

SYLVAN LEARNING SYSTEMS INC  
Form 10-Q  
August 14, 2002

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

- Quarterly Report pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934 for the quarter ended **June 30, 2002** or
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_ .  
Commission File Number 0-22844
- 

**SYLVAN LEARNING SYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**52-1492296**  
(I.R.S. Employer  
Identification No.)

**1001 Fleet Street, Baltimore, Maryland**  
(Address of principal executive offices)

**21202**  
(Zip Code)

Registrant's telephone number, including area code: **(410) 843-8000**

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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 .

The registrant had 40,328,468 shares of Common Stock outstanding as of August 5, 2002.

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SYLVAN LEARNING SYSTEMS, INC.

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**SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES**

**Consolidated Balance Sheets**

**(Dollar and share amounts in thousands, except per share data)**

|   | <b>June 30,<br/>2002</b> | <b>December 31,<br/>2001</b> |
|---|--------------------------|------------------------------|
|   | <b>(Unaudited)</b>       |                              |
| <b>Assets</b>   |                          |                              |
| Current assets:   |                          |                              |
| Cash and cash equivalents   | \$ 140,799               | \$ 102,194                   |
| Available-for-sale securities   | 35,370                   | 60,091                       |
| Receivables:  |                          |                              |
| Accounts receivable   | 76,856                   | 70,925                       |
| Costs and estimated earnings in excess of billings on uncompleted contracts |                          | 1,586                        |
| Notes receivable from tuition financing                                     | 5,071                    | 7,545                        |
| Other notes receivable  | 29,555                   | 18,185                       |
| Other receivables   | 2,971                    | 3,725                        |

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|   | June 30,<br>2002  | December 31,<br>2001 |
|---|-------------------|----------------------|
|   | 114,453           | 101,966              |
| Allowance for doubtful accounts   | (16,544)          | (11,415)             |
|   | 97,909            | 90,551               |
| Inventory   | 7,340             | 7,344                |
| Deferred income taxes   | 3,819             | 3,810                |
| Prepaid expenses and other current assets   | 27,424            | 23,679               |
| <b>Total current assets</b>   | <b>312,661</b>    | <b>287,669</b>       |
| Notes receivable from tuition financing, less current portion   | 5,804             | 8,636                |
| Other notes receivable, less current portion  | 12,434            | 11,601               |
| Property and equipment:   |                   |                      |
| Land  | 17,061            | 14,552               |
| Buildings   | 101,180           | 88,190               |
| Construction-in-progress  | 17,339            | 8,897                |
| Furniture, computer equipment and software  | 120,953           | 115,140              |
| Leasehold improvements  | 37,052            | 34,876               |
|   | 293,585           | 261,655              |
| Accumulated depreciation  | (70,406)          | (60,147)             |
|   | 223,179           | 201,508              |
| Intangible assets:  |                   |                      |
| Goodwill  | 265,169           | 285,784              |
| Other intangible assets, net of accumulated amortization of \$2,540 and \$1,507, at June 30, 2002 and December 31, 2001, respectively | 5,888             | 6,893                |
|   | 271,057           | 292,677              |
| Investments in and advances to affiliates   | 8,929             | 40,387               |
| Other investments   | 19,602            | 27,326               |
| Deferred income taxes   | 19,027            | 13,823               |
| Deferred costs, net of accumulated amortization of \$4,204 and \$3,322 at June 30, 2002 and December 31, 2001, respectively           | 6,254             | 7,943                |
| Other assets  | 24,000            | 17,621               |
| <b>Total assets</b>   | <b>\$ 902,947</b> | <b>\$ 909,191</b>    |

See accompanying notes to consolidated financial statements.

**SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES**

**Consolidated Balance Sheets (continued)**

**(Dollar and share amounts in thousands, except per share data)**

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|   | June 30,<br>2002  | December 31,<br>2001 |
|---|-------------------|----------------------|
|   | (Unaudited)       |                      |
| <b>Liabilities and stockholders' equity</b>   |                   |                      |
| Current liabilities:  |                   |                      |
| Accounts payable  | \$ 16,169         | \$ 15,696            |
| Accrued expenses  | 69,594            | 49,386               |
| Income taxes payable  | 19,408            | 29,754               |
| Current portion of long-term debt   | 16,513            | 6,449                |
| Due to shareholders of acquired companies   | 3,729             | 3,657                |
| Deferred revenue  | 69,445            | 54,578               |
| Other current liabilities   | 2,144             | 8,154                |
| <b>Total current liabilities</b>  | <b>197,002</b>    | <b>167,674</b>       |
| Long-term debt, less current portion  | 124,148           | 124,474              |
| Other long-term liabilities   | 15,070            | 14,207               |
| <b>Total liabilities</b>  | <b>336,220</b>    | <b>306,355</b>       |
| Minority interest   | 68,206            | 56,981               |
| Stockholders' equity:   |                   |                      |
| Preferred stock, par value \$0.01 per share authorized 10,000 shares, no shares issued and outstanding as of June 30, 2002 and December 31, 2001                  |                   |                      |
| Common stock, par value \$0.01 per share authorized 90,000 shares, issued and outstanding shares of 40,321 as of June 30, 2002 and 38,742 as of December 31, 2001 | 403               | 387                  |
| Additional paid-in capital  | 257,387           | 229,386              |
| Retained earnings   | 261,144           | 342,786              |
| Accumulated other comprehensive loss  | (20,413)          | (26,704)             |
| <b>Total stockholders' equity</b>   | <b>498,521</b>    | <b>545,855</b>       |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 902,947</b> | <b>\$ 909,191</b>    |

See accompanying notes to consolidated financial statements.

**SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Operations**

**(Dollar and share amounts in thousands, except per share data)**

|                 | Three months ended June 30, |      |
|-----------------|-----------------------------|------|
|                 | 2002                        | 2001 |
|                 | (Unaudited)                 |      |
| <b>Revenues</b> |                             |      |

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|   | <b>Three months ended June 30,</b> |                    |
|---|------------------------------------|--------------------|
|   | <b>\$</b>                          | <b>\$</b>          |
| Core operating segments                         | 153,921                            | 126,246            |
| Sylvan Ventures                                 | 5,501                              | 33                 |
| <b>Total revenues</b>                           | <b>159,422</b>                     | <b>126,279</b>     |
| <b>Costs and expenses</b>                       |                                    |                    |
| Direct costs:                                   |                                    |                    |
| Core operating segments                         | 126,067                            | 102,342            |
| Sylvan Ventures                                 | 10,876                             | 3,644              |
| General and administrative expenses:            |                                    |                    |
| Core operating segments                         | 5,712                              | 5,901              |
| Sylvan Ventures                                 | 2,173                              | 3,231              |
| Loss on impairment of assets held for sale      | 17,244                             |                    |
| <b>Total costs and expenses</b>                 | <b>162,072</b>                     | <b>115,118</b>     |
| <b>Operating income (loss)</b>                  | <b>(2,650)</b>                     | <b>11,161</b>      |
| <b>Other income (expense)</b>                   |                                    |                    |
| Investment and other income                     | 1,172                              | 1,817              |
| Interest expense                                | (2,376)                            | (2,405)            |
| Sylvan Ventures investment income (losses)      | 273                                | (238)              |
| Loss on investment                              |                                    | (14,231)           |
| Equity in net loss of affiliates:               |                                    |                    |
| Sylvan Ventures                                 | (1,856)                            | (15,588)           |
| Other   | 61                                 | (137)              |
|   | (1,795)                            | (15,725)           |
| Minority interest in consolidated subsidiaries: |                                    |                    |
| Sylvan Ventures                                 | 832                                | 1,805              |
| Other   | (2,123)                            | (2,600)            |
|   | (1,291)                            | (795)              |
| Loss before income taxes                        | (6,667)                            | (20,416)           |
| Income tax benefit                              | 1,584                              | 6,982              |
| <b>Net loss</b>                                 | <b>\$ (5,083)</b>                  | <b>\$ (13,434)</b> |
| <b>Loss per common share, basic and diluted</b> | <b>\$ (0.13)</b>                   | <b>\$ (0.35)</b>   |

See accompanying notes to consolidated financial statements.

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(Dollar and share amounts in thousands, except per share data)

|   | Six months ended June 30, |                 |
|---|---------------------------|-----------------|
|   | 2002                      | 2001            |
|   | (Unaudited)               |                 |
| <b>Revenues</b>   |                           |                 |
| Core operating segments   | \$ 288,348                | \$ 242,465      |
| Sylvan Ventures   | 9,442                     | 63              |
|   | <u>297,790</u>            | <u>242,528</u>  |
| Total revenues  | 297,790                   | 242,528         |
| <b>Costs and expenses</b>   |                           |                 |
| Direct costs:   |                           |                 |
| Core operating segments   | 245,257                   | 206,355         |
| Sylvan Ventures   | 18,390                    | 7,159           |
| General and administrative expenses:  |                           |                 |
| Core operating segments   | 10,821                    | 11,887          |
| Sylvan Ventures   | 4,819                     | 5,322           |
| Loss on impairment of assets held for sale  | 17,244                    |                 |
|   | <u>296,531</u>            | <u>230,723</u>  |
| Total costs and expenses  | 296,531                   | 230,723         |
| Operating income  | 1,259                     | 11,805          |
| <b>Other income (expense)</b>   |                           |                 |
| Investment and other income   | 2,300                     | 5,144           |
| Interest expense  | (4,379)                   | (4,469)         |
| Sylvan Ventures investment income (losses)  | 273                       | (638)           |
| Loss on investment  |                           | (14,231)        |
| Equity in net loss of affiliates:   |                           |                 |
| Sylvan Ventures   | (3,666)                   | (35,374)        |
| Other   | (37)                      | (263)           |
|   | <u>(3,703)</u>            | <u>(35,637)</u> |
| Minority interest in consolidated subsidiaries:   |                           |                 |
| Sylvan Ventures   | 1,228                     | 3,096           |
| Other   | (3,466)                   | (4,020)         |
|   | <u>(2,238)</u>            | <u>(924)</u>    |
| Loss before income taxes and cumulative effect of change in accounting principle          | (6,488)                   | (38,950)        |
| Income tax benefit  | 989                       | 13,932          |
|   | <u>(5,499)</u>            | <u>(25,018)</u> |
| Loss before cumulative effect of change in accounting principle                           | (5,499)                   | (25,018)        |
| Cumulative effect of change in accounting principle, net of income tax benefit of \$7,700 | (76,143)                  |                 |
|   | <u>(81,642)</u>           | <u>(25,018)</u> |
| Net loss  | \$ (81,642)               | \$ (25,018)     |

|   | Six months ended June 30, |           |
|---|---------------------------|-----------|
|   | 2002                      | 2001      |
| <b>Loss per common share, basic and diluted:</b>                |                           |           |
| Loss before cumulative effect of change in accounting principle | \$ (0.14)                 | \$ (0.66) |
| Net loss  | \$ (2.05)                 | \$ (0.66) |

