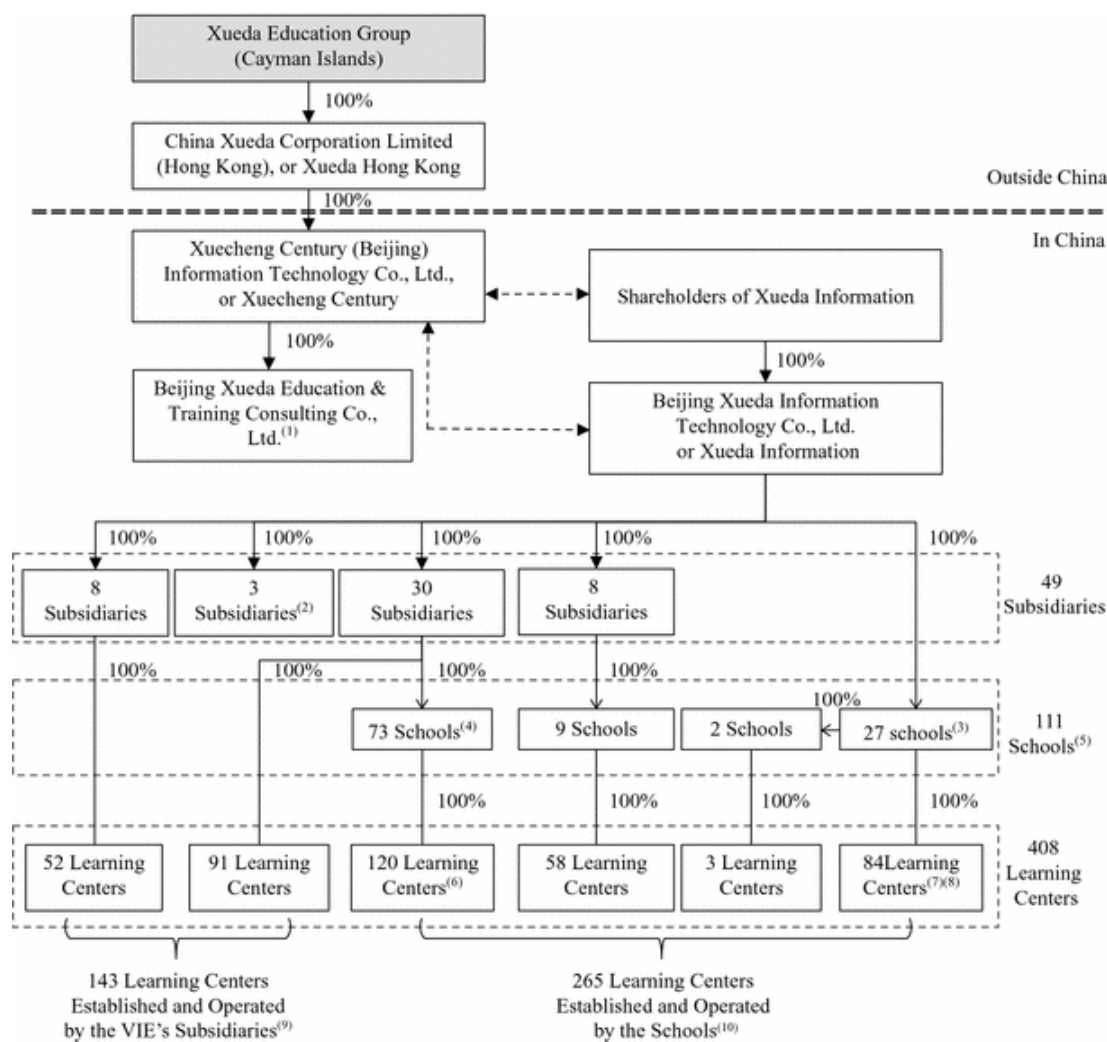
Pursuant to the ECL, employment contracts lawfully entered into prior to the implementation of the ECL and continuing as of the date of its implementation will continue to be valid. Where an employment relationship was established prior to the implementation of the ECL but no written employment contract was entered into, a contract must be entered into within one month after the ECL's implementation.

As of December 31, 2013, 2012 and 2011, we had 15,025, 16,454 and 15,074 full-time employees, respectively, including 8,080, 9,517 and 8,329 instructors, respectively. As of December 31, 2013, we had the following full-time employees by department: 8,080 instructors, 1,391 study counselors, 1,693 education consultants, 75 psychological counselors, 650 in sales and marketing and 3,136 in general and administrative functions, including 19 education research specialists.

### **C. Organizational Structure**

We are a holding company and were incorporated in the Cayman Islands on April 24, 2009. We own 100% of the equity interests in China Xueda Corporation Limited, a holding company incorporated in Hong Kong, or Xueda Hong Kong, which owns 100% of the equity interests in Xuecheng Century, our PRC subsidiary, incorporated in the PRC by us on August 17, 2009.

The following chart sets forth our corporate and operational structure as of December 31, 2013:





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- 
- Equity interest.
- Sponsorship interest.
- ←--- Contractual arrangements, including the Exclusive Service Agreement, the Pledge Agreement, the Exclusive Purchase Right Contract and the Powers of Attorney.
- (1) Beijing Xueda Education & Training Consulting Co., Ltd. was established in October 2011 and has not started business operation as of the date of this annual report.
- (2) These three subsidiaries only provide supplementary services and do not directly operate any school or learning center.
- (3) These 27 schools include:
- (a) 23 schools directly held by our VIE, three of which are registered as schools that do not distribute reasonable returns; and
  - (b) two schools held by Mr. Xin Jin, our co-founder and chief executive officer; one school held by Mr. Rubin Li, chairman of our board of directors, which is registered as a school that does not distribute reasonable returns; and one school held by a manager of one of our VIE's subsidiaries. These individuals hold these four schools on behalf of our VIE under certain nominee agreements between these individuals and our VIE.
- (4) One of these 73 schools is registered as a school that does not distribute reasonable returns.
- (5) These 111 schools include 106 schools that distribute reasonable returns and five that do not distribute reasonable returns.
- (6) These 120 learning centers also include one learning center established and operated by a school that does not distribute reasonable returns (see note (5) above). This learning center contributed less than 0.1% of our consolidated net revenue in 2013.
- (7) These 84 learning centers include:
- (a) 8 learning centers established and operated by the school held by Mr. Xin Jin (see note 3 above);
  - (b) 7 learning centers established and operated by the school held by Mr. Rubin Li (see note 3 above); and
  - (c) one learning center established and operated by the school held by the other individual (see note 3 above).
- These 16 learning centers held by these individuals under nominee agreements contributed an aggregate of 3.5% of our consolidated net revenue in 2013.
- (8) These 84 learning centers also include 20 learning centers established and operated by the four schools that do not distribute reasonable returns (see note 5 above). These 20 learning centers contributed an aggregate of 5.7% of our consolidated net revenue in 2013.
- (9) These 143 learning centers established and operated by our VIE's subsidiaries include (i) 60 learning centers that do not have any education related services in their approved scope of business and (ii) 64 learning centers that have included, among others, "education information" or "education technology related consultation" rather than "education services" or "tutoring services" in their respective approved business scope. These 60 and 64 learning centers contributed 8.1% and 15.6%, respectively, of our consolidated net revenue in 2013. See "Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Our Business and Industry — The learning centers of some of our VIE's subsidiaries and schools may be deemed by government authorities to operate beyond their authorized business scope or without proper registration, which could expose us to certain risks."
- (10) These 265 learning centers established and operated by our VIE's schools include 23 learning centers which were not properly registered as required. These 23 learning centers contributed an aggregate of 2.1% of our consolidated net revenue in 2013. See "Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Our Business and Industry — Some of our subsidiaries and schools may be deemed by government authorities to operate beyond their authorized business scope or without proper registration, which could expose us to certain risks."

Currently, we conduct all of our operations in China through Xuecheng Century, our PRC subsidiary, as well as through a series of contractual arrangements with Xueda Information, our VIE, and its shareholders. Our tutoring business is directly operated by and, as a result, all of our revenue is generated from Xueda Information and its subsidiaries and schools, in which we do not hold any equity or sponsorship interest, as the case may be. As of December 31, 2013, we had a total of 408 learning centers in 77 cities which were established and operated by 49 subsidiaries and 111 schools of our VIE.

In addition, in order to support our continuous growth and expansion, Xueda Information and Xueda Hong Kong each established a wholly owned subsidiary in February 2014, which currently have not commenced operation as of the date of this annual report.

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PRC laws and regulations do not expressly impose limitations or restrictions on foreign investment in the tutoring service sector in China. However, many local government authorities have different views and understandings of the relevant rules and regulations and have adopted different practices in granting licenses and permits for foreign-invested entities providing tutoring services. As a result, there remain significant uncertainties as to whether Xuecheng Century, a wholly foreign owned enterprise under the PRC law, could obtain the requisite licenses and permits to provide tutoring services. See “Item 4. Information on the Company — A. History and Development of the Company — Restructuring.” In addition, we may decide to expand our business into business areas in which foreign ownership and investment are expressly restricted, such as online education services. To address these uncertainties and minimize regulatory risks relating to restrictions on foreign ownership and investment in business areas we may expand into in the future, we have adopted the current organizational structure.

We do not have equity or sponsorship interests in Xueda Information, its subsidiaries or schools. However, as a result of the contractual arrangements described below, we have the power to direct the activities of Xueda Information that most significantly impact its economic performance and the right to receive substantially all of Xueda Information’s economic benefits. Therefore, we treat Xueda Information as our variable interest entity under U.S. GAAP.

We have consolidated the net revenue of Xueda Information and its subsidiaries and schools in our consolidated financial statements in accordance with U.S. GAAP. For the years ended December 31, 2011, 2012 and 2013, \$223.4 million, \$294.0 million and \$347.0 million, or 100%, 100% and 100%, respectively, of our total net revenue is attributable to Xueda Information and its subsidiaries and schools as they conduct all of our tutoring business. As of December 31, 2012 and 2013, Xueda Information and its subsidiaries and schools accounted for an aggregate of 49% and 53%, respectively, of our consolidated total assets, and 86% and 96%, respectively, of our consolidated total liabilities. The assets not associated with Xueda Information and its subsidiaries and schools in these years primarily consisted of cash held by Xueda Education Group, Xueda Hong Kong and Xuecheng Century. The table below sets forth a summary of the cash balances by currency held by Xueda Education Group, Xueda Hong Kong and Xuecheng Century as of December 31, 2012 and 2013, respectively. All of the cash amounts held by Xueda Education Group and Xueda Hong Kong set forth below related to the proceeds from our initial public offering completed in November 2010 and the Warburg Pincus investment completed in conjunction with our initial public offering.

	As of December 31,	
	2012	2013
	(in thousands of \$)	
Xueda Education Group	140,965	12,626
Denominated in \$	24,948	439
Denominated in RMB	116,017	12,187
Xueda Hong Kong	207	40,467
Denominated in \$	64	64
Denominated in RMB	143	40,403
Xuecheng Century	9,350	6,880
Denominated in \$	6,318	6,376
Denominated in RMB	3,032	504

Currently we do not anticipate requesting Xuecheng Century to transfer any cash outside of China to meet our cash needs. However, should such a need arise in the future, we may meet such need with dividend distributions from Xuecheng Century as described under “Item 3.D. Risk Factors—Risk Factors Relating to Doing Business in China—Restrictions on currency exchange may limit our ability to receive and use our revenue effectively.” Any dividend distribution by Xuecheng Century will incur certain cost in the form of withholding tax as discussed under “Item 3.D. Risk Factors—Risk Factors Relating to Doing Business in China—There are significant uncertainties under the EIT Law relating to the withholding tax liabilities of our PRC subsidiary, and dividends payable by our PRC subsidiary to our Hong Kong subsidiary may not qualify to enjoy the treaty benefits.”

*Exclusive Technology Consulting and Management Services Agreement.* Pursuant to the Amended and Restated Exclusive Technology Consulting and Management Services Agreement, or the Exclusive Service Agreement, entered into on August 28, 2009 as amended and restated on July 28, 2010 between Xuecheng Century and Xueda Information, Xuecheng Century has the exclusive right to provide technical consulting and management services to Xueda Information. Such services include course material research and development, employee training, technology development, transfer and consulting services, public relation services, market development and planning services, and other services as the parties may mutually agree from time to time. The Exclusive Service Agreement entitles Xuecheng Century to charge Xueda Information annual service fees that amount to substantially all of the net income of Xueda Information before the service fees. Xuecheng Century has the right to terminate this agreement, at any time during the term of this agreement, by 30-day prior written notice to Xueda Information, whereas Xueda Information may only terminate this agreement on the ground of Xuecheng Century’s gross negligence, fraud or other illegal act, or bankruptcy, lawful dissolution or termination of Xueda Information. Unless terminated earlier in accordance with the above provisions, this agreement has a term of ten years and can be extended automatically, unless indicated otherwise by Xuecheng Century. Xuecheng Century recognized service fees in the total amount of RMB 139.6 million (\$22.7 million) for the year ended December 31, 2013, in consideration for services provided to Xueda Information. The service fees recognized in 2013 were eliminated upon consolidation and had been paid by Xueda Information to Xuecheng Century as of December 31, 2013.

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***Pledge Agreement.*** Pursuant to the Amended and Restated Pledge Agreement, or the Pledge Agreement, entered into on August 28, 2009, as amended and restated on December 31, 2010, among Xuecheng Century and each of the shareholders of Xueda Information, each shareholder of Xueda Information has agreed to pledge his or her equity interest in Xueda Information to Xuecheng Century to secure the performance of Xueda Information's obligations with respect to the fees payable under the Exclusive Service Agreement, and each shareholder of Xueda Information has agreed not to transfer, pledge or otherwise create any encumbrance on his or her equity interest in Xueda Information without the prior written consent of Xuecheng Century. The Pledge Agreement also provides that, starting from the date of its execution, Xuecheng Century is entitled to all income in cash or otherwise, such as all dividends, generated by the pledged equity interest. This agreement has a term of ten years, which will be extended automatically if the Exclusive Service Agreement is extended upon expiry. Our PRC counsel has advised us that the pledges were created and are effective, as such pledges have been registered with the relevant administration for industry and commerce in accordance with the PRC *Property Rights Law*.

***Exclusive Purchase Right Contract.*** Pursuant to the Amended and Restated Exclusive Purchase Right Contract, or the Exclusive Purchase Right Contract, entered into on August 28, 2009, as amended and restated on July 28, 2010, among Xuecheng Century, Xueda Information and its shareholders, each shareholder of Xueda Information is obligated to sell to Xuecheng Century, and Xuecheng Century has an exclusive and irrevocable right to purchase from such shareholder, or cause such shareholders to sell or transfer to Xuecheng Century's designated party, all or part of such shareholder's equity interest in Xueda Information to the extent permissible under applicable PRC law. The purchase price to be paid by Xuecheng Century or its designated party will be the minimum amount of consideration permitted by applicable PRC law at the time when such share transfer occurs. Currently, PRC national laws and regulations do not expressly impose limitations or restrictions on foreign investment in the tutoring service sector in China, nor would the exercise of the purchase price by Xuecheng Century be restricted under PRC national laws and regulations. However, as there remain uncertainties as to whether Xuecheng Century, a wholly foreign owned enterprise under the PRC law, could obtain the requisite licenses and permits to provide tutoring services in practice, we do not expect Xuecheng Century to exercise this purchase right in the foreseeable future. Even if these uncertainties no longer exist in the future, before we determine whether and when to exercise this purchase right, we will also consider all relevant factors including the needs of our business operations and the regulatory environment, and will exercise such purchase right in the manner set forth in this agreement and in accordance with applicable PRC laws and regulations. We believe that our right to exercise this purchase right will not be affected by the current uncertainties as this agreement will remain in force until Xuecheng Century or its designated party purchases all of Xueda Information's equity interests from shareholders of Xueda Information.

Under the Exclusive Purchase Right Contract, Xueda Information undertakes that, before the purchase by Xuecheng Century or its designated party, (i) it will prudentially and effectively conduct its business, deal with its affairs and maintain its existence in accordance with good financial and commercial standards and practices; and (ii) it will at all times conduct all of its operations during the ordinary course of business so as to maintain the value of the assets of Xueda Information and will refrain from any action or inaction sufficient to affect the operating conditions and asset value of Xueda Information. In addition, the shareholders of Xueda Information undertake that, other than the pledges created on the equity interest of Xueda Information under the Pledge Agreement, (i) without prior written consent of Xuecheng Century, it will not sell, transfer, mortgage or otherwise dispose of any legal or beneficial interest in Xueda Information or allow the creation of any encumbrance thereon; and (ii) it will cause the shareholders' meeting of Xueda Information not to approve, in the absence of prior written consent of Xuecheng Century, sale, transfer, mortgage or other disposal of any legal or beneficial interest in Xueda Information or creation of any encumbrance thereon.

***Powers of Attorney.*** Pursuant to the Powers of Attorney executed on August 28, 2009 by each of the shareholders of Xueda Information, each such shareholder irrevocably entrusted Xuecheng Century to exclusively exercise such shareholder's rights in Xueda Information, including without limitation, the power to participate in and vote at shareholders' meetings and execute shareholders' resolutions; exercise all shareholders' rights under the law and Xueda Information's constitutional documents; the power to nominate and appoint the legal representative, the chairperson of the board of directors, directors, executive directors, supervisors, general managers and other senior management of Xueda Information for so long as he or she remains a shareholder of Xueda Information; and the right to sign the transfer agreement on behalf of the shareholders that is necessary to enforce the Pledge Agreement and the Exclusive Purchase Right Contract. The Articles of Association of Xueda Information provide that the major rights of its shareholders include the right to review and approve the annual budget, operating strategy and investment plan, elect the members of board of directors and approve their compensation plan. Therefore, through the irrevocable power of attorney arrangement, Xuecheng Century has the ability to exercise effective control over Xueda Information through shareholder votes and, through such votes, to also control the composition of Xueda Information's board of directors. As a result of these contractual rights, we have the power to direct the activities of Xueda Information that most significantly impact its economic performance and exercise control.

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These contractual arrangements between our PRC subsidiary and Xueda Information and its shareholders enable us to:

- exercise effective control over Xueda Information and its subsidiaries and schools;
- receive substantially all of the economic benefits from Xueda Information and its subsidiaries and schools in consideration for the services provided by Xuecheng Century; and
- have an exclusive and irrevocable right to purchase all or part of the equity interests in Xueda Information at a time we determine suitable after considering all relevant factors, including the needs of our business operations and the regulatory environment.

In the opinion of our PRC legal counsel:

- the ownership structures of Xueda Information and its subsidiaries, and our wholly owned subsidiary in the PRC are in compliance with existing PRC laws and regulations; and
- the contractual arrangements among our wholly owned subsidiary in the PRC, Xueda Information, and the shareholders of Xueda Information are valid, binding and enforceable under, and will not result in any violation of, PRC laws or regulations currently in effect.

We have been advised by our PRC legal counsel, however, that there are substantial uncertainties regarding the interpretation and application of current and future PRC laws and regulations. See “Item 3. Key Information — D. Risk Factors — 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 the contractual arrangements that establish the structure for our business operations do not comply with applicable PRC laws and regulations, we could be subject to severe penalties.”

### **D. Property, Plant and Equipment**

Except for four learning centers in Hefei, Anhui Province, Jinan, Shandong Province, Hangzhou, Zhejiang Province and Yancheng, Jiangsu Province, which have an aggregate space of 2,358 square meters, we currently lease all of the properties we use to operate our business. Our headquarters are located in Beijing, China, where we lease approximately 2,331 square meters of office space. As of December 31, 2013, we leased an aggregate of approximately 280,413 square meters of space for our learning centers.

All of our learning centers operate under our “Xueda” brand. A typical learning center consists of tutoring rooms, customer service operations and administrative facilities. Since 2009, we have implemented a standardized interior design at our new learning center across the country, and we plan to renovate our existing learning centers for the standardized interior design over time.

### **Item 4A. Unresolved Staff Comments**

None.

## **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

*You should read the following discussion and analysis of our financial condition and results of operations in conjunction with our consolidated financial statements and the related notes included elsewhere in this annual report. This discussion may contain forward-looking statements based upon current expectations that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of various factors, including those set forth under “Item 3.D. Risk Factors” or in other parts of this annual report.*

## A. Operating Results

### Overview

We are the leading national provider of tutoring services for primary and secondary school students in China. We derive our revenue from providing personalized tutoring services that are results-oriented and student-centric. Since opening our first learning center in 2004, we have organically built a national network of 408 learning centers (265 of which were established and operated by our VIE's or its subsidiaries' 111 schools and 143 of which were established and operated by our VIE's subsidiaries) and approximately 11,200 full-time service professionals, serving customers located in 77 cities across 28 of China's 31 provinces and municipalities, as of December 31, 2013.

Our business continued to grow in the year ended December 31, 2013. In 2013, we added 25 new learning centers, bringing our total number of learning centers to 408. During the same year, we served approximately 150,000 students.

### Factors Affecting Our Results of Operations

The major factors affecting our results of operations and financial condition include:

- *Overall Economic Conditions and Education Industry Development in China.* We have benefited significantly from overall growth of the economy, the rapid growth of the education industry and the growing demand for educational services, particularly personalized tutoring services, in China. The overall economic growth and increase in disposable household income in China have led to a significant increase in private spending on educational services and a rapid growth of the educational service industry. As a result, the private education sector in the educational service industry in China is growing at a rapid rate. However, any adverse changes in economic conditions in China may have a material adverse effect on the demand for general educational services including tutoring services in China, which in turn may harm our business and results of operations.
- *Regulatory Environment.* Adverse changes in the regulatory environment in China may have a material adverse effect on the education industry in China, which in turn may harm our business and results of operations. The Chinese government regulates all aspects of our business and operations, including the qualification and licensing requirements for entities providing educational services, standards for the operations of learning centers and foreign investments in the education industry, as well as our corporate structure and contractual arrangements with our VIE and its shareholders. We are subject to a legal regime consisting of regulations governing various aspects of our business such as regulations on education, software, internet, audio-video broadcasting, tax, information security, privacy, copyright and trademark protection and foreign exchange. These regulations are evolving and are subject to changes from time to time. Any such change may have a material adverse effect on our business, results of operations and financial condition, either retroactively or prospectively.
- *Competition.* The educational services market in China, particularly the tutoring sector, is highly fragmented, competitive and rapidly evolving. Our competitors consist of private schools, public and private companies that provide tutoring services and individual private tutors. Although we have not faced significant direct competition from other tutoring service providers on a national scale, changes to the overall competitive landscape in China's tutoring service market may affect our ability to compete successfully against current and future competitors, resulting in adverse effects on our market share and results of operations.
- *Course Hours Delivered Related Factors.* Over the past few years, the growth of our net revenue has been driven primarily and directly by increased course hours purchased by and delivered to students served in our tutoring programs. Total course hours delivered reflect the overall revenue-generating services provided across our tutoring service network. The increase in the course hours delivered has primarily been driven by the expansion of our tutoring service network and is also dependent upon the number of students we serve network wide, the "size" of our service contracts and the supply of instructors. These factors, in turn, largely depend on the demand for our tutoring services, the effectiveness of our marketing and brand promotion, the demographic composition of the geographic locations of our learning centers and our ability to respond to competitive pressure. Neither we nor any of our students receive financial assistance for our tutoring services; therefore, third-party financial assistance has not been a contributing factor to our course hours delivered or number of students served.

The increase in our course hours delivered was primarily the result of the following factors.

- *Number of learning centers.* The increase in our course hours delivered has been driven to a substantial extent by the expansion of our tutoring service network. The total number of learning centers in operation increased from 295 in 2011 to 383 in 2012 and further increased to 408 as of December 31, 2013. The number of cities covered by our tutoring service network increased from 63 at the end of 2011 to 73 at the end of 2012 and further increased to 77 as of December 31, 2013. We believe the increase in the number of learning centers and the geographic expansion of our service network have significantly enhanced our brand recognition across the country, which has in turn contributed to the increase in the number of course hours delivered.
- *Number of students served.* The increase in the number of students we serve is also an important driving force of our course hours delivered. We have increased the number of students served through opening new learning centers to further expand our capacity and increasing the utilization of the capacity of our existing learning centers. The number of our annual students served increased from approximately 117,000 in 2011 to approximately 138,690 in 2012 and further increased to approximately 150,000 in 2013.
- *Net revenue generated per full-time instructor and net revenue generated per square meter of learning centers.* We believe net revenue generated per full-time instructor provides a meaningful measure to assess the utilization rate of our service professionals, and net revenue per square meter of learning centers, on the other hand, helps us to assess the utilization rate of our physical premises and facilities. As such, we believe these two measures facilitate our assessment and monitoring of our operating efficiency. Net revenue generated per full-time instructor increased by 24.4% to \$33,470 in 2013 from \$26,910 in 2012. Over the same period, Net revenue generated per square meter of learning centers increased 19.8% from \$1,010 in 2012 to \$1,210 in 2013.
- *Course Fee Related Factors.* Our results of operations are affected by the following course fee related factors:
  - *“Size” of service contracts.* The “size” of our service contracts refers to both the total course fees purchased and service periods under the service contracts. In 2013, the average amount of course fees purchased under each service contract ranged from RMB10,000 to RMB30,000 (\$1,652 to \$4,956). The service periods under our service contracts are stipulated based on the needs of our students, which may be longer than one year and typically range from two to eight months, a decrease from three to ten months in 2010. The decrease in the length of the service periods is primarily a result of our continuous efforts to strengthen our course planning by further fine-tuning our consultation session with potential students which enables the students to complete purchased course hours more efficiently and in a shorter period. We consider the “size” of our service contracts as an important factor affecting our business operations, particularly the results of the immediately succeeding fiscal period. First, service contracts with a large “size” help us secure longer term revenue. Second, revenue not recognized in the current fiscal period as a result of a service term that lasts beyond the end of the current fiscal period will be recorded as deferred revenue, which does not directly impact the results of operations of the current fiscal period, but provides us with a reasonable level of revenue visibility into the succeeding fiscal periods. By analyzing the amount and composition of such deferred revenue, we can plan our operation and resource allocation accordingly, which helps us enhance our overall operating efficiency.
  - *Average hourly course fee.* Our ability to maintain and increase our hourly course fees is an important factor that affects our net revenue. We determine hourly course fees on the basis of a number of factors, primarily the students’ grade levels, the number of course hours purchased and the experience levels of the instructors. We adjust hourly course fees based on local market conditions. Due to the increasing demand for tutoring services, our reputation in the tutoring market and the high quality of our tutoring programs, we were able to steadily raise hourly course fees in the past few years. Our average hourly course fee increased from approximately \$26 in 2011 to \$28 in 2012 and further increased to \$30 in 2013. Under favorable conditions and after taking into consideration such factors as the expected level of competition and the demand and supply situation in the tutoring market, we may decide to further raise our hourly course fees in a disciplined manner in selected geographic markets.
  - *Course fee payment and refund.* We require all of our students to pay the total course fees in full within seven days from the date they enter into a service contract with us. In addition to course fees, each of our new students is required to pay a non-refundable registration fee at the time such student enters into their first service contract with us. The registration fee varies by location and normally ranges from RMB300 (\$49.6) to RMB 1,000 (\$165.2).



Students who are unable to complete all of the prepaid course hours within the service period set forth in the service contract may choose to extend the service period for up to 40 days according to the contractual terms upon prior notice to us, or they may choose to terminate the service contract prior to the expiration of the service period and receive a refund for the course hours prepaid but not delivered. Course fees prepaid for courses purchased but not delivered due to reasons attributable to the students will not be refundable after 26 months of the expiration of the service period set forth in the service contract. Refunds do not affect our reported revenue as the refunded course fees are not yet recognized as revenue before the services are delivered, but have an adverse effect on our cash flow for the period in which the refunds are made. In 2011, 2012 and 2013, course fees refunded amounted to \$18.7 million, \$ 29.0 million and \$33.5 million, respectively. The increase in the amount of course fees refunded was primarily due to the increased number of students served in these periods. The total amount of course fees in cash we received amounted to \$262.9 million, \$ 366.6 million and \$390.1 million in 2011, 2012 and 2013, respectively. For the same periods, our refund rate, defined as the percentage of course fee refunded in a period out of the total amount of course fees collected in such period, was 7.1%, 7.9% and 8.6%, respectively. The refund rate is a cash management measure which only reflects the impact of the refunds on our cash flow.

- Proportions of Learning Centers at Various Development Stages.** When we open new learning centers, it takes time to build management and service teams, accumulate local experience, establish track records and fully ramp up their operation. Learning centers at various development stages have different performance, characteristics and effects on our results of operations. We historically divided our learning centers into four categories based on their development stage. Primarily as a result of the rapid expansion and development of our business, starting from 2012, we divide our learning centers into the following three categories based on their development stages. We believe such re-categorization better represents the different performance, characteristics and effects on our results of operations among our learning centers going forward.
  - Start-up learning centers.** We refer to learning centers in the first 12 months of their operations as “start-up learning centers.” Typically, a start-up learning center incurs significant fixed costs and operating expenses, yet it takes longer for its students served and course hours delivered to ramp up.
  - Growth learning centers.** We refer to learning centers in operation between 12 and 36 months as “growth learning centers.” Typically, both the revenue and net income of a growth learning center increase rapidly.
  - Mature learning centers.** We refer to learning centers with an operating history of 36 months or longer as “mature learning centers.” A mature learning center typically is capable of achieving consistently healthy levels of profitability.

The table below sets forth the numbers of learning centers at various development stages as of the dates indicated, applying the new categorization.

Development Stage	As of December 31,					
	2011		2012		2013	
	Number	% of Total	Number	% of Total	Number	% of Total
Start-up learning centers	97	32.8	109	28.5	38	9.3
Growth learning centers	99	33.6	142	37.1	167	40.9
Mature learning centers	99	33.6	132	34.4	203	49.7
Total	295	100.0	383	100.0	408	100.0

A learning center incurs a substantial amount of fixed costs and expenses throughout its various stages. Such fixed costs and expenses primarily consist of teaching staff’s base salaries, rental and office expenses, leasehold improvement depreciation, and expenses related to management team and administrative staff. With such fixed costs and expenses, and with the fact that a start-up learning center typically has relatively lower utilization at its earlier stage of development, a large number of newly-opened learning centers may lower our overall profitability on a consolidated basis in the first 12 to 18 months after their opening. The number of our learning centers increased by a net of 88, 88 and 25 for the years ended December 31, 2011, 2012 and 2013, respectively. Compared to the 88 learning centers opened in 2012, the 25 learning centers opened in 2013 had a less adverse effect on our gross margin in the relevant year. In the same period, we closed a small number of learning centers for relocation purpose. We closed 13 learning centers in 2013, compared to 12 in 2012 and one in 2011. The closure of learning centers did not have a material effect on our results of operations. In addition, the variation in proportions of learning centers at various development stages in any specific period may affect our overall results of operations and profitability in such period. As our business continues to grow and the base of mature learning centers expands, we expect that the adverse impact of start-up learning centers on our overall results of operations will be less significant over time.

Furthermore, the average cost for opening new learning centers as reflected by capital expenditures decreased from 2011 to 2012 and remained relatively stable from 2012 to 2013. Capital expenditures per learning center, including expenditures incurred for leasehold improvement and property and equipment, were approximately RMB1.2 million, RMB 0.8 million and RMB0.8 million in 2011, 2012 and 2013, respectively. The decrease in capital expenditures per learning center was primarily attributable to our implementation of budget control on leasehold improvements, including a decrease in average lease space per learning center from 700-900 square meters for learning centers opened in 2011 and 400-600 square meters for learning centers opened starting in 2012 to 300-600 square meters for learning centers opened starting from 2013. The smaller average size of the learning centers opened in 2013 is due to the fact that most of these learning centers are added to markets where we have already established a presence, in order to meet the market demand not yet fully satisfied by our existing learning centers in those markets. Going forward, we will determine the size of our learning centers taking into consideration of the operation needs and market demand of our services in the various geographic areas.

We believe that, the average hourly course fee aside, a learning center's revenue-generating capacity depends on the maximum course hours that can possibly be delivered at such learning center in a given period, which in turn is a function of (i) the space/size of such learning center, which translates into the maximum student space (i.e., the number of students that can be housed at a time); and (ii) the maximum number of course hours that can be scheduled for each student space in such period. Although by improving the learning center's course scheduling capability and increase the average number of course hours delivered for each student space, it is possible to increase the revenue-generating capacity, we believe that a learning center's revenue-generating capacity is largely determined by its space/size, which is not affected by the development stage of such learning center. The development stage of a learning center affects the utilization of its revenue-generating capacity: at a learning center's early development stage when its operation is not fully ramped up yet, the learning center's utilization of its revenue-generating capacity is low. As such learning center becomes mature, the utilization of its revenue-generating capacity increases.

Although the new learning centers opened in 2013 and onwards may have a smaller average size compared to learning centers opened in prior years, we expect our overall revenue generating capacity to increase as we continue to open new learning centers. We also expect the overall utilization of our existing revenue generating capacity to increase as more learning centers become mature.

- *Seasonality.* Our results of operations are also affected by seasonal factors. On an individual learning center basis, our net revenue is typically relatively higher in the second quarter compared to the other quarters in the year, because our learning centers generally have the largest number of students served and the highest course hours delivered in the second quarter of each year, the time when most primary and secondary school students prepare for the final exams in the spring semester and, particularly, ninth-grade and 12th-grade students are about to take the high school and college entrance exams in China. Our individual learning centers generally have the lowest number of students served and course hours delivered in September as fewer students use tutoring services immediately after school year starts at the beginning of that month. The month in which the Chinese New Year falls in generally is also a slow month as fewer new students are served immediately before and around the holiday season, which is typically in January or February of each year. As a result, on an individual learning center basis, our revenue is typically relatively lower in the January or February and September of the year.

On the other hand, our costs and expenses generally are not significantly affected by seasonal factors, as a significant portion of such costs and expense are fixed. As a result, our profitability in January or February (depending on which month the Chinese New Year falls in) and September of the year is typically affected the most by such adverse seasonal factors.

We expect the seasonal pattern of our results of operations to continue, although the impact of seasonal factors may not be as prominent in all periods as other factors due to our rapid business expansion.

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## Revenue

Our source of revenue is course fees collected from students, which is a function of course hours delivered in the period and the average hourly course fee. We offer tutoring programs that cover all academic curriculum subjects taught in primary and secondary schools in the markets where we operate. Our tutoring programs typically range in term from two to eight months. The table below sets forth our net revenue and other correlated data for the periods indicated.

	For the Year Ended December 31,		
	2011	2012	2013
Net revenue (in thousands of \$)	221,738	293,157	347,047
Number of students served	116,900	138,688	149,882
Number of learning centers (at period end)	295	383	408
Average hourly course fee (in \$) <sup>(1)</sup>	26	28	30

(1) Represents gross revenue derived from one-on-one tutoring, divided by the total hours of one-on-one tutoring in the relevant period.

## Cost of Revenue and Operating Expenses

Our costs and expenses consist of cost of revenue, general and administrative expenses and selling and marketing expenses.

