

Acorn International, Inc.  
Form 20-F  
May 06, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 20-F**

(Mark One)

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

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2009

OR

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

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
Date of event requiring this shell company report

For the transition period from            to            .

Commission file number: 001-33429

# Acorn International, Inc.

(Exact name of Registrant as specified in its charter)

Not applicable

(Translation of Registrant's name into English)

Cayman Islands

(Jurisdiction of incorporation or organization)

18/F, 20th Building, 487 Tianlin Road, Shanghai 200233

(Address of principal executive offices)

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

| Title of each class                                 | Name of each exchange on which registered |
|---|---|
| American Depositary Shares, each representing three | New York Stock Exchange                   |

ordinary shares, par value \$0.01 per share

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

None

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

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 88,856,915

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  Yes  No

If this report is an annual or transaction report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  Yes  No

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

US GAAP  International Financial Reporting Standards as issued by the  Other

International Accounting Standards Board

If  Other has been checked in response to the previous question indicate by check mark which financial statement item the registrant has elected to follow.  Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  Yes  No

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**INTRODUCTION**

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

ADSs are to our American depositary shares, each of which represents three ordinary shares;

ADRs are to American depositary receipts, which, if issued, evidence our ADSs;

\$ , US\$ and U.S. dollars are to the legal currency of the United States;

China and the PRC are to the People's Republic of China, excluding Taiwan and the special administrative regions of Hong Kong and Macau;

ordinary shares are to our ordinary shares, par value \$0.01 per share;

RMB and Renminbi are to the legal currency of China; and

we , us , our company and our refer to Acorn International, Inc., its predecessor entities and its subsidiaries.

This annual report on Form 20-F includes our audited consolidated statements of operation data for the years ended December 31, 2007, 2008 and 2009, and audited consolidated balance sheet data as of December 31, 2008 and 2009.

We and certain of our shareholders completed the initial public offering of 8,855,000 ADSs, each representing three ordinary shares in May 2007. Our ADSs, each representing three ordinary shares, are listed on the New York Stock Exchange under the symbol **ATV** .

**FORWARD-LOOKING STATEMENTS**

This annual report on Form 20-F contains forward-looking statements that involve risks and uncertainties. All statements other than statements of historical facts are forward-looking statements based on our current expectations, assumptions, estimates and projections about us and our industry. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from those expressed or implied by the forward-looking statements. In some cases, these forward-looking statements can be identified by words or phrases such as **aim** , **anticipate** , **believe** , **continue** , **estimate** , **expect** , **intend** , **to** , **may** , **plan** , **potential** , **will** or other similar expressions. The forward-looking statements included in this annual report relate to, among other

our goals and strategies;

expected trends in our direct sales platform and our distribution network, and in our margins and certain cost or expense items as a percentage of our net revenues;

our future business development, financial condition and results of operations;

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our ability to introduce successful new products and services and attract new customers;

competition in the TV direct sales market and retail market in China for our consumer products and services;

our ability to effectively control our cost of sales and efficiently access media channels and manage our media time; and

PRC governmental policies and regulations relating to our businesses.

The forward-looking statements made in this annual report relate only to events or information as of the date on which the statements are made in this annual report. All forward-looking statements included herein attributable to us or other parties or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date on which the statements are made or to reflect the occurrence of unanticipated events.

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**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**A. Selected Financial Data**

The following selected consolidated statements of operations data for the three years ended December 31, 2007, 2008 and 2009, and the selected consolidated balance sheet data as of December 31, 2008 and 2009, have been derived from our consolidated financial statements for the years ended December 31, 2007, 2008 and 2009, which have been audited by Deloitte Touche Tohmatsu CPA, Ltd., an independent registered public accounting firm, and are included elsewhere in this annual report. Our selected consolidated statements of operations data for the years ended December 31, 2005 and 2006, and our consolidated balance sheet data as of December 31, 2005, 2006 and 2007, have been derived from our audited consolidated financial statements that are not included in this annual report. The selected consolidated financial data should be read in conjunction with those consolidated financial statements and related notes and Item 5, Operating and Financial Review and Prospects in this annual report. Our consolidated financial statements are prepared and presented in accordance with U.S. GAAP. We adopted authoritative guidance regarding accounting for non-controlling interests in our consolidated financial statements on January 1, 2009, retrospectively. In addition, prior period financial statements have been recasted to report the results of discontinued operations. Please refer to Notes 4 and 2(aa) of the notes to consolidated financial statements for detailed information regarding discontinued operations and non-controlling interest, respectively.