See accompanying notes to consolidated financial statements

**SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows**

(Amounts in thousands)

|   | Six months ended June 30, |             |
|---|---------------------------|-------------|
|   | 2002                      | 2001        |
|   | (Unaudited)               |             |
| <b>Operating activities</b>   |                           |             |
| Net loss  | \$ (81,642)               | \$ (25,018) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                           |             |
| Cumulative pre-tax effect of change in accounting principle                               | 83,843                    |             |
| Depreciation  | 13,625                    | 12,081      |
| Amortization  | 911                       | 6,395       |
| Loss on impairment of assets held for sale  | 17,244                    |             |
| Deferred income taxes   | 1,946                     | (190)       |
| Loss (gain) on investments  | (273)                     | 14,869      |
| Equity in net loss of affiliates  | 3,703                     | 35,637      |
| Minority interest in income of consolidated subsidiaries                                  | 2,238                     | 924         |
| Other non-cash items  | (458)                     | 835         |
| Changes in operating assets and liabilities:  |                           |             |
| Receivables   | (12,337)                  | 13,526      |
| Tuition loans, net  | 4,107                     | (3,784)     |
| Inventory, prepaid expenses and other current assets                                      | (5,365)                   | (2,165)     |
| Payables and accrued expenses   | 17,429                    | 167         |
| Income taxes payable  | (13,669)                  | (112,440)   |
| Deferred revenue and other current liabilities  | 8,323                     | (8,878)     |
| Net cash provided by (used in) operating activities                                       | 39,625                    | (68,041)    |
| <b>Investing activities</b>   |                           |             |
| Purchase of available-for-sale securities   | (10,537)                  | (108,045)   |
| Proceeds from sale or maturity of available-for-sale securities                           | 35,419                    | 219,759     |
| Investment in and advances to affiliates and other investments                            | 5,143                     | (36,576)    |
| Purchase of property and equipment  | (25,932)                  | (28,292)    |
| Cash paid for acquired businesses, net of cash received                                   | (21,840)                  | (3,005)     |

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|   | <u>Six months ended June 30,</u> |                   |
|---|----------------------------------|-------------------|
| Payment of contingent consideration for prior period acquisitions                 |                                  | (25,145)          |
| Expenditures for deferred contract costs  | (1,039)                          | (2,085)           |
| Increase in other assets  | (2,824)                          | (730)             |
|   | <u>          </u>                | <u>          </u> |
| Net cash provided by (used in) investing activities                               | (21,610)                         | 15,881            |
|   | <u>          </u>                | <u>          </u> |
| <b>Financing activities</b>   |                                  |                   |
| Proceeds from exercise of options   | 14,501                           | 6,958             |
| Proceeds from issuance of debt  | 12,979                           | 9,600             |
| Payments on debt  | (3,527)                          | (9,412)           |
| Cash received from minority members of Sylvan Ventures                            | 10,326                           | 21,899            |
| Cash distributed to minority members of Sylvan Ventures                           | (12,000)                         |                   |
| Increase (decrease) in other long-term liabilities and other financing activities | (1,269)                          | 699               |
|   | <u>          </u>                | <u>          </u> |
| Net cash provided by financing activities   | 21,010                           | 29,744            |
|   | <u>          </u>                | <u>          </u> |
| Effect of exchange rate changes on cash   | (420)                            | (1,823)           |
|   | <u>          </u>                | <u>          </u> |
| Net increase (decrease) in cash and cash equivalents                              | 38,605                           | (24,239)          |
| Cash and cash equivalents at beginning of period                                  | 102,194                          | 116,490           |
|   | <u>          </u>                | <u>          </u> |
| Cash and cash equivalents at end of period  | \$ 140,799                       | \$ 92,251         |
|   | <u>          </u>                | <u>          </u> |

See accompanying notes to consolidated financial statements.

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**Sylvan Learning Systems, Inc. and Subsidiaries**  
**Notes to Consolidated Financial Statements**  
**Unaudited**  
**(Dollar and share amounts in thousands, except per share amounts)**

**June 30, 2002**

**Note 1 Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month and six month periods ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ended December 31, 2002. The traditional semester programs in the education industry, with a summer break, result in large seasonality in the operating results of Sylvan Learning Systems, Inc. (the "Company"). The consolidated balance sheet at December 31, 2001 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2001.

Core operating segments include the operating results of the following business segments: K-12 Education Services, Online Higher Education, International Universities and English Language Instruction-Spain. Sylvan Ventures revenues and direct costs include the operating results of its consolidated investments (refer to Note 6 for further information). Sylvan Ventures general and administrative expenses include the costs incurred to oversee its investments, to build its investment portfolio and costs included in the start-up phase of consolidated businesses prior to the generation of operating revenues.



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Certain amounts previously reported for 2001 have been reclassified to conform with the 2002 presentation.

### Note 2 New Accounting Standards

In June 2001, the Financial Accounting Standards Board issued Statement No. 142, *Goodwill and Other Intangible Assets*, which establishes financial accounting and reporting standards for acquired goodwill and other intangible assets. Under Statement No. 142, goodwill and indefinite-lived intangible assets are no longer amortized but are subject to annual impairment tests in accordance with the new standard. Other intangible assets that have finite lives will continue to be amortized over their useful lives. The Company adopted Statement No. 142 effective January 1, 2002. Refer to Note 5 for further information.

In August 2001, the Financial Accounting Standards Board issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Statement No. 144 supersedes Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and provides a single accounting model for long-lived assets to be held and used or to be disposed of. The Company adopted Statement No. 144 effective January 1, 2002 and the adoption of the new standard did not have a material impact on the Company's consolidated financial position or results of operations.

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### Note 3 Business Held For Sale and Impairment Loss

In June 2002, the Company adopted a plan to sell the portion of its English Language Instruction segment that is located in Spain ("WSI Spain"). As a result of the pending sale and an estimate of the likely sale proceeds, the Company recognized an impairment charge of \$17,244 related to WSI Spain. The impairment charge is included in loss on impairment of assets held for sale in the consolidated statements of operations. Additionally, the Company realigned its English Language Instruction segment to include only the operations of WSI Spain. The remaining English Language Instruction businesses are now included in the International Universities segment to reflect the combination of business management and the interrelationship of the Wall Street Institute operations and the university programs. See Note 13.

### Note 4 Acquisitions

Effective January 1, 2002, the Company acquired substantially all of the net operating assets of three Sylvan Learning Centers franchise businesses, comprising 30 centers, for cash of \$11,000 and 144 shares of Sylvan common stock with a fair market value of \$3,000. The initial purchase price totaled approximately \$14,096, including acquisition costs of \$96. The purchase price was allocated to acquired assets totaling \$15,046 and assumed liabilities of \$950. The preliminary allocation of the purchase price included in the current period is subject to revision based on the final determination of fair values. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. In connection with the acquisition of the franchises, variable amounts of contingent consideration, up to a maximum of an additional \$8,000, are also payable to the sellers if specified levels of operating results are achieved in 2002, 2003, 2004 and 2005. Upon the resolution of these contingent payments, the Company will record as goodwill any additional consideration owed to the sellers. The results of operations of the acquired franchises are included in the accompanying financial statements commencing on January 1, 2002.

On February 1, 2002, Sylvan Ventures exercised its option to acquire an additional 10% ownership of common stock in Walden E-Learning, Inc. ("Walden") for \$8,000, increasing its ownership percentage in Walden to 51%. Prior to the exercise of its option, Sylvan Ventures had acquired a 41% stake in Walden for \$32,800 in February 2001. The transactions have been accounted for as a step acquisition with a total purchase price of \$39,892, after subtracting previously recorded equity in net losses. The purchase price was allocated to acquired assets totaling \$44,007 and assumed liabilities of \$4,115. The preliminary allocation of the purchase price included in the current period is subject to revision based on the final determination of fair values. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of Walden are consolidated in the accompanying financial statements commencing on February 1, 2002.

On March 1, 2002, the Company acquired for cash all of the outstanding common stock of Hedleton Holding, N.V., which owns all of the capital stock of Escuela Superior De Alta Gestion De Hotel, S.A. ("Marbella"), a private for-profit university located in Marbella, Spain. Marbella was previously a franchise of Swiss Hotel Association Hotel Management School Les Roches ("Les Roches"), which was acquired by the Company in 2000. The results of operations of Marbella are included with Les Roches in the International Universities segment. The purchase price for the outstanding common stock totaled approximately \$6,458, including acquisition costs of \$141. The purchase price was allocated to acquired assets totaling \$9,043 and assumed liabilities of \$2,585. The

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preliminary allocation of the purchase price included in the current period is subject to revision based on the final determination of fair values. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of Marbella are included in the accompanying financial statements commencing on March 1, 2002.

Effective May 1, 2002, the Company acquired an additional 20% ownership interest in Desarrollo del Conocimiento S.A. ("Decon"), a consolidated holding company that controls and operates the Universidad de Las Americas ("UDLA"), for cash of approximately \$6,500, increasing its total ownership in Decon to 80%. The purchase price of the additional interest was accounted for as a step acquisition and was allocated to acquired assets of \$6,500. The preliminary allocation of this additional purchase price included in the current period is subject to revision based on the final determination of fair values.

**Note 5 Goodwill and Other Intangible Assets**

Statement No. 142 requires that goodwill be tested for impairment at the reporting unit level at the time of its adoption and at least annually thereafter, utilizing a two-step methodology. The initial step required the Company to determine the fair value of each reporting unit and compare it to the carrying value, including goodwill, of such unit. When the fair value of the reporting unit exceeded the carrying value, no impairment loss was recognized. The second step required the Company to determine the implied fair value of goodwill. When the carrying value of the reporting unit goodwill exceeded the implied fair value of that goodwill, an impairment loss was recognized in an amount equal to that excess, not exceeding the carrying value of the goodwill. The fair values of reporting units and the related implied fair values of their respective goodwill were determined using discounted cash flows.

As a result of testing goodwill for impairment in accordance with Statement No. 142, as of January 1, 2002, the Company recorded a non-cash charge of \$76,143, net of income tax benefit of \$7,700, which is included as a cumulative effect of a change in accounting principle in the consolidated statements of operations. The impairment charge relates solely to the Wall Street Institute business and consists of the write-down of goodwill related to the distressed operations in Spain (\$22,551 included in the English Language Instruction Spain segment) and amounts originally paid for operations in other countries (\$53,592 included in the International Universities segment).

In addition to requiring annual impairment tests, Statement No. 142 established that goodwill will no longer be amortized. Prior to January 1, 2002, the Company amortized goodwill over periods ranging from 15 to 35 years. The following results of operations of the Company give effect to the non-amortization provisions of Statement No. 142 assuming adoption as of January 1, 2001:

|                                 | Three months ended<br>June 30, 2001 |                                       | Six months ended<br>June 30, 2001 |                                       |
|---------------------------------|-------------------------------------|---------------------------------------|-----------------------------------|---------------------------------------|
|                                 | Net Loss                            | Loss Per Share<br>(Basic and Diluted) | Net Loss                          | Loss Per Share<br>(Basic and Diluted) |
| As reported                     | \$ (13,434)                         | \$ (0.35)                             | \$ (25,018)                       | \$ (0.66)                             |
| Effect of goodwill amortization | 3,091                               | 0.08                                  | 6,987                             | 0.19                                  |
| Adjusted                        | \$ (10,343)                         | \$ (0.27)                             | \$ (18,031)                       | \$ (0.47)                             |

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The following table displays the intangible assets that continue to be subject to amortization and goodwill not subject to amortization as of June 30, 2002:

|                          | Amortizing<br>Intangible<br>Assets | Goodwill   |
|--------------------------|------------------------------------|------------|
| Gross carrying amount    | \$ 8,428                           | \$ 265,169 |
| Accumulated amortization | (2,540)                            |            |

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|                     | Amortizing<br>Intangible<br>Assets | Goodwill   |
|---------------------|------------------------------------|------------|
|                     | _____                              | _____      |
|                     | _____                              | _____      |
| Net carrying amount | \$ 5,888                           | \$ 265,169 |
|                     | _____                              | _____      |

The estimated amortization expense for intangible assets for each of the five years subsequent to December 31, 2001 is as follows: 2002 \$1,845; 2003 \$1,802; 2004 \$1,560; 2005 \$646; and 2006 \$412.