	For the Year Ended December 31,					
	2011		2012		2013	
	\$	% of Net Revenue	\$	% of Net Revenue	\$	% of Net Revenue
(in thousands, except percentages)						
Cost of revenue:						
Teaching staff cost	115,931	52.3	157,101	53.6	171,940	49.5
Rental	26,920	12.2	38,182	13.0	40,958	11.8
Depreciation and amortization	6,682	3.0	13,256	4.5	13,946	4.0
Other	6,689	3.0	11,116	3.8	13,104	3.8
Total cost of revenue	156,222	70.5	219,655	74.9	239,948	69.1
Operating expenses:						
General and administrative expenses	36,425	16.4	46,427	15.8	52,716	15.1
Selling and marketing expenses	25,940	11.7	31,336	10.7	36,308	10.5
Impairment loss on goodwill	—	—	—	—	2,923	0.8
Impairment loss on acquired intangible assets	—	—	—	—	494	0.1
Total operating expenses	62,365	28.1	77,763	26.5	92,441	26.5

**Cost of revenue.** Our cost of revenue primarily consists of:

- *Teaching staff cost*, which consists of base salaries, performance-based teaching fees, and bonuses and benefits paid to or for our full-time teaching staff, as well as performance-based teaching fees paid to our contract instructors. Performance-based teaching fees include teaching fees paid to our teaching staff in relation to work performed during our optional, free Q&A sessions in study rooms at our learning centers which we provide as part of our supporting services to our students. Our teaching staff includes our instructors, study counselors and education consultants. Unlike many tutoring service providers in China, we have a large full-time service team that generated 83.9%, 87.0% and 83.8% of our net revenue for the years ended December 31, 2011, 2012 and 2013, respectively. Our service model features personalized tutoring services delivered by a dedicated team of full-time service professionals primarily through one-on-one tutoring; therefore, teaching staff cost has been, and is expected to continue to be, a major component of our cost of revenue. As more learning centers become growth and mature learning centers and we further enhance the utilization of our instructors, we expect teaching staff cost as a percentage of net revenue to decrease to a stable level in the long term.
- *Rental cost*, which increases primarily as we expand our tutoring service network by opening new learning centers and to a lesser extent, expanding our existing learning centers. In 2011, 2012 and 2013, we added 88, 88 and 25 learning centers to our tutoring service network, respectively. As of December 31, 2011, 2012 and 2013, we had 295, 383 and 408 learning centers in operation, respectively. We expect rental cost as a percentage of net revenue to decrease over time as more learning centers become growth and mature learning centers, improve the utilization of their revenue generating capacity and generate revenue at a rate faster than the increase in rental cost.
- *Depreciation and amortization*, which relates to, as to depreciation charges, furniture, fixture and equipment used in rendering tutoring service and, as to amortization charges, leasehold improvement for our learning centers. Historically, depreciation and amortization have not been an important component of our cost of revenue. As we open new learning centers and strive to improve the facilities of our learning centers to enhance students' learning experience, we expect our investment in furniture, fixture, equipment and leasehold improvement to increase, which will cause depreciation and amortization to increase in absolute amounts. However, as we further standardize our operation procedures and apply them throughout our tutoring service network, we believe depreciation and amortization will remain a small percentage of our cost

of revenue.

- *Other cost*, which primarily consists of office supplies consumed by learning centers in rendering tutoring services.

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We expect our total cost of revenue to increase in absolute amounts as we continue to open new learning centers, better utilize the capacity of our existing learning centers and hire additional instructors, study counselors and education consultants. Although we anticipate that in the long term our revenue growth rate will start declining gradually as the revenue base becomes larger and an increasing portion of our learning centers become mature, we expect the growth rate of our revenue to be faster than the growth rate of our cost of revenue. As a result, we expect our cost of revenue to decrease over time as a percentage of our net revenue as an increasing number of learning centers become growth and mature learning centers and we enhance the utilization of both our instructors and our physical premises and facilities, enhance operating efficiency by applying standardized operation procedures and achieve economies of scale.

**General and administrative expenses.** Our general and administrative expenses primarily consist of (i) compensation and benefits of management team, administrative staff and employees in the information technology function, including share-based compensation expenses, (ii) rental expenses for office space leased for administrative uses, (iii) office administration, human resources management and professional service fees and (iv) to a lesser degree, depreciation and amortization of property and equipment, including purchased software, used in our general and administrative activities. We expect that our general and administrative expenses will increase in absolute amounts in the near term as we hire additional personnel and incur additional costs in connection with business expansion and with being a publicly traded company, including costs of enhancing our internal controls, but will decrease as a percentage of total net revenue as we further improve operating efficiency and achieve economies of scale.

**Selling and marketing expenses.** Our selling and marketing expenses primarily consist of (i) expenses relating to advertising, marketing and brand promotion activities and (ii) salaries and commissions paid to our marketing personnel. We expect that our selling and marketing expenses will continue to increase in absolute amounts as we continue our brand building and marketing activities, increase the number of our learning centers and expand into new geographic areas, but will decrease gradually to reach and remain at a stable percentage of total net revenue due to the cumulative effect of our brand-building, advertising and marketing efforts.

## **Taxation**

### ***Cayman Islands***

We are incorporated in the Cayman Islands. Under the current law of the Cayman Islands, we are not subject to income or capital gains tax in the Cayman Islands. In addition, our payment of dividends, if any, is not subject to withholding tax in the Cayman Islands. For the year ended December 31, 2013, our Cayman holding company's net loss before tax was \$1.1 million.

### ***Hong Kong***

Xueda Hong Kong is subject to a corporate income tax of 16.5%. Xueda Hong Kong was incorporated in 2009 and had no assessable profits during the years ended December 31, 2011, 2012 and 2013 and accordingly we have made no provision for its income tax. For the year ended December 31, 2013, the net income before tax was \$1,835, representing interest income and exchange gain that were not subject to income tax in Hong Kong.

### ***PRC***

**Business tax.** Pursuant to the *Interim Regulations on Business Tax of PRC*, which became effective on January 1, 1994 and was amended on January 1, 2009, all entities and individuals who engage in the provision of services, the transfer of intangible assets or the sale of real properties within PRC are required to pay PRC business tax. Currently, the learning centers established and operated by our VIE and some of its subsidiaries and all the schools in China are subject to a 3% to 5% business tax on gross revenue generated from providing tutoring services, plus related surcharges.

**Value-Added Tax.** In November 2011, the Ministry of Finance and the SAT promulgated the *Pilot Plan for Imposition of Value-Added Tax to Replace Business Tax*, which became effective from January 1, 2012, or the Pilot Plan. As approved by the PRC State Council on July 25, 2012, this Pilot Plan was first launched in Shanghai and was expanded to ten other provinces and municipalities, including Beijing, Tianjin, Jiangsu, Zhejiang, Anhui, Fujian, Hubei, Guangdong, Xiamen and Shenzhen, or collectively, the Ten Pilot Regions, in batches from August 1, 2012 through the end of 2012. The Ministry of Finance and the SAT issued a circular, or the National Rollout Circular, on May 24, 2013, announcing that the Pilot Plan would be rolled out nationwide from August 1, 2013. The National Rollout Circular formalizes the national implementation of the replacement of Business Tax to Value-Added Tax reform, or the VAT reform, under which value-added tax, or VAT, would be applied on certain service revenue which were previously subject to business tax, from a legislative perspective and also provides detailed implementation rules on the national rollout. With many provisions of the National Rollout Circular remaining intact, the Ministry of Finance and the SAT issued a guidance on December 13, 2013 which contains the expansion of the VAT reform in the sectors of railway transportation and postal services from January 1, 2014 to replace the National Rollout Circular.

As of December 31, 2013, our PRC subsidiary and certain VIE's subsidiaries have been required by local tax authorities to apply a VAT rate of 3%, 6% or 17% on certain service revenue which was previously subject to business tax.

**Income tax.** Pursuant to the EIT Law, a uniform 25% enterprise income tax rate is generally applied to both foreign-invested enterprises and domestic enterprises, except where a special preferential rate applies. Our PRC subsidiary and our VIE and its subsidiaries in China are subject to enterprise income tax at a statutory rate of 25%. Xuecheng Century was certified as a "software enterprise" for tax purposes in April 2010 and as a result is eligible for a two-year exemption of income tax for 2010 and 2011 followed by a 12.5% income tax rate for 2012, 2013 and 2014. In light of the uncertainties as to what preferential tax treatments are applicable to our schools, all of our VIE's schools have also accrued and paid income tax at the statutory rate of 25%. See "Item 4. Information on the Company—B. Business Overview—Regulation—the Law for Promoting Private Education and the PE Implementation Rules." For the year ended December 31, 2013, the total taxable income for our PRC subsidiaries and our VIE and its subsidiaries and schools in China was \$ 37.7 million.

Income tax is assessed and paid at subsidiary or branch level; therefore, the net loss from operations generated by a particular entity cannot be transferred to or utilized by other entities within our consolidated company. As a result, our effective tax rate for 2013 was 33.4%.

Under the EIT Law and the EIT Implementation Rules, an enterprise established outside of the PRC with "de facto management bodies" within the PRC is considered a resident enterprise and is subject to enterprise income tax at the rate of 25% on its global income. The EIT Implementation Rules define the term "de facto management bodies" as "establishments that carry out substantial and overall management and control over the manufacturing and business operations, personnel, accounting, properties, etc. of an enterprise." The SAT issued the *Notice Regarding the Determination of Chinese-Controlled Offshore Incorporated Enterprises as PRC Tax Resident Enterprises on the Basis of De Facto Management Bodies*, or Circular 82, on April 22, 2009. Circular 82 provides certain specific criteria for determining whether the "de facto management body" of a Chinese-controlled offshore incorporated enterprise is located in China. Following Circular 82, on August 3, 2011, the SAT issued *Administrative Measures on Income Taxes of Resident Enterprises Incorporated outside Mainland China and Are Controlled by Chinese Enterprises (Trial Implementation)*, or Resident Enterprise Administrative Measures, which was effective as of September 1, 2011. This Resident Enterprise Administrative Measures provides clarification of resident status determination, post-determination administration, as well as competent tax authorities. However, Circular 82 and Resident Enterprise Administrative Measures apply only to offshore enterprises controlled by PRC enterprises, not those invested in by PRC individuals, like our company. Currently there are no further detailed rules or precedents applicable to us governing the procedures and specific criteria for determining "de facto management body" for the company of our type. We do not believe we are a resident enterprise defined and regulated by the aforesaid regulations as none of our shareholders is a PRC company or PRC corporate group. However, it remains unclear how PRC tax authorities will determine the tax residency status of companies like us. See "Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Doing Business in China — Under the EIT Law, we may be classified as a 'resident enterprise' of China. Such classification would likely result in unfavorable tax consequences to us and our non-PRC shareholders." Under the EIT Law and the EIT Implementation Rules, the profits of a foreign invested enterprise generated in 2008 and onwards which are distributed to its immediate holding company outside the PRC will be subject to a withholding tax rate of 10%. Pursuant to a special arrangement between Hong Kong and the PRC, such rate is lowered to 5% if a Hong Kong resident enterprise owns over 25% of a PRC company during the 12 consecutive months preceding the receipt of the dividends. Our PRC subsidiary is currently wholly owned by our Hong Kong subsidiary. However, there is no assurance the PRC tax authorities will grant approvals on the 5% withholding tax rate on dividends received by our Hong Kong subsidiary from our PRC subsidiary. See "Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Doing Business in China — There are significant uncertainties under the EIT Law relating to the withholding tax liabilities of our PRC subsidiary, and dividends payable by our PRC subsidiary to our Hong Kong subsidiary may not qualify to enjoy the treaty benefits."



## **Critical Accounting Policies**

We prepare our financial statements in accordance with U.S. GAAP, which requires us to make estimates and assumptions that affect our reporting of, among other things, assets and liabilities, contingent assets and liabilities and net revenue and expenses. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experiences and other factors that we believe to be relevant under the circumstances. Our management has discussed the development, selection and disclosure of these estimates with our board of directors. Since our financial reporting process inherently relies on the use of estimates and assumptions, actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that could reasonably have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the consolidated financial statements. We consider the policies discussed below to be critical to an understanding of our audited consolidated financial statements because they involve the greatest reliance on our management's judgment. You should read the following description of critical accounting policies, judgments and estimates in conjunction with our consolidated financial statements and other disclosures included with this annual report.

### ***Consolidation of Variable Interest Entity***

We conduct substantially all of our education business through Xueda Information, our variable interest entity, and its subsidiaries and schools. We have, through our wholly owned subsidiary, Xuecheng Century, in the PRC, entered into contractual arrangements with Xueda Information, its subsidiaries and schools and its shareholders such that Xueda Information and its subsidiaries and schools are considered variable interest entities for which we are considered primary beneficiary. These contractual arrangements include the Exclusive Service Agreement, Powers of Attorney, Exclusive Purchase Right Contract and Pledge Agreement. We believe that the Powers of Attorney are valid, binding and enforceable under existing PRC laws and regulations and enable Xuecheng Century to vote on all matters requiring Xueda Information's shareholder approval. We also believe that the Exclusive Purchase Right Contract provide us with a substantive kick out right. More specifically, we believe that the terms of the Exclusive Purchase Right Contracts are exercisable and enforceable under current PRC laws and regulations, and the minimum amount of consideration permitted by the applicable PRC law to exercise such purchase right does not represent a financial barrier or disincentive for us to exercise our rights under the Exclusive Purchase Right Contract. Our rights under the Powers of Attorney and the Exclusive Purchase Right Contract give us the power to control the shareholders of Xueda Information and thus the power to direct the activities that most significantly impact Xueda Information's economic performance. We believe that our ability to exercise control, together with the Exclusive Service Agreement and the Pledge Agreement, gives us the rights to receive substantially all of the economic benefits of Xueda Information and its schools and subsidiaries in consideration for the services provided by Xuecheng Century. Accordingly, as the primary beneficiary of Xueda Information and its subsidiaries and schools and in accordance with U.S. GAAP, we consolidate Xueda Information's financial results and assets and liabilities in our consolidated financial statements.

As advised by Commerce & Finance Law Offices, our PRC counsel, (i) the ownership structures of our VIE and its subsidiaries and schools, and our PRC subsidiary, are in compliance with existing PRC laws and regulations; and (ii) the contractual arrangements among our PRC subsidiary, our VIE, and the shareholders of our VIE are valid, binding and enforceable under, and will not result in any violation of, PRC laws or regulations currently in effect. However, our PRC legal counsel has also advised us that as there are substantial uncertainties regarding the interpretation and application of PRC laws and regulations, the PRC regulatory authorities may take a view that is contrary to the above opinion of our PRC legal counsel. The relevant government authorities may have broad discretion in interpreting the PRC laws and regulations governing the validity of these contractual arrangements. See "Item 3. Key Information — D. Risk Factors — Risk Related to Regulation of Our Business and Our Corporate Structure — We rely on contractual arrangements with our VIE and its shareholders for substantially all of our China operations, which may not be as effective as direct ownership in providing operational control", "— We may have to incur significant cost to enforce, or may not be able to effectively enforce, the contractual arrangements with our VIE and its shareholders in the event of a breach or non-compliance by our VIE or its shareholders", and "— Certain shareholders of our VIE may have potential conflicts of interest with us, which may harm our business and financial condition".

For the years ended December 31, 2011, 2012 and 2013, Xueda Information and its subsidiaries and schools contributed in aggregate 100%, 100% and 100%, respectively, of our total net revenue. As of December 31, 2012 and 2013, Xueda Information and its subsidiaries and schools accounted for an aggregate of 49% and 53%, respectively, of our total assets, and 86% and 96%, respectively, of our total liabilities. The assets not associated with Xueda Information and its subsidiaries and schools primarily consist of cash held by us.

## **Revenue Recognition**

We derive our revenue from personalized tutoring services and through collecting registration fees and course fees from our students.

We charge each new student a non-refundable registration fee ranging from RMB300 (\$49.6) to RMB1,000 (\$165.2) primarily for the consultation and assessment we provide to the student and design of a personalized study plan. We believe that the registration fee is, in substance, an advance payment for future tutoring services, and accordingly recognized over the estimated customer relationship period. The customer relationship period is estimated based on our historical data with respect to service period. The customer relationship period is currently determined to be nine months, a decrease from 15 months in 2010, primarily attributable to our continuous efforts to strengthen our course planning by further fine-tuning our consultation sessions with potential students since the first half of 2011, which enables the students to complete purchased course hours in a more efficient manner, significantly reduces the number of students with a small number of course hours unfinished for extended periods and in turn shortens our average service period. We believe such adjustment enables us to achieve better customer satisfaction and is beneficial to the long term development of our business. The customer relationship period is subject to annual assessment or when an event or other changes indicate the estimate is no longer reasonable.

Course fees for tutoring services are generally collected within seven days after the service contract is signed and recognized proportionately as the tutoring services are delivered. For unused prepaid course hours, students may apply for a 40-day extension within 30 days prior to the expiration date of the service contract. Under the applicable PRC laws and regulations, students are entitled to refund of unused prepaid course fees within two years after the service contract expires. We therefore estimate the refund period to be 26 months, which include the 30-day application period, the 40-day extension period and the two years by law. Deferred revenue relating to unused prepaid course hours of expired contracts is recognized as of the end of the refund period.

## **Goodwill**

The excess of the purchase price over the fair value of net assets acquired is recorded on the consolidated balance sheet as goodwill. Goodwill is not amortized but is tested for impairment annually or more frequently if events or changes in circumstances indicate that it might be impaired.

Goodwill impairment is tested using a two-step process. The first step is to compare the fair values of each reporting unit to its carrying amount, including goodwill. If the fair value of each reporting unit exceeds its carrying amount, goodwill is not considered to be impaired and the second step will not be required. If the carrying amount of a reporting unit exceeds its fair value, the second step is to compare the implied fair value of goodwill to the carrying value of a reporting unit's goodwill. The implied fair value of goodwill is determined in a manner similar to accounting for a business combination with the allocation of the assessed fair value determined in the first step to the assets and liabilities of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. An impairment loss is recognized for any excess in the carrying value of goodwill over the implied fair value of goodwill. We perform goodwill impairment tests annually on December 31 by comparing the carrying value to the fair value of each reporting unit.

We had two reporting units that carried goodwill balances as of December 31, 2013, namely Taiyuan Xueda Education & Training School, or Taiyuan Xueda, and Weland. In the goodwill impairment test, we adopted the discounted cash flow method under the income approach, which considers a number of factors including expected future cash flows, growth rates and discount rates, and requires us to make certain assumptions and estimates regarding industry and economic factors and the future profitability of our business. The assumptions are inherently uncertain and subjective. The discounted cash flow for Taiyuan Xueda and Weland were based on discrete five years' financial forecast developed by our management. Cash flows beyond the forecasted period were estimated using a terminal value calculation, which incorporated historical and forecasted financial trends. Specifically, the income approach valuations included cash flow discount rates of 19.14% and 21.14% and terminal value growth rates of 3% and 3%, for Taiyuan Xueda and Weland, respectively.

As a result of the goodwill impairment test performed as of December 31, 2013, the goodwill of Weland was fully impaired due to the lowered earnings forecast and increased competition in the industry.

### ***Available-for-sale securities***

In July 2012, we entered into a preferred share purchase agreement with the shareholders of Firstleap Education, a company incorporated in the Cayman Islands that provides English training program to two- to ten-year-old children in China. In August 2012, we purchased, for a consideration of \$4.8 million, 1,272,000 convertible preferred shares, which were equivalent to a 12.72% equity interest in Firstleap Education. In July 2013, we purchased additional preferred shares of Firstleap Education for a consideration of \$1.6 million. As such, we acquired in aggregate a 16.11% equity interest in Firstleap Education. The investment is classified as available-for-sale securities and is carried at fair values. The unrealized gains or losses from the changes in fair values are included in accumulated other comprehensive income.

We measured available-for-sale securities at fair value on a recurring basis as of December 31, 2013. The available-for-sale securities do not have a quoted market price in an active market. Accordingly, we adopted a discounted cash flow method under the income approach, which considers a number of factors including expected future cash flows, growth rates and discount rates estimated based on publicly traded companies in the industry and requires us to make certain assumptions and estimates regarding industry economic factors and future profitability. The assumptions are inherently uncertain and subjective. The discounted cash flows for Firstleap Education were based on discrete eight years' financial forecasts. Cash flows beyond the forecasted period were estimated using a terminal value calculation, which incorporated historical and forecasted financial trends and considered long-term earnings growth rates for comparable publicly traded companies. Specifically, the income approach valuations included cash flow discount rate of 21.14%, and terminal value growth rate of 3%.

The estimated fair value of the investment was \$6.9 million as of December 31, 2013. An unrealized holding gain of \$432,000 was reported in accumulated other comprehensive income.

### ***Share-based Compensation***

Our share-based payment transactions with employees are measured based on the grant date fair value of the equity instrument we issued and recognized as a compensation expense over the requisite service period based on a graded vesting schedule, with a corresponding impact reflected in additional paid-in capital.

The fair values of our option awards were estimated on the date of grant using the binomial option pricing model that uses assumptions including the fair value of the ordinary shares underlying the options, volatility, risk free interest rate, dividend yield and exercise multiple. The fair value of our ordinary shares is determined based on the market closing price of our ADSs on the New York Stock Exchange as of the grant date. The volatility of the underlying ordinary shares during the life of the options was estimated based on the historical stock price volatility of our Company and comparable listed companies over a period comparable to the contractual term of the options. We choose the comparable companies by considering synthesis effect of the characteristics including industry, stage of life cycle, size and financial leverage. Risk-free interest rate was estimated based on the yield of treasury bonds of the United States with a maturity period similar to the contractual term of the options. The dividend yield was estimated by us based on our expected dividend policy over the contractual term of the options. Exercise multiple represents the value of the underlying share as a multiple of exercise price of the option which, if achieved, results in exercise of the option.

The fair value of the nonvested shares granted was estimated based on the market closing price of our ADSs on the New York Stock Exchange as of the grant date.

Share-based compensation expense, based on the estimated fair value of share awards granted and the estimated forfeiture rate, will be recorded over vesting periods after the grant date on a straight-line basis with the amount of compensation expenses recognized in any period not less than the portion of the grant date fair value of the share awards vested during that period. The estimate of forfeiture rate is reviewed and adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimate. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change.

For awards with performance condition vesting provision, when achievement of the performance condition is considered probable, we recognize compensation cost on a straight-line basis over the awards vesting periods.

## Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a certain period, we must include an expense within the tax provision in the statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to establish an additional valuation allowance, which could materially impact our financial position and results of operations.

Uncertainties exist with respect to how the EIT Law applies to our overall operations, and more specifically, with regard to our tax residency status. The EIT Law includes a provision specifying that legal entities organized outside of the PRC will be considered residents for PRC income tax purposes if their place of effective management or control is within the PRC. The EIT Implementation Rules provide that non-resident legal entities will be considered PRC residents if substantial and overall management and control over the manufacturing and business operations, personnel, accounting, properties, among others, occur within the PRC. Despite the present uncertainties resulting from the limited PRC tax guidance on the issue, we do not believe that our legal entities organized outside of the PRC should be treated as residents for purposes of the EIT Law. If one or more of our legal entities organized outside of the PRC were characterized as PRC tax residents, the impact would adversely affect our results of operations. See “Item 3. Key Information—D. Risk Factors—Risk Factors Relating to Doing Business in China — Under the EIT Law, we may be classified as a ‘resident enterprise’ of China. Such classification would likely result in unfavorable tax consequences to us and our non-PRC shareholders.”

The impact of an uncertain income tax position on the income tax return is recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Interest and penalties on income taxes will be classified as a component of the provisions for income taxes. We have concluded that there were no significant uncertain tax positions requiring recognition in financial statements for the years ended December 31, 2011, 2012 and 2013. We did not incur any interest and penalties related to potential underpaid income tax expenses and also do not anticipate any significant increases or decreases in unrecognized tax benefits in the next 12 months.

## Results of Operations

The following table sets forth a summary of our consolidated results of operations and selected operating data for the periods indicated. This information should be read together with our consolidated financial statements and related notes included elsewhere in this annual report. The results of operations in any period are not necessarily indicative of the results that may be expected for any future period.

	For the Year Ended December 31,					
	2011		2012		2013	
	\$	% of Net Revenue	\$	% of Net Revenue	\$	% of Net Revenue
	(in thousands, except percentages)					
Net revenue	221,738	100.0	293,157	100.0	347,047	100.0
Cost of revenue <sup>(1)</sup> :						
Teaching staff cost	(115,931)	(52.3)	(157,101)	(53.6)	(171,940)	(49.5)
Rental	(26,920)	(12.2)	(38,182)	(13.0)	(40,958)	(11.8)
Depreciation and amortization	(6,682)	(3.0)	(13,256)	(4.5)	(13,946)	(4.0)
Other	(6,689)	(3.0)	(11,116)	(3.8)	(13,304)	(3.8)
Total cost of revenue	(156,222)	(70.5)	(219,655)	(74.9)	(239,948)	(69.1)
Gross profit	65,516	29.5	73,502	25.1	107,099	30.9
Operating expenses:						
General and administrative expenses <sup>(1)</sup>	(36,425)	(16.4)	(46,427)	(15.8)	(52,716)	(15.1)
Selling and marketing expenses <sup>(1)</sup>	(25,940)	(11.7)	(31,336)	(10.7)	(36,308)	(10.5)
Impairment loss on goodwill	—	—	—	—	(2,923)	(0.8)
Impairment loss on acquired intangible assets	—	—	—	—	(494)	(0.1)
Total operating expenses	(62,365)	(28.1)	(77,763)	(26.5)	(92,441)	(26.5)
Government subsidies	357	0.2	164	0.1	439	0.1
Income/(loss) from operations	3,508	1.6	(4,097)	(1.3)	15,097	4.5
Interest income	3,766	1.7	6,722	2.2	7,279	2.0
Income before income tax expenses	7,274	3.3	2,625	0.9	22,376	6.5
Income tax expenses						
Current	(4,562)	(2.1)	(3,179)	(1.1)	(8,302)	(2.4)
Deferred	2,078	1.0	2,303	0.8	820	0.2
Total income tax expenses	(2,484)	(1.1)	(876)	(0.3)	(7,482)	(2.2)
Net income	4,790	2.2	1,749	0.6	14,894	4.3
Net loss attributable to the noncontrolling interests	—	—	216	0.1	1,257	0.4

Net income attributable to Xueda Education Group	4,790	2.2	1,965	0.7	16,151	4.7
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<b>Selected Operating Data:</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>
Number of learning centers (at period end)	295	383	408
Number of students served	116,900	138,688	149,882
Average hourly course fee (in \$) <sup>(2)</sup>	26	28	30
Number of teaching staff members (at period end)	11,696	13,210	11,873

(1) Includes the following amounts of share-based compensation expenses for the periods indicated:

	<b>For the Year ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
	<b>(in thousands of \$)</b>		
Cost of revenue	6	5	10
General and administrative expenses	4,092	3,156	5,368
Selling and marketing expenses	11	5	4
Total share-based compensation expenses	4,109	3,166	5,382

(2) Represents gross revenue derived from one-on-one tutoring, divided by the total hours of one-on-one tutoring in the relevant period.

**Year Ended December 31, 2013 Compared to Year Ended December 31, 2012**

**Net revenue.** Our total net revenue increased by 18.4% to \$347.0 million for the year ended December 31, 2013 from \$293.2 million for the year ended December 31, 2012, compared to a 32.2% increase from 2011 to 2012. The slowdown in our revenue growth was primarily a result of the significant scale of operations we have achieved.

The increase in net revenue was primarily attributable to the increase in the total number of learning centers as well as in the number of mature learning centers, which also contributed to the increase in the number of students served from approximately 138,690 for the year ended December 31, 2012 to approximately 150,000 for the year ended December 31, 2013. The number of our learning centers in operation increased from 383 as of December 31, 2012 to 408 as of December 31, 2013. The number of mature learning centers increased from 132 as of December 31, 2012 to 203 as of December 31, 2013. In addition, the increase in net revenue for the year ended December 31, 2013 was also attributable to the increase in our average hourly course fee from \$28 for the year ended December 31, 2012 to \$30 for the year ended December 31, 2013, which was due to the increase in hourly course fee and exchange rate fluctuations. See “Item 3. Key Information — A. Selected Financial Data — Exchange Rate Information.”

**Cost of revenue.** Our cost of revenue increased by 9.2% to \$239.9 million for the year ended December 31, 2013 from \$219.7 million for the year ended December 31, 2012. This increase was primarily due to (i) an increase of 9.4% in teaching staff cost from \$157.1 million for the year ended December 31, 2012 to \$171.9 million for the year ended December 31, 2013 as the performance-based teaching bonuses increased as the result of increased net revenue generated, and (ii) a 7.3% increase in rental cost from \$38.2 million for the year ended December 31, 2012 to \$41.0 million for the year ended December 31, 2013 as we leased additional premises for the 25 learning centers newly added in 2013. Cost of revenue as a percentage to net revenue decreased to 69.1% for the year ended December 31, 2013 from 74.9% for the year ended December 31, 2012.



**Gross profit.** Our gross profit increased by 45.7% to \$107.1 million for the year ended December 31, 2013 from \$73.5 million for the year ended December 31, 2012. Gross margin increased to 30.9% for the year ended December 31, 2013 from 25.1% for the year ended December 31, 2012. The increase in gross margin was attributable to the increase in the utilization of our service professionals, as reflected in the net revenue per full-time instructor, which increased by 24.4% from 2012 to 2013, and the improved utilization of our learning centers, as reflected in the net revenue per square meter of learning centers, which increase by 19.8% over the same period.

**Operating expenses.** Our total operating expenses increased by 18.9% to \$92.4 million for the year ended December 31, 2013 from \$77.8 million for the year ended December 31, 2012. Operating expenses for the year of 2013 represented 26.5% of total net revenue, remained stable from the previous year, primarily a result of our cost control measures and a higher operating leverage in 2012.

- **General and administrative expenses.** Our general and administrative expenses increased by 13.5% to \$52.7 million for the year ended December 31, 2013 from \$46.4 million for the year ended December 31, 2012. The increase was primarily due to an increase in the total compensation and benefits paid to our administrative staff as a result of our hiring of new employees in the areas of finance and accounting, technology infrastructure, human resources and general administration to support our expanded operations, as well as the share-based compensation expenses incurred in this period.
- **Selling and marketing expenses.** Our selling and marketing expenses increased by 15.9% to \$36.3 million for the year ended December 31, 2013 from \$31.3 million for the year ended December 31, 2012. This increase was due to the increase in expenses relating to advertising, marketing and brand promotion activities from the year ended December 31, 2012 to the year ended December 31, 2013. The increase in selling and marketing expenses was also due to the expansion of our marketing team, which was in line with the expansion of our tutoring service network and operations.

**Impairment loss on goodwill.** As a result of the lowered earnings forecast and increased competition in the industry, Weland's earnings forecast for future periods was lower than previous estimation, therefore a goodwill impairment loss of \$2.9 million was recognized in the year ended December 31, 2013. See "Item 5. Operating and financial review and prospects—A. Operating results—Goodwill." We did not incur such loss in the year ended December 31, 2012.

**Impairment loss on acquired intangible assets.** As a result of the lowered earnings forecast and increased competition in the industry, in December 2013, we performed an impairment test of the carrying value of the Weland's trademarks and non-compete agreement and recognized an impairment write-down of \$0.5 million for the year ended December 31, 2013. We did not incur such loss in the year ended December 31, 2012.

**Income/(loss) from operations.** As a result of the above, operating income for the year ended December 31, 2013 increased by \$19.2 million to \$15.1 million from a net operating loss of \$4.1 million for the year ended December 31, 2012. The substantial improvement was largely attributable to the impact of our "focus-on-profit" strategy adopted in 2013. The strategy centered on a wide base of initiative and key performance indicators designed to drive our profitability.

**Interest income.** Our interest income primarily generated from cash and cash equivalents, short-term investment and long-term investment. Interest income increased to \$7.3 million for the year ended December 31, 2013 from \$6.7 million for the year ended December 31, 2012, primarily as a result of our investment in financial products offered by banks and other financial institutions that had higher yields compared to those in 2012.

**Income tax expenses.** Income tax expenses at our company level include income taxes payable by (i) Xueda Education Group, which is a tax-exempt company incorporated in the Cayman Islands and as such, was not subject to any income taxes in the Cayman Islands in 2012 and 2013, (ii) Xueda Hong Kong, which is subject to a corporate income tax rate of 16.5% on profits derived from its Hong Kong operations, and did not incur any income tax expenses in 2012 and 2013 because its income in 2012 and 2013 was not derived from its Hong Kong operations, (iii) Xuecheng Century, which was certified as a software enterprise in April 2010 and as a result is eligible for a reduced tax rate of 12.5% in 2012 and 2013, and (iv) Xueda Information and its subsidiaries and schools, at the uniform income tax rate of 25%. As Xueda Education Group and Xueda Hong Kong did not pay any income taxes and Xuecheng Century incurred tax benefits in 2012, our income tax expenses in 2011 and 2012 consisted of taxes incurred by Xueda Information and its subsidiaries and schools under the relevant tax laws and regulations in the PRC. Our income tax expenses increased to \$7.5 million for the year ended December 31, 2013 from \$0.9 million for the year ended December 31, 2012, primarily due to the increase in taxable income of Xueda Information and its subsidiaries and schools to \$28.0 million for the year ended December 31, 2013 from \$12.7 million for the year ended December 31, 2012.

**Net income attributable to Xueda Education Group.** As a result of the foregoing, we generated net income of \$ 16.2 million for the year ended December 31, 2013 and \$2.0 million for the year ended December 31, 2012, respectively.

**Year Ended December 31, 2012 Compared to Year Ended December 31, 2011**

**Net revenue.** Our total net revenue increased by 32.2% to \$293.2 million for the year ended December 31, 2012 from \$221.7 million for the year ended December 31, 2011, compared to a 43.9% increase from 2010 to 2011. The slowdown in our revenue growth was primarily a result of the significant scale of operations we have achieved.

The increase in net revenue was primarily attributable to the increase in the total number of learning centers as well as in the number of mature learning centers, which also contributed to the increase in the number of students served from approximately 117,000 for the year ended December 31, 2011 to approximately 138,690 for the year ended December 31, 2012. The number of our learning centers in operation increased from 295 as of December 31, 2011 to 383 as of December 31, 2012. The number of mature learning centers increased from 99 as of December 31, 2011 to 132 as of December 31, 2012. In addition, the increase in net revenue for the year ended December 31, 2012 was also attributable to the increase in our average hourly course fee from \$26 for the year ended December 31, 2011 to \$28 for the year ended December 31, 2012, which was due to the increase in hourly course fee and exchange rate fluctuations. See “Item 3. Key Information — A. Selected Financial Data — Exchange Rate Information.”

**Cost of revenue.** Our cost of revenue increased by 40.6% to \$219.7 million for the year ended December 31, 2012 from \$156.2 million for the year ended December 31, 2011. This increase was primarily due to (i) a significant increase of 35.5% in teaching staff cost from \$115.9 million for the year ended December 31, 2011 to \$157.1 million for the year ended December 31, 2012 as the headcount of our full-time instructors, study counselors and education consultants increased by 12.9% from December 31, 2011 to December 31, 2012 and performance-based teaching fees and bonuses also increased significantly as the result of increased course hours delivered, and (ii) a 41.8% increase in rental cost from \$26.9 million for the year ended December 31, 2011 to \$38.2 million for the year ended December 31, 2012 as we leased premises for the 88 learning centers newly added in 2012. Cost of revenue as a percentage to net revenue increased to 74.9% for the year ended December 31, 2012 from 70.5% for the year ended December 31, 2011.

**Gross profit.** Our gross profit increased by 12.2% to \$73.5 million for the year ended December 31, 2012 from \$65.5 million for the year ended December 31, 2011. Gross margin decreased to 25.1% for the year ended December 31, 2012 from 29.5% for the year ended December 31, 2011. The decrease in gross margin was due to the decrease in the utilization of our learning centers, which was at a higher rate compared with the increase in the utilization of our service professionals. The utilization of our learning centers, as reflected in the net revenue per square meter of learning centers, decreased by 20.5% from 2011 to 2012. The utilization of our service professionals, as reflected in the net revenue per full-time instructor, increased by 18.9% over the same period.

**Operating expenses.** Our total operating expenses increased by 24.7% to \$77.8 million for the year ended December 31, 2012 from \$62.4 million for the year ended December 31, 2011. Operating expenses as a percentage of net revenue decreased to 26.5% for the year ended December 31, 2012 from 28.1% for the year ended December 31, 2011, primarily as a result of our cost control measures and a higher operating leverage in 2012.

- **General and administrative expenses.** Our general and administrative expenses increased by 27.5% to \$46.4 million for the year ended December 31, 2012 from \$36.4 million for the year ended December 31, 2011. The increase was primarily due to a decrease in foreign exchange gain and an increase in the total compensation and benefits paid to our administrative staff as a result of our hiring of new employees in the areas of finance and accounting, technology infrastructure, human resources and general administration to support our expanded operations, as well as the share-based compensation expenses incurred in this period.
- **Selling and marketing expenses.** Our selling and marketing expenses increased by 20.8% to \$31.3 million for the year ended December 31, 2012 from \$25.9 million for the year ended December 31, 2011. This increase was due to the increase in expenses relating to advertising, marketing and brand promotion activities from the year ended December 31, 2011 to the year ended December 31, 2012. The increase in selling and marketing expenses was also due to the expansion of our marketing team and the related office expenses, which was in line with the expansion of our tutoring service network and operations.

**(Loss)/Income from operations.** As a result of the above, we incurred loss from operations in the amount of \$4.1 million for the year ended December 31, 2012, as compared to profit from operations in the amount of \$3.5 million for the year ended December 31, 2011.

**Interest income.** Our interest income primarily consists of short-term investment income, current account interests and term deposit interests. Interest income increased to \$6.7 million for the year ended December 31, 2012 from \$3.8 million for the year ended December 31, 2011, primarily as a result of our investment in financial products offered by banks and other financial institutions that had higher yields compared to those in 2011.