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|  | For the years ended December 31,                |                     |                     |                     |                  |
|--|---|---------------------|---------------------|---------------------|------------------|
|  | 2005  | 2006 <sup>(5)</sup> | 2007 <sup>(5)</sup> | 2008 <sup>(5)</sup> | 2009             |
|  | (in thousands, except share and per share data) |                     |                     |                     |                  |
| <b>Condensed Consolidated Statements of Operations Data</b>                            |   |                     |                     |                     |                  |
| Revenues:  |   |                     |                     |                     |                  |
| Direct sales, net  | \$ 76,828                                       | \$ 106,600          | \$ 181,320          | \$ 166,947          | \$ 160,358       |
| Distribution sales, net  | 93,512  | 87,560              | 66,717              | 67,190              | 127,228          |
| <b>Total revenues, net</b>   | <b>170,340</b>                                  | <b>194,160</b>      | <b>248,037</b>      | <b>234,137</b>      | <b>287,586</b>   |
| Cost of revenues:  |   |                     |                     |                     |                  |
| Direct sales   | 26,646  | 32,156              | 85,982              | 83,301              | 67,531           |
| Distribution sales   | 43,566  | 41,162              | 37,366              | 37,326              | 83,097           |
| <b>Total cost of revenues</b>  | <b>70,212</b>                                   | <b>73,318</b>       | <b>123,348</b>      | <b>120,627</b>      | <b>150,628</b>   |
| <b>Gross profit</b>  | <b>100,128</b>                                  | <b>120,842</b>      | <b>124,689</b>      | <b>113,510</b>      | <b>136,958</b>   |
| Operating (expenses) income:   |   |                     |                     |                     |                  |
| Advertising expenses   | (55,564)  | (76,262)            | (74,966)            | (73,381)            | (61,048)         |
| Other selling and marketing expenses <sup>(1)</sup>                                    | (13,734)  | (20,256)            | (29,250)            | (38,317)            | (42,956)         |
| General and administrative expenses <sup>(1)</sup>                                     | (12,340)  | (26,354)            | (26,100)            | (27,747)            | (31,196)         |
| Impairment of goodwill and intangible assets   |   |                     |                     | (8,668)             | (15,248)         |
| Other operating income, net  | 1,553   | 2,779               | 3,144               | 5,039               | 6,004            |
| <b>Total operating (expenses) income</b>   | <b>(80,085)</b>                                 | <b>(120,093)</b>    | <b>(127,172)</b>    | <b>(143,074)</b>    | <b>(144,444)</b> |
| Income (loss) from operations  | 20,043  | 749                 | (2,483)             | (29,564)            | (7,486)          |
| Other (expenses) income  | (9,485)   | 2,156               | 13,711              | (667)               | 1,651            |
| Total income tax (expenses) benefits   | (770)   | 696                 | 13                  | (5)                 | 2,539            |
| <b>Income (loss) from continuing operations</b>  | <b>9,788</b>                                    | <b>3,602</b>        | <b>11,241</b>       | <b>(30,236)</b>     | <b>(3,296)</b>   |
| Income from discontinued operations, net of taxes                                      |   | 904                 | 14,474              | 8,274               | 15,363           |
| <b>Net income (loss)<sup>(2)(3)</sup></b>  | <b>9,788</b>                                    | <b>4,506</b>        | <b>25,715</b>       | <b>(21,962)</b>     | <b>12,067</b>    |
| Net income attributable to non-controlling interests <sup>(6)</sup>                    | (1,756)   | (561)               | (7,063)             | (3,629)             | (184)            |
| <b>Net income (loss) attributable to Acorn International, Inc</b>                      | <b>8,032</b>                                    | <b>3,945</b>        | <b>18,652</b>       | <b>(25,591)</b>     | <b>11,883</b>    |
| Deemed dividend on Series A convertible redeemable preferred shares                    | (162)   | (162)               | (54)                |                     |                  |
| <b>Net income (loss) attributable to holders of ordinary shares</b>                    | <b>\$ 7,870</b>                                 | <b>\$ 3,783</b>     | <b>\$ 18,598</b>    | <b>\$ (25,591)</b>  | <b>\$ 11,883</b> |
| Income (loss) per ordinary share:  |   |                     |                     |                     |                  |
| Basic  | \$ 0.13   | \$ 0.05             | \$ 0.20             | \$ (0.29)           | \$ 0.13          |
| Diluted  | \$ 0.12   | \$ 0.05             | \$ 0.19             | \$ (0.29)           | \$ 0.13          |
| Weighted average number of shares used in calculating income (loss) per ordinary share |   |                     |                     |                     |                  |