**Note 6 Investments**

*Consolidated Investments*

eSylvan, Inc. ("eSylvan") was formed to distribute the Company's learning center tutoring product to students at home via computer. During 2001, eSylvan issued common stock representing a minority ownership interest to franchisees of Sylvan Learning Centers to more fully leverage the relationship between center-based and online tutoring. Sylvan Ventures made two preferred stock purchases during 2002 for \$9,400, which increased the Sylvan Ventures ownership share to 92%. The minority interest ownership of the franchisees represents 8% of the voting ownership interest at June 30, 2002.

Walden E-Learning, Inc. ("Walden") is an online university offering Ph.D. and other graduate-level degree programs in education, management and the social and behavioral sciences. Effective February 1, 2002, Sylvan Ventures exercised its option to acquire an additional 10% of Walden, increasing its voting ownership to 51%. As a result, Sylvan Ventures changed its method of accounting for its investment in Walden from the equity method to the consolidation method.

EdVerify, Inc. ("EdVerify") is a business to business digital service provider that specializes in verifying the higher education enrollment and degree attainment of job candidates and credit requestors. Effective June 1, 2002, Sylvan Ventures acquired an additional 35% ownership in EdVerify for \$2,507, increasing its voting ownership to 68%. As a result, Sylvan Ventures changed its method of accounting for its investment in EdVerify from the equity method to the consolidation method.

Connections Academy was formed by Sylvan Ventures to provide online charter schooling to the K-12 market. Connections Academy will begin providing virtual schooling to students in the fall of 2002. Sylvan Ventures owns 100% of Connections Academy and reports the start-up costs of this entity in the general and administrative expenses of Sylvan Ventures until revenues are earned.

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*Investment in Affiliates (Equity Method Investments):*

The Company's investment in and advances to affiliates consist of investments in and loans to companies in the initial or early stages of development. These companies are frequently illiquid or experiencing cash flow deficits from operations. Further, investments are generally unsecured and subordinated to the claims of other creditors. Accordingly, the Company's investments in and advances to affiliates are subject to a high degree of investment and credit risk. The Company has made estimates of the recoverability of loans and advances to its affiliates, and due to the inherent uncertainty of the operations of these affiliates, it is possible that these estimates may change in the near term.

Investments in and advances to affiliates consist principally of investments in common stock and preferred stock, as follows as of June 30, 2002 and December 31, 2001, respectively:

|                           | June 30,<br>2002 | Ownership<br>Interest | December 31,<br>2001 | Ownership<br>Interest |
|---------------------------|------------------|-----------------------|----------------------|-----------------------|
|                           | _____            | _____                 | _____                | _____                 |
| Walden E-Learning, Inc.   | \$               |                       | \$ 31,909            | 41%                   |
| Chancery Software Limited | 6,405            | 42%                   | 6,774                | 42%                   |
| iLearning, Inc.           | 1,876            | 40%                   | 461                  | 27%                   |
| EdVerify, Inc.            |                  |                       | 679                  | 42%                   |
| Other                     | 648              |                       | 564                  |                       |
|                           | _____            |                       | _____                |                       |
| Total                     | \$ 8,929         |                       | \$ 40,387            |                       |

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| June 30,<br>2002 | Ownership<br>Interest | December 31,<br>2001 | Ownership<br>Interest |
|------------------|-----------------------|----------------------|-----------------------|
|------------------|-----------------------|----------------------|-----------------------|

At June 30, 2002, the difference between the carrying amount of equity method investments and the amount of underlying equity in net assets of these investments was \$6,211. Under the provisions of Statement No. 142, the goodwill related to equity method investments is no longer amortized beginning in January 2002. Prior to 2002, the goodwill was amortized primarily over a three-year period as a component of the Company's allocable share of income or loss. For the three month and six month periods ended June 30, 2001, equity in net loss of affiliates included amortization of \$2,174 and \$4,979, respectively.

Each period in the tables below includes summarized financial data of those affiliates accounted for using the equity method in which Sylvan Ventures had an interest at the end of the respective period and includes results of operations data of the affiliates for the entire period.

|  | June 30,<br>2002 | December 31,<br>2001 |
|--|------------------|----------------------|
| Current assets                         | \$ 7,750         | \$ 23,176            |
| Other assets                           | 8,185            | 17,988               |
| Current liabilities                    | 10,902           | 19,916               |
| Long-term and other liabilities        | 16,868           | 17,004               |
| Redeemable convertible preferred stock | 51,906           | 66,878               |

|              | Three months ended June 30, |           | Six months ended June 30, |           |
|--------------|-----------------------------|-----------|---------------------------|-----------|
|              | 2002                        | 2001      | 2002                      | 2001      |
| Net sales    | \$ 5,774                    | \$ 16,022 | \$ 11,133                 | \$ 26,645 |
| Gross profit | 4,724                       | 11,725    | 7,742                     | 18,478    |
| Net loss     | (3,259)                     | (31,423)  | (8,127)                   | (60,502)  |

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*Other Investments (Cost Method Investments):*

Other investments consist of non-marketable investments in common and preferred stocks of private companies in which the Company does not exercise significant influence. These investments are carried at cost unless a decline in estimate fair value is determined to be permanent. Other investments consisted of the following:

|                                    | June 30,<br>2002 | December 31,<br>2001 |
|------------------------------------|------------------|----------------------|
| <i>Core Operating Segments:</i>    |                  |                      |
| Chauncey Group International, Ltd. | \$               | \$ 8,000             |
| Frontline Group, Inc.              | 7,000            | 7,000                |
| Other                              | 5,006            | 5,000                |
| <i>Sylvan Ventures Segment:</i>    |                  |                      |
| ClubMom.com, Inc.                  | 7,596            | 7,326                |
| <b>Total</b>                       | <b>\$ 19,602</b> | <b>\$ 27,326</b>     |

*Realized Investment Income and Losses*

During the three month period ending June 30, 2002, the Company sold its investment in Chauncey Group International, Ltd for cost plus accrued interest, yielding cash proceeds of \$9,750. Additionally, Sylvan Ventures recorded a gain of \$273 upon the exchange of its investment in HigherMarkets for 402 common shares of SciQuest.

During the three month period ending June 30, 2001, the Company recorded a loss on investment of \$14,231. This charge consisted of the reserve for notes receivable and advances to Caliber Learning Network, Inc. ("Caliber") of \$7,497 as well as the accrual of a \$6,734 estimated

liability relating to the Company's guarantee of certain non-cancelable Caliber lease obligations and other Caliber related liabilities incurred by the Company. Due to the uncertainties surrounding the bankruptcy proceedings and the ultimate settlement of Caliber's lease and other liabilities, it is reasonably possible that the Company's loss estimate may change prior to finalization.

#### Note 7 Due to Shareholders of Acquired Companies and Other Contingencies

Due to shareholders of acquired companies consists of the following amounts payable in cash:

|   | June 30,<br>2002 | December 31,<br>2001 |
|---|------------------|----------------------|
| Amounts payable to former shareholders of Drake Prometric         | \$ 3,050         | \$ 3,050             |
| Amounts payable to former shareholders of Les Roches              | 1,125            | 1,029                |
|   | 4,175            | 4,079                |
| Less: long-term portion (included in other long-term liabilities) | (446)            | (422)                |
| <b>Total current portion</b>                                      | <b>\$ 3,729</b>  | <b>\$ 3,657</b>      |

In connection with certain acquisitions, variable amounts of contingent consideration are payable to the seller based upon specified terms. All existing contingent consideration agreements are predicated upon improved operating profitability of the acquired entities and utilize multiples consistent with those used to calculate the initial purchase price. The Company will record the contingent consideration when the contingencies are resolved and the additional consideration is payable.

Variable amounts of contingent consideration are payable to the seller of Les Roches if specified levels of earnings are achieved in 2002. Variable amounts of contingent consideration are payable to the seller of UDLA in 2006 and 2007 if specified levels of earnings are achieved in 2004, 2005 and 2006. Additional purchase consideration of \$500 is due to the sellers of UVM in 2003 if 2002 earnings exceed certain specified amounts. Variable amounts of contingent consideration, up to a maximum of \$8,000, are also payable to the sellers of certain Sylvan Learning Centers franchises repurchased by the Company if specified levels of operating results are achieved in 2002, 2003, 2004 and 2005. In August 2002, the Company entered into negotiations to finalize the amounts due as additional consideration for the acquisition of these Sylvan Learning Center franchises and to acquire other franchise rights from the sellers in the United Kingdom and France. The Company expects an agreement to be reached whereby it will agree to payments totaling approximately \$16,000 in connection with the acquisition of these Sylvan Learning Center operations.

The Company has entered into agreements with certain franchisees of Sylvan Learning Centers and Wall Street Institute that allow the franchisees to require the Company to repurchase the centers at a predetermined multiple of operating results upon the achievement of specified operating thresholds. The Company does not believe that these commitments, if ultimately triggered by future events, would materially impact its liquidity.

#### Note 8 Income Taxes

The tax provisions for the six month periods ended June 30, 2002 and 2001 were based on the estimated effective tax rates applicable for the full years, after giving effect to significant items related specifically to the interim periods, including the reported results of Sylvan Ventures' investments accounted for using the equity method. The Company's income tax provisions for all periods consist of federal, state, and foreign income taxes. The Company's effective tax rate was 15% for the six months ended June 30, 2002, excluding the cumulative effect of the change in accounting principle. Due to the volatility of Sylvan Ventures' income and losses, the Company's consolidated effective tax rate may fluctuate from quarter to quarter. However, on a full year basis the Company estimates that the effective 2002 income tax rate for the Company, prior to the cumulative effect of the change in accounting principle and excluding Sylvan Ventures, will be 30%. The Company estimates that the 2002 effective income tax rate for Sylvan Ventures will be 24%. Fluctuations in the magnitude and timing of the tax impact of Sylvan Ventures' financial results may cause the Company's consolidated effective income tax rate to vary substantially from the statutory rate.

The forecasted income tax rate for the Company excluding Sylvan Ventures has decreased from the income tax rate forecasted in the previous quarter due to the tax benefits associated with the impairment charge recorded in connection with the pending sale of WSI Spain. The forecasted income tax rate for Sylvan Ventures has decreased from the income tax rate forecasted in the previous quarter due to the decrease in

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forecasted losses and the associated tax benefits. The impact of these changes in the estimated effective income tax rates was not material.