**Income tax expenses.** Income tax expenses at our company level include income taxes payable by (i) Xueda Education Group, which is a tax-exempt company incorporated in the Cayman Islands and as such, was not subject to any income taxes in the Cayman Islands in 2011 and 2012; (ii) Xueda Hong Kong, which is subject to a corporate income tax rate of 16.5% on profits derived from its Hong Kong operations, and did not incur any income tax expenses in 2011 and 2012 because its income in 2011 and 2012 was not derived from its Hong Kong operations; (iii) Xuecheng Century, which was certified as a software enterprise in April 2010 and as a result is eligible for an exemption of income tax in 2011 followed by a reduced tax rate of 12.5% in 2012; and (iv) Xueda Information and its subsidiaries and schools, at the uniform income tax rate of 25%. As Xueda Education Group and Xueda Hong Kong did not pay any income taxes and Xuecheng Century incurred tax benefits in 2012, our income tax expenses in 2011 and 2012 consisted of taxes incurred by Xueda Information and its subsidiaries and schools under the relevant tax laws and regulations in the PRC. Our income tax expenses decreased to \$0.9 million for the year ended December 31, 2012 from \$2.5 million for the year ended December 31, 2011, primarily due to the decrease in taxable income of Xueda Information and its subsidiaries and schools to \$12.7 million for the year ended December 31, 2012 from \$16.2 million for the year ended December 31, 2011.

**Net income attributable to Xueda Education Group.** As a result of the foregoing, we generated net income of \$ 2.0 million for the year ended December 31, 2012 and \$4.8 million for the year ended December 31, 2011, respectively.

## **B. Liquidity and Capital Resources**

Our principal source of liquidity has been cash generated from operating activities and from issuance and sale of our Series A1 and Series A2 preferred shares, as well as from proceeds of our initial public offering and the investment by Warburg Pincus. We received course fee in cash of \$262.9 million, \$366.6 million and \$390.1 million in the years ended December 31, 2011, 2012 and 2013, respectively. We currently do not have any bank loans, nor did we have any bank loans in 2011, 2012 or 2013. As of December 31, 2013, we had \$ 117.1 million in cash and cash equivalents. Our cash and cash equivalents consist of cash on hand, demand deposits, term deposits and debt securities with original maturities of three months or less. Although we consolidate the results of the learning centers controlled by Xueda Information, our VIE, our access to the cash and cash equivalents and future earnings of these learning centers is indirect through dividends we receive from Xuecheng Century, our PRC subsidiary. Xuecheng Century, in turn, receives capital resources from Xueda Information in the form of a “consulting and technical service fee” pursuant to the Exclusive Service Agreement.

When considering our liquidity position and our future capital resources and needs, we view as a source of cash the dividends we are entitled to receive from our PRC subsidiary. We have not encountered any difficulties in meeting our cash obligations. While we believe our PRC subsidiary has the ability to pay dividends to us, we do not expect dividends from our PRC subsidiary in the near future because (i) we plan to have our PRC subsidiary retain all its accumulated profits for its own business operation and expansion, and (ii) we have been holding sufficient cash (excluding the cash held by our PRC subsidiary) for our own anticipated cash needs.

In addition, as the result of the restrictions under PRC law on our PRC subsidiary’s ability to make dividend payments and other distributions to us, not all funds of our PRC subsidiary are available to us and our access to such funds is restricted. See “Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Doing Business in China — Restrictions under PRC law on our PRC subsidiary’s ability to make dividend payments and other distributions could materially and adversely affect our ability to make investments or acquisitions, pay dividends or other distributions to you, and otherwise fund and conduct our other businesses.”

We believe that our current cash and cash equivalents and anticipated cash flow from operations will be sufficient to meet our anticipated cash needs, including our cash needs for working capital and capital expenditures, for at least the next 12 months. However, we may need additional cash resources in the future if we experience changed business conditions or other developments. We may also need additional cash resources in the future to pursue opportunities for investment, acquisition, strategic alliance or other similar actions. It is possible that when we need additional cash resources, financing will only be available to us in amounts or on terms that would not be acceptable to us or may not be available at all.

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The following table sets forth a summary of our cash flows for the periods indicated:

	For the Year Ended December 31,		
	2011	2012	2013
	(in thousands of \$)		
Net cash provided by operating activities	24,898	54,644	46,756
Net cash used in investing activities	(11,635)	(43,743)	(120,814)
Net cash used in financing activities	(9,159)	(17,084)	(22,419)
Effect of exchange rate changes	2,272	381	1,596
Net increase (decrease) in cash and cash equivalents	6,376	(5,802)	(94,881)
Cash and cash equivalents, beginning of period	211,370	217,746	211,944
Cash and cash equivalents, end of period	217,746	211,944	117,063

### ***Operating Activities***

Our largest source of operating cash flows is course fees paid in cash by our students. We require all of our students to pay the total course fees in full within seven days from the date they enter into a service contract with us. Our primary uses of cash in operating activities are teaching staff and employee compensation, rental and renovation cost for leased premises and selling and marketing expenses. As a public company, we also incur additional costs and expenses, including costs to prepare for our SOX Section 404 compliance testing and additional legal and accounting costs to comply with the requirements of the Exchange Act that apply to us. We currently anticipate that we will be able to meet our needs to fund operations within at least the next 12 months with operating cash flow and existing cash balances.

We had net cash provided by operating activities in an amount of \$46.8 million for the year ended December 31, 2013, primarily attributable to (a) course fees received in cash in an amount of \$390.1 million as a result of our expanded operations and (b) interests received in cash in an amount of \$5.8 million, offset by (i) cash paid for staff compensation in an amount of \$198.4 million, (ii) rental cost and expenses paid in cash in an amount of \$43.1 million, (iii) course fee refund paid in cash in an amount of \$33.5 million, (iv) advertising and market expenses paid in cash in an amount of \$29.0 million, (v) office related expenses paid in cash of \$24.6 million, (vi) taxes paid in cash of \$17.6 million and (vii) other operation expenses paid in cash of \$2.9 million, all in line with the expansion of our operations. Net cash provided by operating activities decreased by \$7.8 million between the years ended December 31, 2012 and 2013, primarily because of the cash payment for staff compensation, rental, marketing expenses, and office related expenses which increased by \$25.0 million as a result of our business expansion, which was at a higher rate compared with the increase in courses fee received net off refund paid in cash.

We had net cash provided by operating activities in an amount of \$54.6 million for the year ended December 31, 2012, primarily attributable to (a) course fees received in cash in an amount of \$366.6 million as a result of our expanded operations and (b) interests received in cash in an amount of \$7.1 million, offset by (i) cash paid for staff compensation in an amount of \$184.2 million, (ii) rental cost and expenses paid in cash in an amount of \$41.5 million, (iii) course fee refund paid in cash in an amount of \$29.0 million, (iv) advertising and market expenses paid in cash in an amount of \$26.2 million, (v) office related expenses paid in cash of \$18.2 million, (vi) taxes paid in cash of \$16.2 million and (vii) other operation expenses paid in cash of \$3.8 million, all in line with the expansion of our operations. Net cash provided by operating activities increased by \$29.7 million between the years ended December 31, 2011 and 2012, primarily due to the increase of \$103.7 million in course fees received in cash largely attributable to our strengthened fee collection efforts.

We had net cash provided by operating activities in an amount of \$24.9 million for the year ended December 31, 2011, primarily attributable (a) course fees received in cash in an amount of \$262.9 million as a result of our expanded operations, (b) interests received in cash in an amount of \$3.2 million, and (c) government subsidies received in cash in an amount of \$0.4 million, offset by (i) cash paid for staff compensation in an amount of \$136.5 million, (ii) rental cost and expenses paid in cash in an amount of \$31.8 million, (iii) advertising and market expenses paid in cash in an amount of \$22.0 million, (iv) course fee refund paid in cash in an amount of \$18.7 million, (v) office related expenses paid in cash of \$15.8 million, (vi) taxes paid in cash of \$14.5 million and (vii) other operation expenses paid in cash of \$2.3 million, all in line with the expansion of our operations.

### ***Investing Activities***

Our cash used in investing activities normally is related to the purchase of investments, property and equipment used by our learning centers in their operations, which include leasehold improvement.

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Net cash used in investing activities amounted to \$120.8 million for the year ended December 31, 2013, primarily resulting from (a) the purchase of short-term investments in an amount of \$291.4 million, (b) the purchase of property and equipment in an amount of \$10.5 million and (c) two loans extended to a related party in December 2013, respectively, in an aggregate amount of \$2.6 million and (iv) purchase of long term investments in an amount of \$9.8 million, offset by (i) proceeds of \$191.9 million from maturity of short-term investments and (ii) proceeds from maturity of loan to a related party in the amount of \$1.6 million.

Net cash used in investing activities amounted to \$43.7 million for the year ended December 31, 2012, primarily resulting from (a) the purchase of short-term investments in an amount of \$128.3 million, (b) the purchase of property and equipment in an amount of \$19.1 million and (c) two loans extended to a related party in May and November 2012, respectively, in an aggregate amount of \$4.8 million, (d) purchase of available-for-sale securities in an amount of \$4.8 million and (e) payment for business acquisition of Weland in an amount of \$1.2 million, offset by (i) proceeds of \$111.3 million from maturity of short-term investments and (ii) proceeds from maturity of loan to a related party in the amount of \$3.2 million.

Net cash used in investing activities amounted to \$11.6 million for the year ended December 31, 2011, primarily resulting from (a) the purchase of short-term investments in an amount of \$31.2 million, and (b) loan extended to a third party in the amount of \$30.5 million, and (iii) the purchase of property and equipment in an amount of \$26.3 million, offset by (i) the proceeds of \$45.0 million from maturity of short-term investments and (ii) proceeds from maturity of loan to a third party in the amount of \$31.4 million.

### ***Financing Activities***

Our financing activities consisted of payment of cash dividends, repurchase of our ADSs and proceeds from exercise of share options.

Net cash used in financing activities for the year ended December 31, 2013 was \$22.4 million, primarily resulting from payment of special cash dividends to our shareholders in the amount of \$22.7 million, partially offset by proceeds from exercise of share options of \$0.3 million.

Net cash used in financing activities for the year ended December 31, 2012 was \$17.1 million, primarily resulting from payment of special cash dividends to our shareholders in the amount of \$9.9 million and cash paid for ADSs repurchases of \$7.3 million, partially offset by proceeds from exercise of share options of \$0.1 million.

Net cash used in financing activities for the year ended December 31, 2011 was \$9.2 million, primarily resulting from cash paid for ADSs repurchases of \$8.8 million and payment of issuance cost in connection with IPO of \$0.7 million, partially offset by proceeds from exercise of share options of \$0.3 million.

### **Holding Company Structure**

We are a holding company with no material operations of our own. We conduct our operations primarily through Xuecheng Century, our principal operating subsidiary in China, and the learning centers operated by Xueda Information, our VIE. As a result, our ability to pay dividends and to finance any debt we may incur depends upon dividends paid by Xuecheng Century, which in turn depend on service fees paid by Xueda Information to Xuecheng Century under our contractual arrangements with Xueda Information.

If Xuecheng Century incurs debt on its own behalf in the future, the instruments governing its debt may restrict its ability to pay dividends to us. In addition, under PRC laws and regulations, the maximum amount of dividends payable by Xuecheng Century to us is calculated based on its retained earnings as set forth in Xuecheng Century's statutory financial statements, which are prepared under accounting principles generally accepted in the PRC. Prior to the payment of dividends, Xuecheng Century is required to pay income taxes according to PRC laws and make allocations of retained earnings to the reserve fund, enterprise development fund and employee bonus and welfare fund, each at a percentage decided by its board of directors each fiscal year. Xuecheng Century may not distribute any profit to us until any losses incurred in previous fiscal years are fully recovered. As a result of these PRC laws and regulations, Xuecheng Century may be restricted in its ability to transfer its net profit to us in the form of dividends in any given year.



Xueda Information's ability to pay service fees to Xuecheng Century depends on (i) dividends paid by Xueda Information's subsidiaries and (ii) returns distributed by the private schools consolidated by Xueda Information directly or through its subsidiaries. Such subsidiaries are subject to the same restrictions as discussed above when paying dividends to Xueda Information. The private schools controlled by Xueda Information directly or through its subsidiaries are also subject to certain regulations regarding distributing returns to their sponsors. Under the relevant PRC laws and regulations, at the end of each fiscal year, every private school 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 before distributing returns to its sponsors. In the case of a private school that requires reasonable returns, this amount must be not less than 25% of such school's annual net income (as determined under the generally accepted accounting principles of the PRC), if any. See "Item 3. Key Information — D. Risk Factors — Risks Related to Regulation of Our Business and Our Corporate Structure — Our VIE and its subsidiaries may be subject to significant limitations on their ability to sponsor and operate private tutoring schools or make payments to related parties or otherwise be materially and adversely affected by changes in PRC laws and regulations."

## **Capital Expenditures**

Our capital expenditures are incurred primarily in connection with leasehold improvements and investment in equipment for our learning centers. We added 88, 88 and 25 learning centers in 2011, 2012 and 2013, respectively. Our capital expenditures were \$26.3 million, \$ 19.1 million and \$10.5 million in the years ended December 31, 2011, 2012 and 2013, respectively, representing 11.9%, 6.5% and 3.0% of our net revenue in such periods, respectively. In 2011, 2012 and 2013, we incurred approximately \$0.2 million, \$ 0.1 million and \$0.1 million in capital expenditures per new learning center, respectively. Our capital expenditures have been primarily funded by cash generated from our operations and, to a much lesser degree, from our financing activities. The decrease in the capital expenditure per new learning center from \$0.2 million in 2011 to \$ 0.1 million in both 2012 and 2013 was primarily attributable to our implementation of budget control on a per-learning-center basis, including a decrease in average lease space. The lease space on a per-learning-center basis for the learning centers opened since 2013 is expected to be ranged between 300 and 600 square meters, compared to between 400 and 600 square meters for the learning centers opened in 2012 and 700 and 900 square meters in 2011. We intend to cost-efficiently allocate our capital resources by continuing to lease most of our new facilities in the foreseeable future. We have not encountered any difficulties in meeting our cash obligations to date and believe that we will be able to fund our capital needs for at least the next 12 months through cash generated from our operating activities as well as net proceeds from our initial public offering.

## **Recent Accounting Pronouncements**

In March 2013, the Financial Accounting Standards Board, or FASB, has issued an authoritative pronouncement related to parent's accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. When a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided.

For an equity method investment that is a foreign entity, the partial sale guidance still applies. As such, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale of such an equity method investment. However, this treatment does not apply to an equity method investment that is not a foreign entity. In those instances, the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the foreign entity that contains the equity method investment.

Additionally, the amendments in this pronouncement clarify that the sale of an investment in a foreign entity includes both: (1) events that result in the loss of a controlling financial interest in a foreign entity (i.e., irrespective of any retained investment); and (2) events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (sometimes also referred to as a step acquisition). Accordingly, the cumulative translation adjustment should be released into net income upon the occurrence of those events.

The amendments in this pronouncement are effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The amendments should be applied prospectively to derecognition events occurring after the effective date. Prior periods should not be adjusted. Early adoption is permitted. If an entity elects to early adopt the amendments, it should apply them as of the beginning of the entity's fiscal year of adoption. We will adopt this pronouncement on January 1, 2014 and do not expect the adoption of this pronouncement will have a significant impact on its financial condition or results of operations.



In July 2013, the FASB issued a pronouncement which provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The FASB's objective in issuing this Accounting Standards Update, or ASU, is to eliminate diversity in practice resulting from a lack of guidance on this topic in current U.S. GAAP.

The amendments in this ASU state that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets.

This ASU applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. We will adopt this pronouncement on January 1, 2014 and do not expect the adoption of this pronouncement will have a significant impact on its consolidated financial statements.

### **C. Research and Development, Patents and Licenses, etc.**

Our information technology team consists of personnel with extensive experience with large-scale Internet and application development, data processing, product management and operations management. Our information technology team has used a combination of commercially available and custom developed software and hardware systems to establish a scalable technology platform to support our expanding operations and improve our services, and has been crucial to our operations and our successful expansion to date. Currently, our technology platform consists of our comprehensive operations management platform, our extensive educational resources database and our online presence, all of which share a common information technology platform that is secure, scalable and reliable.






Our operations management platform integrates our key management and administrative functions and consists of technology applications that address our key business needs, including school management, financial reporting, sales and operational management and human resources management. Our educational resources database consists of an extensive collection of sample questions and exercises, course outlines, and other tutoring materials and is easily accessible by our service professionals across the country. Our websites present information about our personalized tutoring services, our professional service team, our company and other pertinent information.

We aim to continue to improve and upgrade our technology platform. In 2012, we upgraded our ERP system to roll out such new functions as customer relationship management and complaint processing, which we expect to further improve and modularize our educational resources database to allow easier access, faster retrieval and better reliability. In addition, we continue to refine our websites to offer our students complementary online services, a broader array of pedagogical product lines and more advanced personalized services.

In 2013, we developed a new cloud-based e-learning platform, or the Smart Tutoring System, which was launched in our learning centers nationwide in March 2014. The Smart Tutoring System upgrades our entire teaching system from the personalized tutoring model to a cloud-based, mobile application delivery format that allows students to study anywhere, anytime. Our entire curriculum is available to students in digital interactive format as part of the Smart Tutoring System. The pilot phase of the Smart Tutoring System was well received by our students, parents and instructors. All our instructors are equipped with tablet devices to teach, and our learning centers are all fully equipped to support an e-learning environment. Furthermore, our digital curriculum is enhanced with more than 10,000 short, five-to-ten minute length videos. Embedded with key knowledge points, these short videos give students immediate and precise assistance. From our cloud-based Smart Tutoring System platform, all students have the option to study using their mobile devices, or any Internet enabled device. By blending the benefits of personal instruction in the learning centers with the benefits of the quick responsiveness of the digital interactive format, we enhance our tutoring services.

We have developed our proprietary intellectual property over the past years. Our trademarks, copyrights, trade secrets and other intellectual property rights such as business and technical know-how distinguish our services and products from those of our competitors, and contribute to our competitive advantage in our target markets. To protect our brand and other intellectual property, we rely on a combination of trademark, copyright and trade secret laws as well as confidentiality agreements with our employees, contractors and others.

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Our PRC subsidiary, Xuecheng Century, has registered various trademarks and logos, including “ 学大教育”, “ 学大教育”, “Xueda,” “ 学大教育”, “ 学大教育 个性化课外辅导” and “”, with the Trademark Office of SAIC. In addition, Xuecheng Century has submitted applications in several batches to the Trademark Office of SAIC for the registration of certain other trademarks and logos, including “prime learning,” for our small-group tutoring programs and other trademarks and logos which we believe are material for our operations. As our business grows and branding strategy develops, we may apply for the registration of additional trademarks and logos. Furthermore, Xuecheng Century has registered utility model and design patents with PRC Intellectual Property Bureau for certain teaching utilities it designed and developed, such as various kinds of multi-functional teaching desks. Our current main websites are [www.xueda.com](http://www.xueda.com) and [www.exueda.com](http://www.exueda.com). [www.xueda.com](http://www.xueda.com) is our official website, promoting our corporate identity and providing various marketing information. [www.exueda.com](http://www.exueda.com) is the site for our newly launched e-learning platform. In addition, we have registered certain other domain names, including [www.21edu.com](http://www.21edu.com), [xue.com](http://xue.com) and [ejiajiao.com](http://ejiajiao.com).

We have obtained from relevant government agencies Software Product Certificates for ten sets of software programs developed by us that we believe are material to our business operations, including Xueda Education Perfect Personalized Teaching System, Xueda Education Educational Resource Integration System Software V1.0, Xueda Education Student Personalized Performance Testing System Software v1.0, Xueda Education ERP System, Xueda Office Administration System and Xueda Human Resources Management System.

We cannot be certain that our efforts to protect our intellectual property rights will be adequate or that third parties will not infringe or misappropriate these rights. In addition, there can be no assurance that competitors will not independently develop similar intellectual property. If others are able to copy and use our programs and services, we may not be able to maintain our competitive position. Furthermore, the application of laws governing intellectual property rights in China and abroad is uncertain and evolving and could involve substantial risk to us. If litigation is necessary to enforce our intellectual property rights or determine the scope of the proprietary rights of others, we may have to incur substantial costs or divert other resources, which could harm our business.

### **D. Trend Information**

Other than as disclosed elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events for the current fiscal year that are reasonably likely to have a material effect on our net revenue, income, profitability, liquidity or capital reserves, or that caused the disclosed financial information to be not necessarily indicative of future operating results or financial conditions.

### **E. Off-Balance Sheet Arrangements**

We have not entered into any financial guarantees or other commitments to guarantee the payment obligations of any third parties. In addition, we have not entered into any derivative contracts that are indexed to our shares and classified as shareholders’ equity or that are not reflected in our consolidated financial statements. Furthermore, we do not have any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity. Moreover, we do not have any variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

### **F. Tabular Disclosure of Contractual Obligations**

The following table sets forth our contractual obligations and commercial commitments as of December 31, 2013:

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 Years
	(in thousands of \$)				
Operating leasing obligations	117,862	36,271	51,088	20,258	10,245

### **G. Safe Harbor**

See “Forward-Looking Statements.”

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### A. Directors and Senior Management

The following table sets forth certain information relating to our directors and executive officers.

Name	Age	Position/Title
Rubin Li	36	Chairman of board of directors
Xin Jin	37	Director and chief executive officer
Jinbo Yao	37	Director
William Hsu	48	Director
Yafei Wang	59	Independent Director
Sean Shao	57	Independent Director
Cheung Kin Au-Yueng	65	Independent Director
Cheung Lun Julian Cheng	40	Director
Christine Lu-Wong	45	Chief financial officer
Wei Zhang	55	Vice president
Qiang Deng	46	Vice president
Zhijun Diao	39	Vice president

### Biographical Information

*Mr. Rubin Li* is a co-founder and chairman of the board of directors of our company. Since 2001, Mr. Li has served as co-president, director and chairman of the board of directors of our company. Prior to founding our company, from 2000 to 2001, Mr. Li was a computer engineer of Tsinghua Tong Fang Co., Ltd., a corporation listed on the Shanghai Securities Exchange in the PRC. Mr. Li received his bachelor's degree in thermal energy and engineering from the University of Science and Technology Beijing in China in 2000. He completed his studies in master's courses in educational economics and management at Beijing Normal University in China from 2006 to 2008.

*Mr. Xin Jin* is a co-founder, director and the chief executive officer of our company. Since 2002, Mr. Jin has served in various other managerial positions at our company, including general manager and co-president. Prior to founding our company, he served as a marketing director and product director of *www.net.cn*, a China-based Internet application service provider from 1999 to 2002. Mr. Jin received his bachelor's degree in economics and business from the Capital University of Economics and Business in China in 1999.

*Mr. Jinbo Yao* is a co-founder of our company and has served as a director of our company since 2001. Mr. Yao currently also serves as chief executive officer of *www.58.com*, a China-based classified information website founded by him in 2005. From 2000 to 2005, Mr. Yao served as product manager, chief director and vice president of marketing at *www.net.cn*, a China-based Internet application service provider. Prior to that, in 2000, Mr. Yao founded *www.domain.cn*, which was subsequently acquired by *www.net.cn*. Mr. Yao received his bachelor's degree in computer science and chemistry from the Ocean University of China in Qingdao, China in 1999.

*Mr. William Hsu* has served as a director of our company since June 2011. Mr. Hsu is a managing director at CDH China Management Company Limited, or CDH. Prior to joining CDH in 2007, Mr. Hsu was a senior vice president at GIC Special Investments Pte. Ltd., the private equity arm of the Government of Singapore Investment Corporation, from 1996 to 2006. Mr. Hsu worked in the Singapore, Hong Kong and Beijing offices of GIC Special Investments Pte. Ltd., where he focused his investment activities on the Greater China market and played an instrumental role in a number of successful investments, covering a wide range of sectors, such as semiconductor, electronics, software, financial services, industrial and consumer products. Mr. Hsu has over 10 years of investment experience in both venture capital and traditional business sectors in China. Mr. Hsu received his bachelor's and master's degrees in engineering from University of California, Berkeley in the United States in 1986 and 1989, respectively.

*Ms. Yafei Wang* has served as a director of our company since 2008 and was determined to be an independent director in February 2011. Ms. Wang has over 20 years of experience in management and corporate finance matters. She has been an associate professor of the Guanghua School of Management of Peking University since 1995 and an independent director of Li Ning Company Limited since 2002. Ms. Wang received her MBA degree from Lancaster University Management School in the United Kingdom in 1990 and her bachelor's degree in international politics from Fudan University in China in 1981. From 1985 to 1986, Ms. Wang was a visiting scholar at the University of Maryland, College Park in the United States.

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*Mr. Sean Shao* has served as an independent director of our company and chairman of the audit committee since 2010. Mr. Sean Shao currently serves as (i) independent director and chairman of the audit committee of: UTStarcom Holdings Corp., a provider of interactive, IP-based network solutions listed on NASDAQ, since October 2012; Yongye International, Inc., a Chinese agricultural nutrient company listed on NASDAQ, since April 2009 and China Biologic Products, Inc., a biopharmaceutical company listed on NASDAQ, since July 2008 and (ii) independent director and chairman of the nominating committee of Agria Corporation, a Chinese agricultural company listed on NYSE, since November 2008. Mr. Shao served as the chief financial officer of Trina Solar Limited, a manufacturer of integrated solar-power products, from 2006 to 2008. In addition, he served from 2004 to 2006 as the chief financial officer of ChinaEdu Corporation, an educational service provider, and of Watchdata Technologies Ltd., a Chinese security software company. Prior to that, Mr. Shao worked at Deloitte Touche Tohmatsu Certified Public Accountants LLP, formally Deloitte Touche Tohmatsu CPA Ltd., for approximately a decade. Mr. Shao received his master's degree in health care administration from the University of California at Los Angeles in 1988 and his bachelor's degree in art from East China Normal University in 1982. Mr. Shao is a member of the American Institute of Certified Public Accountants.

*Mr. Cheung Kin Au-Yueng* has served as an independent director of our company since October 2011. Mr. Au-Yueng has been an executive director of various companies in the Morningside Group, a privately-owned investment company, since late 1996. He has more than 30 years of general management experience gained through working with Morningside Group and several other major multi-national companies. Prior to joining Morningside, he had been serving as head of Gillette's operations in China for five years. While with Morningside, Mr. Au-Yueng has been overseeing the operations of the Morningside Group and its portfolio companies in China. He had served on the board of directors of a portfolio company listed on the Growth Enterprise Market of the Hong Kong Stock Exchange for over four years and had also been seconded to a company listed on NASDAQ as chief operating officer for about half year. He is currently a director of The9 Limited a NASDAQ-listed company. Mr. Au-Yueng holds a master's degree in physics and an MBA degree from Indiana University.

*Mr. Cheung Lun Julian Cheng* has served as a director of our company since 2010. Mr. Cheng is a managing director in the China group at Warburg Pincus LLC, which he joined in 2000. Mr. Cheng is also a director for a number of other private companies. Prior to joining Warburg Pincus Asia LLC, Mr. Cheng worked for the capital markets and investment banking divisions of Salomon Smith Barney and Bankers Trust in Hong Kong. Mr. Cheng received his bachelor's degree in economics from Harvard University in the United States in 1996.

*Ms. Christine Lu-Wong* has served as our chief financial officer since November 2012. Ms. Lu-Wong has over 19 years of finance operation and management experience with multinational corporations, public accounting firms and U.S.-listed Chinese enterprises. Her broad professional expertise covers financial planning and reporting, accounting, internal controls, M&A, tax and capital raising. Prior to joining our company, Ms. Lu-Wong was chief financial officer of NASDAQ-listed Pactera Technology International Ltd. (formerly, HiSoft Technology International Limited), a global consulting and technology services provider. From 2007 to 2009, she served as vice president of finance at NYSE-listed WuXi PharmaTech Inc., a China-based research and development outsourcing company. Ms. Lu-Wong also held various positions at major global companies and accounting firms, including Hewlett-Packard Company, Sun Microsystems, Inc. and PricewaterhouseCoopers. She received her bachelor's degree in international trade and economics from Guangdong University of Foreign Studies, and an M.B.A. in Accounting from Golden Gate University. Ms. Lu-Wong is a Certified Public Accountant in the State of California, USA.

*Ms. Wei Zhang* has served as a vice president of our company since 2008. Prior to joining our company in 2006, Ms. Zhang served as a vice president and director of the education management department of Shanxi Dongda Enterprise Group from 2003 to 2005. From 2000 to 2003, she served as a vice president of Sichuan Enlide Education Group. From 1998 to 2000, Ms. Zhang served as a teaching director and the principal of Shanxi Dongda School. From 1982 to 1998, Ms. Zhang worked with schools affiliated with the Third Engineering Bureau of the Ministry of Railway of the PRC in various capacities, including as a teacher, teaching director, and educational research and development director. Ms. Zhang graduated from Hegang Teachers' College in Heilongjiang, China in 1979 and also studied at the biology department of Harbin Normal University in China in 1981.

*Mr. Qiang Deng* has served as a vice president of our company since 2007 and joined our company in 2005. From 2001 to 2005, Mr. Deng worked in various managerial positions at long distance learning companies including Peking University-Affiliated Schools Lianxiang Long-distance Education Co., Ltd. and Internet School of Beijing No. 4 High School. From 1998 to 2001, Mr. Deng served as the director for [www.chinaedu.com](http://www.chinaedu.com), a provider of distance education services. From 1996 to 1998, he served as a physics teacher at Beijing Huicai Private School. From 1990 to 1996, he worked as a sales manager at Huahai Computer Co., Ltd. Mr. Deng received his bachelor's degree in mechanical engineering from Beijing University of Civil Engineering and Architecture in 1990 and completed the master's courses in developing and educational psychology in the Beijing Normal University in 2008.

*Mr. Zhijun Diao* has served as a vice president of our company since January 2013. Mr. Diao joined our company in June 2009 as assistant to the president. From December 2009 to April 2011, he served as the general manager of our Tianjin region. From April 2011 to January 2013, he worked as the general manager of our business operations in Beijing and Tianjin. Mr. Diao received his bachelor's degree in mathematics education from Shanxi Normal University in 1998 and completed the master's courses in industrial economics from Capital University of Economics and Business in 2005.

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The business address of each of our directors and executive officers is c/o Xueda Education Group, A-4 Xibahe Beili, Chaoyang District, Beijing, 100028, People's Republic of China.

Three of our former executive officers who served as our president, chief information officer and chief financial officer resigned in February, March and November 2012, respectively, for personal reasons.

## **B. Compensation**

### **Compensation of Directors and Executive Officers**

During 2013, the aggregate cash compensation that we paid to our directors and officers as a group was RMB 3.0 million (\$0.4 million). Walkers, our Cayman Islands counsel, has advised us that Cayman Islands law does not require an exempted company incorporated in the Cayman Islands, such as our company, to disclose the individual compensation of its executive officers and directors. Our full-time employees in the PRC, including our executive officers, participate in a government-mandated defined contribution plan pursuant to which certain pension benefits, medical care, unemployment insurance, employee housing fund and other welfare benefits are provided to qualified employees. During 2013, the total amount we set aside/accrued for such benefits for our executive officers was RMB 183,646 (\$29,872). We do not provide our directors with any pension, retirement or similar benefits. As of the date of this annual report:

- Options to purchase an aggregate of 13,065,903 ordinary shares have been granted under our 2009 share incentive plan to our directors, executive officers and employees. These options were granted on March 16, 2010 and August 22 and December 18, 2012, at an original exercise price of \$0.99, \$1.645 and \$1.26 per share, respectively, and an expiration period of ten years. On September 20, 2010, the exercise price of the 3,343,845 share options granted to a former officer on March 16, 2010 was increased to \$1.89 per share from \$0.99 per share. 2,089,905 of such re-priced share options were forfeited upon this officer's resignation in February 2012, and the remaining options to purchase 1,253,740 ordinary shares were cancelled in October 2012. As of March 20, 2014, options to purchase 4,535,686 ordinary shares were outstanding.
- From February 2011 to the date of this annual report, we had granted a total of 10,494,538 restricted shares and restricted share units to our directors, executive officers and employees. As of March 20, 2014, 1,797,894 of such shares have vested.

### **Employment Agreements**

We have entered into employment agreements with all of our executive officers. Under these agreements, each of our executive officers is employed for a specified time period. We may terminate his or her employment for cause at any time, with prior written notice, for certain acts of the executive officer, including but not limited to a conviction to a felony, or willful gross misconduct by the executive officer in connection with his or her employment, and in each case if such acts have resulted in material and demonstrable financial harm to us. An executive officer may, with prior written notice, terminate his or her employment at any time for any material breach of the employment agreement by us that is not remedied promptly after receiving the remedy request from the employee. Furthermore, either party may terminate the employment agreement at any time without cause upon advance written notice to the other party. Upon termination, the executive officer is generally entitled to a severance pay of at least one month's salary.

Each executive officer has agreed to hold, both during and subsequent to the terms of his or her agreement, in confidence and not to use, except in pursuance of his or her duties in connection with the employment, any of our confidential information, technological secrets, commercial secrets and know-how. Our executive officers have also agreed to disclose to us all inventions, designs and techniques resulted from work performed by them, and to assign us all right, title and interest of such inventions, designs and techniques.

### **Stock-Based Compensation Plans**

Our amended and restated equity incentive plan adopted in November 2009, or the 2009 share incentive plan, provides for the grant of options, share appreciation rights, or other share-based awards, collectively referred to as "awards." The purpose of the plan is to aid us in recruiting and retaining key employees, directors or consultants and to motivate such persons to exert their best efforts on behalf of our company by providing incentives through the granting of awards. Our board of directors and shareholders initially authorized the issuance of up to 11,146,151 ordinary shares upon exercise of awards granted under the 2009 share incentive plan. The total number of ordinary shares that may be issued under the plan shall automatically increase on January 1 of each calendar year, commencing with January 1, 2011, by an amount equal to (i) 1% of the total number of ordinary shares issued and outstanding on December 31 of the immediately preceding calendar year, and (ii) such number of ordinary shares as may be established by the board of directors or its compensation committee. The cancelled options and restricted shares are considered to be available for further awards. As of the date of this annual report, the total number of ordinary shares that may be issued under the plan is 2,087,324. Our board of directors believes that our company will benefit from the added interest that such persons will have in the welfare of the company as a result of their proprietary interest in the company's success.

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*Termination of Awards.* Options have specified terms set forth in a share option agreement. If the recipient's employment with the company is terminated for any reason, the recipient's vested options will remain exercisable subject to the provisions of the plan and the option agreement and the recipient's unvested options will terminate without consideration. If the options are not exercised or purchased by the last day of the exercise period, they will terminate.

*Administration.* The 2009 share incentive plan is administered by the compensation committee of our board of directors. Our board of directors or the compensation committee is authorized to interpret the plan, to establish, amend and rescind any rules and regulations relating to the plan, and to make any other determinations that it deems necessary or desirable for the administration of the plan. Our board of directors or the compensation committee will determine the provisions, terms and conditions of each award consistent with the provisions of the plan, including, but not limited to, the exercise price for an option, vesting schedule, forfeiture provisions, form of payment of exercise price and other applicable terms.

*Options.* We may grant share options under the 2009 share incentive plan. The exercise price of the share options shall be no less than, (i) with respect to share options granted to individuals subject to taxation in the United States, 100% of the fair market value of a Share, and with respect to all other share options, 85% of the fair market value of a share, in each case, on the date the share option is granted. The term of options granted under the 2009 share incentive plan may not exceed ten years from the date of grant. The consideration to be paid for our ordinary shares upon exercise of an option or purchase of shares underlying the option may include cash, check or other cash-equivalent, consideration received by us in a cashless exercise and, to the extent permitted by our compensation committee and subject to the provisions of the option agreement, ordinary shares or a combination of ordinary shares and cash or cash-equivalent.

*Restricted shares.* Restricted shares may be granted under our 2009 share incentive plan. Restricted share awards are ordinary shares that are subject to various restrictions, including restrictions on transferability and forfeiture provisions. Restricted shares will vest and the restrictions on such shares will lapse, in accordance with terms and conditions established at the time of grant. Recipients of restricted share awards generally will have voting rights upon grant without regard to vesting, but will have no dividend rights with respect to restricted shares that have not vested. Restricted shares that do not vest upon the termination of the grantee's employment or service will be forfeited without consideration.

*Restricted share units.* Restricted share units may be granted as one of the other stock-based awards under our 2009 share incentive plan. Restricted share units represent the right to receive our ordinary shares at a specified date in the future, subject to forfeiture of the right upon termination of employment or service during the applicable restriction period. The awards may be settled in shares, cash, or a combination of both, as the compensation committee may determine.