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|         |            |            |            |            |            |
|---------|------------|------------|------------|------------|------------|
| Basic   | 45,814,725 | 48,979,394 | 77,738,701 | 86,856,467 | 88,174,675 |
| Diluted | 48,645,299 | 53,607,999 | 84,472,947 | 86,856,467 | 88,174,675 |

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|  | 2005       | 2006       | As of December 31,<br>2007 |            |            | 2008 | 2009 |
|--|------------|------------|----------------------------|------------|------------|------|------|
|  |            |            | (in thousands)             |            |            |      |      |
| <b>Condensed Consolidated Balance Sheet Data</b> |            |            |                            |            |            |      |      |
| Cash and cash equivalents                        | \$ 35,386  | \$ 40,744  | \$ 148,743                 | \$ 147,649 | \$ 142,953 |      |      |
| Prepaid advertising expenses                     | 20,090     | 25,384     | 23,151                     | 16,757     | 9,968      |      |      |
| Total assets                                     | 100,372    | 118,699    | 287,776                    | 304,185    | 274,018    |      |      |
| Deferred revenue                                 |            | 4,193      | 13,352                     | 12,798     |            |      |      |
| Total liabilities                                | 12,569     | 15,183     | 35,160                     | 74,860     | 68,992     |      |      |
| Total liabilities and equity                     | \$ 100,372 | \$ 118,699 | \$ 287,776                 | \$ 304,185 | \$ 274,018 |      |      |

|   | For the years ended December 31, |       |                                    | 2009  |
|---|----------------------------------|-------|------------------------------------|-------|
|   | 2007                             | 2008  | (in thousands, except percentages) |       |
| <b>Selected Operating Data</b>  |                                  |       |                                    |       |
| Number of inbound calls generated through direct sales platforms <sup>(4)</sup> | 6,900                            | 7,320 |                                    | 7,450 |
| Conversion rate for inbound calls to product purchase orders <sup>(4)</sup>     | 16.8%                            | 23.2% |                                    | 31.0% |
| Total TV direct sales program minutes   | 890                              | 596   |                                    | 410   |

- (1) Includes share-based compensation of:

|                                      | 2005       | For the years ended December 31, |            |            | 2009       |
|--------------------------------------|------------|----------------------------------|------------|------------|------------|
|                                      |            | 2006                             | 2007       | 2008       |            |
|                                      |            | (in thousands)                   |            |            |            |
| Other selling and marketing expenses | \$ (168)   | \$ (741)                         | \$ (423)   | \$ (292)   | \$ (94)    |
| General and administrative expenses  | \$ (2,168) | \$ (7,932)                       | \$ (6,096) | \$ (2,997) | \$ (1,751) |

- (2) Includes:

|   | 2005       | For the years ended December 31, |            |            | 2009     |
|---|------------|----------------------------------|------------|------------|----------|
|   |            | 2006                             | 2007       | 2008       |          |
|   |            | (in thousands)                   |            |            |          |
| Share-based compensation                          | \$ (2,336) | \$ (8,673)                       | \$ (6,519) | \$ (3,289) | (1,846)  |
| Expensed offering costs                           |            | (3,166)                          |            |            |          |
| Change in fair value in warrant liability         | (10,059)   |                                  |            |            |          |
| Goodwill and intangible assets impairment losses  |            |                                  |            | (8,668)    | (15,248) |
| Loss on change in fair value of derivative assets |            |                                  |            | (3,275)    | (1,306)  |

The change in fair value in warrant liability resulted from our issuance on January 21, 2005 of a warrant allowing the holder to acquire 2,882,155 shares of our series A-1 convertible redeemable preferred shares upon payment of \$8.0 million in cash, corresponding to a per share exercise price of \$2.78. The warrant was exercised in full on December 28, 2005. The warrant was deemed a freestanding derivative liability which required the warrant to be measured at fair value upon initial recognition and subsequent to initial recognition. Accordingly, we recognized a non-cash charge in connection with marking the warrant to fair value for the period prior to exercise.

- (3) Net income for the periods presented reflect effective tax rates, which may not be representative of our long-term expected effective tax rates in light of the tax holidays and exemptions enjoyed by certain of our PRC subsidiaries and our consolidated affiliated entities. See Item 5.A, Operating and Financial Review and Prospects Operating Results Taxation .