At June 30, 2002, undistributed earnings of non-U.S. subsidiaries totaled approximately \$118,400. Deferred tax liabilities have not been recognized for these undistributed earnings because it is management's intention to reinvest such undistributed earnings outside of the U.S. If all undistributed earnings were remitted to the U.S., the amount of incremental U.S. federal income taxes, net of foreign tax credits, would be approximately \$34,540.

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### Note 9 Stockholder's Equity

The components of stockholders' equity are as follows:

|   | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balance at December 31, 2001  | \$ 387          | \$ 229,386                       | \$ 342,786           | \$ (26,704)                                   | \$ 545,855                       |
| Options exercised for purchase of 1,095 shares of common stock, including income tax benefit of \$4,253 | 11              | 18,744                           |                      |   | 18,755                           |
| Issuance of 23 shares of common stock in connection with the employee stock purchase plan               |                 | 376                              |                      |   | 376                              |
| Issuance of 318 shares of common stock in connection with the conversion of debentures                  | 3               | 4,997                            |                      |   | 5,000                            |
| Issuance of 144 shares of common stock in connection with acquisitions                                  | 2               | 2,999                            |                      |   | 3,001                            |
| Options granted to non-employees  |                 | 206                              |                      |   | 206                              |
| Other equity activity   |                 | 679                              |                      |   | 679                              |
| Comprehensive loss:   |                 |                                  |                      |   |                                  |
| Net loss for the six months ended June 30, 2002   |                 |                                  | (81,642)             |   | (81,642)                         |
| Foreign currency translation adjustment   |                 |                                  |                      | 6,267   | 6,267                            |
| Unrealized loss on available-for-sale securities  |                 |                                  |                      | 7   | 7                                |
| Minimum pension liability adjustment  |                 |                                  |                      | 17  | 17                               |
| <b>Total comprehensive loss</b>   |                 |                                  |                      |   | <b>(75,351)</b>                  |
| Balance at June 30, 2002  | \$ 403          | \$ 257,387                       | \$ 261,144           | \$ (20,413)                                   | \$ 498,521                       |

### Note 10 Comprehensive Loss

The components of comprehensive loss, net of related income taxes, are as follows:

|   | Three months ended June 30, |                    | Six months ended June 30, |                    |
|---|-----------------------------|--------------------|---------------------------|--------------------|
|   | 2002                        | 2001               | 2002                      | 2001               |
| Net loss  | \$ (5,083)                  | \$ (13,434)        | \$ (81,642)               | \$ (25,018)        |
| Foreign currency translation adjustment                 | 10,475                      | (4,423)            | 6,267                     | (14,721)           |
| Unrealized gain (loss) on available-for-sale securities | 163                         | (227)              | 7                         | (204)              |
| Minimum pension liability adjustment                    | 17                          |                    | 17                        |                    |
| <b>Comprehensive income (loss)</b>                      | <b>\$ 5,572</b>             | <b>\$ (18,084)</b> | <b>\$ (75,351)</b>        | <b>\$ (39,943)</b> |

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**Note 11 Loss Per Share**

The following table summarizes the computations of basic and diluted loss per common share:

|  | Three months ended<br>June 30, |             | Six months ended<br>June 30, |             |
|--|--------------------------------|-------------|------------------------------|-------------|
|  | 2002                           | 2001        | 2002                         | 2001        |
| Numerator used in basic and diluted loss per common share:                                       |                                |             |                              |             |
| Loss before cumulative effect of change in accounting principle                                  | \$ (5,083)                     | \$ (13,434) | \$ (5,499)                   | \$ (25,018) |
| Cumulative effect of change in accounting principle  |                                |             | (76,143)                     |             |
| Net loss   | \$ (5,083)                     | \$ (13,434) | \$ (81,642)                  | \$ (25,018) |
| Denominator:   |                                |             |                              |             |
| Weighted average common shares outstanding   | 40,110                         | 37,877      | 39,767                       | 37,665      |
| Net effect of dilutive stock options based on treasury stock method using average market price   |                                |             |                              |             |
| Effect of convertible debentures   |                                |             |                              |             |
| Weighted average common shares outstanding and additional dilution from common stock equivalents | 40,110                         | 37,877      | 39,767                       | 37,665      |
| Loss per common share, basic and diluted:  |                                |             |                              |             |
| Loss before cumulative effect of change in accounting principle                                  | \$ (0.13)                      | \$ (0.35)   | \$ (0.14)                    | \$ (0.66)   |
| Cumulative effect of change in accounting principle  |                                |             | (1.91)                       |             |
| Net loss   | \$ (0.13)                      | \$ (0.35)   | \$ (2.05)                    | \$ (0.66)   |

Stock options and the convertible debentures were not dilutive for the three month and six month periods ended June 30, 2002 and 2001 as the Company reported a net loss.

**Note 12 Contingencies**

On November 18, 1996, ACT, Inc. filed suit against the Company alleging that the Company violated federal antitrust laws and committed various state law torts in connection with the operations of its computer-based testing operations and in obtaining a testing services contract from the National Association of Securities Dealers ("NASD"). The trial court granted the Company's motion for summary judgment and ACT, Inc. filed its appeal of the decision to the U.S. Court of Appeals for the Eighth Circuit. On July 11, 2002, the U.S. Court of Appeals for the Eighth Circuit affirmed the decision of the trial court on all counts. The decision of the Eighth Circuit became final on August 1, 2002. The only available appeal to ACT is to the U.S. Supreme Court. Management is unable to predict the ultimate outcome of any appeal, but believes that the ultimate resolution of the matter will not have a material effect on the Company's consolidated financial position.

The Company is subject to other legal actions arising in the ordinary course of its business. In management's opinion, the Company has adequate legal defenses and/or insurance coverage with respect to the eventuality of such actions and does not believe any settlement would materially affect the Company's financial position.

**Note 13 Business Segment Information**

The Company realigned its English Language Instruction segment to include only the operations of WSI Spain. The remaining English Language Instruction business is now included in the International

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Universities segment. All segment information has been reclassified to conform to the new presentation.

|   | Three months ended June 30, |                   | Six months ended June 30, |                    |
|---|-----------------------------|-------------------|---------------------------|--------------------|
|   | 2002                        | 2001              | 2002                      | 2001               |
| <b>Operating revenues:</b>              |                             |                   |                           |                    |
| K-12 Education Services                 | \$ 60,570                   | \$ 51,866         | \$ 113,543                | \$ 101,321         |
| Online Higher Education                 | 16,705                      | 13,281            | 22,290                    | 18,438             |
| International Universities              | 73,317                      | 56,311            | 145,551                   | 112,369            |
| English Language Instruction-Spain      | 3,329                       | 4,788             | 6,964                     | 10,337             |
| Sylvan Ventures                         | 5,501                       | 33                | 9,442                     | 63                 |
|   | <u>\$ 159,422</u>           | <u>\$ 126,279</u> | <u>\$ 297,790</u>         | <u>\$ 242,528</u>  |
| <b>Segment operating profit (loss):</b> |                             |                   |                           |                    |
| K-12 Education Services                 | \$ 14,878                   | \$ 12,325         | \$ 24,597                 | \$ 21,077          |
| Online Higher Education                 | 5,955                       | 4,390             | 4,485                     | 3,002              |
| International Universities              | 8,457                       | 6,456             | 16,362                    | 10,300             |
| English Language Instruction Spain      | (18,680)                    | 733               | (19,597)                  | 1,731              |
| Sylvan Ventures                         | (9,131)                     | (22,668)          | (17,160)                  | (48,430)           |
|   | <u>\$ 1,479</u>             | <u>\$ 1,236</u>   | <u>\$ 8,687</u>           | <u>\$ (12,320)</u> |

Segment operating profit (loss) is calculated as net operating profit (loss) for operating segments. Segment profit for Sylvan Ventures is calculated as the sum of their revenues, operating costs, general and administrative expenses, net investment income (loss) and equity in net loss of affiliates. Similar to its relationship with other university partners, Canter and Associates (which is included in the Online Higher Education segment) and Walden (which is included in the Sylvan Ventures segment) have entered into a formal agreement in which Canter markets and distributes its teacher training courses through a graduate degree program at Walden University for a percentage of the gross tuition fees, determined at fair value rates, associated with this program. For the quarter and the six month period ended June 30, 2002, consolidated earned tuition fees from this program totaled \$1,145 and \$1,387, respectively. The following table reconciles the reported information on segment profit (loss) to income (loss) before income taxes reported in the consolidated statements of operations:

|  | Three months ended June 30, |                    | Six months ended June 30, |                    |
|--|-----------------------------|--------------------|---------------------------|--------------------|
|  | 2002                        | 2001               | 2002                      | 2001               |
| Total profit (loss) for reportable segments  | \$ 1,479                    | \$ 1,236           | \$ 8,687                  | \$ (12,320)        |
| Corporate general and administrative expense | (5,712)                     | (5,901)            | (10,821)                  | (11,887)           |
| Other expense and minority interest, net     | (2,434)                     | (15,751)           | (4,354)                   | (14,743)           |
|  | <u>\$ (6,667)</u>           | <u>\$ (20,416)</u> | <u>\$ (6,488)</u>         | <u>\$ (38,950)</u> |

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| Segment Assets | Goodwill |
|----------------|----------|
|----------------|----------|



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|                                    | Segment Assets    |                      | Goodwill          |                      |
|------------------------------------|-------------------|----------------------|-------------------|----------------------|
|                                    | June 30,<br>2002  | December 31,<br>2001 | June 30,<br>2002  | December 31,<br>2001 |
| K-12 Education Services            | \$ 121,697        | \$ 106,184           | \$ 59,168         | \$ 45,128            |
| Online Higher Education            | 102,115           | 101,517              | 68,169            | 67,691               |
| International Universities         | 401,382           | 379,053              | 102,841           | 142,827              |
| English Language Instruction Spain |                   | 65,596               |                   | 29,951               |
| Sylvan Ventures                    | 92,417            | 70,430               | 34,804            |                      |
|                                    | <u>\$ 717,611</u> | <u>\$ 722,780</u>    | <u>\$ 264,982</u> | <u>\$ 285,597</u>    |

The decrease in goodwill at June 30, 2002 is primarily due to the impairment of certain Wall Street Institute amounts, partially offset by the acquisition of Sylvan Learning Centers franchises in the K-12 Education Services segment, the acquisition of Marbella in the International Universities segment, and the acquisition of additional Walden ownership interest which resulted in its consolidation in the Sylvan Ventures segment.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The statements contained herein include forward-looking statements. Forward-looking statements include information about possible or assumed results of operations, business strategies, financing plans, competitive position and potential growth opportunities. Forward-looking statements include all statements that are not historical facts and are generally accompanied by words such as "may," "will," "intend," "anticipate," "believe," "estimate," "expect," "should" or similar expressions. These statements also relate to the Company's contingent payment obligations relating to acquisitions, future capital requirements, potential acquisitions and the Company's future development plans and are based on current expectations. Forward-looking statements involve various risks, uncertainties and assumptions. The Company's actual results may differ materially from those expressed in these forward-looking statements.