*Change in Control.* If a third party acquires us through the purchase of all or substantially all of our assets, a merger or other business combination or if during any two consecutive year period individuals who at the beginning of such period constituted the board of directors cease for any reason to constitute a majority of our board of directors, then, if so determined by our board of directors or the compensation committee with respect to the applicable award agreement or otherwise, any outstanding awards that are unexercisable or otherwise unvested or subject to lapse restrictions will automatically be deemed exercisable or otherwise vested or no longer subject to lapse restrictions, as the case may be, as of immediately prior to such change in control. Our board of directors or the compensation committee may also, in its sole discretion, decide to cancel such awards for fair value, provide for the issuance of substitute awards that will substantially preserve the otherwise applicable terms of any affected awards previously granted, or provide that affected options will be exercisable for a period of at least 15 days prior to the change in control, but not thereafter.

*Amendment and Termination of Plan.* Our board of directors may at any time amend, alter or discontinue the 2009 share incentive plan. Amendments or alterations to the 2009 share incentive plan are subject to shareholder approval if they increase the total number of shares reserved for the purposes of the plan or change the maximum number of shares for which awards may be granted to any participant. Any amendment, alteration or termination of the 2009 share incentive plan must not adversely affect awards already granted without written consent of the recipient of such awards. Unless terminated earlier by our board of directors, the 2009 share incentive plan will continue in effect for a term of ten years from the date of its adoption.

*Granted Options.* As of March 20, 2014, we had granted options to purchase an aggregate of 1 3,065,903 ordinary shares to our directors, officers and employees, options to purchase 4,535,686 of which are outstanding. Among these options:



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- Options to purchase 2,089,904 ordinary shares have an exercise price of \$1.645 per share and are subject to a two-year vesting schedule, with 50% vesting on May 22, 2013 and 2014, respectively;
- Options to purchase 491,930 ordinary shares have an exercise price of \$1.26 per share and are subject to a four-year vesting schedule, vesting in eight equal installments on each date that is six months after the prior vesting date, with the first installment vesting after the first full six months after November 22, 2012; and
- Options to purchase 1,953,852 ordinary shares have an exercise price of \$0.99 per share and are subject to a four-year vesting schedule, with 25% vesting on March 16, 2011, 2012, 2013 and 2014, respectively.

### **C. Board Practices**

We have eight directors, three of whom are independent directors, on our board of directors. Any director on our board may be removed by way of an ordinary resolution of shareholders. Any vacancies on our board of directors or additions to the existing board of directors can be filled by the affirmative vote of all of the remaining directors. Each of our directors holds office until such director resigns or is removed by way of an ordinary resolution of shareholders. We have no service contracts with any of our directors that provide benefits to them upon termination.

All of our executive officers are appointed by and serve at the discretion of our board of directors. Our executive officers are elected by and may be removed by a majority vote of our board of directors.

### **Board Committees**

To enhance our corporate governance, we have established two committees under the board of directors: the audit committee and the compensation committee. We have adopted a charter for each of these committees. The committees have the following functions and members.

#### ***Audit Committee***

Our audit committee consists of Mr. Sean Shao, Mr. Cheung Kin Au-Yueng and Ms. Yafei Wang. Mr. Sean Shao is the chairman of our audit committee and meets the criteria of an audit committee financial expert as set forth under the applicable rules of the Securities and Exchange Commission, or the SEC. Our board of directors has determined that each of Mr. Shao, Mr. Au-Yueng and Ms. Wang satisfies the requirements for an “independent director” within the meaning of Section 303A of the NYSE Listed Company Manual and meets the criteria for independence set forth in Rule 10A-3 of the Exchange Act. Our board of directors has determined that the simultaneous service by Mr. Sean Shao on the audit committee of three other public companies would not impair his ability to effectively serve on our audit committee. The audit committee oversees our accounting and financial reporting processes and the audits of the financial statements of our company. The audit committee is responsible for, among other things:

- selecting our independent registered public accounting firm and pre-approving all auditing and non-auditing services permitted to be performed by our independent registered public accounting firm;
- reviewing with our independent registered public accounting firm any audit problems or difficulties and management’s response;
- reviewing and approving all proposed related-party transactions, as defined in Item 404 of Regulation S-K under the Securities Act;
- discussing the annual audited financial statements with management and our independent registered public accounting firm;
- reviewing major issues as to the adequacy of our internal controls and any special audit steps adopted in light of significant control deficiencies;
- annually reviewing and reassessing the adequacy of our audit committee charter;
- such other matters that are specifically delegated to our audit committee by our board of directors from time to time;
- meeting separately and periodically with management and our internal auditor and independent registered public accounting firm; and
- reporting regularly to the full board of directors.

#### ***Compensation Committee***

Our compensation committee consists of Mr. William Hsu, Ms. Yafei Wang and Mr. Jinbo Yao. Mr. William Hsu is the chairman of our compensation committee. Our board of directors has determined that Ms. Yafei Wang satisfies the requirements for an “independent director” within the meaning of section 303A of the NYSE Listed Company Manual and meets the criteria for independence set forth in Rule 10A-3 of the Exchange Act. Our compensation committee assists the board in reviewing and approving the compensation structure of our directors and executive officers, including all forms of compensation to be provided to our directors and executive officers. Members of the compensation committee are not prohibited from direct involvement in determining their own compensation. Our chief executive officer may not be present at any committee meeting during which his compensation is deliberated. The compensation committee is responsible for, among other things:



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- approving and overseeing the compensation package for our executive officers;
- reviewing and making recommendations to the board with respect to the compensation of our directors;
- reviewing and approving corporate goals and objectives relevant to the compensation of our chief executive officer, evaluating the performance of our chief executive officer in light of those goals and objectives, and setting the compensation level of our chief executive officer based on such evaluation; and
- reviewing periodically and making recommendations to the board regarding any long-term incentive compensation or equity plans, programs or similar arrangements, annual bonuses, employee pension and welfare benefit plans.

### **Duties of Directors**

Under Cayman Islands law, our directors have a fiduciary duty to act honestly in good faith with a view to our best interests. Our directors also have a duty to exercise the care, diligence and skills that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our third amended and restated memorandum and articles of association. A director may be liable for any loss suffered by us as a result of their fiduciary duties.

The functions and powers of our board of directors include, among others:

- convening shareholders' annual general meetings and reporting its work to shareholders at such meetings;
- issuing authorized but unissued shares;
- declaring dividends and distributions;
- exercising the borrowing powers of our company and mortgaging the property of our company;
- approving the transfer of shares of our company, including the registering of such shares; and
- exercising any other powers conferred by the shareholders meetings or under our third amended and restated memorandum and articles of association.

### **Remuneration and Borrowing**

The directors may determine remuneration to be paid to the directors. The compensation committee will assist the directors in reviewing and approving the compensation structure for the directors. The directors may exercise all the powers of the company to borrow money and to mortgage or charge its undertaking, property and uncalled capital and to issue debentures or other securities, whether outright or as security, for any debt obligations of our company or of any third party.

### **Qualification**

There is no requirement for our directors to own any shares in our company in order for them to qualify as a director.

### **Terms of Directors and Executive Officers**

We currently have eight directors, three of whom are independent directors. Any director on our board may be removed by way of an ordinary resolution of shareholders. Any vacancies on our board of directors or additions to the existing board of directors can be filled by the affirmative vote of all of the remaining directors. Each of our directors holds office until such director resigns or is removed by way of an ordinary resolution of shareholders.

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All of our executive officers are appointed by and serve at the discretion of our board of directors. Our executive officers are elected by and may be removed by a majority vote of our board of directors.

**D. Employees**

**Employees**

As of December 31, 2013, 2012 and 2011, we had 15,025, 16,454 and 15,074 full-time employees, respectively, including 8,080, 9,517 and 8,329 instructors, respectively. As of December 31, 2013, we had the following full-time employees by function:

Instructors	8,080
Education consultants	1,693
Study counselors	1,391
Psychological counselors	75
Sales and marketing	650
General and administration staff	3,136
Total	15,025

As required by regulations in China, we participate in various employee social security plans that are administered by municipal and provincial governments, including housing, pension, medical insurance and unemployment insurance. We are required under relevant PRC laws to make contributions to employee benefit plans at specified percentages of the total salaries, bonuses and certain allowance of our employees, up to a maximum amount specified by the relevant local governments from time to time.

None of our employees are represented by collective bargaining arrangements, and we consider our relations with our employees to be good.

**E. Share Ownership**

There are no different voting rights among our shareholders. We are not aware of any arrangement that may, at a subsequent date, result in a change of control of our company. For information regarding the share ownership of our directors and officers, see “Item 7. Major Shareholders and Related Party Transactions — A. Major Shareholders.” For information as to stock options granted to our directors, executive officers and other employees, see “Item 6. Directors, Senior Management and Employees—B. Compensation — Stock-Based Compensation Plans.”

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

**A. Major Shareholders**

The following table sets forth information with respect to the beneficial ownership of our ordinary shares, on a fully diluted basis, as of March 28, 2014, by:

- each of our directors and executive officers; and
- each person known to us to own beneficially more than 5% of our ordinary shares.

The calculation in the table below is based on 122,860,624 ordinary shares outstanding as of March 28, 2014 (excluding 7,587,784 unvested restricted shares).

Beneficial ownership is determined in accordance with the rules and regulations of the SEC. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, we have included shares that the person has the right to acquire within 60 days, including through the exercise of any option, warrant or other right or the conversion of any other security. These shares, however, are not included in the computation of the percentage ownership of any other person.

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The business address of each of our directors and executive officers is c/o Xueda Education Group, A-4 Xibahe Beili, Chaoyang District, Beijing 100028, People's Republic of China.

	Number	%
<b>Directors and Executive Officers:</b>		
Rubin Li <sup>(1)</sup>	21,150,930	17.2
Xin Jin <sup>(2)</sup>	28,180,098	22.9
Jinbo Yao <sup>(3)</sup>	10,972,720	8.9
William Hsu <sup>(4)</sup>	14,429,502	11.7
Yafei Wang <sup>(5)</sup>	2,237,585	1.8
Sean Shao	—	—
Cheung Kin Au-Yueng	*	*
Cheung Lun Julian Cheng <sup>(6)</sup>	8,624,000	7.0
Christine Lu-Wong	*	*
Wei Zhang	*	*
Qiang Deng	*	*
Zhijun Diao	*	*
All directors and executive officers as a group	86,585,840	70.5
<b>Principal Shareholders:</b>		
Golden Section Holding Corporation <sup>(7)</sup>	28,180,098	22.9
CDH Xueda Limited <sup>(8)</sup>	14,429,502	11.7
Goodor Corporation <sup>(9)</sup>	21,150,930	17.2
WP X Investments IV Ltd. <sup>(10)</sup>	8,624,000	7.0
Nihao China Corporation <sup>(11)</sup>	10,972,720	8.9

\* Beneficially owns less than 1% of our outstanding ordinary shares.

- (1) Represents 21,150,930 ordinary shares, including 666,000 ordinary shares represented by 333,000 ADSs which were purchased from the open market, owned by Goodor Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Li's family trust. See also footnote 9 below.
- (2) Represents 28,180,098 ordinary shares, including 740,418 ordinary shares represented by 370,209 ADSs which were purchased from the open market, owned by Golden Section Holding Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Jin's family trust. See also footnote 7 below.
- (3) Includes 10,972,720 ordinary shares owned by Nihao China Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Yao's family trust. See also footnote 11 below.
- (4) Includes 14,429,502 ordinary shares issued upon conversion at the time of our initial public offering of the same number of Series A1 preferred shares owned by CDH Xueda Limited. See also footnote 8 below. Mr. William Hsu disclaims beneficial ownership of any of the shares held by CDH Xueda Limited, except to the extent of his pecuniary interest in that entity as a whole.
- (5) Includes 2,237,585 ordinary shares issued upon conversion at the time of our initial public offering of the same number of Series A2 preferred shares owned by Happyall Ltd, a British Virgin Islands company 100% beneficially owned by Ms. Yafei Wang, and 15,015 ordinary shares held by Ms. Wang.
- (6) Includes 6,624,000 ordinary shares and 1,000,000 ADSs representing 2,000,000 ordinary shares held by WP X Investments IV Ltd. See also footnote 10 below. Mr. Cheng is a managing director in the China group at Warburg Pincus LLC and disclaims beneficial ownership of any of the shares held by WP X Investments IV Ltd., except to the extent of his pecuniary interest in that entity as a whole.
- (7) Includes 28,180,098 ordinary shares, including 740,418 ordinary shares represented by 370,209 ADSs which were purchased from the open market, owned by Golden Section Holding Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Xin Jin. The mailing address of Golden Section Holding Corporation is Trinity Chambers, P.O. Box 4301, Road Town, Tortola, British Virgin Islands.
- (8) Includes 14,429,502 ordinary shares issued upon conversion at the time of our initial public offering of the same number of Series A1 preferred shares owned by CDH Xueda Limited, a British Virgin Islands company 100% beneficially owned by CDH Venture Partners. CDH Venture GP I Company Limited, a Cayman Islands exempted limited liability company, is the general partner of CDH Venture Partners, L.P. and has the power to direct CDH Venture Partners as to the voting and disposition of shares directly and indirectly held by CDH Venture Partners, L.P. Mr. William Hsu is a director and a member of the investment committee of CDH Venture GP I Company Limited. Mr. William Hsu disclaims beneficial ownership of any of the shares held by CDH Xueda Limited, except to the extent of his pecuniary interest in that entity. The mailing address of CDH Xueda Limited is Kingston Chambers, P.O. Box 173, Road Town, Tortola, British Virgin Islands.
- (9) Represents 21,150,930 ordinary shares, including 666,000 ordinary shares represented by 333,000 ADSs which were purchased from the open market, owned by Goodor Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Rubin Li. The mailing address of Goodor

Corporation is Trinity Chambers, P.O. Box 4301, Road Town, Tortola, British Virgin Islands.

- (10) Includes 6,624,000 ordinary shares and 1,000,000 ADSs representing 2,000,000 ordinary shares held by WP X Investments IV Ltd., a Cayman Islands company. Based on the Schedule 13D/A filed with the Securities and Exchange Commission on June 23, 2011, WP X Investments IV Ltd., is a wholly owned subsidiary of Warburg Pincus Private Equity X, L.P., a Delaware limited partnership and Warburg Pincus X Partners, L.P., a Delaware limited partnership, both of which are managed by Warburg Pincus LLC, a New York limited liability company. Warburg Pincus X, L.P., a Delaware limited partnership, is the sole general partner of each of Warburg Pincus Private Equity X, L.P. and Warburg Pincus X Partners, L.P. Warburg Pincus X LLC, a New York limited liability company, is the sole general partner of Warburg Pincus X, L.P. Warburg Pincus Partners, LLC, a New York limited liability company, is the sole member of Warburg Pincus X LLC. Warburg Pincus & Co., a New York general partnership, is the managing member of Warburg Pincus Partners, LLC. Each of Messrs. Charles R. Kaye and Joseph P. Landy is a managing general partner of Warburg Pincus & Co. and co-president and managing member of Warburg Pincus LLC. The address of the principal business and principal office of WP X Investments IV Ltd. is c/o Warburg Pincus Asia Ltd, 8th Floor, Newton Tower, Sir William Newton Street, Port Louis, Mauritius. The address of the principal business and principal office of each of the other entities and persons is c/o Warburg Pincus LLC, 450 Lexington Avenue, New York, New York 10017.
- (11) Includes 10,972,720 ordinary shares owned by Nihao China Corporation, a British Virgin Islands company 100% beneficially owned by Mr. Jinbo Yao. The mailing address of Nihao China Corporation is Trinity Chambers, P.O. Box 4301, Road Town, Tortola, British Virgin Islands.



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As of March 28, 2014, other than the 39.7% of our ordinary shares underlying our ADSs which were held by Citibank, N.A. — Hong Kong, as the custodian on behalf of Citibank, N.A., the depositary, none of our ordinary shares were held in the United States. Our ADSs, representing 48,752,102 ordinary shares, or 39.7% of our total issued and outstanding ordinary shares, were held by two registered holders of record in the United States. Since these ADSs are held by brokers or other nominees, the number of record holders in the United States is not representative of the number of beneficial holders or their country of residence.

None of our existing shareholders has different voting rights from other shareholders. We are not aware of any arrangement that may, at a subsequent date, result in a change of control of our company.

**B. Related Party Transactions**

**Contractual Arrangements relating to Certain Affiliated Entities**

For a description of the contractual arrangements among our PRC subsidiary, Xuecheng Century, our VIE, Xueda Information and its shareholders, see “Item 4. Information on the Company — C. Organizational Structure.”

We use advertising services provided by Beijing 58 Information and Technology Co., Ltd, or Beijing 58, and Beijing Chengshi Wanglin Information and Technology Co., Ltd., or Chengshi Wanglin, two PRC-incorporated Internet-based classified information providers of which Mr. Jinbo Yao is a major shareholder. In 2011, 2012 and 2013, we paid advertising service fee in amounts of \$493 thousand, \$141 thousand and \$ 101 thousand, respectively, to Beijing 58 and nil, \$153 and \$11 to Chengshi Wanglin, respectively. There was no unsettled balance as of December 31, 2011, 2012 and 2013. We may continue to use advertising services provided by Beijing 58 and Chengshi Wanglin in the future.

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In the first half of 2010 and before we became a public company, we extended loans in a total amount of \$41 thousand to Shanghai Chuan Xue Network Technology Co., Ltd., or Chuan Xue, a company majority owned by Mr. Xin Jin, to fund its development of course materials which we had expected to use in the tutoring services we provided to our students. The loans to Chuan Xue were free of interest and had no definite terms of repayment. These loans were repaid in December 2012. We did not make any other loans similar to the Chuan Xue loans, nor do we intend to continue to make similar loans, to our directors or executive officers or entities they control.

In March 2012, Xueda Information and two individuals, one of whom is the wife of Mr. Xin Jin, our co-founder and chief executive officer, and Mr. Junbo Song, a shareholder of our VIE, entered into a share transfer framework agreement with the selling shareholders of Beijing Weland International Education and Technology Corp., or Weland, a company incorporated in China that organizes Chinese students to attend various model United Nations conferences and relevant trainings in the United States and China. Pursuant to this agreement, in June 2012, Xueda Information acquired 60% of the equity interest in Weland for a consideration of RMB18.9 million (\$3.0 million). The two individuals acquired an aggregate of 10% of the equity interest in Weland for an aggregate consideration of RMB3.1 million (\$0.5 million).

In May and November 2012, Xueda Information extended two entrusted loans to Beijing Lebai Education Consulting Co., Ltd., or Lebai, an affiliate of Firstleap Education (a company in which we acquired an aggregated of 16.11% equity interest in August 2012 and July 2013), in an amount of RMB20 million (\$3.2 million) and RMB10 million (\$1.6 million), respectively, to fund Lebai's business operations. Each of these loans had a term of six months and bore an interest rate of 10% per annum. The RMB20 million (\$3.2 million) loan was fully repaid in November 2012 and the RMB10 million (\$1.6 million) loan was fully repaid in May 2013. In December 2013, Xuecheng Century provided two unsecured loans to Lebai in a total amount of RMB16 million (\$2.6 million), to support Lebai's business operations. Such loans are for a period from December 2013 to April 2014 and bear an interest rate of 4% per annum. In 2012 and 2013, Xuecheng Century generated rental income of \$99 thousand and \$159 thousand, respectively, from Lebai for one of its learning centers located in Beijing leased by Lebai. In 2013, Xuecheng Century and Xueda Information's subsidiaries generated the tutoring related services income of \$117 thousand from Lebai.

### ***Series A1 and Series A2 Preferred Shares***

On August 28, 2009, we issued to CDH Xueda Limited 21,555,920 Series A1 preferred shares and to Happyall Ltd, Poda Capital Limited and Wavesong Ltd, or the Series A2 investors, an aggregate of 8,796,920 Series A2 preferred shares. All outstanding Series A1 and Series A2 preferred shares have been automatically converted into our ordinary shares at a conversion ratio of 1:1, upon the completion of our initial public offering. The proceeds from the issuance and sale of Series A1 and Series A2 preferred shares were used for capital expenditure and working capital purposes.

### **Employment Agreements**

See "Item 6. Directors, Senior Management and Employees — B. Compensation — Employment Agreements."

### **Stock Incentive Plan**

See "Item 6. Directors, Senior Management and Employees — B. Compensation — Stock Based Compensation Plans."

### **Shareholders of our VIE**

All but one of the shareholders of our VIE are also beneficial owners of our shares. See "Item 4. Information on the Company — C. Organizational Structure." We have not created any additional incentives, whether financial, contractual or otherwise, to encourage the shareholders of our VIE, in their capacity as such, to act in the best interest of our company.

### **Registration Rights**

We entered into a shareholders agreement with all of our then existing shareholders in August 2009 and an investor and registration rights agreement with Warburg Pincus in October 2010, under which we granted those shareholders and Warburg Pincus certain registration rights, including demand registration rights, piggyback registration rights and Form F-3 registration rights.

#### ***Demand Registration Rights***

Under the terms of the shareholders agreement dated August 28, 2009 among us and our then existing shareholders, from the date that is six months after our initial public offering, shareholders holding at least 20% of our registrable securities then outstanding may, on no more than two occasions, require us to file a registration statement under the Securities Act covering the registration of all or part of the registrable securities. Under the investor and registration rights agreement by and between us and Warburg Pincus dated October 20, 2010, Warburg Pincus has similar demand registration rights on no more than two occasions.

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Registrable securities are (i) any of our ordinary shares issuable or issued upon conversion of our preferred shares, (ii) any of our ordinary shares issued as a dividend or other distribution with respect to, in exchange for, or in replacement of, the shares referenced in (i) and (ii), (iii) any other ordinary shares owned or later acquired by the holder of our preferred shares, and (iv) the ordinary shares and ADSs issued and offered by us and the ordinary shares sold by Goodor Corporation to Warburg Pincus, but excluding any of our shares sold in a transaction in which the registration rights are not assigned in accordance with the shareholders agreement and any registrable securities sold in a public offering, whether sold pursuant to Rule 144 of the Securities Act, or Rule 144, in a registered offering, or otherwise.

We will not be obligated to effect any such registration if we have, within the six-month period preceding the date of such request, already effected a registration under the Securities Act pursuant to provisions regarding demand registration or Form F-3 registration, or in which the holders of registrable securities had an opportunity to participate pursuant to the provisions relating to piggyback registration. We have the right to defer the filing of a registration statement for up to 90 days if we furnish to the holders of registrable securities requesting such registration a certificate signed by our president or chief executive officer stating that, in the good faith judgment of our board of directors, it would be materially detrimental to us and our shareholders for such registration statement to be filed at such time, provided that we may not utilize this deferral right more than once in any 12-month period. The underwriters of any underwritten offering have the right to limit the number of shares to be included in the applicable registration statement so long as they determine that marketing factors require such a limitation, provided that:

- the number of shares of registrable securities to be included in such underwriting and registration may not be reduced unless all other securities of us are first entirely excluded from the underwriting and registration; and
- the number of registrable securities held by the requesting holders included in such registration is not reduced below 25% of the aggregate number of securities included in such registration statement.

### *Piggyback Registration Rights*

Holders of registrable securities also have “piggyback” registration rights, which may require us to register all or any part of the registrable securities then held by such holders when we register any ordinary shares, but excluding registration relating to any employee benefit plan or relating to a corporate reorganization. Registration pursuant to piggyback registration rights is not deemed to be a demand registration, and there is no limit on the number of times the holders may request registration of their registrable securities pursuant to their piggyback registration rights. The underwriters of any underwritten offering have the right to limit the number of shares to be included in the applicable registration statement so long as they determine in good faith that marketing factors require such a limitation, provided that:

- the number of shares that may be included in the registration shall be allocated, first, to us, second, to each of the requesting holders of registrable securities, and third, to holders of other securities of us; and
- the number of registrable securities held by the requesting holders included in such registration is not reduced below 25% of the aggregate number of securities included in such registration statement.

### *Form F-3 Registration Rights*

Holders holding at least 20% of our registrable securities then outstanding, or Warburg Pincus, as the case may be, may request in writing that we effect a registration on Form F-3 and any related qualification or compliance with respect to all or a part of the registrable securities owned by such holder. We will not be obligated to effect any such registration, qualification or compliance pursuant to provisions regarding Form F-3 registration if, among other things, the aggregate amount of securities to be sold under the registration statement is less than \$500,000 or we have, within the six-month period preceding the request, already effected a registration under the Securities Act. Registration pursuant to Form F-3 registration rights is not deemed to be a demand registration, and there is no limit on the number of times the holders may exercise their Form F-3 registration rights.

### *Expenses of Registration*

We will pay all expenses incurred by us relating to any demand, piggyback or Form F-3 registration, except that the requesting holders shall bear the expense of any underwriting discounts and selling commissions relating to the offering of their securities. We will not be required to pay for any expenses of any registration proceeding begun pursuant to demand registration rights, if the registration request is subsequently withdrawn at the request of the holders of a majority of the registrable securities to be registered.

### *Termination of Our Obligations*

Notwithstanding the foregoing, we will have no obligations to effect the demand registration, piggyback registration and Form F-3 registration with respect to any registrable securities proposed to be sold by a holder of registrable securities in a registered public offering (i) two years after the consummation of a qualified initial public offering, or (ii) if, in the opinion of our counsel, all such registrable securities proposed to be sold by a holder may then be sold without registration in any 90 day period pursuant to Rule 144 under the Securities Act.

#### **C. Interests of Experts and Counsel**

Not applicable.

### **ITEM 8. FINANCIAL INFORMATION**

#### **A. Consolidated Statements and Other Financial Information**

See “Item 18. Financial Statements.”

#### **Legal and Administrative Proceedings**

From time to time, we are subject to legal proceedings, investigations and claims incidental to the conduct of our business. We are not currently a party to any legal proceeding or investigation which, in the opinion of our management, is likely to have a material adverse effect on our business, financial condition or results of operations.

#### **Dividend Policy**

On November 19, 2012, our board of directors declared a special cash dividend in the amount of \$0.25 per ordinary share, or \$0.50 per ADS to shareholders of record at the close of business on December 19, 2012. The aggregate amount of cash dividends paid was approximately \$32.6 million, which was funded by surplus cash on Cayman holding company’s balance sheet. \$9.9 million of the cash dividends was paid on December 31, 2012, and the remaining \$22.7 million was paid in January 2013. On February 26, 2014, our board of directors authorized the payment of a dividend of \$0.16 per ADS, or \$0.08 per ordinary share. The dividend will be payable on or about April 15, 2014 to holders of ordinary shares (which includes holders of ADSs) on record as of the close of business on March 28, 2014, which will be funded by surplus cash on our Cayman holding company’s balance sheet. The aggregate amount of cash dividends to be paid is approximately \$11 million.

Other than as described in the preceding paragraph, we have not declared or paid any dividends on our ordinary shares. We have no present plan to declare any additional dividends on our ordinary shares in the foreseeable future. We currently intend to retain most, if not all, of our available funds and any future earnings to operate and expand our business.

Any determination to declare and pay dividends is made at the discretion of our board of directors and may be based on a number of factors, including our operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and other factors that the board of directors may deem relevant. If we pay any dividends, we will pay our ADS holders to the same extent as holders of our ordinary shares, subject to the terms of the deposit agreement, including the fees and expenses payable thereunder. Cash dividends on our ordinary shares, if any, will be paid in U.S. dollars.

We are a holding company incorporated in the Cayman Islands. In order for us to distribute any dividends to our shareholders and ADS holders, we may rely on dividends distributed by our PRC subsidiary. Certain payments from our PRC subsidiary to us are subject to PRC taxes, such as withholding income tax. In addition, regulations in the PRC currently permit payment of dividends of a PRC company only out of accumulated distributable after-tax profits as determined in accordance with its articles of association and the accounting standards and regulations in China. Our PRC subsidiary is required to set aside at least 10% of its after tax profit based on PRC accounting standards every year to a statutory common reserve fund until the aggregate amount of such reserve fund reaches 50% of the registered capital of such subsidiary. Allocations to this statutory fund can only be used for specific purposes and are not transferable to the company’s shareholders in the form of loans, advances or dividends. See “Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Doing Business in China — Restrictions under PRC law on our PRC subsidiary’s ability to make dividend payments and other distributions could materially and adversely affect our ability to make investments or acquisitions, pay dividends or other distributions to you, and otherwise fund and conduct our other businesses.”

## B. Significant Changes

We have not experienced any significant changes since the date of our audited consolidated financial statements included in this annual report.

## ITEM 9. THE OFFER AND LISTING

### A. Offer and Listing Details.

Our ADSs, each representing two of our ordinary shares, have been listed on the New York Stock Exchange since November 2, 2010 under the symbol “XUE.” The table below shows, for the periods indicated, the high and low market prices on the New York Stock Exchange for our ADSs.

	Sale price	
	High	Low
	(in \$)	
Annual highs and lows		
2011	11.57	2.41
2012	4.92	2.30
2013	7.25	2.45
Quarterly highs and lows		
First quarter 2012	4.92	3.01
Second quarter 2012	4.16	2.92
Third quarter 2012	3.99	2.47
Fourth quarter 2012	3.50	2.30
First quarter 2013	3.17	2.45
Second quarter 2013	3.50	2.84
Third quarter 2013	5.00	3.18
Fourth quarter 2013	7.25	4.11
First quarter 2014 (through March 20, 2014)	7.70	5.10
Monthly highs and lows		
September 2013	5.00	3.75
October 2013	5.20	4.11
November 2013	5.77	4.46
December 2013	7.25	5.43
January 2014	7.70	5.82
February 2014	7.04	5.75
March 2014 (through March 28, 2014)	5.97	5.10

### B. Plan of Distribution

Not applicable.

### C. Markets

Our ADSs, each representing two of our ordinary shares, have been listed on the New York Stock Exchange since November 2, 2010 under the symbol “XUE.”

### D. Selling Shareholders

Not applicable.

### E. Dilution

Not applicable.

### F. Expenses of the Issue

Not applicable.

## ITEM 10. ADDITIONAL INFORMATION

### A. Share Capital

Not applicable.

### B. Memorandum and Articles of Association

We incorporate by reference into this annual report the description of our third amended and restated memorandum and articles of association contained in our F-1 registration statement (File No. 333-169971), initially filed with the Commission on October 15, 2010. Our shareholders adopted our third amended and restated memorandum and articles of association by unanimous resolutions on October 8, 2010.

### C. Material Contracts

We have not entered into any material contracts other than in the ordinary course of business and other than those described in “Item 4. Information on the Company” or elsewhere in this annual report.

### D. Exchange Controls

See “Item 4. Information on the Company — B. Business Overview — Regulation — Regulations on Foreign Exchange.”

### E. Taxation

The following summary of the material Cayman Islands, Hong Kong, People’s Republic of China and United States federal income tax consequences of an investment in our ADSs or ordinary shares is based upon laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change. This summary does not deal with all possible tax consequences relating to an investment in our ADSs or ordinary shares, such as the tax consequences under state, local and other tax laws.

#### **Cayman Islands Taxation**

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to us levied by the Government of the Cayman Islands except for stamp duties which may be applicable on instruments executed in, brought within or produced before a court in, the jurisdiction of the Cayman Islands. The Cayman Islands is not party to any double tax treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

#### **Hong Kong Taxation**

The following is a summary of the material Hong Kong tax consequences of the ownership of the ADSs by an investor that holds the ADSs as capital assets. This summary does not purport to address all possible tax consequences of the ownership of the ADSs and does not take into account the specific circumstances of any particular purchasers, some of which may be subject to special rules. This summary is based on the tax laws of Hong Kong as in effect on the date of this annual report.

#### ***Hong Kong profits tax***

An ADS holder would be liable for profits tax in Hong Kong for its purchase and sale of the ADSs if the following three conditions are satisfied:

- the ADS holder carries on a trade, profession or business in Hong Kong;
- the ADS holder derives profits from that trade, profession or business, other than profits arising from the sale of capital assets; and
- those profits arise in or are derived from Hong Kong (i.e. the profits have a Hong Kong source).

If a liability arises, the normal profits tax rates applicable to corporations for the year of assessment of 2012/2013 is 16.5% and the normal profits tax rates applicable to individual for the year of assessment of 2012/2013 is 15%.

#### ***Dividends received on ADSs***

According to the current tax practice of the Hong Kong Inland Revenue Department, dividends paid by us on ADSs would not be subject to any Hong Kong tax, even if received by investors in Hong Kong.



### ***Capital gains from the sale of ADSs***

There is no tax on capital gains in Hong Kong. Any gains derived from the disposal of the ADSs acquired by the investor for long-term investment will not be taxable in Hong Kong.

### ***Stamp duty***

No Hong Kong stamp duty is payable on the purchase and sale of the ADSs.

### **People's Republic of China Taxation**

We are a holding company incorporated in the Cayman Islands and we may gain substantial income by way of dividends from our PRC subsidiary. The EIT Law and the EIT Implementation Rules, both of which became effective on January 1, 2008, provide that China-sourced income of foreign enterprises, such as dividends paid by a PRC subsidiary to its foreign investor, will normally be subject to PRC withholding tax at a rate of 10%, unless any such foreign investor's jurisdiction of incorporation has an applicable tax treaty with China that provides for a different withholding arrangement.

Under the EIT Law and the EIT Implementation Rules, an enterprise established outside of the PRC with “*de facto* management bodies” within the PRC is considered a resident enterprise and is subject to enterprise income tax at the rate of 25% on its global income. The EIT Implementation Rules define the term “*de facto* management bodies” as “establishments that carry out substantial and overall management and control over the manufacturing and business operations, personnel, accounting, properties, etc. of an enterprise.” The State Administration of Taxation issued the *Notice Regarding the Determination of Chinese-Controlled Offshore Incorporated Enterprises as PRC Tax Resident Enterprises on the Basis of De Facto Management Bodies*, or Circular 82, on April 22, 2009. Circular 82 provides certain specific criteria for determining whether the “*de facto* management body” of a Chinese-controlled offshore incorporated enterprise is located in China. Following Circular 82, on August 3, 2011, the SAT issued *Administrative Measures on Income Taxes of Resident Enterprises Incorporated outside Mainland China and Are Controlled by Chinese Enterprises (Trial Implementation)*, or Resident Enterprise Administrative Measures, which was effective as of September 1, 2011. This Resident Enterprise Administrative Measures provides clarification of resident status determination, post-determination administration, as well as competent tax authorities. However, Circular 82 and Resident Enterprise Administrative Measures apply only to offshore enterprises controlled by PRC enterprises, not those invested in by PRC individuals, like our company. Currently there are no further detailed rules or precedents applicable to us governing the procedures and specific criteria for determining “*de facto* management body” for the company of our type. We do not believe we are a resident enterprise defined and regulated by the aforesaid regulations as none of our shareholders is a PRC company or PRC corporate group. However, it remains unclear how PRC tax authorities will determine the tax resident status of companies like us. If the PRC authorities were to subsequently determine, or any future regulation provides, that we should be treated as a PRC resident enterprise, we would be subject to a 25% enterprise income tax on our global income, which will increase our tax burden and could adversely affect our financial condition and results of operations.

Therefore, if we are regarded as a PRC resident enterprise, the amount of dividends, if any, we may pay to our shareholders and ADS holders may be decreased, although dividends distributed from our PRC subsidiary, Xuecheng Century, to us could be exempted from the PRC dividend withholding tax, since such income is exempted under the EIT Law and the EIT Implementation Rules to a PRC resident recipient. If the PRC tax authorities determine we are a PRC resident enterprise for EIT purposes, we may be required to withhold a PRC withholding tax of 10% from dividends we pay to our non-PRC enterprise shareholders and a 20% withholding tax from dividends we pay to our non-PRC individual shareholders, including the holders of our ADSs. In addition, non-PRC shareholders may be subject to PRC tax on gains realized on the sale or other disposition of ADSs or ordinary shares, if such income is treated as sourced from within the PRC. It is unclear whether our non-PRC shareholders would be able to claim the benefits of any tax treaties between their tax residence and the PRC in the event that we are considered as a PRC resident enterprise.

See “Item 3. Key Information — D. Risk Factors — Risk Factors Relating to Doing Business in China — Under the EIT Law, we may be classified as a ‘resident enterprise’ of China. Such classification would likely result in unfavorable tax consequences to us and our non-PRC shareholders.”