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- (4) Does not include calls generated under our marketing services arrangements (first introduced in 2006) that are primarily marketing in nature and result in limited direct sales revenues, such as our prior arrangement with China Unicom.
- (5) The results of operations for these periods have been recasted to report discontinued operations of a former subsidiary which was incorporated in December 2005 and started operation in 2006.
- (6) We adopted authoritative guidance regarding accounting for non-controlling interests in our consolidated financial statements on January 1, 2009, retrospectively.

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Our business is primarily conducted in China and all of our net revenues and expenses are denominated in Renminbi. However, periodic reports made to shareholders are expressed in U.S. dollars using the then current exchange rates. This annual report contains translations of Renminbi amounts into U.S. dollars at specific rates solely for the convenience of the reader. The conversion of Renminbi into U.S. dollars in this annual report is based on the noon buying rate in the City of New York for cable transfers of Renminbi as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise noted, all translations from Renminbi to U.S. dollars and from U.S. dollars to Renminbi in this annual report were made at a rate of RMB6.8259 to US\$1.00, the noon buying rate in effect as of December 31, 2009. The noon buying rate in effect as of April 30, 2010 was RMB6.8247 to \$1.00. We make no representation that any Renminbi or U.S. dollar amounts could have been, or could be, converted into U.S. dollars or Renminbi, as the case may be, at any particular rate, the rates stated below, or at all. The Chinese government imposes control over its foreign currency reserves in part through direct regulation of the conversion of Renminbi into foreign currencies and through restrictions on foreign trade.

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

| Period   | Noon Buying Rate |                        |        |        |
|----------|------------------|------------------------|--------|--------|
|          | Period-End       | Average <sup>(1)</sup> | Low    | High   |
| 2004     | 8.2765           | 8.2768                 | 8.2774 | 8.2764 |
| 2005     | 8.0702           | 8.1940                 | 8.2765 | 8.2702 |
| 2006     | 7.8041           | 7.9723                 | 8.0702 | 7.8041 |
| 2007     | 7.2946           | 7.5806                 | 7.8127 | 7.2946 |
| 2008     | 6.8225           | 6.9477                 | 7.2946 | 6.7800 |
| 2009     | 6.8259           | 6.8307                 | 6.8176 | 6.8470 |
| October  | 6.8264           | 6.8267                 | 6.8292 | 6.8248 |
| November | 6.8265           | 6.8271                 | 6.8300 | 6.8255 |
| December | 6.8259           | 6.8275                 | 6.8299 | 6.8240 |
| 2010     |                  |                        |        |        |
| January  | 6.8268           | 6.8269                 | 6.8295 | 6.8258 |
| February | 6.8258           | 6.8285                 | 6.8330 | 6.8258 |
| March    | 6.8258           | 6.8262                 | 6.8270 | 6.8254 |
| April    | 6.8247           | 6.8256                 | 6.8275 | 6.8229 |

(1) Annual averages are calculated from month-end rates. Monthly averages are calculated using the average of the daily rates during the relevant period.

**B. Capitalization and Indebtedness**

Not applicable.

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

Not applicable.

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**D. Risk Factors**

**Risks Relating to Our Business**

*Our evolving business model and the evolution of China's direct sales industry makes it difficult to evaluate our business and future prospects.*

Our business model continues to evolve in conjunction with the evolution of China's direct sales industry (including the TV home shopping industry) and market conditions. The direct sales industry in China is still in the early stage of development and the competitive landscape and range of products and services being offered continue to evolve rapidly. Our business model has varied throughout our operating history in response to changes in the direct sales industry. Historically, we focused on our proprietary branded products, such as Ozing and Meijin. In 2006, we began selling and marketing certain third-party branded products and services on our TV direct sales platform pursuant to joint sales and marketing services arrangements, which, to date, we have sold through our nationwide distribution network only in limited quantities. Additionally, in 2007, we began relationships with four established domestic banks through which we directly market products through specialized catalogs to credit card holders of these banks. As of December 31, 2009, we have established relationships with 26 domestic banks. However, our arrangements with these banks are not exclusive and the banks may send catalogs of our competitors to the credit card holders as well. In addition, the banks retain the right to elect which products are offered in our catalogs, and we may not be able to market our featured products or our highest profit margin products. Further, sales generated from our other direct sales platforms have grown at a faster pace than our sales from TV direct sales platform in 2009 primarily due to our utilization of our customer database, the changing regulatory environment and the increase in media price. We expect sales from other direct sales platforms, including catalogs, third party banks, Internet and outbound calls, to be of higher growth potential and growing importance to our business in the future. The evolution of our business model makes it difficult for you to evaluate our business and future prospects.