Future events and actual results could differ materially from those set forth in the forward-looking statements as a result of many factors. These factors may include, without limitation: the Company's ability to continue to make acquisitions and to successfully integrate and operate acquired businesses; changes in student enrollment; the development and expansion of our franchise system and the effect of new technology applications in the educational services industry; failure to maintain or renew required regulatory approval, accreditation or state authorizations; the Company's ability to effectively manage business growth; possible increased competition from other educational service providers; the effect on the business and results of operations of fluctuations in the value of foreign currencies; and the many risks associated with the operation of an increasingly global business, including complicated legal structures, foreign currency, legal, tax and economic risks and the risk of changes in the business climate in the markets where the Company operates. These forward-looking statements are based on estimates, projections, beliefs and assumptions of management and speak only as of the date made and are not guarantees of future performance.

**Overview**

Sylvan Learning Systems, Inc. (the "Company" or "Sylvan") is a leading international provider of educational services to families and schools. The Company provides lifelong educational services through five separate business segments. The K-12 Education Services segment includes: Sylvan Learning Centers, which designs and delivers individualized tutorial programs to school-aged children through franchised and Company-owned learning centers; Schülerhilfe, a major provider of tutoring services in Germany; and Sylvan Education Solutions, which principally provides educational programs

to students of public and non-public school districts through contracts funded by Title I and state-based programs. The Online Higher Education segment provides professional development and graduate degree programs to teachers through Canter and Associates and Sylvan Teacher Institute. The International Universities segment owns or maintains controlling interests in five private universities located in Spain, Switzerland, Mexico, Chile and France and also includes the non-Spain operations of Wall Street Institute ("WSI"), a European-based franchiser and operator of learning centers that teach the English language in the post-secondary market. The English Language Instruction-Spain segment consists of the operations of WSI located in Spain, which represent the business held for sale. The Sylvan Ventures segment invests in and develops

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companies that are creating emerging technology solutions for the education marketplace, and consolidates the operations of eSylvan, Inc., Walden E-Learning, Inc. ("Walden"), and EdVerify, Inc. which are majority-owned subsidiaries.

### Results of Operations

Revenues generated by Sylvan's five business segments are described as follows: K-12 Education Services primarily earns franchise royalties, franchise sales fees, Company-owned learning center revenues and contract-based revenues from providing supplemental remedial education services to public and non-public schools; Online Higher Education primarily earns revenues from providing teacher training products and distance-learning instructional services; International Universities earns tuition and related fees paid by the students of Universidad Europea de Madrid ("UEM"), Swiss Hotel Association Hotel Management School Les Roches ("Les Roches"), Universidad del Valle de Mexico ("UVM"), Universidad de Las Americas ("UDLA") and École Supérieure du Commerce Extérieur ("ESCE"), as well as franchise royalties, Company-owned center revenues and franchise sales fees related to WSI operations outside of Spain; English Language Instruction-Spain earns franchise royalties, Company-owned center revenues and franchise sales fees related to the WSI business in Spain; and Sylvan Ventures primarily earns tuition and related fees from the students of Walden and eSylvan.

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The following table sets forth the percentage relationships of operating revenues and direct costs for each segment, as well as certain income statement line items expressed as a percentage of total revenues for the periods indicated:

|  | <b>Three months<br/>ended June 30,</b> |              | <b>Six months<br/>ended June 30,</b> |              |
|--|--|--------------|--------------------------------------|--------------|
|  | <b>2002</b>                            | <b>2001</b>  | <b>2002</b>                          | <b>2001</b>  |
| <b>Revenues:</b>   |  |              |                                      |              |
| K-12 Education Services  | 38%                                    | 41%          | 38%                                  | 42%          |
| Online Higher Education  | 10%                                    | 10%          | 8%                                   | 8%           |
| International Universities   | 46%                                    | 45%          | 49%                                  | 46%          |
| English Language Instruction Spain   | 2%                                     | 4%           | 2%                                   | 4%           |
| Sylvan Ventures  | 4%                                     |              | 3%                                   |              |
| <b>Total revenues</b>  | <b>100%</b>                            | <b>100%</b>  | <b>100%</b>                          | <b>100%</b>  |
| <b>Direct costs:</b>   |  |              |                                      |              |
| K-12 Education Services  | 28%                                    | 31%          | 30%                                  | 33%          |
| Online Higher Education  | 7%                                     | 7%           | 6%                                   | 6%           |
| International Universities   | 41%                                    | 40%          | 43%                                  | 42%          |
| English Language Instruction Spain   | 3%                                     | 3%           | 3%                                   | 4%           |
| Sylvan Ventures  | 7%                                     | 3%           | 6%                                   | 3%           |
| <b>Total direct costs</b>  | <b>86%</b>                             | <b>84%</b>   | <b>88%</b>                           | <b>88%</b>   |
| <b>General and administrative expenses:</b>  |  |              |                                      |              |
| Core operating segments  | 4%                                     | 5%           | 4%                                   | 5%           |
| Sylvan Ventures  | 1%                                     | 2%           | 2%                                   | 2%           |
| Loss on impairment of assets held for sale   | 11%                                    |              | 6%                                   |              |
| <b>Operating income (loss)</b>   | <b>(2%)</b>                            | <b>9%</b>    | <b>5%</b>                            | <b>5%</b>    |
| Non-operating expense (including equity in net loss of Ventures affiliates) net loss of Ventures affiliates) | (2%)                                   | (25%)        | (2%)                                 | (21%)        |
| <b>Loss before income taxes and cumulative effect of change in accounting principle</b>                      | <b>(4%)</b>                            | <b>(16%)</b> | <b>(2%)</b>                          | <b>(16%)</b> |
| Income tax benefit   | 1%                                     | 6%           | 6%                                   | 6%           |

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|   | Three months<br>ended June 30, |       | Six months<br>ended June 30, |       |
|---|--------------------------------|-------|------------------------------|-------|
|   |                                |       |                              |       |
| Loss before cumulative effect of change in accounting principle | (3%)                           | (10%) | (2%)                         | (10%) |
| Cumulative effect of change in accounting principle             |                                |       | (25%)                        |       |
| Net loss  | (3%)                           | (10%) | (27%)                        | (10%) |

*Comparison of results for the three months ended June 30, 2002 to results for the three months ended June 30, 2001.*

**Revenues.** Total revenues increased by \$33.1 million, or 26%, to \$159.4 million for the three months ended June 30, 2002 (the "2002 fiscal quarter") from \$126.3 million for the three months ended June 30, 2001 (the "2001 fiscal quarter"). This revenue increase was primarily driven by increases in tuition and enrollment at universities in the International Universities segment, acquisitions of learning centers and same center revenue growth in the K-12 Education Services segment.

*K-12 Education Services* revenue increased by \$8.7 million, or 17%, to \$60.6 million for the 2002 fiscal quarter compared to the 2001 fiscal quarter. Franchise royalties increased by \$1.5 million, or 22%, in 2002 as a result of a net increase of 15 new learning centers opened after June 30, 2001 and a 22% increase in same center revenue. Same center revenue growth was driven by the success of

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national advertising programs and increased length of stay. Revenues from Company-owned learning centers increased \$7.0 million, or 47%, to \$22.1 million during the 2002 fiscal quarter. Same center revenues increased 17%, or \$2.5 million, with the remaining revenue increase of \$4.5 million generated from 30 Company-owned centers acquired from franchise owners and 2 new centers opened during the past year. International revenues, primarily Schülerhilfe, increased by \$0.7 million, or 16%, in the 2002 fiscal quarter compared to the 2001 fiscal quarter. The remaining revenue increase of \$0.3 million for the 2002 fiscal quarter compared to the 2001 fiscal quarter relates to other franchise services and Ivy West. Contract-based revenues decreased by \$0.8 million, or 4%, to \$20.2 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter due to a lower number of public school contracts. Operating revenue for K-12 Education Services represents 38% of total revenues of the Company for the 2002 fiscal quarter.

*Online Higher Education* revenue increased by \$3.4 million, or 26%, to \$16.7 million for the 2002 fiscal quarter compared to the 2001 fiscal quarter. Canter teacher training revenue increased by \$3.7 million, or 29%, to \$16.4 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter. The Canter revenue increase is due to greater product demand, particularly the distance learning masters programs, which saw enrollments for the summer 2002 semester increase by 23% to 10,800 students. Sylvan Teacher Institute revenue decreased by \$0.3 million, or 55%, to \$0.3 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter. The decrease is due to a planned decrease in professional development workshops performed in the 2002 fiscal quarter compared to the 2001 fiscal quarter. Operating revenue for Online Higher Education represents 10% of the total revenues of the Company for the 2002 fiscal quarter.

*International Universities* revenue for the 2002 fiscal quarter increased by \$17.0 million, or 30%, to \$73.3 million compared to the 2001 fiscal quarter. This revenue increase was driven by increased tuition and enrollments at each of the universities, particularly at UDLA, which increased its enrollment by 50% compared to the 2001 fiscal quarter. Additionally, revenue increased by \$1.5 million due to the acquisition of a controlling interest in ESCE, which occurred in the fourth quarter of 2001 and, therefore, did not contribute to revenue for the 2001 fiscal quarter. Non-Spain WSI revenues increased \$2.1 million, primarily due to the acquisition of centers in Portugal in the third quarter of 2001. Operating revenue for International Universities represents 46% of total revenues of the Company for the 2002 fiscal quarter.

*English Language Instruction Spain* revenue decreased by \$1.5 million, or 30%, to \$3.3 million for the 2002 fiscal quarter compared to the 2001 fiscal quarter. This revenue decrease was the result of decreased tuition revenues in existing Company-owned centers, as well as decreased royalties and didactic material sales to franchises due to oversaturation by English language instruction providers in Spain. Operating revenue for English Language Instruction Spain represents 2% of total revenues of the Company for the 2002 fiscal quarter.

*Sylvan Ventures* revenue increased to \$5.5 million for the 2002 fiscal quarter. The increase is a result of revenues generated from Walden (\$4.8 million) and eSylvan (\$0.7 million) for the 2002 fiscal quarter. Prior to February 2002, Walden was accounted for under the equity method. Operating revenues for Sylvan Ventures represents 4% of total revenues of the Company for the 2002 fiscal quarter.

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**Direct Costs.** Total direct costs of revenues increased \$31.0 million, or 29%, to \$137.0 million for the 2002 fiscal quarter from \$106.0 million for the 2001 fiscal quarter. Excluding the impact of goodwill amortization in the 2001 fiscal quarter of \$2.5 million, direct costs increased \$33.5 million, or 32%, for the 2002 fiscal quarter. Direct costs as a percentage of total revenues were 86% in the 2002 fiscal quarter compared to 84% in the 2001 fiscal quarter. Excluding the impact of goodwill amortization, direct costs as a percentage of revenues were 82% in the 2001 fiscal quarter.

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*K-12 Education Services* expenses increased \$6.2 million to \$45.7 million, or 75% of K-12 Education Services revenue for the 2002 fiscal quarter, compared to \$39.5 million, or 76% of K-12 Education Services revenue for the 2001 fiscal quarter. Approximately \$5.0 million of the 2002 fiscal quarter increase relates to expenses incurred in Company-owned learning centers due to the acquisition of 30 franchised learning centers and costs associated with higher revenues at existing Company-owned centers. International expenses, primarily related to Schülerhilfe, increased \$0.6 million. Franchise support costs increased \$1.9 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter. These expense increases were partially offset by a decrease in contract-based expenses of \$0.8 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter, which was consistent with the decrease in revenue over the same period.