### **United States Federal Income Taxation**

The following summary describes the material United States federal income tax consequences of the ownership of our ordinary shares and ADSs as of the date hereof. The discussion is applicable only to United States Holders (as defined below) who hold our ordinary shares or ADSs as capital assets. As used herein, the term “United States Holder” means a beneficial owner of an ordinary share or ADS that is for United States federal income tax purposes:

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- an individual citizen or resident of the United States;
- a corporation (or other entity treated as a corporation for United States federal income tax purposes) created or organized in or under the laws of the United States, any state thereof or the District of Columbia;
- an estate the income of which is subject to United States federal income taxation regardless of its source; or
- a trust if it (1) is subject to the primary supervision of a court within the United States and one or more United States persons have the authority to control all substantial decisions of the trust or (2) has a valid election in effect under applicable United States Treasury regulations to be treated as a United States person.

This summary does not represent a detailed description of the United States federal income tax consequences applicable to you if you are subject to special treatment under the United States federal income tax laws, including if you are:

- a dealer in securities or currencies;
- a financial institution;
- a regulated investment company;
- a real estate investment trust;
- an insurance company;
- a tax-exempt organization;
- a person holding our ordinary shares or ADSs as part of a hedging, integrated or conversion transaction, a constructive sale or a straddle;
- a trader in securities that has elected the mark-to-market method of accounting for your securities;
- a person liable for alternative minimum tax;
- a person who owns or is deemed to own 10% or more of our voting stock;
- a partnership or other pass-through entity for United States federal income tax purposes; or
- a person whose “functional currency” is not the United States dollar.

The discussion below is based upon the provisions of the Internal Revenue Code of 1986, as amended, or the Code, and final and proposed regulations, rulings and judicial decisions thereunder as of the date hereof, and such authorities may be replaced, revoked or modified so as to result in United States federal income tax consequences different from those discussed below. In addition, this summary is based, in part, upon representations made by the depositary to us and assumes that the deposit agreement, and all other related agreements, will be performed in accordance with their terms.

If a partnership holds ordinary shares or ADSs, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding our ordinary shares or ADSs, you should consult your tax advisors.

This summary does not contain a detailed description of all the United States federal income tax consequences to you in light of your particular circumstances and does not address the Medicare tax on net investment income, or the effects of any state, local or non-United States tax laws. ***If you are considering the purchase, ownership or disposition of our ordinary shares or ADSs, you should consult your own tax advisors concerning the United States federal income tax consequences to you in light of your particular situation as well as any consequences arising under the laws of any other taxing jurisdiction.***

### **ADSs**

If you hold ADSs, for United States federal income tax purposes, you generally will be treated as the owner of the underlying ordinary shares that are represented by such ADSs. Accordingly, deposits or withdrawals of ordinary shares for ADSs will not be subject to United States federal income tax.

## ***Taxation of Dividends***

Subject to the discussion under “— Passive Foreign Investment Company” below, the gross amount of distributions on the ADSs or ordinary shares (including any amounts withheld to reflect PRC withholding taxes) will be taxable as dividends, to the extent paid out of our current or accumulated earnings and profits, as determined under United States federal income tax principles. Such income (including any withheld taxes) will be includable in your gross income as ordinary income on the day actually or constructively received by you, if you own the ordinary shares, or by the depositary, if you own ADSs. Such dividends will not be eligible for the dividends received deduction allowed to corporations under the Code.

With respect to non-corporate United States Holders, certain dividends received from a qualified foreign corporation may be subject to reduced rates of taxation. A foreign corporation is treated as a qualified foreign corporation with respect to dividends paid by that corporation on shares (or ADSs backed by such shares) that are readily tradable on an established securities market in the United States. U.S. Treasury Department guidance indicates that our ADSs, which are listed on the New York Stock Exchange, but not our ordinary shares, are readily tradable on an established securities market in the United States. Thus, subject to the discussion of PFICs below, we believe that dividends we pay on our ordinary shares that are represented by ADSs, but not on our ordinary shares that are not so represented, will meet such conditions required for the reduced tax rates. There can be no assurance that our ADSs will be considered readily tradable on an established securities market in later years. Subject to the discussion of PFICs below, a qualified foreign corporation also includes a foreign corporation that is eligible for the benefits of certain income tax treaties with the United States. In the event that we are deemed to be a PRC “resident enterprise” under the PRC tax law (see discussion under “Item 10. Additional Information — E. Taxation — People’s Republic of China Taxation”), we may be eligible for the benefits of the income tax treaty between the United States and the PRC, and if we are eligible for such benefits, dividends we pay on our ordinary shares, regardless of whether such shares are represented by ADSs, would be subject to the reduced rates of taxation. Notwithstanding the foregoing, however, non-corporate United States Holders will not be eligible for reduced rates of taxation on any dividends received from us, if we are a passive foreign investment company, or PFIC, in the taxable year in which such dividends are paid or in the preceding taxable year (as discussed under “— Passive Foreign Investment Company” below). Non-corporate United States Holders that do not meet a minimum holding period requirement during which they are not protected from the risk of loss or that elect to treat the dividend income as “investment income” pursuant to Section 163(d)(4) of the Code will not be eligible for the reduced rates of taxation regardless of our status as a qualified foreign corporation. In addition, the rate reduction will not apply to dividends if the recipient of a dividend is obligated to make related payments with respect to positions in substantially similar or related property. This disallowance applies even if the minimum holding period has been met. You should consult your own tax advisors regarding the application of these rules given your particular circumstances.

In the event that we are deemed to be a PRC “resident enterprise” under the PRC tax law, you may be subject to PRC withholding taxes on dividends paid to you with respect to the ADSs or ordinary shares. Subject to certain conditions and limitations, PRC withholding taxes on dividends, if any, may be treated as foreign taxes eligible for credit against your United States federal income tax liability. For purposes of calculating the foreign tax credit, dividends paid to you with respect to our ordinary shares or ADSs will be treated as income from sources outside the United States and will generally constitute passive category income. Furthermore, in certain circumstances, if you have held our ordinary shares or ADSs for less than a specified minimum period during which you are not protected from risk of loss, or are obligated to make payments related to the dividends, you will not be allowed a foreign tax credit for any foreign taxes imposed on dividends paid on our ordinary shares or ADSs. The rules governing the foreign tax credit are complex. You are urged to consult your tax advisors regarding the availability of the foreign tax credit under your particular circumstances.

To the extent that the amount of any distribution exceeds our current and accumulated earnings and profits for a taxable year, as determined under United States federal income tax principles, the distribution will be treated first as a tax-free return of capital, causing a reduction in the adjusted basis of your ADSs or ordinary shares (thereby increasing the amount of gain, or decreasing the amount of loss, to be recognized by you on a subsequent disposition of your ADSs or ordinary shares), and to the extent the amount of the distribution exceeds your tax basis, the excess will be taxed as capital gain recognized on a sale or exchange. We do not expect to keep earnings and profits in accordance with United States federal income tax principles. Therefore, you should expect that a distribution will generally be reported as a dividend (as discussed above).

## ***Passive Foreign Investment Company***

Based on the nature of our business and the composition of our income and valuation of our assets, including goodwill, we believe that we were a PFIC for 2013 and may be a PFIC in 2014 or the future. As the determination of PFIC status is based on an annual determination that cannot be made until the close of a taxable year, and involves extensive factual investigation, including ascertaining the fair market value of all of our assets on a quarterly basis and the character of each item of income we earn, all as discussed below, our U.S. counsel expresses no opinion with respect to our PFIC status.

In general, we will be a PFIC for any taxable year in which:

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- at least 75% of our gross income is passive income, or
- at least 50% of the value (determined based on a quarterly average) of our assets is attributable to assets that produce or are held for the production of passive income.

For this purpose, passive income generally includes dividends, interest, royalties and rents (other than royalties and rents derived in the active conduct of a trade or business and not derived from a related person). If we own at least 25% (by value) of the stock of another corporation, we will be treated, for purposes of the PFIC tests, as owning our proportionate share of the other corporation's assets and receiving our proportionate share of the other corporation's income. However, it is not entirely clear how the contractual arrangements between us and our affiliated consolidated entities will be treated for purposes of the PFIC rules. If it is determined that we do not own the stock of the affiliated consolidated entities for United States federal income tax purposes, we would likely be treated as a PFIC.

The determination of whether we are a PFIC is made annually. Accordingly, it is possible that we may be a PFIC in the current or any future taxable year due to changes in our asset or income composition. Because we have valued our goodwill based on the market value of our equity, a decrease in the price of our ADSs may also result in our becoming a PFIC. This risk is particularly heightened due to the recent volatility in the price of our ADSs. If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares, you will be subject to special tax rules discussed below.

If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares, you will be subject to special tax rules with respect to any "excess distribution" received and any gain realized from a sale or other disposition, including a pledge, of ADSs or ordinary shares. Distributions received in a taxable year that are greater than 125% of the average annual distributions received during the shorter of the three preceding taxable years or your holding period for the ADSs or ordinary shares will be treated as excess distributions. Under these special tax rules:

- the excess distribution or gain will be allocated ratably over your holding period for the ADSs or ordinary shares,
- the amount allocated to the current taxable year, and any taxable year prior to the first taxable year in which we were a PFIC, will be treated as ordinary income, and
- the amount allocated to each other year will be subject to tax at the highest tax rate in effect for that year and the interest charge generally applicable to underpayments of tax will be imposed on the resulting tax attributable to each such year.

In addition, non-corporate United States Holders will not be eligible for reduced rates of taxation on any dividends received from us, if we are a PFIC in the taxable year in which such dividends are paid or in the preceding taxable year. You will generally be required to file Internal Revenue Service Form 8621 if you hold our ADSs or ordinary shares in any year in which we are classified as a PFIC.

If we are a PFIC for any taxable year during which you hold our ADSs or ordinary shares and any of our non-United States subsidiaries is also a PFIC, you would be treated as owning a proportionate amount (by value) of the shares of the lower-tier PFIC for purposes of the application of these rules. You are urged to consult your tax advisors about the application of the PFIC rules to any of our subsidiaries.

In certain circumstances, in lieu of being subject to the excess distribution rules discussed above, you may make an election to include gain on the stock of a PFIC as ordinary income under a mark-to-market method, provided that such stock is regularly traded on a qualified exchange. Under current law, the mark-to-market election may be available to holders of ADSs because the ADSs are listed on the New York Stock Exchange, which constitutes a qualified exchange, although there can be no assurance that the ADSs are "regularly traded" for purposes of the mark-to-market election. It should also be noted that only the ADSs and not our ordinary shares are listed on the New York Stock Exchange. Consequently, if you are a holder of ordinary shares that are not represented by ADSs, you generally will not be eligible to make a mark-to-market election if we are or become a PFIC.

If you make an effective mark-to-market election, you will include in each taxable year that we are a PFIC as ordinary income the excess of the fair market value of your ADSs at the end of the year over your adjusted tax basis in the ADSs. You will be entitled to deduct as an ordinary loss each year the excess of your adjusted tax basis in the ADSs over their fair market value at the end of the year, but only to the extent of the net amount previously included in income as a result of the mark-to-market election. If you make an effective mark-to-market election, in each taxable year that we are a PFIC any gain you recognize upon the sale or other disposition of your ADSs will be treated as ordinary income and any loss will be treated as ordinary loss, but only to the extent of the net amount previously included in income as a result of the mark-to-market election.

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Your adjusted tax basis in the ADSs will be increased by the amount of any income inclusion and decreased by the amount of any deductions under the mark-to-market rules. If you make a mark-to-market election it will be effective for the taxable year for which the election is made and all subsequent taxable years unless the ADSs are no longer regularly traded on a qualified exchange or the Internal Revenue Service consents to the revocation of the election. You are urged to consult your tax advisor about the availability of the mark-to-market election, and whether making the election would be advisable in your particular circumstances.

Alternatively, you can sometimes avoid the rules described above with respect to the stock you own in a PFIC by electing to treat such PFIC as a “qualified electing fund” under Section 1295 of the Code. However, this option is not available to you because we do not intend to comply with the requirements necessary to permit you to make this election. You are urged to consult your tax advisors concerning the United States federal income tax consequences of holding ADSs or ordinary shares if we are considered a PFIC in any taxable year.

### ***Taxation of Capital Gains***

For United States federal income tax purposes, you will recognize taxable gain or loss on any sale or exchange of ADSs or ordinary shares in an amount equal to the difference between the amount realized for the ADSs or ordinary shares and your tax basis in the ADSs or ordinary shares. Subject to the discussion under “—Passive Foreign Investment Company” above, such gain or loss will generally be capital gain or loss. Capital gains of non-corporate United States Holders (including individuals) derived with respect to capital assets held for more than one year are eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations. Any gain or loss recognized by you will generally be treated as United States source gain or loss. However, in the event that we are deemed to be a PRC “resident enterprise” under PRC tax law (see discussion under “Item 10. Additional Information — E. Taxation—People’s Republic of China Taxation”) and PRC taxes were imposed on any gain, and if you are eligible for the benefits of the income tax treaty between the United States and the PRC, you may elect to treat such gain as PRC source gain. If you are not eligible for the benefits of the treaty or you fail to make the election to treat any gain as PRC source, then you may not be able to use the foreign tax credit arising from any PRC tax imposed on the disposition of our ADSs or ordinary shares unless such credit can be applied (subject to applicable limitations) against tax due on other income treated as derived from foreign sources. You are urged to consult your tax advisors regarding the tax consequences if a foreign tax is imposed on a disposition of ADSs or ordinary shares, including the availability of the foreign tax credit under your particular circumstances.

### ***Information reporting and backup withholding***

In general, information reporting will apply to dividends in respect of our ADSs or ordinary shares and the proceeds from the sale, exchange or redemption of our ADSs or ordinary shares that are paid to you within the United States (and in certain cases, outside the United States), unless you are an exempt recipient. Backup withholding may apply to such payments if you fail to provide a taxpayer identification number or certification of other exempt status or fail to report in full dividend and interest income.

Any amounts withheld under the backup withholding rules will be allowed as a refund or a credit against your United States federal income tax liability provided the required information is timely furnished to the Internal Revenue Service.

#### **F. Dividends and Paying Agents**

Not applicable.

#### **G. Statement by Experts**

Not applicable.

#### **H. Documents on Display**

We have previously filed with the SEC our registration statement on Form F-1 (File No. 333-169971), as amended. As allowed by the SEC, in Item 19 of this annual report, we incorporate by reference certain information we previously filed with the SEC. This means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is considered to be part of this annual report.

You may read and copy this annual report, including the exhibits incorporated by reference in this annual report, at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549 and at the SEC’s regional offices in New York, New York and Chicago, Illinois. You can also request copies of this annual report, including the exhibits incorporated by reference in this annual report, upon payment of a duplicating fee, by writing information on the operation of the SEC’s Public Reference Room.

The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports and other information regarding registrants that file electronically with the SEC. Our annual report and some of the other information submitted by us to the SEC may be accessed through this website.

As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and officers, directors and principal shareholders are exempt from the reporting and short-swing profit recovery provisions contained in Section 16 of the Exchange Act.

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In accordance with NYSE Rule 203.01, we will post this annual report on our website [www.21edu.com](http://www.21edu.com). In addition, we will provide hardcopies of our annual report to shareholders, including ADS holders, free of charge upon request.

**I. Subsidiary Information**

Not applicable.

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

**Foreign Exchange Risk**

Our financial statements are expressed in U.S. dollars, which is our reporting and functional currency. However, all of our revenue and substantially all of our expenses are denominated in Renminbi. Accordingly, changes in the value of Renminbi against U.S. dollar may have a material effect on our reported and consolidated revenue, costs and expenses, gross margin and net income. Moreover, the value of assets and liabilities denominated in Renminbi fluctuates along with changes in the exchange rates.

The value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China. On July 21, 2005, the PRC government changed its decade-old policy of pegging the value of the Renminbi to the U.S. dollar. Under the revised policy, the Renminbi is permitted to fluctuate within a narrow and managed band against a basket of certain foreign currencies. This change in policy resulted in a more than 20% appreciation of the Renminbi against the U.S. dollar in the following three years. Since July 2008, however, the Renminbi has traded within a narrow range against the U.S. dollar. As a consequence, the Renminbi has fluctuated significantly since July 2008 against other freely traded currencies, in tandem with the U.S. dollar. Recently, the People's Bank of China has decided to proceed further with reform of the Renminbi exchange regime and to enhance the Renminbi exchange rate flexibility. In April 2013, the People's Bank of China announced that it would expand the floating range of the trading price of the Renminbi against the U.S. dollar from 0.5% to 1.0%, beginning on April 16, 2012. In March 2014, the People's Bank of China announced that it would further expand the floating range of the trading price of the Renminbi against the U.S. dollar from 1.0% to 2.0%, beginning on March 17, 2014. It is difficult to predict how long the current situation may last and when and how Renminbi exchange rates may change going forward. To the extent that we need to convert U.S. dollars we receive into Renminbi for our operations, appreciation of the Renminbi against the U.S. dollar would have an adverse effect on the Renminbi amount we receive from the conversion. Conversely, if we decide to convert Renminbi 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 Renminbi would have a negative effect on the U.S. dollar amounts available to us.

Considering the amount of our cash and cash equivalents as of December 31, 2013, a 1.0% change in the exchange rate between the Renminbi and the U.S. dollar would result in an increase or decrease of \$ 1.1 million to our total cash and cash equivalents. We have not used any forward contracts or currency borrowings to hedge our exposure to foreign currency exchange risk.

**Interest Rate Risk**

Our exposure to interest rate risk primarily relates to interest income generated by excess cash which is mostly held in interest-bearing bank deposits. We have not used derivative financial instruments to hedge interest risk. Interest-earning instruments carry a degree of interest rate risk. We have not been exposed, nor do we anticipate being exposed to material risks due to changes in market interest rates. However, our future interest income may fall short of expectations due to changes in market interest rates.

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

**A. Debt Securities**

Not applicable.

**B. Warrants and Rights**

Not applicable.

**C. Other Securities**

Not applicable.



## D. American Depositary Shares

### Fees Paid by Our ADS Holders

As an ADS holder, you will be required to pay the following service fees to the depositary, Citibank, N.A.:

Service	Fees
• Issuance of ADSs	Up to U.S. 5¢ per ADS issued
• Cancellation of ADSs	Up to U.S. 5¢ per ADS canceled
• Distribution of cash dividends or other cash distributions	Up to U.S. 5¢ per ADS held
• Distribution of ADSs pursuant to stock dividends, free stock distributions or exercise of rights	Up to U.S. 5¢ per ADS held
• Distribution of securities other than ADSs or rights to purchase additional ADSs	Up to U.S. 5¢ per ADS held
• Depositary Services	Up to U.S. 5¢ per ADS held on the applicable record date(s) established by the Depositary
• Transfer of ADRs	U.S. \$1.50 per certificate presented for transfer

As an ADS holder you will also be responsible to pay certain fees and expenses incurred by the depositary and certain taxes and governmental charges such as:

- Fees for the transfer and registration of ordinary shares charged by the registrar and transfer agent for the ordinary shares in the Cayman Islands (i.e., upon deposit and withdrawal of ordinary shares).
- Expenses incurred for converting foreign currency into U.S. dollars.
- Expenses for cable, telex and fax transmissions and for delivery of securities.
- Taxes and duties upon the transfer of securities (i.e., when ordinary shares are deposited or withdrawn from deposit).
- Fees and expenses incurred in connection with the delivery or servicing of ordinary shares on deposit.

Depositary fees payable upon the issuance and cancellation of ADSs are typically paid to the depositary bank by the brokers (on behalf of their clients) receiving the newly issued ADSs from the depositary bank and by the brokers (on behalf of their clients) delivering the ADSs to the depositary bank for cancellation. The brokers in turn charge these fees to their clients. Depositary fees payable in connection with distributions of cash or securities to ADS holders and the depositary services fee are charged by the depositary bank to the holders of record of ADSs as of the applicable ADS record date.

The Depositary fees payable for cash distributions are generally deducted from the cash being distributed. In the case of distributions other than cash (i.e., stock dividend, rights), the depositary bank charges the applicable fee to the ADS record date holders concurrent with the distribution. In the case of ADSs registered in the name of the investor (whether certificated or uncertificated in direct registration), the depositary bank sends invoices to the applicable record date ADS holders. In the case of ADSs held in brokerage and custodian accounts (via DTC), the depositary bank generally collects its fees through the systems provided by DTC (whose nominee is the registered holder of the ADSs held in DTC) from the brokers and custodians holding ADSs in their DTC accounts. The brokers and custodians who hold their clients' ADSs in DTC accounts in turn charge their clients' accounts the amount of the fees paid to the depositary banks.

In the event of refusal to pay the depositary fees, the depositary bank may, under the terms of the deposit agreement, refuse the requested service until payment is received or may set off the amount of the depositary fees from any distribution to be made to the ADS holder.

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Note that the fees and charges you may be required to pay may vary over time and may be changed by us and by the depositary. You will receive prior notice of such changes.

***Fees and Payments from the Depositary to Us***

Our depositary has agreed to reimburse us for certain expenses we incur that are related to the administration and maintenance of the ADS program. There are limits on the amount of expenses for which the depositary will reimburse us, but the amount of reimbursement available to us is not related to the amounts of fees the depositary collects from investors. The depositary has reimbursed us for any expenses related to the administration and maintenance of the facility in an amount of \$1.2 million, after deduction of applicable U.S. taxes, as of December 31, 2013.

**PART II**

**ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

None.

**ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS**

See “Item 10. Additional Information” for a description of the rights of securities holders, which remain unchanged.

Our ADSs, each representing two of our ordinary shares, have been listed on the New York Stock Exchange since November 2, 2010 under the symbol “XUE”. We completed our initial public offering of 15,444,500 ADSs, each representing two ordinary shares, at \$9.50 per ADS on November 5, 2010 after our ordinary shares and American Depositary Receipts were registered under the Securities Act. The effective date of our registration statement on Form F-1 (File number: 333-169971) was November 1, 2010. Goldman Sachs (Asia) L.L.C. was the sole bookrunner and Robert W. Baird & Co. Incorporated and William Blair & Company, L.L.C. were the other underwriters for the initial public offering of our ADSs.

As of December 31, 2013, we had used \$16.1 million of the proceeds of our initial public offering in repurchasing our ADSs under our announced share repurchase program. See “Item 16E. Purchase of Equity Securities by the Issuer and Affiliated Purchasers.”

**ITEM 15. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures designed to provide reasonable assurance that information required to be disclosed in reports filed under the Exchange Act is recorded, processed, summarized and reported within the specified time periods and accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our management, under the supervision and with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures, as defined in Rules 13a-15(e) or 15d-15(e) promulgated under the Exchange Act, at December 31, 2013, and have concluded that our disclosure controls and procedures were effective.

**Management’s Annual Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements in accordance with U.S. GAAP and includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that our receipts and expenditures are being made only in accordance with authorizations of our management or our board of directors, and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our interim or annual consolidated financial statements.

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

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Our management, including our chief executive officer and chief financial officer, assessed the effectiveness of our internal control over financial reporting as of December 31, 2013. Based on its assessment, our management concluded that, as of the end of our most recent fiscal year, December 31, 2013, our internal control over financial reporting was effective based on the above criteria.

Our independent registered public accounting firm, Deloitte Touche Tohmatsu Certified Public Accountants LLP, who audited the financial statements included in this annual report on Form 20-F, has issued an attestation report on our internal control over financial reporting. The attestation report appears below.

There were no significant changes in our internal control over financial reporting during the year ended December 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Xueda Education Group

We have audited the internal control over financial reporting of Xueda Education Group (the “Company”), its subsidiaries, its variable interest entity (“VIE”) and its VIE’s subsidiaries (collectively, the “Group”) as of December 31, 2013 based on the criteria established in Internal Control — Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Group’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Group’s internal control over financial reporting based on our audit.

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

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

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Group maintained, in all material respects, effective internal control over financial reporting as of December 31, 2013, based on the criteria established in Internal Control — Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2013 of the Group and our report dated March 31, 2014 expressed an unqualified opinion on those financial statements.

Deloitte Touche Tohmatsu Certified Public Accountants LLP  
Beijing, the People's Republic of China  
March 31, 2014

#### ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Board of Directors has determined that Mr. Sean Shao qualifies as “audit committee financial expert” as defined in Item 16A of Form 20-F. All of the members of our audit committee satisfy the “independence” requirements of the NYSE rules and Rule 10A-3(b)(1) under the Exchange Act.

#### ITEM 16B. CODE OF ETHICS

Our board of directors has adopted a code of ethics that applies to our directors, officers, employees and agents, including certain provisions that specifically apply to our chief executive officer, chief financial officer, chief operating officer, chief technology officer, vice presidents and any other persons who perform similar functions for us. We filed our code of business conduct and ethics, as amended and restated, as an exhibit to this annual report. We hereby undertake to provide to any person without charge, a copy of our code of business conduct and ethics within ten working days after we receive such person's written request.

#### ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

At the direction of the government of the People's Republic of China in accordance with the *Scheme of the Localization Restructuring of Chinese-Foreign Cooperative Accounting Firms*, Deloitte Touche Tohmatsu CPA Limited, our principal external auditors, has restructured to a new partnership and changed its name to Deloitte Touche Tohmatsu Certified Public Accountants LLP, effective from January 1, 2013. Deloitte Touche Tohmatsu Certified Public Accountants LLP has succeeded Deloitte Touche Tohmatsu CPA Limited for all purposes and assumed all of the obligations and rights of Deloitte Touche Tohmatsu CPA Limited with effect from January 1, 2013. Deloitte Touche Tohmatsu CPA Limited and Deloitte Touche Tohmatsu Certified Public Accountants LLP are hereinafter referred to as “Deloitte”.

The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by Deloitte for the periods indicated. We did not pay any other fees to our auditors during the periods indicated below.

	Year Ended December 31,	
	2012	2013
	(in thousands of \$)	
Audit Fees <sup>(1)</sup>	1,378	1,373
Audit-related Fees <sup>(2)</sup>	53	—
Tax Fees	52	25
Total	1,483	1,398

(1) “Audit fees” represent the aggregate fees billed for each of the fiscal years listed for professional services rendered by our principal auditors for the audit of our annual financial statements or services that are normally provided by the auditors in connection with statutory and regulatory filings or engagements.

(2) “Audit-related fees” represent the aggregate fees billed in each of the fiscal years listed for assurance and related services by our principal auditors for services rendered that are reasonably related to the performance of the audit or review of our consolidated financial statements and are not reported under “Audit fees”. Services comprising the fees disclosed under the category of “Audit-related fees” involve principally limited reviews performed on our consolidated financial statements.

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The policy of our audit committee is to pre-approve all audit and non-audit services provided by Deloitte, including audit services, audit-related services, tax services and other services as described above, other than those for *de minimus* services which are approved by the Audit Committee prior to the completion of the audit.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS.**

In September 2011, we announced a share repurchase program approved by our board of directors. The share repurchase program was concluded in November 2012.

In March 2014, we announced privately-negotiated repurchases and purchases by us and certain members of our senior management of 12 million ordinary shares from one of our co-founders and certain pre-IPO investors, at a total consideration of approximately \$31.1 million.

**ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT.**

Not applicable.

**ITEM 16G. CORPORATE GOVERNANCE.**

We are a "foreign private issuer" (as such term is defined in Rule 3b-4 under the Exchange Act), and our ADSs, each representing two ordinary shares, are listed on the New York Stock Exchange. Under Section 303A of the New York Stock Exchange Listed Company Manual, New York Stock Exchange listed companies that are foreign private issuers are permitted to follow home country practice in lieu of the corporate governance provisions specified by the New York Stock Exchange with limited exceptions. The following summarizes some significant ways in which our corporate governance practices differ from those followed by domestic companies under the listing standards of the New York Stock Exchange.

Under the New York Stock Exchange Listed Company Manual, or the NYSE Manual, U.S. domestic listed companies are required to have a compensation committee and a nominating/corporate governance committee, each composed entirely of independent directors, which are not required under the Companies Law of the Cayman Islands, our home country. Currently, our compensation committee is composed of three members, only one of whom is an independent directors. We do not have, nor do we intend to establish, a nominating/corporate governance committee. Our board of directors performs the duties of the nominating/corporate governance committee and regularly reviews our corporate governance principles and practice. The NYSE Manual also requires U.S. domestic listed companies to regularly hold executive sessions for non-management directors, or an executive session that only includes independent directors at least once a year. We are not subject to this requirement under the Cayman Islands law and have decided to follow our home country practice on this matter. In addition, the NYSE Manual requires shareholder approval for certain matters, such as requiring that shareholders must be given the opportunity to vote on all equity compensation plans and material revisions to those plans, which is not required under the Cayman Islands law. We intend to comply with the requirements of Cayman Islands law only in determining whether shareholder approval is required.

**ITEM 16H. MINE SAFETY DISCLOSURE.**

Not applicable.

**PART III**

**ITEM 17. FINANCIAL STATEMENTS.**

We have elected to provide financial statements pursuant to Item 18.

**ITEM 18. FINANCIAL STATEMENTS.**

The following financial statements are filed as part of this annual report, together with the report of the independent auditors:

- [Report of Independent Registered Public Accounting Firm](#)
- [Consolidated Balance Sheets as of December 31, 2012 and 2013](#)
- [Consolidated Statements of Operations for the years ended December 31, 2011, 2012 and 2013](#)
- [Consolidated Statements of Comprehensive Income for the years ended December 31, 2011, 2012 and 2013](#)
- [Consolidated Statements of Changes in Equity for the years ended December 31, 2011, 2012 and 2013](#)
- [Consolidated Statements of Cash Flows for the years ended December 31, 2011, 2012 and 2013](#)

- [Notes to the Consolidated Financial Statements](#)

**ITEM 19. EXHIBITS.**

<b>Exhibit Number</b>	<b>Description of Document</b>
1.1*	Third Amended and Restated Memorandum and Articles of Association of the Registrant as currently in effect
2.1*	Registrant's Form of Ordinary Share Certificate
2.2†	Form of Deposit Agreement between the Registrant and Citibank, N.A., as depositary
2.3†	Form of American depositary receipt evidencing American depositary shares (included in Exhibit 2.2)
2.4*	Shareholders Agreement, dated as of August 28, 2009
4.1*	Form of Indemnification Agreement between the Registrant and its directors
4.2*	Form of Employment Agreement between the Registrant and its executive officers
4.3*	English translation of Amended and Restated Exclusive Technology Consulting and Management Service Agreement, dated as of July 28, 2010, between Xuecheng Century (Beijing) Information Technology Co., Ltd. and Beijing Xueda Information Technology Co., Ltd.
4.4*	English translation of Amended and Restated Pledge Agreement, dated as of December 31, 2010, between Xuecheng Century (Beijing) Information Technology Co., Ltd. and shareholders of Beijing Xueda Information Technology Co., Ltd.
4.5*	English translation of Amended and Restated Exclusive Purchase Right Contract, dated as of July 28, 2010, between Xuecheng Century (Beijing) Information Technology Co., Ltd. and shareholders of Beijing Xueda Information Technology Co., Ltd.
4.6*	English translations of form of powers of attorney executed by shareholders of Beijing Xueda Information Technology Co. Ltd. in favor of Xuecheng Century (Beijing) Information Technology Co., Ltd.
4.7*	Amended and Restated 2009 Equity Incentive Plan of the Registrant
4.8*	Subscription Agreement, dated as of October 20, 2010, between the Registrant and WP X Investments IV Ltd.
4.9*	Investor and Registration Rights Agreement, dated as of October 20, 2010, between the Registrant and WP X Investment IV Ltd.
4.10††	English translation of Share Transfer Framework Agreement, dated March 30, 2012, among Xueda Information, shareholders of Beijing Weland International Education and Technology Corp. and the other parties thereto
4.11†††	Firstleap Education Series A Preferred Shares Purchase Agreement, dated July 9, 2012, among Firstleap Education, Xueda Education Group and other parties thereto
4.12†††	English translation of Entrusted Loan Agreement, dated May 4, 2012, among Xueda Information, Bank of Beijing and Beijing Lebai Education Consulting Co., Ltd.
4.13†††	English translation of Entrusted Loan Agreement, dated November 28, 2012, among Xueda Information, Bank of Beijing and Beijing Lebai Education Consulting Co., Ltd.
8.1††	List of Subsidiaries of the Registrant



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11.1	English translation of Amended and Restated Code of Business Conduct and Ethics of the Registrant
12.1	CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
12.2	CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
13.1	CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
13.2	CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
15.1	Consent of Deloitte Touche Tohmatsu Certified Public Accountants LLP
101.INS**	XBRL Instance Document.
101.SCH**	XBRL Taxonomy Extension Schema Document.
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB**	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document.

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\* Previously filed with the Registration Statement on Form F-1 (File No. 333-169971), initially filed on October 15, 2010 and incorporated herein by reference.

\*\* XBRL (eXtensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

† Previously filed with the Registration Statement on Form F-6 (File No. 333-169976), dated October 15, 2010 and incorporated herein by reference.

†† Previously filed with the annual report on Form 20-F (File No. 001-34914), dated April 27, 2012 and incorporated herein by reference.

††† Previously filed with the annual report on Form 20-F (File No. 001-34914), dated April 3, 2013 and incorporated herein by reference.

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## SIGNATURES

The registrant hereby certifies that it meets all of the requirements for filing its annual report on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

### **Xueda Education Group**

By: /s/ Xin Jin  
Name: Xin Jin  
Title: Chief Executive Officer and Director

Date: March 31, 2014

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**XUEDA EDUCATION GROUP**  
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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF  
XUEDA EDUCATION GROUP

We have audited the accompanying consolidated balance sheets of Xueda Education Group (the “Company”), its subsidiaries, its variable interest entity (“VIE”) and the VIE’s subsidiaries (collectively, the “Group”) as of December 31, 2012 and 2013, and the related consolidated statements of operations, comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Group’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Group as of December 31, 2012 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Group’s internal control over financial reporting as of December 31, 2013, based on the criteria established in Internal Control — Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 31, 2014 expressed an unqualified opinion on the Group’s internal control over financial reporting.

Deloitte Touche Tohmatsu Certified Public Accountants LLP  
Beijing, the People’s Republic of China  
March 31, 2014

**XUEDA EDUCATION GROUP**

**CONSOLIDATED BALANCE SHEETS**

(In thousands of U.S. dollars, except for shares and per share data)

	December 31,	
	2012	2013
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	211,944	117,063
Short-term investments	26,126	129,619
Prepaid expenses and other current assets	12,911	16,642
Amounts due from related parties	1,592	2,631
Deferred tax assets-current	4,335	6,139
<b>Total current assets</b>	<b>256,908</b>	<b>272,094</b>
Property and equipment, net	40,616	34,826
Acquired intangible assets, net	563	—
Deferred tax assets-noncurrent	2,585	1,460
Rental deposits	4,493	4,807
Long-term investments	5,125	15,197
Goodwill	3,729	897
Other noncurrent assets	2,246	2,337
<b>Total assets</b>	<b>316,265</b>	<b>331,618</b>
<b>Liabilities</b>		
<b>Current liabilities:</b>		
Deferred revenue-current (including deferred revenue of the consolidated VIE without recourse to the Company of \$105,027 and \$103,871 as of December 31, 2012 and 2013, respectively)	105,027	103,871
Accrued expenses and other current liabilities (including accrued expenses and other current liabilities of the consolidated VIE without recourse to the Company of \$23,051 and \$29,993 as of December 31, 2012 and 2013, respectively)	25,157	35,275
Income taxes payable (including income taxes payable of the consolidated VIE without recourse to the Company of \$4,329 and \$8,675 as of December 31, 2012 and 2013, respectively)	4,329	9,383
Dividends payable (including dividends payable of the consolidated VIE without recourse to the Company of nil and nil as of December 31, 2012 and 2013, respectively)	22,665	—
Deferred income-current (including deferred income of the consolidated VIE without recourse to the Company of nil and nil as of December 31, 2012 and 2013, respectively)	347	347
<b>Total current liabilities</b>	<b>157,525</b>	<b>148,876</b>
Deferred revenue-noncurrent (including deferred revenue of the consolidated VIE without recourse to the Company of \$28,765 and \$29,983 as of December 31, 2012 and 2013, respectively)	28,765	29,983
Deferred income-noncurrent (including deferred income of the consolidated VIE without recourse to the Company of nil and nil as of December 31, 2012 and 2013, respectively)	607	260
Deferred tax liabilities-noncurrent (including deferred tax liabilities of the consolidated VIE without recourse to the Company of \$141 and nil as of December 31, 2012 and 2013, respectively)	141	—
<b>Total liabilities</b>	<b>187,038</b>	<b>179,119</b>

**XUEDA EDUCATION GROUP**

**CONSOLIDATED BALANCE SHEETS - continued**  
(In thousands of U.S. dollars, except for shares and per share data)

	December 31,	
	2012	2013
Commitments (Note 16)		
Equity		
Ordinary shares (par value \$0.0001 per share; 469,647,160 shares authorized; 140,027,952 and 144,243,870 shares issued; 130,377,436 and 133,610,982 shares outstanding as of December 31, 2012 and 2013, respectively)	14	14
Treasury shares, at cost	(16,124)	(16,124)
Additional paid-in capital	149,303	157,149
Statutory reserves	2,028	3,952
(Accumulated deficits) retained earnings	(7,046)	7,181
Accumulated other comprehensive (loss) income	(311)	215
Total Xueda Education Group shareholders' equity	127,864	152,387
Noncontrolling interests	1,363	112
Total equity	129,227	152,499
Total liabilities and equity	316,265	331,618

See notes to consolidated financial statements.