*Our operating results fluctuate from period to period, making them difficult to predict. Our operating results for a particular period could fall below our expectations or the expectations of investors or any market analyst that may issue reports or analyses regarding our ADSs, resulting in a decrease in the price of our ADSs.*

Our operating results are highly dependent upon, and will fluctuate based on, the following product and service-related factors:

the mix of TV direct sales programs, including the portion thereof dedicated to products and services marketed by us pursuant to joint sales and marketing services arrangements, and brand promotion advertising;

the mix of products and services selected by us for marketing through our TV direct sales programs, our non-TV direct sales channels and our nationwide distribution network and their average selling prices;

the mix of our non-TV versus TV direct sales platforms;

new product or service introductions by us or our competitors and our ability to identify new products and services;

the availability of competing products and services and possible reductions in the sales price of our products and services over time in response to competitive offerings or in anticipation of our introduction of new or upgraded offerings;

seasonality with respect to certain of our products, such as our electronic learning products, for which sales are typically higher around our first and third fiscal quarters corresponding with the end and beginning of school semesters in China, respectively.

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a product's connection to a one-time event, such as our Olympic collectible products, for which sales decreased significantly following the 2008 Olympic Games;

increases in component costs, such as the recent increase in the cost of flash memory, which is a key component of our electronic learning product;

the cycles of our products and services featured in our TV direct sales programs, with such sales typically growing rapidly over the initial promotional period and then declining over time, sometimes precipitously in a short period of time;

the market of certain featured products becoming saturated over time;

discounts offered to our distributors as part of incentive plans to stimulate sales;

the success of our distributors in promoting and selling our products locally; and

the potential negative impact distributor sales may have on our own direct sales efforts.

In addition, factors not directly relating to our products and services which could cause our operating results to fluctuate in a particular period or in comparison to a prior period include:

any requirement to suspend or terminate a particular TV direct sales program, including in response to regulatory actions;

new laws, regulations or rules promulgated by the PRC government governing the TV direct sales industry;

negative publicity about our products and services;

natural disasters, such as the severe snow storms or earthquake experienced by China in 2008;

the amount and timing of operating expenses incurred by us, including our media procurement expenses, inventory-related losses, bad debt expense, product returns and options grants to our employees;

gains and losses related to our investments in marketable securities; and

the level of advertising and other promotional efforts by us and our competitors in a particular period.

Due to these and other factors, our operating results will vary from period to period, will be difficult to predict for any given period, may be adversely affected from period to period and may not be indicative of our future performance. If our operating results for any period fall below our expectations or the expectations of investors or any market analyst that may issue reports or analyses regarding our ADSs, the price of our ADSs is likely to decrease.

***Our best-selling featured product lines account for, and are expected to continue to account for, the substantial majority of our sales. Featured products sales may decline, these products may have limited product lifecycles, and we may fail to introduce new products and services to offset declines in sales of our featured products.***

Our five best-selling featured products or product lines accounted for approximately 79.5%, 73.7% and 81.8% of our gross revenues in 2007, 2008 and 2009, respectively. In 2009, our electronic learning product line, which has consistently been one of our five best-selling products and had been the best-selling product prior to 2007, was our best-selling product, and accounted for approximately 30.2% of our gross revenues. Sales of our cell phone product line, which was our best-selling product in 2008, accounted for approximately 21.3% of our gross revenues in 2009. The composition of our five best-selling featured products has varied from year to year. We expect that a small number of our featured product lines will continue to account for a substantial majority of our sales.

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Only approximately 10.4% of our TV direct sales customers purchased products or services through our direct sales platform more than once in 2009. Our featured products may fail to maintain or achieve sufficient consumer market popularity and sales may decline due to, among other factors, the introduction of competing products, entry of new competitors, customer dissatisfaction with the value or quality offered by our products, negative publicity or market saturation (particularly in the area of cell phones). Consequently, our future sales success depends on our ability to successfully identify, develop, introduce and distribute in a timely and cost-effective manner new and appealing products and services, including new and upgraded products and services.