*Online Higher Education* expenses increased by \$1.9 million to \$10.8 million, or 64% of Online Higher Education revenue for the 2002 fiscal quarter, compared to \$8.9 million, or 67% of Online Higher Education revenue for the 2001 quarter. The decrease in expenses as a percentage of revenue for the 2002 fiscal quarter is primarily due to the adoption of Statement No. 142 in 2002, which discontinued the amortization of goodwill. The amortization of goodwill related to the Canter acquisition was \$0.8 million in the 2001 fiscal quarter or 6% of Online Higher Education revenue for the 2001 fiscal quarter. This decrease in expenses as a percentage of revenue was partially offset by an increase in expenses as a percentage of revenue due to the inclusion of the operating results of OnlineLearning.net in the 2002 fiscal quarter. The acquisition of OnlineLearning.net, effective July 1, 2001, resulted in lower margin revenue in the fiscal 2002 quarter.

*International Universities* expenses increased by \$15.0 million to \$64.9 million, or 88% of International Universities revenue for the 2002 fiscal quarter, compared to \$49.9 million, or 89% of International Universities revenue for the 2001 fiscal quarter. The increase in expenses reflects i) a higher volume of operating activities at the universities compared to the 2001 fiscal quarter; ii) the acquisition of ESCE, which occurred in the fourth quarter of 2001; iii) an increase in overhead costs, including staffing expenses, as a result of the increase in the business, iv) an increase in marketing campaign expenses related to efforts associated with recruiting new students, primarily at UEM and v) an increase in expenses at WSI primarily associated with the acquisition of centers in Portugal. The timing of summer semester breaks results in significant seasonal fluctuations in operating results based primarily on the geographical location of the individual university. Revenues and direct instructional expenses are recorded during the period that classes are in session; however, certain basic operating and marketing expenses continue during the semester break, which distorts comparisons of expenses as a percentage of revenues.

*English Language Instruction Spain* expenses increased by \$0.7 million to \$4.8 million for the 2002 fiscal quarter compared to \$4.1 million for the 2001 fiscal quarter. Excluding the impact of goodwill amortization of \$0.9 million in the 2001 fiscal quarter, English Language Instruction Spain expenses increased by \$1.6 million. This increase in operating expenses is primarily the result of increased marketing and advertising costs necessary to compete for enrollments in the oversaturated marketplace, expenses related to the takeover of certain previously franchised centers and expenses incurred to support the franchise network in the difficult Spain market.

*Sylvan Ventures* operating expenses increased to \$10.9 million in the 2002 fiscal quarter from \$3.6 million in the 2001 fiscal quarter as a result of the consolidation of Walden and EdVerify direct costs for the 2002 fiscal quarter. Operating expenses are comprised of the expenses of the revenue generating consolidated investments in eSylvan (\$3.9 million), Walden (\$6.6 million), and Edverify (\$0.4 million). Prior to February 2002 and June 2002 respectively, Walden and EdVerify were accounted for under the equity method. eSylvan's direct costs increased by \$0.3 million in comparison to the 2001 fiscal quarter due to expansion of services and operations.

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**Other Expenses.** Core operating segment general and administrative expenses decreased by \$0.2 million in the 2002 fiscal quarter compared to the 2001 fiscal quarter. The decrease is primarily due to increased leveraging of centralized costs and cost control efforts. Core operating segment general and administrative expenses decreased to 4% of core operating segment revenues in the 2002 fiscal quarter, compared to 5% of revenues in the 2001 fiscal quarter, due to strong revenue expansion combined with cost controls.

*Sylvan Ventures* management costs decreased by \$1.0 million to \$2.2 million for the 2002 fiscal quarter compared to \$3.2 million for the 2001 fiscal quarter. The decrease is due to a significant reduction in the costs to research, value, and manage the investment portfolio of

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\$2.3 million, offset by expenses incurred in the start-up of Connections Academy of \$1.1 million for the 2002 fiscal quarter. Start-up costs are expensed and reported in general and administrative expenses until revenues are generated by the business.

*English Language Instruction Spain* - Loss on impairment of assets held for sale of \$17.2 million represents the write off of assets related to WSI Spain due to the Company's decision to dispose of the business unit, and the lack of material value expected to be received upon sale. The asset write-offs include franchise receivables, fixed assets and working capital amounts that the Company expects to transfer to a buyer upon sale.

*Sylvan Ventures* equity in net losses of affiliates decreased to \$1.9 million for the 2002 fiscal quarter compared to \$15.6 million for the 2001 fiscal quarter. These losses relate to Sylvan Ventures' share of operating losses generated by the early stage enterprises in the investment portfolio not under Sylvan Ventures' control. This decrease was primarily due to Sylvan Ventures change in strategy to focus mainly on managing its current investments compared to heavy investing in the acquisition of new early stage enterprises, as well as the consolidation of Walden and EdVerify. The reduction in the number of early stage enterprises slowed the losses absorbed by Sylvan Ventures, as these companies initially generate significant losses. Additionally, a number of the enterprises in which Sylvan Ventures invested throughout 2000 and 2001 are further along in their business life cycle, and thus are generating smaller losses than in their earlier stages in the 2001 fiscal quarter. The adoption of FAS 142 also resulted in Sylvan Ventures no longer amortizing goodwill associated with equity method investments. The amortization of goodwill related to the Sylvan Ventures equity investments in the 2001 fiscal quarter was \$2.2 million. Minority interests' share of Sylvan Ventures losses totaled \$0.8 million and \$1.8 million for the 2002 and 2001 fiscal quarters, respectively.

Other non-operating items improved by \$14.3 million for the 2002 fiscal quarter compared to the 2001 fiscal quarter, primarily due to the \$14.2 million loss on the Caliber investment which was incurred in the 2001 fiscal quarter.

The Company's effective tax rate was 24% for the 2002 fiscal quarter. This reported effective income tax rate differs from the U.S. federal statutory tax rate due to the impact of state income taxes, minority interests, foreign income taxed at lower rates and the inability to utilize tax benefits from certain investment losses of Sylvan Ventures. Due to the volatility of Sylvan Ventures' income and losses, the Company's consolidated effective tax rate may fluctuate from quarter to quarter. However, on a full year basis the Company estimates that the 2002 effective income tax rate for the Company, prior to the cumulative effect of the change in accounting principle and excluding Sylvan Ventures, will be 30%. The Company estimates that the 2002 effective income tax rate for Sylvan Ventures will be 24%. The forecasted income tax rate for the Company excluding Sylvan Ventures has decreased from the income tax rate forecasted in the previous quarter due to the tax benefits associated with the impairment charge recorded in connection with the pending sale of WSI Spain. The forecasted income tax rate for Sylvan Ventures has decreased from the income tax rate forecasted in the previous quarter due to the decrease in forecasted losses and the associated tax benefit.

### *Comparison of results for the six months ended June 30, 2002 to results for the six months ended June 30, 2001.*

**Revenues.** Total revenues increased by \$55.3 million, or 23%, to \$297.8 million for the six months ended June 30, 2002 (the "2002 fiscal six month period") from \$242.5 million for the six months ended June 30, 2001 (the "2001 fiscal six month period"). This revenue increase was primarily driven by increases in tuition and enrollment at universities in the International Universities segment, as well as acquisitions of learning centers and same center revenue growth in the K-12 Education Services segment.

*K-12 Education Services* revenue increased by \$12.2 million, or 12%, to \$113.5 million for the 2002 fiscal six month period compared to the 2001 fiscal six month period. Franchise royalties increased by \$2.2 million, or 17%, as a result of a net increase of 15 new learning centers opened after June 30, 2001 and a 16% increase in same center revenue. Same center revenue growth was driven by the success of national advertising programs and increased length of stay. Revenues from Company-owned learning centers increased \$11.2 million, or 40%, to \$39.0 million during the 2002 fiscal six month period. Same center revenues increased 11%, or \$3.1 million, with the remaining revenue increase of \$8.1 million generated from 30 Company-owned centers acquired from franchise owners and 2 new centers opened during the past year. International revenues, primarily Schülerhilfe, increased by \$0.8 million, or 10%, in the 2002 fiscal six month period compared to the 2001 fiscal six month period. The remaining revenue increase of \$0.5 million for the 2002 fiscal six month period compared to the 2001 fiscal six month period relates to other franchise services and Ivy West. Contract-based revenues decreased by \$2.5 million, or 6%, to \$40.0 million in the 2002 fiscal six month compared to the 2001 fiscal six month period due to a lower number of public school contracts. Operating revenue for K-12 Education Services represents 38% of total revenues of the Company for the 2002 fiscal six month period.

*Online Higher Education* revenue increased by \$3.9 million, or 21%, to \$22.3 million for the 2002 fiscal six month period compared to the 2001 fiscal six month period. Canter teacher-training revenue increased by \$4.5 million, or 26%, to \$21.8 million during the 2002 fiscal six month period compared to the 2001 fiscal six month period. Canter's revenue increase is due to greater demand for its products, particularly the

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distance learning masters programs, which saw enrollments for the Summer 2002 semester increase by 23% to 10,800 students. Sylvan Teacher Institute revenue decreased by \$0.6 million, or 56%, to \$0.5 million in the 2002 fiscal six month period compared to the 2001 fiscal six month period. The decrease is due to the planned decrease in professional development workshops performed in the 2002 fiscal six month period compared to the 2001 fiscal six month period. Operating revenue for Online Higher Education represents 8% of total revenues of the Company for the 2002 fiscal six month period.

*International Universities* revenue for the 2002 fiscal six month period increased by \$33.2 million, or 30%, to \$145.6 million compared to the 2001 fiscal six month period. This increase is primarily due to an increase in overall enrollment of 18%. Additionally, revenue increased by \$3.0 million due to the acquisition of a controlling interest in ESCE, which occurred in the fourth quarter of 2001 and, therefore, did not contribute to revenue for the 2001 fiscal six month period. Non-Spain WSI revenues increased \$5.4 million, primarily due to the acquisition of centers in Portugal in the third quarter of 2001. Operating revenue for International Universities represents 49% of total revenues of the Company for the 2002 fiscal six month period.

*English Language Instruction Spain* revenue decreased by \$3.4 million, or 33%, to \$7.0 million for the 2002 fiscal six month period compared to the 2001 fiscal six month period. This revenue decrease was the result of decreased tuition revenues in existing Company-owned centers, as well as decreased royalties and didactic material sales to franchises due to oversaturation by English language instruction

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providers in Spain. Operating revenue for English Language Instruction Spain represents 2% of total revenues of the Company for the 2002 fiscal six month period.

*Sylvan Ventures* revenue increased to \$9.4 million for the 2002 fiscal six month period from \$0.1 million for the 2001 fiscal six month period. The increase is a result of revenues generated from Walden (\$8.2 million) for the months of February through June 2002 and eSylvan (\$1.2 million) revenues throughout the 2002 fiscal six month period. Prior to February 2002, Walden was accounted for under the equity method. Operating revenues for Sylvan Ventures represents 3% of total revenues of the Company for the 2002 fiscal six month period.