**XUEDA EDUCATION GROUP**

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(In thousands of U.S. dollars, except for shares and per share data)

	Years ended December 31,		
	2011	2012	2013
Net revenues	221,738	293,157	347,047
Cost of revenues (including share-based compensation expenses of \$6, \$5 and \$10 for 2011, 2012 and 2013, respectively)	(156,222)	(219,655)	(239,948)
Gross profit	65,516	73,502	107,099
Operating expenses:			
General and administrative (including share-based compensation expenses of \$4,092, \$3,156 and \$5,368 for 2011, 2012 and 2013, respectively)	(36,425)	(46,427)	(52,716)
Selling and marketing (including share-based compensation expenses of \$11, \$5 and \$4 for 2011, 2012 and 2013, respectively)	(25,940)	(31,336)	(36,308)
Impairment loss on goodwill	—	—	(2,923)
Impairment loss on acquired intangible assets	—	—	(494)
Total operating expenses	(62,365)	(77,763)	(92,441)
Government subsidies	357	164	439
Income (loss) from operations	3,508	(4,097)	15,097
Interest income	3,766	6,722	7,279
Income before income tax expenses	7,274	2,625	22,376
Income tax expenses	(2,484)	(876)	(7,482)
Net income	4,790	1,749	14,894
Net loss attributable to the noncontrolling interests	—	216	1,257
Net income attributable to Xueda Education Group ordinary shareholders	4,790	1,965	16,151
Net income per ordinary share:			
Net income attributable to Xueda Education Group ordinary shareholders			
Basic	0.03	0.01	0.12
Diluted	0.03	0.01	0.12
Weighted average shares used in calculating net income per ordinary share			
Basic	137,745,176	131,316,004	131,681,540
Diluted	142,268,913	131,776,207	134,466,868

See notes to consolidated financial statements.



**XUEDA EDUCATION GROUP**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(In thousands of U.S. dollars, except for shares and per share data)

	Years ended December 31,		
	2011	2012	2013
Net income	4,790	1,749	14,894
Other comprehensive income, net of tax:			
Change in cumulative foreign currency translation adjustments	118	250	439
Unrealized gain on available-for-sale securities, net of tax effects of nil, nil and nil for the years ended December 31, 2011, 2012 and 2013, respectively	—	339	93
Total comprehensive income	4,908	2,338	15,426
Comprehensive loss attributable to noncontrolling interests	—	208	1,251
Total comprehensive income attributable to Xueda Education Group	4,908	2,546	16,677

See notes to consolidated financial statements.

**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY**  
(In thousands of U.S. dollars, except for shares and per share data)

[illegible]

translation adjustments	—	—	—	—	—	—	—	433	433	6	439
Net unrealized gain on available-for-sale securities, net of tax effects of nil for the year	—	—	—	—	—	—	—	93	93	—	93
Net income	—	—	—	—	—	—	16,151	—	16,151	(1,257)	14,894
Balance at											
December 31, 2013	<u>133,610,982</u>	<u>14</u>	<u>(16,124)</u>	<u>157,149</u>	<u>—</u>	<u>3,952</u>	<u>7,181</u>	<u>215</u>	<u>152,387</u>	<u>112</u>	<u>152,499</u>

See notes to consolidated financial statements.

**XUEDA EDUCATION GROUP**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(In thousands of U.S. dollars)

	Years ended December 31,		
	2011	2012	2013
Cash flows from operating activities:			
Net income	4,790	1,749	14,894
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization of property and equipment	8,109	15,308	16,117
Amortization of acquired intangible assets	—	47	81
Impairment of goodwill	—	—	2,923
Impairment of acquired intangible assets	—	—	494
Loss on disposal of property and equipment	425	690	639
Share-based compensation expense	4,109	3,166	5,382
Deferred income taxes	(2,078)	(2,303)	(820)
Foreign exchange gain	—	—	(1,042)
Changes in assets and liabilities:			
Prepaid expenses and other current assets	(8,850)	4,275	(2,144)
Amounts due from related parties	—	56	(3)
Rental deposits	(1,246)	(660)	(180)
Other non-current assets	84	(1,652)	(25)
Deferred revenue	10,742	30,486	(3,869)
Accrued expenses and other current liabilities	5,737	3,591	9,829
Income tax payable	1,776	237	4,828
Deferred income	1,300	(346)	(348)
Net cash provided by operating activities	24,898	54,644	46,756
Cash flows from investing activities:			
Purchase of short-term investments	(31,175)	(128,307)	(291,384)
Proceeds from maturity of short-term investments	45,026	111,266	191,838
Acquisition of businesses (net of cash acquired of nil, \$1,765 and nil for the years ended December 31, 2011, 2012, and 2013, respectively)	—	(1,196)	—
Purchases of long-term investments	—	(4,786)	(9,839)
Loan to third party	(30,542)	—	—
Proceeds from maturity of loan to third party	31,375	—	—
Loan to a related party	—	(4,777)	(2,636)
Proceeds from maturity of loan to a related party	—	3,185	1,634
Purchase of property and equipment	(26,331)	(19,145)	(10,469)
Proceeds from disposal of property and equipment	12	17	42
Net cash used in investing activities	(11,635)	(43,743)	(120,814)
Cash flows from financing activities:			
Repurchase of ordinary shares	(8,846)	(7,278)	—
Payment of issuance cost in connection with initial public offering ("IPO")	(733)	—	—
Payment received for shares subscribed during IPO	155	—	—
Proceeds from exercise of options	265	123	246
Payment of dividend distribution	—	(9,929)	(22,665)
Net cash used in financing activities	(9,159)	(17,084)	(22,419)
Effect of exchange rate changes	2,272	381	1,596
Net increase (decrease) in cash and cash equivalents	6,376	(5,802)	(94,881)
Cash and cash equivalents, beginning of year	211,370	217,746	211,944
Cash and cash equivalents, end of year	217,746	211,944	117,063
Supplemental disclosure of cash flow information			
Income taxes paid	2,635	2,897	3,248
Major non-cash investing activity:			
Payable for property and equipment	2,871	2,393	1,888

See notes to consolidated financial statements.



# XUEDA EDUCATION GROUP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013 (In thousands of U.S. dollars, except for shares and per share data)

### 1. ORGANIZATION AND PRINCIPAL ACTIVITIES

Xueda Education Group (the “Company”) was incorporated under the laws of the Cayman Islands on April 24, 2009. The Company, its subsidiaries, its consolidated variable interest entity (“VIE”) and VIE’s subsidiaries and schools (collectively the “Group”) are primarily engaged in providing private personalized tutoring services for primary and secondary school students in the People’s Republic of China (“PRC”).

As of December 31, 2013, details of the Company’s subsidiaries and VIE and VIE’s significant subsidiaries and schools were as follows:

Name	Incorporation or acquisition date	Place of establishment/ incorporation	Legal ownership
<b>Subsidiaries:</b>			
Xuecheng Century (Beijing) Information Technology Co., Ltd. (“Xuecheng Century”)	Aug 17, 2009	PRC	100%
China Xueda Corporation Limited (“Xueda HK”)	May 13, 2009	Hong Kong	100%
Beijing Xueda Education & Training Consulting Co., Ltd.	Oct 31, 2011	PRC	100%
<b>VIE:</b>			
Beijing Xueda Information Technology Co., Ltd. (“Xueda Information”)	Jul 13, 2009	PRC	Nil*
<b>VIE’s significant subsidiaries and schools:</b>			
Taiyuan Xueda Education & Training School(1)	Dec 8, 2008	PRC	Nil*
Nanchang Xueda Education & Training School(1)	Apr 20, 2009	PRC	Nil*
Qingdao Xueda Pre-exam Tutoring School(1)	Jun 10, 2009	PRC	Nil*
Suzhou Xuecheng Information Technology Co., Ltd.	Sep 28, 2009	PRC	Nil*
Wuhan Xueda Information Technology Co., Ltd.	Oct 12, 2009	PRC	Nil*
Wuxi Xueda Information Technology Co., Ltd.	Oct 15, 2009	PRC	Nil*
Hohhot Xueda Information Technology Co., Ltd.	Oct 21, 2009	PRC	Nil*
Tianjin Xueda Educational Information Consulting Co., Ltd.	Oct 26, 2009	PRC	Nil*
Beijing Xuecheng Shidai Information Technology Co., Ltd.	Oct 28, 2009	PRC	Nil*
Changsha Xuezhi Information Technology Co., Ltd.	Nov 3, 2009	PRC	Nil*
Kunming Xueda Information Technology Co., Ltd.	Nov 6, 2009	PRC	Nil*
Guangzhou Xueda Educational Technology Co., Ltd.	Nov 24, 2009	PRC	Nil*
Shenzhen Xueda Information Technology Co., Ltd.	Nov 25, 2009	PRC	Nil*
Chengdu Xueda Information Technology Co., Ltd.	Nov 30, 2009	PRC	Nil*
Jinan Xueda Education & Training School(1)	Dec 17, 2009	PRC	Nil*
Beijing Xicheng Xueda Training School(1)	Feb 1, 2010	PRC	Nil*
Dalian Shahekou Xueda Education & Training School(1)	Mar 5, 2010	PRC	Nil*
Hangzhou Xueda Education Consulting Co., Ltd.	Mar 9, 2010	PRC	Nil*
Beijing Weland International Education and Technology Corp.	Jun 1, 2012	PRC	Nil*
Guiyang Xueda Information Technology Co., Ltd.	Apr 9, 2010	PRC	Nil*
Fuzhou Gulou Xueda Education & Training School(1)	Apr 26, 2010	PRC	Nil*
Shijiazhuang Yuhua District Xueda Education & Training School(1)	Apr 26, 2010	PRC	Nil*
Beijing Dongcheng Xueda Training School(1)	May 27, 2010	PRC	Nil*
Changchun Xueda Education & Training School(1)	Jun 11, 2010	PRC	Nil*
Xi’an Xueda Education & Training School(1)	Jun 18, 2010	PRC	Nil*
Shenyang Xueda Education & Training School(1)	Aug 10, 2010	PRC	Nil*
Nanjing Xueda Education & Training School(1)	Sep 30, 2010	PRC	Nil*
Nantong Chongchuan District Xueda Education Training School(1)	Nov 19, 2010	PRC	Nil*
Xi’an Beilin District Xueda Education Training School(1)	Dec 14, 2010	PRC	Nil*
Shanghai Jinshan District Xueda Education School of Continuing Studies(1)	Dec 16, 2010	PRC	Nil*
Hefei Xueda Education Training Department(1)	Dec 27, 2010	PRC	Nil*
Beijing Chaoyang Xueda Training School(1)	Jan 25, 2011	PRC	Nil*
Xi’an Yanta Xueda Education & Training School(1)	Feb 24, 2011	PRC	Nil*

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

Beijing Haidian Xueda Training School(1)	May 31, 2011	PRC	Nil*
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\* These entities are controlled by the Company pursuant to the contractual arrangements disclosed below.

- (1) These private schools are established and controlled by Xueda Information or its subsidiaries. Under PRC laws and regulations, entities who establish private schools are commonly referred to as “sponsors” instead of “owners” or “shareholders”. The economic substance of “sponsorship” in respect of private schools is substantially similar to that of ownership with respect to legal, regulatory and tax matters.

***The VIE arrangements***

There are some uncertainties as to whether applicable PRC laws and regulations prohibit foreign investors from holding equity interest in PRC education companies. As a Cayman Islands corporation, the Company is deemed a foreign legal person under PRC laws. Accordingly, Xuecheng Century, the Company’s wholly owned subsidiary in the PRC, as a foreign invested company, may be deemed to be ineligible to engage in education business in the PRC.

The Company therefore conducts substantially all of its activities through the VIE, Xueda Information, and its subsidiaries and schools in the PRC. The VIE and its subsidiaries and schools hold leases and other assets necessary to operate the Company’s learning centers, provide tutoring services and generate all of the Company’s revenues. To provide the Company the power to control and the ability to receive substantially all of the expected residual returns of the VIE and its subsidiaries and schools, Xuecheng Century entered into a series of contractual arrangements with Xueda Information and its shareholders in August 2009.

- Agreements that transfer economic benefits to Xuecheng Century

***Exclusive technology consulting and management service agreement***

Pursuant to the exclusive consulting and management service agreement between Xueda Information and Xuecheng Century, Xuecheng Century has the exclusive right to provide to Xueda Information consulting services, technical support and training services, including industry and customer research, employee training, IT system maintenance and support, website and network construction and maintenance, and other services. Xuecheng Century is entitled to charge Xueda Information an annual service fee and adjust the service fee rate from time to time according to the amount of services it has provided to Xueda Information. The annual service fee amounts are determined at Xuecheng Century’s sole discretion. The terms of the exclusive consulting and management service agreement are 10 years and can be automatically extended for an additional 10 years at Xuecheng Century’s discretion. Xuecheng Century has the right to terminate this agreement, at any time during the term of this agreement, by 30-day prior written notice to Xueda Information, whereas Xueda Information may only terminate this agreement on the ground of Xuecheng Century’s gross negligence, fraud or other illegal act, or bankruptcy, lawful dissolution or termination of Xueda Information.



**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

*The VIE arrangements* - continued

*Pledge agreement*

Pursuant to the equity pledge agreement between Xuecheng Century and the nominee shareholders of Xueda Information, the nominee shareholders of Xueda Information pledged all of their equity interests in Xueda Information to Xuecheng Century to guarantee Xueda Information's performance of its obligations under the exclusive technology consulting and management service agreement. If Xueda Information breaches its contractual obligations under that agreement, Xuecheng Century, as the pledgee, will be entitled to certain rights, including the right to sell the pledged equity interests. The nominee shareholders of Xueda Information agree that, without prior written consent of Xuecheng Century, they will not dispose of the pledged equity interests or create or allow any encumbrance on the pledged equity interests that would prejudice Xuecheng Century's interest. During the term of the equity pledge agreement, Xuecheng Century is entitled to receive all income in cash or otherwise generated from the pledged equity interests, such as all dividends paid on the pledged equity interests. The pledge agreement has an initial term of 10 years, and will remain effective for as long as the exclusive technology consulting and management service agreement is effective.

- Agreements that provide Xuecheng Century effective control over Xueda Information

*Power of attorney*

Pursuant to the power of attorney, the nominee shareholders of Xueda Information each executed an irrevocable power of attorney assigning Xuecheng Century or any person designated by Xuecheng Century as their attorney-in-fact to vote on their behalf on all matters of Xueda Information requiring shareholder approval under PRC laws and regulations and the articles of association of Xueda Information.

The Articles of Incorporation of Xueda Information states that the major rights of the shareholders include the power to review and approve the annual budget, operating strategy and investment plan, elect the members of board of directors and approve their compensation plan. Therefore, through the irrevocable power of attorney arrangement, Xuecheng Century has the ability to exercise effective control over Xueda Information through shareholder votes and, through such votes, to also control the composition of the board of directors and thus appoint the senior management of Xueda Information. The power of attorneys will remain effective for as long as the nominee shareholders are shareholders of Xueda Information.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

*The VIE arrangements* - continued

*Exclusive purchase right contract*

Pursuant to the exclusive purchase right contract, Xuecheng Century has the exclusive and irrevocable right to purchase or designate another party to purchase from the nominee shareholders the equity interest in Xueda Information at the lowest amount of consideration permitted by the PRC law when and to the extent that applicable PRC law permits Xuecheng Century to own all or part of such equity interest in Xueda Information. This agreement will terminate upon the lawful transfer of all equity interests in Xueda Information to Xuecheng Century. Through the exclusive purchase right contract, each of Xueda Information's shareholders irrevocably granted Xuecheng Century an exclusive right to acquire, at any time, for its own account or through one or more PRC individuals or entities as nominee shareholders of its choice to replace the existing shareholders of Xueda Information, which constitutes a substantive kick-out right that is exercisable and enforceable under current PRC laws and regulations. This kickout right reinforces Xuecheng Century's ability to direct the activities that most significantly impact Xueda Information's economic performance.

As a result of these contractual arrangements, Xuecheng Century has (1) the power to direct the activities of Xueda Information that most significantly impact Xueda Information's economic performance through its control over the board of directors and management of Xueda Information and (2) the right to receive economic benefits from Xueda Information, and accordingly, the Company has consolidated the financial results of Xueda Information and its subsidiaries and schools in the consolidated financial statements for all the periods presented.

In concluding that the Company is the primary beneficiary of Xueda Information, the Company believes that the powers of attorney are valid, binding and enforceable under existing PRC laws and regulations and enable the Company, through Xuecheng Century, to vote on all matters requiring shareholder approval for Xueda Information. In addition, the Company believes that the exclusive purchase right contract provides the Company, through Xuecheng Century, with a substantive kickout right. More specifically, the terms of the exclusive purchase right contract are exercisable and enforceable under current PRC laws and regulations, and the minimum amount of consideration permitted by the applicable PRC laws to exercise such purchase right does not represent a financial barrier or disincentive for the Company, through Xuecheng Century, to exercise such purchase right. The Company's rights under the powers of attorney and the exclusive purchase right contract provide the Company with control over the shareholders of Xueda Information and thus provide the Company with the power to direct the activities that most significantly impact Xueda Information's economic performance.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
**(In thousands of U.S. dollars, except for shares and per share data)**

**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

*The VIE arrangements* - continued

*Risks in relation to the VIE structure*

The Company believes that the contractual arrangements with Xueda Information and its shareholders are in compliance with existing PRC laws and regulations and are valid, binding and enforceable and will not result in any violation of PRC laws or regulations currently in effect. However, substantial uncertainties exist regarding the interpretation of current and future PRC laws, regulations and the PRC regulatory authorities may take a contrary view. If the legal structure and contractual arrangements were found to be in violation of any existing PRC laws and regulations, the regulatory authorities may exercise their discretion and:

- revoke the business and operating licenses of our PRC subsidiaries or consolidated affiliated entities;
- restrict the rights to collect revenues from any of our PRC subsidiaries;
- discontinue or restrict the operations of any related-party transactions among our PRC subsidiaries or consolidated affiliated entities;
- require our PRC subsidiaries or consolidated affiliated entities to restructure the relevant ownership structure or operations;
- take other regulatory or enforcement actions, including levying fines that could be harmful to our business; or
- impose additional conditions or requirements with which we may not be able to comply.

The imposition of any of these penalties may result in a material adverse effect on the Company's ability to conduct its business. In addition, if the imposition of any of these penalties causes the Company to lose the rights to direct the activities of the VIE and its subsidiaries and schools or the right to receive their economic benefits, the Company would no longer be able to consolidate the financial results of the VIE, its subsidiaries or schools.

The Company's ability to control Xueda Information depends on the powers of attorney that enable Xuecheng Century to vote on all matters requiring shareholder approval for Xueda Information. As noted above, the Company believes these powers of attorney are valid, binding and enforceable under existing PRC laws and regulations but may not be as effective as direct equity ownership.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

*The VIE arrangements* - continued

*Risks in relation to the VIE structure* - continued

Certain shareholders of Xueda Information are also beneficial owners or directors of the Company. In addition, certain beneficial owners and directors of the Company are also directors or officers of Xueda Information. Their interests as beneficial owners of Xueda Information may differ from the interests of the Company as a whole. The Company cannot be certain that if conflicts of interest arise, these parties will act in the best interests of the Company or that conflicts of interests will be resolved in the Company's favor. Currently, the Company does not have existing arrangements to address potential conflicts of interest these parties may encounter in their capacity as beneficial owners of Xueda Information, on the one hand, and as beneficial owners of the Company, on the other hand. The Company believes the shareholders of Xueda Information will not act contrary to any of the contractual arrangements and the exclusive purchase right contract provides the Company with a mechanism to remove them as shareholders of Xueda Information should they act to the detriment of the Company. If any conflict of interest or dispute between the Company and the shareholders of Xueda Information arises and the Company is unable to resolve it, the Company would have to rely on legal proceedings in the PRC. Such legal proceedings could result in disruption of its business; moreover, there is substantial uncertainty as to the ultimate outcome of any such legal proceedings.

The Group's tutoring business has been directly operated by (and as a result all of the Group's revenues have been generated from) the VIE and its subsidiaries and schools. The Company has consolidated the net revenues of Xueda Information and its subsidiaries and schools in its consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"). For the years ended December 31, 2011, 2012 and 2013, \$223,379, \$294,047 and \$347,047, or 100%, 100% and 100%, respectively, of the Company's total net revenues were attributable to Xueda Information and its subsidiaries and schools as they conducted all of our tutoring business. As of December 31, 2012 and 2013, Xueda Information and its subsidiaries and schools accounted for an aggregate of 49% and 53%, respectively, of the Group's consolidated total assets, and 86% and 96%, respectively, of the Group's consolidated total liabilities. The assets not associated with the Xueda Information and its subsidiaries and schools primarily consisted of cash held by the Company, Xueda HK and Xuecheng Century. The financial information of the VIE and VIE's subsidiaries and schools as of December 31, 2012 and 2013 and for the years ended December 31, 2011, 2012 and 2013 were as follows:

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
(In thousands of U.S. dollars, except for shares and per share data)

**1. ORGANIZATION AND PRINCIPAL ACTIVITIES - continued**

*The VIE arrangements* - continued

	December 31,	
	2012	2013
Cash and cash equivalents	61,418	56,947
Prepaid expense and other current assets	11,402	12,902
Total current assets	107,348	129,836
Total assets	154,133	175,603
Deferred revenue	133,792	133,854
Total current liabilities	132,407	142,539
Total liabilities	161,313	172,522
Total equity	(7,180)	3,081

	Years ended December 31,		
	2011	2012	2013
Net revenues	223,379	294,047	347,047
Net (loss) income	(2,056)	6,282	10,089
Net cash provided by operating activities	17,355	48,370	43,003
Net cash used in investing activities	(7,095)	(37,363)	(48,532)

There are no consolidated VIE's assets that are collateral for the VIE's obligations and which can only be used to settle the VIE's obligations. No creditors (or beneficial interest holders) of the VIE have recourse to the general credit of the Company or any of its consolidated subsidiaries. No terms in any arrangements, considering both explicit arrangements and implicit variable interests, require the Company or its subsidiaries to provide financial support to the VIE. However, if the VIE ever needs financial support, the Company or its subsidiaries may, at its option and subject to statutory limits and restrictions, provide financial support to the VIE through loans to the shareholders of the VIE or entrustment loans to the VIE.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of presentation**

The consolidated financial statements of the Group have been prepared in accordance with US GAAP.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Basis of consolidation**

The consolidated financial statements include the financial statements of the Company, its subsidiaries, its VIE and the VIE's subsidiaries. All inter-company transactions and balances have been eliminated upon consolidation.

**Noncontrolling interests**

Noncontrolling interests are separately presented as a component of equity in the consolidated financial statements.

**Cash and cash equivalents**

Cash and cash equivalents consist of cash on hand, demand deposits, term deposits and debt securities with original maturities of three months or less.

**Investments**

Investments consist of trading securities, held-to-maturity securities and available-for-sale securities.

Trading securities are securities that are bought and held principally for the purpose of selling them in the near term and are reported at fair value, with unrealized gains and losses recognized in earnings.

The Group's held-to-maturity securities consist of term deposits and debt securities placed with banks. Held-to maturity securities that will mature within one year are included in short-term investment and others are included in long-term investments. Investments are classified as held-to-maturity when the Group has the positive intent and ability to hold the security to maturity, and are recorded at amortized cost.

Investments classified as available-for-sale securities are carried at their fair values and the unrealized gains or losses from the changes in fair values are included in accumulated other comprehensive income.

The Group reviews its investments for other-than-temporary impairment ("OTTI") based on the specific identification method. The Group considers available quantitative and qualitative evidence in evaluating potential impairment of its investments. If the cost of an investment exceeds the investment's fair value, the Group considers, among other factors, general market conditions, government economic plans, the duration and the extent to which the fair value of the investment is less than the cost, the Group's intent and ability to hold the investment, and the financial condition and near term prospects of the issuers.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
**(In thousands of U.S. dollars, except for shares and per share data)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Investments - continued**

If there is OTTI on debt securities, the Group separates the amount of the OTTI into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, which represents the difference between a security's amortized cost basis and the discounted present value of expected future cash flows. The amount due to other factors is recognized in other comprehensive income if the entity neither intends to sell and will not more likely than not be required to sell the security before recovery. The difference between the amortized cost basis and the cash flows expected to be collected is accreted as interest income.

**Fair value**

Fair value is the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Group considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Authoritative literature provides a fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The level in the hierarchy within which the fair value measurement in its entirety falls is based upon the lowest level of input that is significant to the fair value measurement as follows:

**Level 1**

Level 1 applies to assets or liabilities for which there are quoted prices in active markets for identical assets or liabilities.

**Level 2**

Level 2 applies to assets or liabilities for which there are inputs other than quoted prices included within Level 1 that are observable for the asset or liability such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical assets or liabilities in markets with insufficient volume or infrequent transactions (less active markets); or model-derived valuations in which significant inputs are observable or can be derived principally from, or corroborated by, observable market data.

**Level 3**

Level 3 applies to assets or liabilities for which there are unobservable inputs to the valuation methodology that are significant to the measurement of the fair value of the assets or liabilities.



**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Financial instruments**

Financial instruments are primarily in the form of cash and cash equivalents, amounts due from related parties, short-term investments and long-term investments. The carrying amounts of these financial instruments except for long-term investments, approximate their fair values because of their generally short maturities. The carrying amount of long-term held-to-maturity investments approximates their fair value due to the fact that the related interest rates approximate rates currently offered by financial institutions for similar debt instruments of comparable maturities. There is no quoted market value for the long-term available-for-sale; however, management estimates its fair value using discounted cash flow method. Fair value of such financial instruments is not necessarily representative of the amount that could be realized or settled.

**Use of estimates**

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses in the financial statements and the accompanying notes. Significant accounting estimates reflected in the Group's financial statements include revenue recognition, valuation allowance for deferred tax assets, share-based compensation, fair value of available-for-sale securities and goodwill impairment. Actual results could differ from those estimates.

**Property and equipment**

Property and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization is calculated on a straight-line basis over the following estimated useful lives:

Building	20-40 years
Furniture, fixtures and equipment	3 years
Motor vehicles	5 years
Leasehold improvements	Shorter of useful life of the assets or the lease term

**Acquired intangible assets**

Intangible assets with definite lives are carried at cost less accumulated amortization. Amortization of definite-lived intangible assets is computed using the straight-line method over the estimated average useful lives, which are as follows:

Trademark	10 years
Non-Compete Agreement	5 years

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
**FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013**  
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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Impairment of long-lived assets with definite lives**

Long-lived assets are tested for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may no longer be recoverable. When these events occur, the Group compares the carrying value of the long-lived assets to the estimated undiscounted future cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected undiscounted cash flow is less than the carrying amount of the assets, the Group would recognize an impairment loss equal to the difference between the fair value and the carrying amount of the assets.

**Business combinations**

Business combinations are recorded using the acquisition method of accounting. The assets acquired, the liabilities assumed, and any noncontrolling interests of the acquiree at the acquisition date, if any, are measured at their fair values as of the acquisition date. Goodwill is recognized and measured as the excess of the total consideration transferred plus the fair value of any noncontrolling interest of the acquiree, if any, at the acquisition date over the fair values of the identifiable net assets acquired. Common forms of the consideration made in acquisitions include cash and common equity instruments. Consideration transferred in a business acquisition is measured at the fair value as at the date of acquisition.

Where the consideration in an acquisition includes contingent consideration the payment of which depends on the achievement of certain specified conditions post-acquisition, the contingent consideration is recognized and measured at its fair value at the acquisition date and if recorded as a liability it is subsequently carried at fair value with changes in fair value reflected in earnings.

**Goodwill**

Goodwill is not amortized but is evaluated for impairment annually or whenever events or changes in circumstances indicate that the goodwill might be impaired following a two-step process. The first step compares the fair value of each reporting unit to its carrying amount, including goodwill. If the fair value of each reporting unit exceeds its carrying amount, goodwill is not considered to be impaired and the second step will not be required. If the carrying amount of a reporting unit exceeds its fair value, the second step compares the implied fair value of goodwill to the carrying value of a reporting unit's goodwill. The implied fair value of goodwill is determined in a manner similar to accounting for a business combination with the allocation of the assessed fair value determined in the first step to the assets and liabilities of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. An impairment loss is recognized for any excess in the carrying value of goodwill over the implied fair value of goodwill.

**XUEDA EDUCATION GROUP**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued**  
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**(In thousands of U.S. dollars, except for shares and per share data)**

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Revenue recognition**

Revenues are recognized when earned and are reported net of business taxes and value added taxes.

The primary sources of the Group's revenues are as follows:

(a) Registration fees

The Group charges each new student a non-refundable registration fee ranging from \$49.56 (RMB300) to \$165.19 (RMB1,000) for diagnosis and designing a personalized tutoring plan for the student. The nonrefundable registration fee is amortized over the estimated average customer relationship life. The average customer relationship life is estimated based on the Group's historical data and the estimate is subject to annual assessment or when an event or other changes indicate the estimate is no longer reasonable.

(b) Tuition fees for private personalized tutoring services

Tuition revenues are collected in advance and are initially recorded as deferred revenue. Tuition revenues are recognized proportionately as the tutoring sessions are delivered. Deferred revenue relating to unused prepaid tutoring hours of expired contracts are recognized as revenues in the twenty-sixth month after the contract expiration date if no refund has been claimed by then. The refund period of twenty-six months was determined according to the applicable PRC laws and regulations. After such period, refund claims are not supported by the applicable PRC laws and regulations.

The Group's PRC subsidiaries, VIE and VIE's subsidiaries and schools are subject to business taxes and other related surcharges at a rate of 3.3% or 5.5% of gross revenues generated from its private personalized tutoring service. Business taxes are reported as a deduction to revenue when incurred and amounted to \$11,723, \$13,834 and \$12,802 for the years ended December 31, 2011, 2012 and 2013, respectively.

In July 2012, the Ministry of Finance and the State Administration of Taxation jointly issued a circular regarding the pilot collection of value added taxes ("VAT") in lieu of business tax in certain areas and industries in the PRC. Starting from September 1, 2012, the VIE's certain subsidiaries became subject to VAT at the rates of 3%, 6% or 17%, on certain service revenues which were previously subject to business tax. VAT is also reported as a deduction to revenue when incurred and amounted to \$67 and \$999 for the years ended December 31, 2012 and 2013.

Entities that are VAT general taxpayers are allowed to offset qualified input VAT paid to suppliers against their output VAT liabilities. However, entities that are VAT small scale taxpayers, cannot offset their output VAT against their output VAT liabilities. Net VAT balance between input VAT and output VAT is recorded in either other current liabilities or other current assets on the consolidated balance sheets.

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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Advertising costs**

Advertising costs are expensed as incurred. The Group incurred advertising costs totaling \$21,471, \$26,448 and \$29,015 for the years ended December 31, 2011, 2012 and 2013, respectively, which were recorded as a component of selling and marketing expenses in the accompanying consolidated statements of operations.

**Lease accounting**

The Group evaluates each lease for classification as either a capital lease or an operating lease. If substantially all of the benefits and risks of ownership have been transferred to the lessee, the Group records the lease as a capital lease at its inception. The Group performs this evaluation at the inception of the lease and when a modification is made to a lease. If the lease agreement provides rent holidays or calls for a scheduled rent increase during the lease term, the Group recognizes the lease expense on a straight-line basis over the lease term. The difference between rent expense and rent paid is recorded as deferred rent. The term of the Group's leases typically ranges from one to five years and some of them are subject to renewal at fair market value.

**Government subsidies**

The Company receives government subsidies from the local government authorities for encouraging local area development and technology development. Government subsidies are recognized upon receipt as other operating income because the subsidies are not intended to compensate for specific expenditure and not subject to future return. For the years ended December 31, 2011, 2012 and 2013, \$357, \$164 and \$439 were received and recognized in other operating income, respectively.

**Foreign currency translation**

The functional and reporting currency of the Company and Xueda HK is US dollar. The functional currency of the Company's subsidiary, VIE and VIE's subsidiaries and schools in the PRC is Renminbi ("RMB").

Assets and liabilities are translated from each entity's functional currency to the reporting currency at the exchange rate on the balance sheet date. Equity amounts are translated at historical exchange rates, and revenues, expenses, gains and losses are translated using the average rate for the year. Translation adjustments are reported as cumulative foreign currency translation adjustments and are shown as a separate component of other comprehensive income in the consolidated statements of comprehensive income.

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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Foreign currency translation - continued**

Monetary assets and liabilities denominated in currencies other than the applicable functional currencies are translated into the functional currencies at the prevailing rates of exchange at the balance sheet date. Nonmonetary assets and liabilities are remeasured into the applicable functional currencies at historical exchange rates. Transactions in currencies other than the applicable functional currencies during the year are converted into the functional currencies at the applicable rates of exchange prevailing at the transaction dates. Transaction gains and losses are recognized in the consolidated statements of operations.

**Share-based compensation**

Share-based compensation with employees is measured based on the grant date fair value of the equity instrument. The Company recognizes the compensation costs net of a forfeiture rate on a straight-line basis over the requisite service period of the award, which is generally the vesting period of the award, with the amount of compensation expenses recognized in any period not less than the portion of the grant date fair value of the options vested during that period. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures are recognized through a cumulative catch-up adjustment in the period of change.

For awards with performance condition vesting provision, when achievement of the performance condition is deemed probable, the Company recognized compensation cost on a straight-line basis over the awards vesting periods.

**Income taxes**

Current income taxes are provided for in accordance with the laws of the relevant tax authorities.

Deferred income taxes are recognized when temporary differences exist between the tax basis of assets and liabilities and their reported amounts in the financial statements. Net operating loss carry forwards and credits are applied using enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that a portion of or all of the deferred tax assets will not be realized. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on their characteristics.

The impact of an uncertain income tax position on the income tax return is recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Interest and penalties on income taxes will be classified as a component of the provisions for income taxes.

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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Comprehensive income**

Comprehensive income includes net income, unrealized gain on available-for-sale securities and foreign currency translation adjustments. The Group presents the components of net income, the components of other comprehensive income and total comprehensive income in two separate but consecutive statements.

**Net income per share**

Basic net income per share attributable to Xueda Education Group ordinary shareholders is computed by dividing net income attributable to Xueda Education Group ordinary shareholders by the weighted average number of ordinary shares outstanding during the period. Diluted net income per share attributable to Xueda Education Group ordinary shareholders reflects the potential dilution that could occur if securities or other contracts to issue ordinary shares were exercised or converted into ordinary shares. The dilutive effect of stock options is computed using treasury stock method.

**Significant risks and uncertainties**

*Foreign currency risk*

RMB is not a freely convertible currency. The State Administration for Foreign Exchange, under the authority of the People's Bank of China, controls the conversion of RMB into foreign currencies. The value of RMB is subject to changes in central government policies and to international economic and political developments affecting supply and demand in the China Foreign Exchange Trading System market. The cash and cash equivalents of the Group included aggregate amounts of \$180,272 and \$109,895, which were denominated in RMB, at December 31, 2012 and 2013, respectively, representing 85.1% and 93.9% of the cash and cash equivalents balances as of December 31, 2012 and 2013, respectively. The Group's short-term investments of \$26,126 and \$129,619 as of December 31, 2012 and 2013, respectively, were also denominated in RMB.

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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Significant risks and uncertainties - continued**

*Concentration of credit risk*

Financial instruments that potentially expose the Group to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments, amount due from related parties and held-to-maturity securities classified as long-term investments.

Substantially all of the Group's cash and cash equivalents, short-term investments and held-to maturity securities classified as long-term investments are held by financial institutions located within the PRC. Financial institutions in the PRC do not have insurance similar to that provided by the Federal Deposit Insurance Corporation in the United States of America. The Group's investment policy limits its exposure to concentrations of credit risks in relation to its investments.

The Group's amount due from related parties consists of direct loans provided to a related party located within the PRC in the amount of nil and \$2,631 as of December 31, 2012 and 2013, respectively. The Group does not foresee a credit risk associated with such loans based on evaluations of the financial conditions of the related party.

**Recent accounting pronouncements**

In March 2013, the Financial Accounting Standards Board ("FASB") has issued an authoritative pronouncement related to parent's accounting for the cumulative translation adjustment upon derecognition of certain subsidiaries or groups of assets within a foreign entity or of an investment in a foreign entity. When a reporting entity (parent) ceases to have a controlling financial interest in a subsidiary or group of assets that is a nonprofit activity or a business (other than a sale of in substance real estate or conveyance of oil and gas mineral rights) within a foreign entity, the parent is required to release any related cumulative translation adjustment into net income. Accordingly, the cumulative translation adjustment should be released into net income only if the sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided.

For an equity method investment that is a foreign entity, the partial sale guidance still applies. As such, a pro rata portion of the cumulative translation adjustment should be released into net income upon a partial sale of such an equity method investment. However, this treatment does not apply to an equity method investment that is not a foreign entity. In those instances, the cumulative translation adjustment is released into net income only if the partial sale represents a complete or substantially complete liquidation of the foreign entity that contains the equity method investment.



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**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - continued**

**Recent accounting pronouncements - continued**

Additionally, the amendments in this pronouncement clarify that the sale of an investment in a foreign entity includes both: (1) events that result in the loss of a controlling financial interest in a foreign entity (i.e., irrespective of any retained investment); and (2) events that result in an acquirer obtaining control of an acquiree in which it held an equity interest immediately before the acquisition date (sometimes also referred to as a step acquisition). Accordingly, the cumulative translation adjustment should be released into net income upon the occurrence of those events.

The amendments in this pronouncement are effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The amendments should be applied prospectively to derecognition events occurring after the effective date. Prior periods should not be adjusted. Early adoption is permitted. If an entity elects to early adopt the amendments, it should apply them as of the beginning of the entity's fiscal year of adoption. The Group will adopt this pronouncement on January 1, 2014 and does not expect the adoption of this pronouncement will have a significant impact on its financial condition or results of operations.

In July 2013, the FASB issued a pronouncement which provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The FASB's objective in issuing this Accounting Standards Update ("ASU") is to eliminate diversity in practice resulting from a lack of guidance on this topic in current U.S. GAAP.

The amendments in this ASU state that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets.

This ASU applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The Group will adopt this pronouncement on January 1, 2014 and does not expect the adoption of this pronouncement will have a significant impact on its consolidated financial statements.

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**3. ACQUISITION**

In an effort to diversify its service offerings to primary and secondary school students, in June 2012, Xueda Information acquired 60% of the equity interest of Beijing Weland International Education and Technology Corp., (“Weland”) for a total cash consideration of \$2,961. Weland provides services to students in the PRC for short-term overseas studies, including hosting the Model United Nations Conference. This transaction was considered a business acquisition and therefore was recorded using the acquisition method of accounting. The acquired assets and liabilities were recorded at fair value at the date of acquisition, resulting in a goodwill balance of \$2,795. The net revenue and net loss of Weland in the amount of \$831 and \$540, respectively, have been included in the consolidated statement of operations for the year ended December 31, 2012.

With the assistance of a third party appraiser, the Group allocated the purchase price to assets acquired and liabilities assumed as follows:

Purchase price allocation		Useful life
Cash and cash equivalents	\$ 1,765	
Advance to suppliers	62	
Acquired intangible assets		
- Trademark	408	10 years
- Non-Compete Agreement	188	5 years
Fixed assets	4	
Total assets acquired	2,427	
Deferred tax liabilities	(150)	
Liabilities assumed	(540)	
Noncontrolling interest	(1,571)	
Total net assets	166	
Goodwill	2,795	
Total	\$ 2,961	

The following summary of unaudited pro forma results of operations for the years ended December 31, 2011 and 2012 were presented with the assumption that the significant acquisitions during the year ended December 31, 2012 occurred as of January 1, 2011. These pro forma results have been prepared for comparative purposes only and do not purport to be indicative of the results of operations which would have resulted had the significant acquisitions occurred as of January 1, 2011, nor are they indicative of future operating results.

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**3. ACQUISITION - continued**

	<b>Years ended December 31,</b>	
	<b>2011</b>	<b>2012</b>
Pro forma net revenue	227,436	296,548
Pro forma net income attributable to Xueda Education Group	4,999	2,414
Pro forma net income per ordinary share-basic	0.04	0.02
Pro forma net income per ordinary share-diluted	0.04	0.02

The Group recorded an impairment loss related to the goodwill of Weland for the year ended December 31, 2013, as set out in Note 7.

**4. PREPAID EXPENSES AND OTHER CURRENT ASSETS**

Prepaid expenses and other current assets consisted of:

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
Other receivable (i)	1,794	1,241
Prepaid rental expenses	6,857	7,288
Advance to suppliers	965	1,095
Prepaid advertisement expenses	513	565
Short-term deposits	461	451
Interest receivable	458	1,051
Staff advances and others	1,296	2,166
Option exercising cost receivable (ii)	567	2,785
	<b>12,911</b>	<b>16,642</b>

(i) Other receivable consists of cash that had been received from students but held by the third-party online payment processing agencies. The funds are transferred to the Group shortly after payments are received by the third-party online payment processing agencies.

(ii) Option exercising cost receivable is the amount paid by employees to exercise options but held by a third party service provider. The funds are transferred to the Group shortly after payments are received by the third-party service provider.

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**5. PROPERTY AND EQUIPMENT**

Property and equipment consist of the following:

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
Buildings	5,800	5,969
Furniture, fixtures and equipment	21,603	25,296
Motor vehicles	2,146	2,334
Leasehold improvements	37,217	40,947
Less: accumulated depreciation and amortization	(26,150)	(39,720)
	<u>40,616</u>	<u>34,826</u>

Depreciation and amortization expenses for the years ended December 31, 2011, 2012 and 2013 were \$8,109, \$15,308 and \$16,117, respectively.

**6. ACQUIRED INTANGIBLE ASSETS**

Acquired intangible assets arose from the acquisitions of Weland in 2012 and consisted of the following:

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
Trademark	408	417
Non-Compete Agreement	188	193
	<u>596</u>	<u>610</u>
Less: Accumulated amortization	(47)	(128)
Less: Accumulated impairment	—	(494)
Exchange difference	14	12
Acquired intangible assets, net	<u>563</u>	<u>—</u>

Due to the lowered earnings forecast and increased competition in the industry, in December 2013, the Group performed, with the assistance of an independent valuation expert, an impairment test of the carrying value of the Weland trademarks and non-compete agreement to determine whether any impairment existed. This assessment resulted in an impairment write-down of \$494, which was included in "Impairment loss on acquired intangible assets" in the accompanying statements of operations for the year ended December 31, 2013. The fair value of acquired intangible assets is measured on a non-recurring basis, as set out in Note 9.

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**7. GOODWILL**

The Group has two reporting units, Taiyuan Xueda Education & Training School (“Taiyuan Xueda”) and Weland, that carry goodwill. The changes in the carrying amount of goodwill for the years ended December 31, 2012 and 2013 were as follows:

	December 31,					
	2012			2013		
	Taiyuan Xueda	Weland	Total	Taiyuan Xueda	Weland	Total
Gross amount						
Beginning balance at January 1	863	—	863	872	2,857	3,729
Acquisition (Note 3)	—	2,795	2,795	—	—	—
Exchange difference	9	62	71	25	83	108
Ending balance at December 31	872	2,857	3,729	897	2,940	3,837
Accumulated impairment loss						
Beginning balance at January 1	—	—	—	—	—	—
Charge for the year	—	—	—	—	(2,923)	(2,923)
Exchange difference	—	—	—	—	(17)	(17)
Ending balance at December 31	—	—	—	—	(2,940)	(2,940)
Goodwill, net	872	2,857	3,729	897	—	897

The Group performs its annual goodwill impairment tests on December 31 of each year. Due to the lowered earnings forecast and increased competition in the industry, a goodwill impairment loss of \$2,923 related to Weland was recognized in the year ended December 31, 2013. The fair value of the reporting unit of Weland was estimated based on the discounted cash flows as set out in Note 9.

During the years ended December 31, 2011, 2012 and 2013, the Company recognized goodwill impairment losses of \$nil, \$nil and \$2,923, respectively.

**8. INVESTMENTS**

***Cash equivalents***

The Group’s cash equivalents consist of term deposits and debt securities with original maturities of less than three months.

The Group measured the cash equivalents at amortized cost. Interest income of \$2,016, \$4,177 and \$895 were recognized in the consolidated statements of operations for the years ended December 31, 2011, 2012 and 2013.

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**8. INVESTMENT - continued**

***Short-term investments***

As of December 31, 2012 and 2013, the Group's short-term investments consist of trading securities and held-to-maturity securities with maturities of less than one year.

Trading securities

The Group measured the trading securities at fair value based on quoted market prices in an active market. Gains from the trading securities of nil, nil and \$12 were recognized in the consolidated statements of operations for the years ended December 31, 2011, 2012 and 2013, respectively.

Held-to-maturity securities - short-term

The Group measured the held-to-maturity securities at amortized cost. Interest income of \$593, \$2,074 and \$5,728 were recognized in the consolidated statements of operations for the years ended December 31, 2011, 2012 and 2013.

***Long-term investments***

The Group's long-term investments consist of held-to-maturity securities with maturities of greater than 12 months and available-for-sale securities.

Held-to-maturity securities - long-term

The Group's long-term held-to-maturity securities consist of debt securities placed with banks with maturities greater than one year, which are stated as amortized cost. Interest income of nil, nil and \$86 were recognized in the consolidated statements of operations for the years ended December 31, 2011, 2012 and 2013. As of December 31, 2013, the long-term held-to-maturity securities will mature in October, 2015.

Available-for-sale securities

In July 2012, the Company entered into a preferred share purchase agreement with the shareholders of Firstleap Education ("Firstleap"), a company incorporated in the Cayman Islands that provides English training program to children aged from 2 to 10 years in the PRC. The Company purchased, for a cash consideration of \$4,786, 1,272,000 convertible redeemable preferred shares, which is equivalent to a 12.72% equity ownership interest in Firstleap.

On July 16, 2013, the Company contributed an additional capital of \$1,632 million in Firstleap's convertible redeemable preferred shares. Consequently, the Company's beneficial interest in Firstleap increased from 12.72% to 16.11%. As a result of the additional investment, the Company has two seats out of six in the board of Firstleap, compared to one seat out of five previously.

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**8. INVESTMENT - continued**

***Long-term investments - continued***

At any time and from time to time on or after January 1, 2017 without consummation of a qualified initial public offering of Firstleap, the Company may require Firstleap to redeem the preferred shares.

The investment is classified as available-for-sale securities and is measured at fair value as of the balance sheet date. Unrealized holding gains and losses are excluded from earnings and are reported in other comprehensive income until realized. Unrealized holding gains of nil, \$339 and \$93 were reported in other comprehensive income for the years ended December 31, 2011, 2012 and 2013.

Investments as of December 31, 2012 and 2013 were as follows:

	As of December 31, 2012				
	Amortized cost	Gross un- recognized holding gains	Gross un- recognized holding losses	Unrealized gain in accumulated other comprehensive income	Fair value
Cash and cash equivalents:					
Cash equivalents					
Term deposits	77,784	—	—	—	77,784
	77,784	—	—	—	77,784
Short-term investments:					
Held-to-maturity securities					
Fixed-rate debt securities	26,126	133	—	—	26,259
	26,126	133	—	—	26,259
Long-term investments:					
Available-for-sale securities					
Convertible redeemable preferred shares	4,786	—	—	339	5,125
	4,786	—	—	339	5,125

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**8. INVESTMENT - continued**

	As of December 31, 2013				
	Amortized cost	Gross un- recognized holding gains	Gross un- recognized holding losses	Unrealized gain in accumulated other comprehensive income	Fair value
<b>Cash and cash equivalents:</b>					
<b>Cash equivalents</b>					
Term deposits	11,827	—	—	—	11,827
Adjustable-rate debt securities	4,326	—	—	—	4,326
	<u>16,153</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>16,153</u>
<b>Short-term investments:</b>					
<b>Trading securities</b>					
Adjustable-rate debt securities	1,553	—	—	—	1,553
<b>Held-to-maturity securities</b>					
Fixed-rate debt securities	23,958	132	(5)	—	24,085
Adjustable-rate debt securities	33,479	11	—	—	33,490
Term deposits	70,629	—	—	—	70,629
	<u>129,619</u>	<u>143</u>	<u>(5)</u>	<u>—</u>	<u>129,757</u>
<b>Long-term investments:</b>					
<b>Held-to-maturity securities</b>					
Adjustable-rate debt securities	8,347	—	(85)	—	8,262
<b>Available-for-sale securities</b>					
Convertible redeemable preferred shares	6,418	—	—	432	6,850
	<u>14,765</u>	<u>—</u>	<u>(85)</u>	<u>432</u>	<u>15,112</u>

The fair values of trading securities and available-for-sale securities as measured, and cash equivalents and held-to-maturity securities as disclosed are further discussed in Note 9.

**9. FAIR VALUE MEASUREMENT**

Fair value disclosed or measured on a recurring basis

The fair values of the Group's trading securities and available-for-sale securities as measured, and cash equivalents and held-to-maturity securities as disclosed are determined based on the discounted cash flow method. The following table summarizes the Group's financial assets measured or disclosed at fair value on a recurring basis.



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**9. FAIR VALUE MEASUREMENT - continued**

Fair value disclosed or measured on a recurring basis - continued

		Fair value disclosure or measurement at December 31, 2012 using		
	Fair value at December 31, 2012	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<u>Fair value disclosure</u>				
Cash and cash equivalents:				
Cash equivalents				
Term deposits	77,784	—	77,784	—
Short-term investments:				
Held-to-maturity securities				
Fixed-rate debt securities	26,259	—	26,259	—
<u>Fair value measurement</u>				
Long-term investments:				
Available-for-sale securities				
Convertible redeemable preferred shares	5,125	—	—	5,125
Total assets measured at fair value	5,125	—	—	5,125

	Fair value at December 31, 2013	Fair value disclosure or measurement at December 31, 2013 using		
		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
<b><u>Fair value disclosure</u></b>				
<b>Cash and cash equivalents:</b>				
<b>Cash equivalents</b>				
Term deposits	11,827	—	11,827	—
Adjustable-rate debt securities	4,326	—	4,326	—
<b>Short-term investments:</b>				
<b>Held-to-maturity securities</b>				
Fixed-rate debt securities	24,085	—	24,085	—
Adjustable-rate debt securities	33,490	—	33,490	—
Term deposits	70,629	—	70,629	—
<b>Long-term investments:</b>				
<b>Held-to-maturity securities</b>				
Adjustable-rate debt securities	8,262	—	8,262	—
<b><u>Fair value measurement</u></b>				
<b>Short-term investments:</b>				
<b>Trading securities</b>				
Adjustable-rate debt securities	1,553	1,553	—	—
<b>Long-term investments:</b>				
<b>Available-for-sale securities</b>				
Convertible redeemable preferred shares	6,850	—	—	6,850
<b>Total assets measured at fair value</b>	8,403	1,553	—	6,850

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**9. FAIR VALUE MEASUREMENT - continued**

Fair value disclosed or measured on a recurring basis - continued

The available-for-sale securities do not have a quoted market rate. The Group adopted a discounted cash flow method under the income approach, which take into consideration a number of factors that include expected future cash flows, growth rates and discount rates from publicly traded companies in the industry and requires the Group to make certain assumptions and estimates regarding industry economic factors and future profitability. The assumptions are inherently uncertain and subjective. The expected future cash flows for Firstleap were based on discrete eight years financial forecasts developed by management for planning purposes. Cash flows beyond the forecasted period were estimated using a terminal value calculation, which incorporated historical and forecasted financial trends and considered long-term earnings growth rates for publicly traded comparable companies. Specifically, the income approach valuations included a cash flow discount rate of 21.14%, and a terminal value growth rate of 3%.

The following is a reconciliation of the beginning and ending balances for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the years ended December 31, 2012 and 2013, which only contains available-for-sale securities.

	<b>Fair Value Measurement Using Significant Unobservable Inputs (Level 3)</b>	
	<b>2012</b>	<b>2013</b>
Beginning balance	—	5,125
Total unrealized gains included in other comprehensive income	339	93
Purchase	4,786	1,632
Ending balance	5,125	6,850

Fair value measured on a non-recurring basis

The Group measured the fair value of acquired intangible assets of Weland using “relief from royalty” or “with or without” valuation methods. These acquired intangible assets are considered Level 3 assets because the Group used unobservable inputs, such as royalty rate, forecast financial performance of the acquired business and discount rates, to determine the fair value of these acquired assets. The Group has recognized impairment loss of \$359 and \$135 related to trademark and non-compete agreement, respectively, for the year ended December 31, 2013, as set out in Note 6.

The Group measured the fair value of goodwill using the income approach valuation methodology, based on which to recognize the impairment loss for the Weland reporting unit in 2013 as set out in Note 7. The goodwill is considered as Level 3 assets because the Group used unobservable inputs, such as five-year earnings forecast, weighted average cost of capital (“WACC”) and lack of marketability discount (“LoMD”), to determine the fair value of the goodwill. The WACC and LoMD used in the fair value measurement for the Weland reporting unit were 21% and 30%, respectively.

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**10. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES**

Accrued expenses and other current liabilities consisted of the following:

	<b>December 31,</b>	
	<b>2012</b>	<b>2013</b>
Accrued employee payroll and welfare benefits	14,459	22,027
Payable for purchase of property and equipment	2,393	1,888
Accrued rental expenses	3,344	3,442
Business taxes and other tax payable	1,970	2,414
Individual income taxes withheld	513	579
Payable to other service providers and suppliers	1,400	3,531
Other	1,078	1,394
	<u>25,157</u>	<u>35,275</u>

**11. INCOME TAXES**

The current and deferred components of income tax expenses (benefits) were as follows:

	<b>Years ended December 31,</b>		
	<b>2011</b>	<b>2012</b>	<b>2013</b>
Current	4,562	3,179	8,302
Deferred	(2,078)	(2,303)	(820)
Total income tax expenses	<u>2,484</u>	<u>876</u>	<u>7,482</u>

The Company is a tax-exempt entity incorporated in the Cayman Islands.

Xueda HK located in Hong Kong and is subject to an income tax rate of 16.5%. Xueda HK did not record any income tax expense during the years ended December 31, 2011, 2012 and 2013 because Xueda HK is an investment holding company with no substantive business operations in Hong Kong.

Xueda Information and its subsidiaries and schools, which were incorporated in the PRC ("PRC subsidiaries"), are subject to PRC Enterprise Income Tax (EIT), on the taxable income in accordance with the relevant PRC income tax laws, which have adopted a unified income tax rate of 25% since January 1, 2008. Xuecheng Century was certified as a "software enterprise" and was exempt from income taxes in 2010 and 2011, followed by a 12.5% of income tax rate for 2012, 2013, and 2014.

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**11. INCOME TAXES - continued**

The principal components of deferred income taxes were as follows:

	December 31,	
	2012	2013
Current deferred tax assets		
Deferred income-current	104	104
Accrued expenses (i)	4,420	6,671
Less: valuation allowance	(189)	(636)
Net current deferred tax assets	4,335	6,139
Noncurrent deferred tax assets		
Deferred income-noncurrent	182	78
Net operating loss carry forwards	3,816	4,025
Less: valuation allowance	(1,413)	(2,643)
Net noncurrent deferred tax assets	2,585	1,460
Noncurrent deferred tax liabilities		
Acquired intangible assets	(141)	—
Net non-current deferred tax liabilities	(141)	—

- (i) Accrued expenses deferred tax assets relate to accrued advertising, payroll and welfare expenses. According to the EIT law, accrued payments related to certain employee expenses, including employee payroll and certain welfare expenses, are not deductible for tax until the actual payments occur. The EIT law also limits the amount of advertising expenses deductible for any period to no more than 15% of gross revenue of such period and permits the amount of the advertising expense in excess of such 15% limit to be carried forward to future periods.

The net operating loss carry forwards for Xueda Information and its subsidiaries and schools was \$16,100 as of December 31, 2013 and will expire on various dates through 2018. The valuation allowances as of December 31, 2012 and 2013 were primarily related to net operating losses generated by certain subsidiaries and schools of Xueda Information because the Group believes that it is more likely than not that the related deferred tax assets will not be utilized in the future.

The tax basis of the investment of Xuecheng Century in Xueda Information has been greater than the carrying value of this investment. Under US GAAP, a deferred tax asset should be recognized for this temporary difference only if it is apparent that the temporary difference will reverse in the foreseeable future. Absent of evidence of a reversal in the foreseeable future, no deferred tax asset for such temporary difference was recorded.

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**11. INCOME TAXES - continued**

Reconciliation between total income tax expenses and the amount computed by applying the PRC EIT statutory rate to income before income taxes is as follows:

	Years ended December 31,		
	2011	2012	2013
Expected income tax expenses at PRC EIT statutory rate of 25%	1,819	656	5,594
Effect of preferential tax rate and tax holiday	(760)	745	(601)
Effect on tax rates in different tax jurisdictions (i)	(1,052)	(228)	6
Tax effect of expenses that are not deductible in determining taxable profit (ii)	809	226	806
Changes in valuation allowance	1,668	(523)	1,677
<b>Total income tax expenses</b>	<b>2,484</b>	<b>876</b>	<b>7,482</b>

- (i) Effect on tax rates in different tax jurisdictions relates to the interest income and exchange gains generated by the Company and Xueda HK from its RMB-denominated deposits, which are exempted in Cayman Islands, and not subject to Hong Kong income taxes in accordance with the Hong Kong Inland Revenue Ordinance as Xueda HK is an investment holding company with no substantive business operations in Hong Kong.
- (ii) Expenses not deductible for tax purposes include impairment losses, entertainment expenses, employees' training expenses that are not deductible in the computation of net income before income taxes.

If the tax holidays granted to Xuecheng Century were not available, income tax provision and earnings per share amounts would be as follows:

	Years ended December 31,		
	2011	2012	2013
Increase (decrease) in income tax expense	760	(745)	601
(Reduction) Increase in net income per share-basic	(0.01)	0.01	(0.00)
(Reduction) Increase in net income per share-diluted	(0.01)	0.01	(0.00)

The Group did not identify significant unrecognized tax benefits for the years ended December 31, 2011, 2012 and 2013. The Group did not incur any interest and penalties related to potential underpaid income tax expenses and also does not anticipate any significant increases or decreases in unrecognized tax benefits in the next 12 months from December 31, 2013.

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**11. INCOME TAXES - continued**

Uncertainties exist with respect to how the current income tax law in the PRC applies to the Group's overall operations, and more specifically, with regard to tax residency status. The EIT Law includes a provision specifying that legal entities organized outside of the PRC will be considered residents for Chinese Income tax purposes if the place of effective management or control is within the PRC. The implementation rules to the New EIT Law provide that non-resident legal entities will be considered PRC residents if substantial and overall management and control over the manufacturing and business operations, personnel, accounting and properties occurs within the PRC. On April 22, 2009, the State Administration of Taxation (the "SAT") issued the Notice Regarding the Determination of Chinese-Controlled Offshore Incorporated Enterprises as PRC Tax Resident Enterprises on the Basis of De Facto Management Bodies, or Circular 82, which provides certain specific criteria for determining whether the "de facto management body" of a Chinese-controlled offshore-incorporated enterprise is located in China. In addition, on August 3, 2011, the SAT issued a bulletin to made clarification in the areas of resident status determination, post-determination administration, as well as competent tax authorities. The Group does not believe that the legal entities organized outside of the PRC within the Group should be treated as residents for EIT law purposes. However, if the PRC tax authorities subsequently determine that the Company and its subsidiaries registered outside the PRC should be deemed resident enterprises, the Company and its subsidiaries registered outside the PRC will be subject to the PRC income taxes, at a rate of 25%.

If any entity within the Group that is outside the PRC were to be a non-resident for PRC tax purposes dividends paid to it out of profits earned by PRC subsidiary after January 1, 2008 would be subject to a withholding tax at a rate of 10%, subject to reduction by an applicable tax treaty with the PRC. Aggregated undistributed earnings of the Company's subsidiaries and variable interest entity located in the PRC that are available for distribution was \$4,612 as of December 31, 2013. The Company did not record any tax on any of the aforementioned undistributed earnings because the relevant subsidiaries do not intend to declare dividends and the Company intends to permanently reinvest it within the PRC.

**12. ORDINARY SHARES**

In 2011 and 2013, the Company issued 1,300,000 and 3,427,854 ordinary shares, respectively, to its depositary bank for future exercise of share options and vesting of nonvested shares, which are not considered as outstanding shares until they are delivered to the employees upon exercise of vested stock options or vesting of nonvested shares. Out of these 4,727,854 shares issued to its depositary bank, 3,460,998 and 1,187,376 shares had been issued to the employees upon exercise of their share options and vesting of nonvested shares as of December 31, 2013, respectively. 79,480 shares remain available for future option exercise or nonvested shares vesting, which were not considered as outstanding shares as of December 31, 2013, and therefore were excluded from the computation of earnings per share.

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**12. ORDINARY SHARES - continued**

In September 2011, the board of directors approved a shares repurchase program to repurchase up to \$30,000 of its outstanding ADSs ("ADSs" refers to the Company's American depositary shares, each of which represents two ordinary shares). The Company engaged an independent investment bank to act as a broker-dealer in connection with such repurchases. 5,210,168 and 4,155,864 ordinary shares were repurchased from existing shareholders at an average price of \$1.70 and \$1.75 per share for the years ended December 31, 2011 and 2012, respectively. No ordinary share was repurchased during the year ended December 31, 2013. The repurchased shares were accounted for as treasury stock and recorded at an aggregate cost of \$16,124.

**13. NET INCOME PER SHARE**

The following table sets forth the computation of basic and diluted net income per share for the periods indicated:

	Years ended December 31,		
	2011	2012	2013
Net income-basic (numerator):			
Net income attributable to Xueda Education Group ordinary shareholders	4,790	1,965	16,151
Shares (denominator):			
Weighted average ordinary shares outstanding used in computing basic net income per share-basic	137,745,176	131,316,004	131,681,540
Effect of dilutive securities:			
Plus incremental weighted average ordinary shares from assumed conversions of stock options and nonvested shares using the treasury stock method	4,523,737	460,203	2,785,328
Weighted average ordinary shares outstanding used in computing diluted net income per share-diluted	142,268,913	131,776,207	134,466,868
Net income per ordinary share-basic	0.03	0.01	0.12
Net income per ordinary share-diluted	0.03	0.01	0.12

As of December 31, 2012 and 2013, 356,219 and 414,233 options, 1,248,944 and 105,533 nonvested shares were excluded in computation of diluted net income per share, respectively, because their effects were anti-dilutive. There were no anti-dilutive options and nonvested shares as of December 31, 2011.

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**14. SHARE-BASED COMPENSATION**

On November 13, 2009, the Company adopted a Stock Incentive Plan, which allows the Company to grant its employees, directors and consultants awards including option, stock appreciation right, dividend equivalent right, restricted stock and other right or benefit. The maximum aggregate number of shares which may be issued pursuant to all awards is 11,146,151 shares. The term of an incentive stock option shall be no more than ten years from the date of grant thereof. However, in the case of an incentive stock option granted to a grantee who, at the time the option is granted, owns stock representing more than ten percent of the voting power of all classes of stock of the Company or any parent or subsidiary of the Company, the term of the incentive stock option shall be five years from the date of grant thereof or such shorter term as may be provided in the award agreement.

In December 2010 and May 2013, the Company revised the Stock Incentive plan. According to Amended and Restated 2009 Equity Incentive Plan, the share limit shall initially be 11,146,151 and shall automatically increase on January 1 of each calendar year during the term of this plan, commencing with January 1, 2011, by an amount equal to (i) 1% of the total number of shares issued and outstanding on December 31 of the immediately preceding calendar year and (ii) such number of shares as may be established by the Board of Directors or the Compensation Committee. Moreover, the option price per share shall be determined by the Compensation Committee, but shall not be less than, (i) with respect to options granted to individuals subject to taxation in the United States, 100% of the fair market value of a share, and (ii) with respect to all other options, 85% of the fair market value of a share, in each case, on the date an option is granted. The share limit was 18,168,270 and 1,381,732 shares were available for future grant as of December 31, 2013.

*Stock options*

In February 2012, concurrent with an officer's resignation in February 2012, 417,979 of his shares options, which would have been forfeited upon his resignation, were modified to vest on March 15, 2012 and became exercisable within six months of his resignation. The incremental share-based compensation expenses of \$339 as of the modification date were recognized immediately.

On August 22, 2012, the Company granted 2,089,904 share options to an employee with an exercise price of \$1.65 per share, for which 50% of the share options vest on May 22, 2013 and 2014, respectively.

On December 18, 2012, the Company granted 655,902 share options to another employee with an exercise price of \$1.26 per Share. 1/8 of the share options vested on May 22, 2013, and 1/8 of the share options vest every six months thereafter over next 3.5 years.



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**14. SHARE-BASED COMPENSATION - continued**

*Stock options - continued*

A summary of the share option activities is as follows:

	Number of options	Weighted average exercise price	Outstanding options		Aggregate intrinsic value
			Weighted average grant-date fair value	Weighted average remaining contractual Term (Years)	
Options outstanding at January 1, 2011	10,309,062	\$ 1.28	\$ 1.24		
Exercised	(336,114)	\$ 0.99	\$ 1.24		
Forfeited	(422,296)	\$ 0.99	\$ 1.24		
Options outstanding at December 31, 2011	9,550,652	\$ 1.31	\$ 1.24		
Granted	2,745,806	\$ 1.55	\$ 0.66		
Exercised	(679,402)	\$ 0.99	\$ 1.24		
Forfeited	(4,341,736)	\$ 1.68	\$ 1.24		
Options outstanding at December 31, 2012	7,275,320	\$ 1.20	\$ 1.02		
Exercised	(2,445,482)	\$ 1.01	\$ 1.21		
Forfeited	(259,458)	\$ 0.99	\$ 1.24		
Options outstanding at December 31, 2013	4,570,380	\$ 1.32	\$ 0.91	7.50	\$ 7,982
Options vested and expected to vest as of December 31, 2013	4,375,550	\$ 1.33	\$ 0.90	7.56	\$ 7,578
Option exercisable as of December 31, 2013	2,058,908	\$ 1.32	\$ 0.94	7.31	\$ 3,588

The total intrinsic value of options exercised during the years ended December 31, 2011, 2012 and 2013 were \$1,080, \$345 and \$2,763, respectively.

The Company recorded share-based compensation expenses of \$3,242, \$1,752 and \$1,900 for the years ended December 31, 2011, 2012 and 2013, respectively. As of December 31, 2013, there was \$755 of share-based compensation related to stock options that is expected to be recognized over a weighted average period of 0.8 years.

During the three years ended December 31, 2013, only two batches of options were granted in 2012. The fair value of options granted was estimated on the date of grant using the binomial option pricing model with the following assumptions:

	Years ended December 31, 2012
Weighted average expected volatility	57.9%
Weighted average risk-free interest rate	1.8%
Weighted average expected dividend yield	0%
Weighted average fair value of the underlying ordinary shares	\$1.21 per share
Weighted average exercise multiple	2.8 times

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**14. SHARE-BASED COMPENSATION - continued**

*Stock options - continued*

(1) Volatility

The volatility of the underlying ordinary shares during the life of the options was estimated based on the historical stock price volatility of the Company and comparable listed companies over a period comparable to the contractual term of the options.

(2) Risk-free interest rate

Risk-free interest rate was estimated based on the yield of treasury bonds of the United States with a maturity period similar to the contractual term of the options.

(3) Dividend yield

The dividend yield was estimated by the Company based on its expected dividend policy over the contractual term of the options.

(4) Fair value of underlying ordinary shares

The closing market price of the ordinary shares of the Company as of the grant date was used as the fair value of the ordinary shares on that date.

(5) Exercise multiple

Exercise multiple represents the value of the underlying share or stock price as a multiple of exercise price of the option which, if achieved, results in exercise of the option.

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**14. SHARE-BASED COMPENSATION - continued**

*Nonvested shares*

In the years ended December 31, 2011, 2012 and 2013, the Company granted 1,974,368, 1,888,313 and 6,001,339 nonvested shares to employees and consultants, respectively. Nonvested shares vest over a period ranged from one to four years. Out of the nonvested shares granted, the vesting of 6,000,000 shares is subject to certain performance conditions such as target revenue and earnings before interest expenses and income taxes.

The grant-date fair value of nonvested shares was determined based on the closing price of the Company's ADSs on New York Stock Exchange on such dates.

A summary of the nonvested shares activity is as follows:

	<u>Number of Nonvested shares outstanding</u>	<u>Weighted average grant-date fair value</u>	<u>Aggregate intrinsic value</u>
Nonvested shares outstanding at January 1, 2011	—	—	
Granted	1,974,368	4.24	
Forfeited	(435,700)	4.47	
Vested	(51,250)	4.84	
Nonvested shares outstanding at December 31, 2011	1,487,418	4.15	
Granted	1,888,313	1.32	
Forfeited	(275,303)	4.30	
Vested	(348,062)	4.16	
Nonvested shares outstanding at December 31, 2012	2,752,366	2.19	
Granted	6,001,339	1.69	
Forfeited	(397,857)	3.07	
Vested	(788,064)	2.15	
Nonvested shares outstanding at December 31, 2013	7,567,784	1.69	\$ 23,195
Nonvested shares vested and expected to vest at December 31, 2013	7,099,086	1.68	\$ 21,759

The total fair value of shares vested during the year ended December 31, 2011, 2012 and 2013 was \$248, \$1,448 and \$1,315, respectively. The Company recorded share-based compensation expenses of \$867, \$1,414 and \$3,482 for the years ended December 31, 2011, 2012 and 2013, respectively. As of December 31, 2013, there was \$9,030 of share-based compensation related to nonvested shares that is expected to be recognized over a weighted average period of 2.4 years.

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**15. MAINLAND CHINA CONTRIBUTION PLAN AND PROFIT APPROPRIATION**

Full time employees of the Group in the PRC participate in a government-mandated defined contribution plan pursuant to which certain pension benefits, medical care, unemployment insurance, employee housing fund and other welfare benefits are provided to employees. Chinese labor regulations require the Group to accrue for these benefits based on certain percentages of the employees' salaries. Total provisions for such employee benefits were \$18,435, \$24,214 and \$26,609 for the years ended December 31, 2011, 2012 and 2013, respectively.

**16. COMMITMENTS**

The Group leases offices under non-cancelable operating leases agreements. Rent expenses under operating leases for the years ended December 31, 2011, 2012 and 2013 were \$28,927, \$40,490, and \$42,429, respectively.

Future minimum lease payments under non-cancelable operating leases agreements are as follows:

Years ending December 31,	
2014	36,271
2015	29,755
2016	21,333
2017	12,578
2018 and thereafter	17,925
	<u>117,862</u>

**17. RELATED PARTY TRANSACTIONS**

The details of related party balances as of December 31, 2012 and 2013 and transactions for the years ended December 31, 2011, 2012 and 2013 are as follows:

(1) Amounts due from related party

	Amounts due from related party	
	December 31,	
	2012	2013
Amounts due from Beijing Lebai Education Consulting Co., Ltd. ("Lebai") (i)	1,592	2,631

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**17. RELATED PARTY TRANSACTIONS - continued**

- (i) As of December 31, 2013, the Company had an aggregate 16.11% equity interest in Firstleap Education and Jin Xin, the Chief Executive Officer of the Company and Chirstine Lu-Wong, the Chief Financial Officer of the Company are appointed the board members of Firstleap.

In November 2012, Xueda Information signed a three-party loan agreement with Lebai, an affiliate of Firstleap, and Bank of Beijing whereby the Company loaned RMB10 million (equivalent to \$1,592) to Lebai through Bank of Beijing for a period from November 18, 2012 to May 28, 2013 at an annual interest rate of 10%. This loan was fully repaid in 2013.

In December 2013, Xuecheng Century provided two unsecured loans to Lebai, in a total amount of RMB16 million (equivalent to \$2,631), to support Lebai's business operations. Such loans are for a period from December 2013 to April 2014 and bear an interest rate of 4% per annum.