**Direct Costs.** Total direct costs of revenues increased \$50.1 million, or 23%, to \$263.6 million for the 2002 fiscal six month period from \$213.5 million for the 2001 fiscal six month period. Excluding the impact of goodwill amortization in the 2001 fiscal six month period of \$5.8 million, direct costs increased \$55.9 million, or 27%, for the 2002 fiscal six month period. Direct costs as a percentage of total revenues remained constant at 88% in the 2002 and 2001 fiscal six month periods. Excluding the impact of goodwill amortization, direct costs as a percentage of revenues were 86% in the 2001 fiscal six month period.

*K-12 Education Services* expenses increased \$8.7 million to \$88.9 million, or 78% of K-12 Education Services revenue for the 2002 fiscal six month period, compared to \$80.2 million, or 79% of K-12 Education Services revenue for the 2001 fiscal six month period. Approximately \$8.7 million of the 2002 fiscal six month period increase relates to expenses incurred in Company-owned learning centers due to the acquisition of 30 franchised learning centers and costs associated with higher revenues at existing Company-owned centers. International expenses, primarily related to Schülerhilfe, increased \$1.1 million. Franchise support costs increased \$1.7 million in the 2002 fiscal six month period compared to the 2001 fiscal six month period. These expense increases were partially offset by a decrease in contract-based expenses of \$2.2 million in the 2002 fiscal six month period compared to the 2001 fiscal six month period, primarily due to improved cost controls on existing business and declines in the contract-based revenues.

*Online Higher Education* expenses increased by \$2.4 million to \$17.8 million, or 80% of Online Higher Education revenue for the 2002 fiscal six month period, compared to \$15.4 million, or 84% of Online Higher Education revenue for the 2001 fiscal six month period. The decrease in expenses as a percentage of revenue for the 2002 fiscal six month period is primarily due to the adoption of Statement No. 142 in 2002, which discontinued the amortization of goodwill. The amortization of goodwill related to the Canter acquisition was \$1.5 million in the 2001 fiscal six month period or 7% of Online Higher Education revenue for the 2001 fiscal six month period. This decrease in expenses as a percentage of revenue was partially offset by an increase in expenses as a percentage of revenue due to the inclusion of operating results of OnlineLearning.net in the 2002 fiscal six month period. The acquisition of OnlineLearning.net, effective July 1, 2001, resulted in lower margin revenue in the fiscal 2002 six month period.

*International Universities* expenses increased by \$27.1 million to \$129.2 million, or 89% of International Universities revenue for the 2002 fiscal six month period, compared to \$102.1 million, or 91% of International Universities revenue for the 2001 fiscal six month period. The increase in expenses reflects i) a higher volume of operating activities at the universities compared to the 2001 fiscal six month period, ii) the acquisition of ESCE, which occurred in the fourth quarter of 2001, iii) an increase in overhead costs, including staffing expenses, as a result of the increase in the business and iv) an increase in expenses at WSI primarily associated with the acquisition of centers in Portugal. The decrease in expenses as a percentage of revenue is primarily due to operating efficiencies achieved throughout the International Universities segment,

particularly at UEM and UVM, as well as in administrative overhead costs relative to the higher revenue levels. The timing of summer semester breaks results in significant seasonal fluctuations in operating results based primarily on the

geographical location of the individual university. Revenues and direct instructional expenses are recorded during the period that classes are in session; however, certain basic operating and marketing expenses continue during the semester break, which distorts comparisons of expenses as a percentage of revenues.

*English Language Instruction Spain* expenses increased by \$0.7 million to \$9.3 million for the 2002 fiscal six month period compared to \$8.6 million for the 2001 fiscal six month period. Excluding the impact of goodwill amortization of \$2.0 million in the 2001 fiscal six month period, English Language Instruction Spain expenses increased by \$2.7 million. The increase in expenses for the 2002 fiscal six month period is primarily the result of increased marketing and advertising costs necessary to compete for enrollments in the oversaturated marketplace, expenses related to the takeover of certain previously franchised centers and expenses incurred to support the franchise network in the difficult Spain market.

*Sylvan Ventures* expenses increased to \$18.4 million in the 2002 fiscal six month period from \$7.2 million in the 2001 fiscal six month period as a result of the consolidation of Walden and EdVerify direct costs. Operating expenses are comprised of the expenses of revenue generating consolidated investments in eSylvan (\$7.7 million), Walden (\$10.3 million) and EdVerify (\$0.4 million). Prior to February 2002 and June 2002 respectively, Walden and EdVerify were accounted for under the equity method. eSylvan's direct costs increased by \$0.6 million in comparison to the 2001 fiscal six month period due to expansion of services and operations.

**Other Expenses.** Core operating segment general and administrative expenses decreased by \$1.0 million in the 2002 fiscal six month period compared to the 2001 fiscal six month period. The decrease is primarily due to increased leveraging of centralized costs and cost control efforts. Core operating segment general and administrative expenses decreased to 4% of core operating segment revenues in the 2002 fiscal six month period, compared to 5% of revenues in the 2001 fiscal six month period, due to strong revenue expansion combined with cost controls.

*Sylvan Ventures* management costs decreased by \$0.5 million to \$4.8 million for the 2002 fiscal six month period compared to \$5.3 million for the 2001 fiscal six month period. The decrease is due to a \$3.1 million reduction in the costs to research, value and manage the investment portfolio offset by expenses incurred in the start-up of Connections Academy of \$2.6 million for the 2002 fiscal six month period. Start-up costs are expensed and reported in general and administrative expenses until revenues are generated by the business.

*English Language Instruction Spain* - Loss on impairment of assets held for sale of \$17.2 million represents the write off of assets related to WSI Spain due to the Company's decision to dispose of the business unit, and the lack of material value expected to be received upon sale. The asset write-offs include franchise receivables, fixed assets and working capital amounts that the Company expects to transfer to a buyer upon sale.

*Sylvan Ventures* equity in net losses of affiliates decreased to \$3.7 million for the 2002 fiscal six month period from \$35.4 million for the 2001 fiscal six month period. These losses relate to Sylvan Ventures' share of operating losses generated by the early stage enterprises in the investment portfolio not under Sylvan Ventures' control. This decrease was primarily due to Sylvan Ventures change in strategy to focus mainly on managing its current investments compared to heavy investing in the acquisition of new early stage enterprises, as well as the consolidation of Walden and EdVerify. The reduction in the number of early stage enterprises slowed the losses absorbed by Sylvan Ventures, as these companies initially generate significant losses. Additionally, a number of the enterprises in which Sylvan Ventures invested throughout 2000 and 2001 are further along in their business life cycle, and thus are generating less losses than in their earlier stages in the 2001 fiscal six month period. The adoption of FAS 142 also resulted in Sylvan Ventures no longer amortizing goodwill associated with equity method investments. The amortization of goodwill related to the Sylvan Ventures equity investments in the 2001 fiscal six month period was \$5.0 million. Minority interests' share of Sylvan

Ventures losses totaled \$1.2 million and \$3.1 million for the 2002 and 2001 fiscal six month periods, respectively.

Other non-operating items improved by \$12.3 million for the 2002 fiscal six month period compared to the 2001 fiscal six month period due to the \$14.2 million loss on the Caliber investment which was incurred in the 2001 fiscal six month period, partially offset by a decrease in

interest income of \$2.3 million resulting from lower investment balances and a reduced interest rate environment.

The Company's effective tax rate was 15% for the 2002 fiscal six month period, excluding the cumulative effect of change in accounting principle. This reported effective income tax rate differs from the U.S. federal statutory tax rate due to the impact of state income taxes, minority interests, foreign income taxed at lower rates and the inability to utilize tax benefits from certain investment losses of Sylvan Ventures. Due to the volatility of Sylvan Ventures' income and losses, the Company's consolidated effective tax rate may fluctuate from quarter to quarter. However, on a full year basis the Company estimates that the 2002 effective income tax rate for the Company, prior to the cumulative effect of the change in accounting principle and excluding Sylvan Ventures, will be 30%. The Company estimates that the 2002 effective income tax rate for Sylvan Ventures will be 24%. The forecasted income tax rate for the Company excluding Sylvan Ventures has decreased from the income tax rate forecasted in the previous quarter due to the tax benefits associated with the impairment charge recorded in connection with the pending sale of WSI Spain. The forecasted income tax rate for Sylvan Ventures has decreased from the income tax rate forecasted in previous quarter due to the decrease in forecasted losses and the associated tax benefits.

**Cumulative Effect of Change in Accounting Principle.** As a result of adopting Statement No. 142 as of January 1, 2002 and performing the required transitional impairment tests, the Company recorded a non-cash charge of \$76.1 million, net of income tax benefit of \$7.7 million, which is included in cumulative effect of a change in accounting principle in the consolidated statements of operations. The impairment charge relates solely to the English Language Instruction business and consists of the write-down of goodwill related to the distressed operations in Spain and amounts originally paid for franchise rights and corporate center operations in other countries.

**Liquidity and Capital Resources**

**Condensed Statement of Cash Flows  
Six Months Ended June 30, 2002**

|   | <u>Core Operating<br/>Segments</u> | <u>Sylvan<br/>Ventures</u> | <u>Consolidated</u> |
|---|------------------------------------|----------------------------|---------------------|
| <b>Operating activities</b>   |                                    |                            |                     |
| Net loss  | \$ (66,180)                        | \$ (15,462)                | \$ (81,642)         |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                                    |                            |                     |
| Cumulative pre-tax effect of change in accounting principle                               | 83,843                             |                            | 83,843              |
| Depreciation and amortization   | 13,194                             | 1,342                      | 14,536              |
| Loss on impairment of assets held for sale  | 17,244                             |                            | 17,244              |
| Other non-cash items  | 6,437                              | 719                        | 7,156               |
| Changes in working capital  | (1,147)                            | (365)                      | (1,512)             |
| Net cash provided by (used in) operating activities                                       | <u>53,391</u>                      | <u>(13,766)</u>            | <u>39,625</u>       |
| <b>Investing activities</b>   |                                    |                            |                     |
| Investments in affiliates and other investments   | 7,913                              | (2,770)                    | 5,143               |
| Cash paid for acquired businesses, net of cash received                                   | (23,091)                           | 1,251                      | (21,840)            |
| Other investing activities  | (13,915)                           | 9,002                      | (4,913)             |
| Net cash provided by (used in) investing activities                                       | <u>(29,093)</u>                    | <u>7,483</u>               | <u>(21,610)</u>     |
| <b>Financing activities</b>   |                                    |                            |                     |
| Net cash distributed to minority members of Sylvan Ventures                               |                                    | (1,674)                    | (1,674)             |
| Intercompany funding  | (28,949)                           | 28,949                     |                     |
| Other financing activities  | 22,851                             | (167)                      | 22,684              |



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|   | Core Operating<br>Segments | Sylvan<br>Ventures | Consolidated |
|---|----------------------------|--------------------|--------------|
| Net cash provided by (used in) financing activities | (6,098)                    | 27,108             | 21,010       |
| Effect of exchange rate changes on cash             | (420)                      |                    | (420)        |
| Net increase in cash and cash equivalents           | 17,780                     | 20,825             | 38,605       |
| Cash and cash equivalents at beginning of period    | 101,877                    | 317                | 102,194      |
| Cash and cash equivalents at end of period          | \$ 119,657                 | \$ 21,142          | \$ 140,799   |

Cash provided by operations was \$39.6 million for the 2002 fiscal six month period, net of \$13.8 million cash used in operations related to Sylvan Ventures. This compares to cash used in operations of \$68.0 million for the 2001 fiscal six month period, of which \$20.5 million related to Sylvan Ventures. The reported net loss of \$81.6 million was offset by significant non-cash items, such as the pre-tax cumulative effect of change of accounting principle of \$83.8 million, loss on impairment of assets of \$17.2 million, depreciation and amortization charges of \$14.5 million, equity in net loss of affiliates, primarily of Sylvan Ventures of \$3.7 million and minority interest of \$2.2 million. Cash used in working capital activity totaled \$1.5 million in the 2002 fiscal six month period of which \$0.4 million related to Sylvan Ventures. In the 2001 fiscal six month period, working capital related decreases in liquidity of \$113.6 million consisted primarily of income tax payments resulting from the first quarter 2000 sale of Prometric and \$8.9 million related to Sylvan Ventures.