(2) Transactions with related party

	Years ended December 31,		
	2011	2012	2013
Advertising services provided by Beijing 58 Information and Technology Co., Ltd. ("Beijing 58") (ii)	493	141	101
Advertising services provided by Beijing Chengshi Wanglin Information and Technology Co., Ltd. ("Chengshi Wanglin") (ii)	—	153	11
<b>Total</b>	<b>493</b>	<b>294</b>	<b>112</b>
Rental income generated from Lebai	—	99	159
Tutoring related services income generated from Lebai	—	—	117
<b>Total</b>	<b>—</b>	<b>99</b>	<b>276</b>

- (ii) Yao Jinbo, a beneficial owner of the Group, is also the chairman and shareholder of Beijing 58 and Chengshi Wanglin. Beijing 58 and Chengshi Wanglin provided advertisement services to the Group. There was no unsettled balance as of December 31, 2012 and 2013.

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**18. STATUTORY RESERVES**

Prior to payment of dividends, pursuant to the PRC laws and regulations, enterprises incorporated in the PRC must make appropriations from after-tax profit to non-distributable reserve funds as determined by the Board of Directors of each company. These reserves include (i) general reserve, and (ii) other reserves at the discretion of the Board of Director.

Subject to certain cumulative limits, the general reserve requires annual appropriations of 10% of after-tax profits as determined under PRC laws and regulations at each year-end until the balance reaches 50% of the PRC entity registered capital; the other reserve appropriations are at the Company's discretion. These reserves can only be used for specific purposes of enterprise expansion and are not distributable as cash dividends. The Company's subsidiaries, the VIE and the VIE's subsidiaries contributed \$108, \$370 and \$1,114 to the general reserve during the years ended December 31, 2011, 2012 and 2013, respectively.

PRC laws and regulations require private schools that require reasonable returns to make annual appropriations of 25% of after-tax income before payments of dividend to a fund to be used for the construction or maintenance of the school or procurement or upgrading of educational equipment. For private schools that do not require reasonable returns, this amount should be equivalent to no less than 25% of the annual increase of its net assets as determined in accordance with generally accepted accounting principles in the PRC. The Group's private schools made appropriation to the reserve of \$913, \$114 and \$810 for the years ended December 31, 2011, 2012 and 2013, respectively.

These reserves are included as statutory reserves in the consolidated statements of changes in equity. The statutory reserves cannot be transferred to the Company in the form of loans or advances and are not distributable as cash dividends except in the event of liquidation.

**19. RESTRICTED NET ASSETS**

Under the PRC laws and regulations, distributions by the PRC entities can only be paid out of distributable profits computed in accordance with the PRC GAAP, and the PRC entities are restricted from transferring a portion of their net assets to the Company. Amounts restricted include paid-in capital and the statutory reserves of the Company's PRC entities. The balance of restricted net assets was \$34,114 as of December 31, 2013.

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### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - continued FOR THE YEARS ENDED DECEMBER 31, 2011, 2012 AND 2013 (In thousands of U.S. dollars, except for shares and per share data)

#### 20. SEGMENT INFORMATION

The Group is mainly engaged in private personalized tutoring services in the PRC. The Group's chief operating decision maker ("CODM") has been identified as the Chief Executive Officer who reviews results of operations by geographic location (i.e. city rather than learning centers), each location constituting a subsidiary of Xueda Information, when making decisions about allocating resources and assessing performance of the Group. Consequently, the Group has determined that each location represents an operating segment. However, under the aggregation criteria set forth in the US GAAP with respect to segment reporting, the Group operates in only one reportable segment as all of its operating segments have similar economic characteristics and provide the same tutoring services.

The Group's net revenues for the years ended December 31, 2011, 2012 and 2013 were all generated from the services provided in the PRC. The Group's long-lived assets as of December 31, 2012 and 2013 were all located in the PRC.

#### 21. SUBSEQUENT EVENTS

- (1) On February 27, 2014, the Group declared a cash dividend in the amount of \$0.16 per ADS. The cash dividend will be paid out of additional paid-in capital on April 15, 2014 to shareholders of record at the closure of business on March 28, 2014. The aggregate amount of cash dividends to be paid is approximately \$11,000.
- (2) On March 25, 2014, the Company announced that the Company and some members of its senior management have jointly offered to repurchase or purchase 12 million unregistered ordinary shares of the Company from a co-founder and certain pre-IPO investors, including 2 million unregistered ordinary shares (equivalent to 1 million ADSs) from Mr. Jinbo Yao, co-founder of the Company, and 4 million and 6 million unregistered ordinary shares, respectively (equivalent to 2 million and 3 million ADSs, respectively), from CDH Xueda Limited and Warburg Pincus, LLC, the Company's pre-IPO venture capital investors.

The privately negotiated aggregate price for the repurchase and purchases was approximately \$31,100. The Company's Board of Directors has approved to fund approximately \$28,200 from the Company's available working capital to repurchase approximately 10.9 million ordinary shares (equivalent to 5.4 million ADSs), which the Company intended to retire from its outstanding shares. Concurrently, certain members of the Company's senior management will use their personal funds of approximately \$2,900 to purchase approximately 1.1 million ordinary shares (equivalent to 555,000 ADSs).



个性化教育  
Personalized Education

Xueda Education Group

Code of Business Conduct and Ethics





**All My Colleagues in Xueda Education Group:**

The reputation of the Company is crucial to us, thus to ensure all business activities of Xueda Education Group (hereinafter referred to as “**Xueda**” or the “**Company**”) in compliance with the highest ethical and legal conduct code is the duty of every Xuedaer. *Xueda Education Group Code of Business Conduct and Ethics* (hereinafter referred to as the “**Code**”) is also designed to help you understand how to maintain and promote the Company’s reputation, unite our enterprise and the entire staff, and make them become a community of interests and values.

To strictly comply with this Code is the duty of each employee. The managers of each department shall clearly and accurately articulate this Code to the staff in the department, and shall be responsible for the implementation of the Code in their respective departments, and meanwhile shall reiterate the importance of this Code to the seasoned and fresh employees in the departments at least once on an annual basis. Violation of the Code may lead to serious consequences such as dismissal, or even assumption of civil or criminal liability in certain circumstances.

The established Compliance Committee of the Company will be responsible for the implementation of all compliance policies of the Company, including this Code. The Compliance Committee consists of the Chief Executive Officer, the Chief Financial Officer, Senior Director of Human Resources, the Chief Counsel of the Company and other staff appointed from time to time by the Company.

This Code will apply to you, your spouse and your close relatives. It will also apply to the partnerships, funds or other entities controlled by you, your spouse or your relatives.

Every Xuedaer, please keep in mind that the reputation of Xueda is created by us, each Xuedaer, with every effort every day. Integrity is consistently the core of Xueda’s culture; it was so in the past and will always be so in the future. Let us work together to maintain the reputation and the culture of Xueda and strive for building up Xueda as a great education enterprise!

Thank you!

**Chief Executive Officer,  
Xueda Education Group**



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April 18, 2013

**As an employee of Xueda Education Group, during the period of employment, you shall comply with the following code of conduct:**

1. It is prohibited to engage in any activity which would conflict with the interest of the Company, such as competing business, corporate opportunities, financial interests, part-time behavior and personal business activities, etc.
2. It is prohibited to take advantage of your position and power to engage in any activity, which would impair the interest of the Company, such as encroachment of property of the Company, counterfeit of contracts, scalp of courses, false record of courses, false reimbursement and false accounting, etc. Any employee is prohibited to conceal any fund or asset or not to include the same into the account of the Company in any event. Otherwise, the employee will be accused of the criminal liability for such prohibited behavior.
3. To comply with the rules and policies of the Company on confidentiality and perform the duties of confidentiality relevant to your position.
4. To protect the assets and intellectual property of the Group and ensure that the assets can be effectively used for proper business purposes. For example, any courseware, invention, work, computer software, know-how or commercial information, as a result of performance of your duties, shall remain with the Company's property and is prohibited to be used privately or disclosed to any competitor.
5. Only without prejudice to making objective and fair business decision and strictly in compliance with the prior approval in Xueda's internal approval process for entertainment expenses, gifts can be exchanges with customers or suppliers or entertainments can be treated.
6. It is prohibited to conduct any stock trading by virtue of insider information of the Group. Such behavior is illegal and the law-breaker will assume the criminal liability for it.
7. To be obligated to report any behavior which would impair the interest of the Company to the Compliance Committee. Whistle-blowing email of the Group: jubao@21edu.com.

Please carefully read and be aware of the full text of *Xueda Education Code of Business Conduct and Ethics* below.

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## **Xueda Education**

### **Code of Business Conduct and Ethics**

Xuedaers will be committed to the highest standards of good faith and engrave “always adhering to honesty and integrity” in the values of Xueda Education and all Xuedaers minds.

#### **I. Definition**

“Xueda” or “Company” means Xueda Education Group and all of its subsidiary companies and training schools.

“Employees” mean all employees who ordinarily enter into employment contracts (or form employment relationships) with Xueda Education Group or any of its subsidiary companies or training schools and work for Xueda.

“Workplace” means all places owned, leased or otherwise occupied by Xueda and ordinarily used for the business of the Company, including offices and working sites.

#### **II. Purpose**

This Code of Business Conduct and Ethics (the “Code”) sets out general guidelines for conducting the business of China Xueda Education Group in accordance with the highest standard of business ethics. To the extent this Code requires a higher standard

than that required by commercial practice or applicable laws, rules or regulations, we adhere to these higher standards.

### **III. Applicability**

We firmly believe that all business achievements of the Group rely on the goodwill of the Group and all employees, including, but not limited to directors and senior managements, as well as all employees' compliance with the highest standard of integrity and principled business ethics. Therefore, this Code applies to all units which will be included in the consolidated statements of the Company as required under the General Accepted Accounting Principles in the United States (the "U.S. GAAP"), including, but not limited to China Xueda Education Group and all of its affiliates or subsidiaries worldwide (the "Group"). This Code also applies to all Employees, whether they work for the Company on a full-time, part-time, consultative, or temporary basis, including, but not limited to all of the directors, senior managements, employees and advisors of the Company (the "Applicable Person")

### **IV. This Code is designed to deter wrongdoing, or non-compliance and to promote:**

- to act in accordance with the highest standard of personal good faith and professional ethics, and consistently comply with all applicable laws, rules and regulations;
- to always do right things honestly and ethically, including ethically handling actual or nominal conflicts of interest between personal and professional relationships;
- to completely, fairly, accurately, promptly, and clearly file or submit all reports and documents with U.S. Securities and Exchange Commission (the "SEC") and make full, fair, accurate, timely and understandable disclosure;
- to promptly and internally report violations of the Code;
- to adhere to the accountability for the Code;

- This Code was adopted by the Board of Directors of Xueda Education Group and became effective as of April 6, 2013, and released in the intranet and extranet of the Company, regularly circulated to all Applicable Persons.

## **V. Statement**

To adhere to this Code is each Applicable Person's primary responsibility. All Applicable Persons firmly adhere to honesty and ethics as the code of conduct and comply with the highest standard of personal and professional good faith, do not tolerate any others to attempt to break or avoid the responsibility of ethics and good faith. When an Applicable Person performs his relevant duties, each decision shall be made in accordance with the standard of honesty and ethics.

### **Special Statement of Directors and Senior Managements of the Group**

- to uphold honesty and integrity by setting an example and adhere to the highest standard of good faith;
- to ensure the Applicable Persons have sufficient knowledge, aspiration and resources to comply with this Code;
- to supervise the Applicable Persons to comply with this Code;
- to implement this Code and all other relevant standards of the Company;
- to support questions, improvements or concerns raised by the Employees with respect to compliance with the professional ethics;
- to report violation of this Code to the Compliance Committee.

## **VI. Conflicts of Interest**

### **Identification of Conflicts of Interest**

A conflict of interest occurs when an Applicable Person influences, or would influence, in any manner, the objective interests of the Group as a whole. You should actively avoid any private interest that would influence your ability to act in the

interests of the Group or that would make it difficult for you to perform your work objectively and effectively. You should not take advantage of your position or the power in connection therewith to seek the private interest for yourself, your family or friends and should avoid your personal interest (or the interest of your family) to conflict or overlap with the interest of the Company or cause any potential conflict or overlap.

**Major conflicts of interest are as follows:**

**Competing Business**

**Any Applicable Person covenants:**

- during the period of employment, not to concurrently serve or hold a position in any business that competes with the Group;
- during the period of employment, not to organize a company by himself/herself or on his/her behalf or as an actual controller to compete with the Group;
- not to seize the customers and resources of the Group before leaving office and not to take away the customers and resources of the Group;
- not to induce any other employee to leave office and have adverse effect on the Company;
- during the non-competition period after leaving office, not to carry on any business which competes with the Company or not to be employed by any company which engage in the business competing with the Company;
- Involving his close relatives or by mean of the name of another person, shall be deemed as the Applicable Person's act.

The acts above, if approved in written by the Board of Directors of the Group, shall be exceptional.



### **Corporate Opportunity**

No Applicable Person should use the property, information of the Group or his or her position with the Group to secure a business opportunity that would otherwise be available to the Group. If you discover a business opportunity that is in the Group's line of business, by using the property, information of the Group or by virtue of your position in the Group, you must first present the business opportunity to the Group before pursuing the opportunity in your individual capacity. For example, if the associated relationship (or financial interest) between an Applicable Person and any other person or entity, based on reasonable speculation, would influence his or her independent judgment in the best interest of the Group, then the associated relationship or financial interest shall be deemed as a conflict of interest.

### **Financial Interest**

- No Applicable Person may have any financial interest (ownership or beneficial interest) in any other business entity if such financial interest adversely affects his or her performance of duties to the Company, or requires the Applicable Person to devote significant working hours at the Company;
- No Applicable Person may hold any ownership interest in a company competing with the Company;
- The fact that an Applicable Person has financial interest in a or a potential competitor to, a customer or supplier of the Group or a contracting party with the Group shall be deemed as a conflict of interest, however, provided that an Applicable Person may hold up to but no more than 5% ownership in a publicly traded company competing with the Group;
- Other than the ordinary remuneration, if an Applicable Person engages in any transaction related to this Group and make profits therefrom without any legal basis, this shall be deemed as a conflict of interest. Such transaction includes borrowing or lending funds from or to or secure debts for, accept gifts, entertainments or presents from a competitor to, a customer or supplier of the Group or a contracting party with the Group;
- If an Applicable Person uses or discloses the non-public information of the Company, which he or she obtains by virtue of his or her position, for personal interest, it shall be deemed as a conflict of interest;
- Loans or Other Financial Transactions. No Applicable Person may obtain loans or guarantees of personal obligations from, or enter into any other personal financial transaction with, any company that is a major customer, supplier or competitor of the Company. This Code does not prohibit arm's-length transactions with recognized banks or other financial institutions;

- It is hard to list all circumstances which would give rise to conflicts of interest. We hope an Applicable Person could avoid any circumstance which would give rise to actual or nominal conflicts of interest. All actual or nominal conflicts of interest shall be settled in accordance with integrity and ethics.

#### **Part-time Behavior and Personal Business Activities**

An Employee shall avoid any part-time behavior in conflict with his or her fidelity obligations to the Company or interest of the Company, in particular:

- The Employee shall not be directly or indirectly employed by any competitor to the Company or work for it, serving as a formal employee, contracted employee, consultant or any other position;
- Without prior approval in written by the Compliance Committee, the Employee shall not directly or indirectly be employed by any other company or entity or work for it, serving as a formal employee, contracted employee, consultant or any other position;
- Without prior approval in written by the Compliance Committee, the Employee shall not market or provide any products/services which are similar to the products/services of the Company;
- The Employee shall not market any products/services of any competitor to the Company or in any manner, support or promote the marketing activities of any competitor to the Company;
- The Employee shall not occupy his or her working hours at the Company for any other company;
- The Employee shall not take advantage of any resource of the Company, such as the computer network and the office equipment, for any other company.

With respect to the policies for external part-time jobs and the relevant application process of the Company, please consult with the Human Resources Department of the Company.

## **Disclosure of Conflicts of Interest**

The Company requires that the Applicable Persons fully disclose any situation that could be reasonably expected to give rise to a conflict of interest. If an Applicable Person suspects that he or she may have a conflict of interest, he or she must report it immediately to his or her direct superior or a higher officer and ask for direction. Meanwhile, directors or financial officers are required to report the relevant conflicts of interest to the Board of Directors and the Compliance Committee. Other officers and Employees are required to report the relevant matters to their direct superiors. Conflicts of interest may only be waived by the Board of Directors or the Compliance Committee and will be promptly disclosed to the public to the extent required by law.

## **VII. Internal Accounting Control**

The Company pays the highest degree of attention to maintaining its sound financial disclosure. The annual report, quarterly report and press release of the Company and other public disclosure of the Company's financial conditions embody that the Company attaches great importance to such responsibility.

For this purpose, the Company adopts a detailed "Company Disclosure Policy" and other forms to require the Compliance Committee to quarterly discuss the internal accounting control status, the fairness and completeness of the report system and financial information of the Company in connection with the responsibility of disclosure. The Compliance Committee will assist the senior management and the Audit Committee of the Board in supervising the internal accounting control regime and evaluating the disclosure process of the Company.

The Employee should assist the senior management and the Board of Directors in maintaining fair and complete financial records of the Company. The Employee shall comply with all relevant accounting system and rules, as well as the accounting policy of the Company. The books and records of the Company shall be properly prepared and maintained. It is prohibited to make any false accounts. It is also prohibited to pay any amounts without stating the detailed purpose and the nature of

such payment, or complying with supporting documents. Without any duly authorization, any Employee shall not be entitled to access to the books and records of the Company or use the assets of the Company.

If you finds any behavior which makes you suspect the fairness and completeness of the internal accounting control/disclosure of the Company, or you have reasons to doubt the accuracy of the financial reports of the Company, please immediately report these things to the Compliance Committee. If it is not convenient for you to tell your name, you can report anonymously. It is strictly prohibited to retaliate against any Employee reporting these problems.

#### **VIII. Confidentiality of Trade Secrets**

During the term of employment, an Applicable Person must comply with any and all written or unwritten rules and policies concerning confidentiality and shall fulfill the duties and responsibilities of confidentiality relevant to his or her position at the Group.

To the extent that no relevant rules set out in the confidentiality policies or there exist uncertainties in such policies, an Applicable Person shall also, adhering to the attitude of prudence and honesty, take any necessary and reasonable measures to safeguard the secrecy of the know-hows and trade secrets of the Group, known or held by him or her, during the term of employment, or the same owned by any third party, but subject to the confidentiality obligations of the Company.

Except required for performance of his or her duties, an Applicable Person covenants, without first obtaining special approval from the Group, he or she shall not disclose, announce, release, publish, instruct, transfer or otherwise make any third party available to know-hows and trade secrets owned by the Group or not owned by the Group but subject to the Group's confidentiality obligation, nor shall use such confidential information out of the course of his or her duties to the Company.

#### **IX. Intellectual Property**

All inventions, creative works, computer software, and know-how or other trade secrets developed by an Applicable Person in the course of performing his or her

duties or primarily by using the Group's materials and technical resources while working at the Group, shall remain with the property of the Group. The Group can freely use these inventions, works, computer software, know-how or other trade secrets within its business scope to carry out production, operation or transfer them to any third party. The Applicable Person should, upon the Group's request, provide all necessary information and take all necessary actions, including application, registration and etc., to assist the Group in obtaining and exercising the relevant intellectual property.

With respect to the inventions, works, computer software, know-how or other trade secrets above, the relevant moral rights (excluding the right of authorship entitled to the Group under the law) can be enjoyed by the Applicable Person as the inventor, creator or developer. The Group respects the moral rights of the Applicable Person and assist the Applicable Person in exercising these rights.

#### **X. Family Members and Work**

The actions of family members outside the workplace may also give rise to conflicts of interest because these actions may influence an Applicable Person's objectivity in making decisions on behalf of the Company. If a family member of an Applicable Person is interested in doing business with the Company, the criteria as to whether to enter into or continue the business relationship, and the terms and conditions of the relationship, must be no less favorable to the Company compared with those that would apply to a non-relative seeking to do business with the Company under similar circumstances.

An Applicable Person should report any situation involving family members that could reasonably be expected to give rise to a conflict of interest to his or her supervisor or the Compliance Committee. For purposes of this Code, "Family Members" include your spouse, children, brothers and sisters, parents and parents in-laws.

## **XI. Commercial Gifts and Entertainments**

The Group's business conduct is based on the principle of "fair transaction." Therefore, no Applicable Person may give or receive kickbacks, bribery, or secretly accept or seek commissions or any other personal benefits.

Commercial gifts and entertainments can express compliments. Appropriate commercial gifts and entertainments are welcome courtesies designed to build relationships and understandings among business partners. However, the relationships with them must be based on a reasonable business decision and a fair transaction. Gifts and entertainments should never impair, or potentially impair, the Applicable Person's ability to make objective and fair business decisions.

It is the responsibility of an Applicable Person to use good judgment in this regard. Generally speaking, an Applicable Person may give or receive gifts or entertainments to or from customers or suppliers only if the gifts or entertainments could not be viewed as an inducement to any particular business decision. All gifts and entertainments expenses made on behalf of the Company must be properly accounted for on expense reports.

An Applicable Person may only accept appropriate gifts. The Group encourages an Applicable Person to submit gifts received to the Group. It is not required to obtain approval for appropriate gifts and/or entertainments and/or gifts or entertainments valued below RMB300 as follows:

- occasionally meal with partners;
- occasionally invited to participate in cultural and sports activities;
- other reasonable and routine gifts and entertainments, including holiday gifts.

The total value of such unilateral gifts received from a customer each year shall be controlled within a reasonable range. The ordinary promotional materials with nominal value received from a customer, such as a pen or a calendar, do not require approval.

### **Gifts and Entertainments Not Permitted to Receive**

Receiving expensive gifts, and/or accepting other types of entertainments, or often accepting unilateral gifts and entertainments is obviously wrong, whether or not a *fait accompli*, the Group absolutely prohibits such actions, no person shall be entitled to approve such actions. The actions above may violate a variety of laws and regulations, including the United States Foreign Corrupt Practices Act (the “FCPA”). The Company strictly prohibits any Employee to make any payments or dealings prohibited under the FCPA. An Applicable Person must not accept any of the followings from a customer or a supplier:

- any illegal gifts or entertainments or gifts or entertainments which would result in illegality;
- any cash gifts or cash equivalents (such as coupons, loans, stocks, stock options);
- treats or gifts provided by the other party as a “reward”, or as part of a deal, gifts or entertainments provided by the other party as a condition to a deal;
- recreational activities, treats or gifts which are indecent and for sexual purposes, or contrary to the principles of mutual respect that we are committed to;
- any activities which cause any other person to entertain or give gifts while such entertainments or gifts violate the policies of the employer of the person.

### **Must Ask for Instruction under any of the Following Circumstances**

If you encounter entertainments or gifts not attributable to two categories above and not sure whether you can accept or not, you must report to your superior for approval. For example:

- gifts or entertainment activities valued over RMB300;



- large cultural and sports activities, such as large games ticket or a large cultural show;
- any travel or entertainment event lasting more than one day.

### **Treats and Gifts**

You must be cautious to treats or gifts. Provision of social networking arrangements or business etiquette with symbolic value, such as moderate gifts, caterings or entertainments, is common practice in a commercial society for building up friendly atmosphere and enhancing the business relationship. You shall determine whether the specific approach is appropriate and proper. Occasional treats or gifts with nominal value from or to a non-governmental individual or entity are appropriate, except that the employer of the receiver prohibits this practice.

**Certain behaviors are always prohibited. You must not make or take any of the following treats or gifts which are:**

- illegal;
- knowingly in violation of the policies of the other party's organization;
- cash or other financial instruments (such as bank check, travel check, draft, investment securities or negotiable notes);
- indecent and related to sex, or contrary to the principles of mutual respect that we are committed to;
- of reward nature (provide some rewards)
- without appropriate records;
- treats or gifts to governmental officials without prior approval by the Compliance Committee of the Company.

The Group does not recognize a variety of political contributions or political donations and considers such acts as bribery, except with prior written approval by the Compliance Committee of the Company.

## **XII. Compliance with Relevant Laws and Regulations**

One of fundamentals for establishing this Code is to fully comply with all relevant laws and regulations, and terms and spirits set out in the listing requirements and rules of the stock exchange where the Company is listed.

The Group and all Applicable Persons must understand and have responsibility to ensure compliance with the laws of the cities, provinces, regions and countries in which the Group is registered or operates its business, including, but not limited to laws related to copyrights, trademarks and trade secrets, privacy, insider trading, commercial bribery and kickbacks, offering or receiving gratuities, employment harassment, fire control and public security, false or misleading financial information, misuse of corporate assets. You should understand and comply with all laws, rules and regulations that apply to your position at the Company. If any doubt exists about whether an act is lawful, you should immediately seek advices from the Chief Counsel of the Company.

## **XIII. Protection and Reasonable Use of Assets**

An Applicable Person should protect the Group's assets, including, but not limited to tangible assets and intangible assets and ensure efficient and exclusive use of them for legitimate business purposes only. Theft, negligence, waste, misconduct and malfeasance will have a direct impact on the Group's profitability. The use of the funds or assets of the Group, whether the final benefits therefrom are personal or not, for any unlawful or improper purpose is strictly prohibited.

**To ensure the protection and proper use of the Group's assets, all Applicable Persons should:**

- exercise reasonable care to prevent theft, damage or misuse of the Group's property;

- promptly report the actual or suspected theft, damage or misuse of the Group's property;
- safeguard all electronic programs, data, communications and written materials from improper access by others; and
- use the Group's property for legitimate business purposes.

#### **XIV. Complete, fair, Accurate, Timely and Clear Disclosure**

The Group is obligated to report and disclose its financial results and other material information about its business to the public and the SEC. The Group is committed to promptly disclose accurate and complete information regarding its business, financial condition and results of operations. An Applicable Person must strictly comply with all applicable standards, laws, regulations and policies for accounting and financial reporting of transactions, estimates and forecasts. Inaccurate, incomplete or untimely reporting will be intolerable and can severely damage the Group's goodwill and result in serious legal liability.

**Applicable Persons should prevent from, and promptly report, any possibility of inaccurate or incomplete financial reporting. Particular attention should be paid to:**

- the performance of the underlying business inconsistent with a variety of financial statements;
- transactions without an lawful, reasonable business purpose;
- circumvention of requirements for ordinary review and approval, filing procedures.

To ensure the public reports are complete, fair and clear, an Applicable Person may be required to provide or prepare necessary information. The Group hopes that the relevant Applicable Persons solemnly treat this duty and provide the accurate relevant information in accordance with the requirements for public disclosure.

The Group's senior financial officers and other employees working in the finance department have special responsibilities to ensure that all of the Group's financial disclosures are full, fair, accurate, timely and understandable. Any practice or situation that might undermine this objective should be reported for obtaining written approval.

#### **Disclosure of Norms**

**The Company will disclose such norms to the public in one or more manners as follows:**

- the Company can disclose such norms as an attachment to the annual report;
- the Company can post such norms on the website of the Company, if so, the Company shall disclose the website of the Company in its annual report and state its intention to use such disclosure manner;
- the Company can also, in the annual report, undertake to provide such norms to any person upon his or her request free of charge.

**The Company will promptly disclose the following content in Form 8-K:**

- All changes to norms applicable to the CEO, CFO, the accounting director and other persons performing the relevant duties (the "Designated Persons"); and
- A list of all persons who are exempted from liability under certain provisions of such norms and the corresponding dates, whether granted by the Company to the Designated Persons or impliedly.

#### **XV. Company Records**

Accurate and reliable records are crucial to the Group's business and form the basis of its earnings statements, financial reports and other disclosures to the public. The Company's records are the source of essential data that guides business decision-making and strategic planning. The Company records include, but not

limited to, business data, transaction information, financial records, electronic data files and all other records maintained in the ordinary course of our business.

All Company records must be complete, accurate and reliable in all material respects. There is never an acceptable reason to make false or misleading entries. Undisclosed or unrecorded funds, payments or receipts are strictly prohibited.

All books and records shall comply with requirements of U.S.GAAP or other applicable accounting principles, fully and truly reflecting the transactions of the Group. It is not permitted to intentionally hide or distort the truth of transactions in the books and records of the Company. Applicable Persons shall ensure all books and records consistent with established procedures for disclosure and control, and internal control rules for financial reports. In addition, it shall be fully noted that these control procedures will be adjusted according to the actual situations and disclosure requirements in the future.

All Applicable Persons shall report the accounting issues they think questionable. This rule applies to all reports and records for internal and external use. If any Applicable Person finds any suspected accounting issues of the Group, he or she should promptly report the relevant matters to a member of the Compliance Committee or directly report the same to the united whistle-blowing email box of the Group

#### **XVI. Insider Information Trading**

Insider information includes all non-public information which would influence investment decisions from the perspective of investors, whether favorable or unfavorable. Insider information is not necessarily confirmative information, also includes prospective information, and even may also include information which conveys “possible” events, such as unreleased financial results, the upcoming administrative approvals or refusals in connection with combination, merger & acquisition or restructure of significant assets of the Company, threatened major litigations, arbitrations or any other commercially important facts.

The Group has already established the anti-insider trading policies, applicable to all directors, senior managements and employees. Such policies prohibit you to trade the stocks of the Group or any of its affiliates or partners. Such policies also prohibit you to “remind” others of any insider information, including, but not limited to your spouse, associates, friends or brokers.

You have responsibilities to comply with the anti-insider trading policies, if you have any questions or concerns in this regard, please contact the CFO or the Chief Counsel of the Group.

The violation of insider trading policies may lead to assumption of severe civil or criminal liability. If you believe that you may hold important non-public information, please be sure to consult with the CFO or the Chief Counsel before any stock trading.

## **XVII. Fraud and Similar Misconducts**

The Company prohibits any form of fraudulent conducts. Fraudulent conducts include, but not limited to:

- dishonest or deceptive acts;
- to encroach the Company’s property, by means of violating the policies for finance and contract management, falsely stating and claiming or false contracts or otherwise, for seeking improper benefits;
- to forge or alter promissory notes, such as the checks or drafts of the Company;
- to forge or alter the seal of the Company;
- to embezzle the property of the Company, the employees, customers, partners or suppliers;
- to scalp, transfer, forge or alter course hours for seeking improper benefits;
- to misappropriate the cash, marketable securities, supplies or other property of the Company;

- unauthorized disposal or disclosure of the Company's transactions;
- To tamper with the Company's records or financial reports privately or for any other reasons.

Where each employee is aware of any possible or occurred fraudulent activities, he or she shall be obligated to immediately report such activities to the Compliance Committee.

#### **XVIII. Misleading Auditor for Financial Reports of the Company**

The Company's officers are prohibited from taking any action or instructing others to coerce, manipulate, mislead or fraudulently influence the Company's auditors to render the financial statements of the Company materially misleading.

**Prohibited acts include:**

- if the auditor challenges to the accounting books of the Company, to threaten to cancel the ongoing or upcoming audit services;
- if an auditor challenges to the accounting books of the Company, to manage to cause the auditor to withdraw from such auditing;
- to provide the auditor with wrong or misleading legal analysis;
- to bribe or induce to provide employment opportunities or contracts for evading the auditing;
- blackmail or violent coercion.

#### **XIX. Violation of this Code**

The Group will investigate and evaluate any violation of this Code and such violation will be subject to appropriate discipline, based upon the facts and circumstances case by case. This discipline will result in serious consequences to your occupational development, even being dismissed. If your improper conduct causes losses to the Group, you will be claimed by the Group for compensation.

## **XX. Whistleblowing Violation of this Code**

All Applicable Persons have their duties to report any known or suspected violation of this Code, including any violation of laws, rules, regulations or policies that apply to the Group. Reporting a known or suspected violation of this Code will not be considered as an act of disloyalty, but an act to safeguard the reputation and integrity of the Company and its employees.

If an Applicable Person is aware of any violation of this Code, he or she should immediately report the violation to the appropriate person as follows: to report to the dedicated whistleblowing email of the Group (jubao@21edu.com); to report to his or her direct superior or the higher supervisor in oral or in written. If, for some reasons, you are not convenient to report directly, or you encounter any improper obstacle, please directly inform the same to any member of the Compliance Committee, CEO, CFO, or the Chairman of the Audit Committee of the Board of Xueda. You can also report anonymously. All questions and reports of known or suspected violations of this Code will be treated with sensitivity and discretion. The Group will carry out a reward policy to the persons who report the truth so as to encourage reporting, promote honesty and integrity.

The special department of the Group will sincerely and carefully investigate the reported violation of this Code. The Group and the person in charge of reported matters will strictly keep confidentiality for the whistleblower.

It is strictly prohibited to retaliate against a bona fide whistleblower. If a whistleblower is suffered from reprisal or retaliation for reporting a known or suspected violation, the retaliating person will be subject to disciplinary action up to and including termination of employment.

## **XXI. Waiver of this Code**

Waivers of this Code will be granted on a case-by-case basis and only in extraordinary circumstances. Waivers of this Code may be decided only by the Board of Directors, or the appropriate committee of the Board of Directors, and will be



promptly disclosed in accordance with the law, regulations of the SEC and the relevant rules and listing requirements of the stock exchange on which the Company is listed.

## **XXII. Program for Build-up of Code of Business Conduct and Ethics**

The program for build-up of Code of Business Conduct and Ethics will be fully supported by the Board of Directors of the Group and the established Compliance Committee will be responsible for implementation of all compliance policies, including this Code. The Compliance Committee consists of the CEO, CFO, HR Senior Director, Chief Counsel of the Company and other persons appointed by the Company from time to time. The Company's Board of Directors and the Compliance Committee will jointly supervise the implementation of the program for build-up of Code of Business Conduct and Ethics and the specific approaches are:

- to arrange positions and formulate duties for implementation of this program;
- to supervise the training and communication activities for the program;
- to review and supervise the implementation of the program;
- to supervise the internal investigation process;
- to supervise the discipline review procedures for illegal and irregular acts;
- to supervise the accessibility of the channels to reflect issues.

## **XXIII. Conclusion**

This Code contains general guidelines for conducting the business of the Group in accordance with the highest standards of business ethics. If you have any questions, doubts or suggestions about this Code, please contact the Compliance Committee. We expect all Applicable Persons to adhere to this Code. Each Applicable Person is separately responsible for his or her actions. Any conduct that violates this Code cannot be justified by claiming that it was ordered by his or her superior or someone in higher management. If you engage in any conduct prohibited by this Code, you

will be deemed to have serious violation. Such conduct will subject you to disciplinary action, up to termination of employment.

### **Covenant and Statement**

**To: Xueda Education Group**

I acknowledge formal receipt of the full text of *Xueda Education Group Code of Business Conduct and Ethics* . After carefully reading, I am aware of and understand all contents and provisions in *Xueda Education Group Code of Business Conduct and Ethics* . I work for Xueda Education Group and its subsidiary companies and schools and hereby covenant and state that I will fully accept and strictly comply with all terms in *Xueda Education Group Code of Business Conduct and Ethics* . I clearly understand that the violation of such Code will lead to serious consequences, even being dismissed.

**Signature of Employee:**

**Date:**

**Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Xin Jin, certify that:

1. I have reviewed this annual report on Form 20-F of Xueda Education Group;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: March 31, 2014

By: /s/ Xin Jin  
Name: **Xin Jin**  
Title: **Chief Executive Officer**

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**Certification by the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Christine Lu-Wong, certify that:

1. I have reviewed this annual report on Form 20-F of Xueda Education Group;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: March 31, 2014

By: /s/ Christine Lu-Wong  
Name: **Christine Lu-Wong**  
Title: **Chief Financial Officer**

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**Certification by the Chief Executive Officer**

**Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Annual Report on Form 20-F of Xueda Education Group (the “Company”) for the year ended December 31, 2013 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Xin Jin, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 31, 2014

By: /s/ Xin Jin  
Name: **Xin Jin**  
Title: **Chief Executive Officer**

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**Certification by the Chief Financial Officer****Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Annual Report on Form 20-F of Xueda Education Group (the "Company") for the year ended December 31, 2013 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christine Lu-Wong, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: March 31, 2014

By: /s/ Christine Lu-Wong  
Name: **Christine Lu-Wong**  
Title: **Chief Financial Officer**

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**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We consent to the incorporation by reference in the Registration Statement No. 333-171434 on Form S-8 of our reports dated March 31, 2014, relating to the consolidated financial statements of Xueda Education Group, its subsidiaries, its variable interest entity (the “VIE”) and its VIE’s subsidiaries (collectively, the “Group”), and the effectiveness of the Group’s internal control over financial reporting, appearing in the Annual Report on Form 20-F of Xueda Education Group for the year ended December 31, 2013.

/s/ Deloitte Touche Tohmatsu Certified Public Accountants LLP  
Deloitte Touche Tohmatsu Certified Public Accountants LLP  
Beijing, the People’s Republic of China

March 31, 2014

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