Cash used in investing activities was \$21.6 million for the 2002 fiscal six month period, net of \$7.5 million cash provided by investing activities related to Sylvan Ventures. This compares to cash provided by investing activities of \$15.9 million for the 2001 fiscal six month period, net of \$38.3 million cash used in investing activities related to Sylvan Ventures. The 2002 investment activity

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was primarily the result of purchases of property and equipment of \$25.9 million, and net cash paid for acquired businesses of \$21.8 million, partially offset by net proceeds from the sale of available-for-sale securities of \$24.9 million. The 2001 fiscal six month period investment activity primarily consisted of net proceeds from the sale of available-for-sale securities of \$111.7 million, partially offset by increases in investments in and advances to affiliates of \$36.6 million, purchases of property and equipment of \$28.3 million, and payments for acquisitions of \$28.2 million. At June 30, 2002, the Company has accrued obligations payable in cash of \$4.2 million related to contingent consideration for certain prior acquisitions. These amounts are expected to be paid later in 2002.

Cash provided by financing activities was \$21.0 million in the 2002 fiscal six month period, net of \$1.8 million cash used in financing activities related to Sylvan Ventures, excluding intercompany funding. This compares to cash provided by financing activities of \$29.7 million in the 2001 fiscal six month period, of which \$19.4 million related to Sylvan Ventures, excluding intercompany funding. The 2002 financing activity related primarily to cash received from the exercise of options of \$14.5 million, and proceeds from the issuance of debt of \$13.0 million, partially offset by payments of long-term debt of \$3.5 million, costs incurred in connection with potential International Universities public offering of \$1.7 million, and net payments to the minority interest partners in Sylvan Ventures of \$1.7 million. Cash provided by financing activities in the 2001 fiscal six month period related primarily to cash received from the minority interest partners in Sylvan Ventures of \$21.9 million and proceeds from the exercise of options of \$7.0 million.

The Company's Board of Directors has approved a stock repurchase program pursuant to which the Company, from time to time and at management's discretion, may purchase up to an aggregate of 3.5 million shares of Sylvan Learning Systems common stock on the open market. In 2000, the Company repurchased 13.2 million shares through two separate self-tender offerings at an average price of approximately \$15.17.

The Company anticipates that cash flow from operations, available cash and existing credit facilities will be sufficient to meet its operating requirements, including expansion of its existing business, funding International University acquisitions, payment of contingent consideration and funding of Sylvan Ventures investments and operating costs. Sylvan Ventures has outstanding commitments to provide additional funding of approximately \$9.0 million to certain portfolio companies. The Company continues to examine opportunities in the educational services industry for potential synergistic acquisitions.

**Contingent Matters**

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In connection with certain acquisitions, variable amounts of contingent consideration are payable to the seller based upon specified terms. All existing contingent consideration agreements are predicated upon improved operating profitability of the acquired entities and utilize multiples consistent with those used to calculate the initial purchase price. The Company will record the contingent consideration when the contingencies are resolved and the additional consideration is payable.

Variable amounts of contingent consideration are payable to the seller of Les Roches if specified levels of earnings are achieved in 2002. Variable amounts of contingent consideration are payable to the seller of UDLA in 2006 and 2007 if specified levels of earnings are achieved in 2004, 2005 and 2006. Additional purchase consideration of \$0.5 million is due to the sellers of UVM in 2003 if 2002 earnings exceed certain specified amounts. Variable amounts of contingent consideration, up to a maximum of \$8.0 million, are also payable to the sellers of certain Sylvan Learning Centers franchises repurchased by the Company if specified levels of operating results are achieved in 2002, 2003, 2004 and 2005. In August 2002, the Company entered into negotiations to finalize the amounts due as additional consideration for the acquisition of these Sylvan Learning Center franchises and to acquire

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other franchise rights from the sellers in the United Kingdom and France. The Company expects an agreement to be reached whereby it will agree to payments totaling approximately \$16.0 million in connection with the acquisition of these Sylvan Learning Center operations.

The Company has entered into agreements with certain franchisees of Sylvan Learning Centers and Wall Street Institute that allow the franchisees to require the Company to repurchase the centers in the future at a predetermined multiple of operating results upon the achievement of specified operating thresholds. The Company does not believe that these commitments, if ultimately triggered by future events, would materially effect its liquidity.

### **Seasonality in Results of Operations**

The Company experiences seasonality in results of operations primarily as a result of changes in the level of student enrollments and the timing of semester cycles, particularly in the International Universities segment. Timing of semester breaks at the International Universities results in the strongest operating performance being achieved in the second and fourth quarters of the year. Other factors that impact the seasonality of operating results include: timing of contracts funded under Title I, timing of summer vacations, timing of franchise license fees and the timing of Sylvan Ventures' development costs. Revenues and profits in any period will not necessarily be indicative of results in subsequent periods.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISK**

Market risk is the risk of loss to future earnings, to fair values or to future cash flows that may result from the changes in the price of financial instruments. The Company is exposed to financial market risks, including changes in foreign currency exchange rates, interest rates, equity prices and investment values. The Company occasionally uses derivative financial instruments to protect against adverse currency movements related to significant foreign acquisitions. Exposure to market risks related to operating activities is managed through the Company's regular operating and financing activities.

#### *Foreign Currency Risk*

The Company derives approximately 54% of its revenues from customers outside the United States. This business is transacted through a network of international subsidiaries, generally in the local currency that is considered the functional currency of that foreign subsidiary. Expenses are also incurred in the foreign currencies to match revenues earned and minimize the Company's exchange rate exposure to operating margins. A hypothetical 10% adverse change in average annual foreign currency exchange rates would have decreased operating income and cash flows for the 2002 fiscal six month period by \$2.0 million. The Company generally views its investment in most of its foreign subsidiaries as long-term. The effects of a change in foreign currency exchange rates on the Company's net investment in foreign subsidiaries are reflected in other comprehensive income (loss). A 10% depreciation in functional currencies relative to the U.S. dollar would have resulted in a decrease in the Company's net investment in foreign subsidiaries of approximately \$24.1 million at June 30, 2002.

#### *Interest Rate Risk*

The Company holds its cash and cash equivalents in high quality, short-term, fixed income securities. Consequently, the fair value of the Company's cash and cash equivalents would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due to the short-term nature of the Company's portfolio. The Company's long-term revolving credit facility bears interest at variable rates, and the fair

value of this instrument is not significantly affected by changes in market interest rates. The Company's convertible debentures bear interest at 5%, which currently

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approximates the market rate. A 100 basis point decrease in interest rates would have reduced net interest income for the 2002 fiscal six month period by \$0.7 million.

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#### *Equity Price Risk*

The fair value of the Company's convertible debentures is sensitive to fluctuations in the price of the Company's common stock into which the debentures are convertible. Changes in equity prices would result in changes in the fair value of the Company's convertible debentures due to the difference between the current market price of the debentures and the market price at the date of issuance of the debentures. A 10% increase in the 2002 fiscal six month period end market price of the convertible debentures would result in an increase of approximately \$12.0 million in the net fair value of the debentures.

The Company is exposed to equity price risks on equity securities included in the portfolio of investments entered into for the promotion of business and strategic objectives. The Company typically does not attempt to reduce or eliminate its market exposure on these securities. A 10% adverse change in equity prices would not materially impact the fair value of the Company's marketable securities or other comprehensive income (loss).

#### *Investment Risk*

The Company's investment portfolio contains debt securities that mature within one year. A hypothetical 10% adverse change in the fair value of the debt securities would not materially adversely impact earnings or cash flows because of the Company's ability to hold the debt securities until maturity.

In addition to the debt securities, the Company has an investment portfolio that consists of direct investment positions in education technology companies through Sylvan Ventures, as well as short-term investments in available-for-sale debt and equity securities. The Company's investment portfolio is exposed to risks arising from changes in these investment values.

The Company's investment portfolio includes a number of holdings of non-publicly traded companies in the educational services industry. The Company accounts for these investments using either the cost method (cost less impairment, if any) or the equity method of accounting. Equity method investments are specifically excluded from the scope of this disclosure. Non-public investments where the Company owns less than a 20% interest are subject to fluctuations in market value, but their current illiquidity reduces the exposure to pure market risk while increasing the risk that the Company may not be able to liquidate these investments in a timely manner for their estimated value.

All the potential impacts noted above are based on sensitivity analysis performed on the Company's financial position at June 30, 2002. Actual results may differ materially.

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## **PART II OTHER INFORMATION**

### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

- (a) The Company held its Annual Meeting of Stockholders on June 6, 2002.
- (b)

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The following sets forth information regarding each matter voted upon at the Annual Meeting. There were 39,817,530 shares of common stock outstanding as of the record date for, and entitled to vote at, the Annual Meeting.

Proposal No. 1. The stockholders approved election of all of the nominees to the board of directors. The tabulation of votes on this proposal is as follows:

| <b>Nominee</b>             | <b>For</b> | <b>Withheld</b> |
|----------------------------|------------|-----------------|
| R. Christopher Hoehn-Saric | 27,457,489 | 8,432,643       |
| John A. Miller             | 35,501,101 | 389,031         |
| David A. Wilson            | 35,737,383 | 152,749         |

Proposal No. 2. The stockholders ratified the selection of Ernst & Young, LLP as the Company's independent auditors. The tabulation of votes on this proposal is as follows:

|                    |            |
|--------------------|------------|
| For Approval       | 34,540,210 |
| Against Approval   | 1,295,962  |
| Abstain            | 53,960     |
| Total Shares Voted | 35,890,132 |

### ITEM 5. OTHER INFORMATION

The Registrant has filed with the Securities and Exchange Commission the certifications of its Chief Executive Officer and Chief Financial Officer required by Section 906 of the Sarbanes-Oxley Act of 2002.

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None

(b) Reports on Form 8-K

The Company did not file any reports on Form 8-K during the six month period ended June 30, 2002.

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### SIGNATURE

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

SYLVAN LEARNING SYSTEMS, INC.

Date: August 14, 2002

/s/ SEAN R. CREAMER

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Sean R. Creamer, *Senior Vice President and  
Chief Financial Officer*

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