Our product and service sales for a given period will depend upon, among other things, a positive customer response to our TV direct sales programs, our effective management of product inventory and the stage of our products' lifecycles during the period. Customer response to our TV direct sales programs depends on many factors, including the appeal of the products and services being marketed, the effectiveness of the TV direct sales programs, the viability of competing products and services and the timing and frequency of airtime. Our new products and services may not receive market acceptance. In addition, from time to time, we experience delays in the supply of our products to customers due to production delays or shortages or inadequate inventory management, and we lose potential product sales as a result. Furthermore, during a product's lifecycle, problems may arise regarding regulatory, intellectual property, product liability or other issues which may affect the continued viability of the product for sale.

Although we have previously offset declining sales of a featured product line through increased sales of a new or expanded featured product line, we may be unable to do so in the future. For example, in 2009, after eliminating the sales from Yiyang Yukang, our sales of cell phone products by direct sales declined to approximately \$33 million from \$56 million in 2008, though the total sales of cell phones is still growing from \$56 million in 2008 to \$61 million in 2009. Sales of our cosmetics and Meijin electronic dictionary products increased to approximately \$21.4 million and \$4.0 million, respectively, in 2009 compared to 2008. However, sales of our cell phone products may not recover in 2010 and we may not be able to identify new products to cover the decline in our sales of cell phone products. If we fail to identify and introduce additional successful products and services, including those to replace existing featured products suffering from declining sales or approaching the end of their product lifecycle, our gross revenues may not grow or may decline and our market share and value of our brand may be materially and adversely affected.

### ***We may not fully realize the desired synergy of our acquisition of Yiyang Yukang.***

On December 24, 2008, we completed our acquisition of Yiyang Yukang, a cell phone producer and distributor in China. We acquired Yiyang Yukang with an aim to build and develop our own cell phone brands, as well as to take advantage of Yiyang Yukang's nationwide distribution network to facilitate sales of our featured cell phone products. In 2009, we recorded a \$15.2 million impairment loss of intangible assets for Yiyang Yukang, which was primarily caused by (i) overall under-performance in the mobile handsets business of Yiyang Yukang and (ii) Yiyang Yukang's change in business strategy to launch its proprietary Uking brand and changes incurred in the acquired distribution network. There can be no assurance that our desired synergy as a result of the acquisition will be carried out fully and smoothly and will not encounter any difficulties or delays.

In addition, we do not have relevant experience in managing and operating a cell phone manufacturer and maintain only low level supervision over the daily operation of Yiyang Yukang. We rely highly upon the core management of Yiyang Yukang in operating the company, and we may be unable to integrate and retain employees and management personnel. There are operational and managerial uncertainties associated with our newly acquired business and there can be no assurance that the management of Yiyang Yukang can sustain the levels of profitability or produce the anticipated results. In 2009, Yiyang Yukang's performance has fallen below our management's expectation and there can be no assurance its operation results and profitability will achieve the level we anticipate in 2010 or in the future.



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*Our business depends significantly on the strength of our product and service brands and corporate reputation; our failure to develop, maintain and enhance our product and service brands and corporate reputation may materially and adversely affect the level of market recognition of, and trust in, our products and services.*

In China's fragmented, developing and increasingly competitive consumer market, product and service brands and corporate reputation have become critical to the success of our new products and services and the continued popularity of our existing products and services. Our ability to develop, maintain and enhance a given product or service's brand image and recognition depends largely on our ability to remain a leader in the TV direct sales market industry in China. Our brand promotion efforts, particularly our brand promotion activities, may be expensive and may fail to either effectively promote our product and service brands or generate additional sales.

Our product and service brands, corporate reputation and product sales could be harmed if, for example:

our advertisements, including our TV direct sales programs, or the advertisements of the owners of the third-party brands that we market or those of our distributors, are deemed to be misleading or inaccurate;

our products or services fail to meet customer expectations;

we provide poor or ineffective customer service;

our products or services contain defects or otherwise fail;

consumers confuse our products with inferior or counterfeit products;

consumers confuse our TV direct sales programs with those of our competitors, some of which may promote inferior products, be misleading or inaccurate, or be of poor production quality; or

consumers find our outbound calls intrusive or annoying.

For example, in July 2006, several articles appeared in the Chinese media that, among other things, questioned the pricing and quality of our products, in particular targeting our electronic learning products. The negative media coverage led to a decline in sales volume and revenue for this product and several of our other products. In addition, in September 2007, an article published in the Chinese media reported that the State Administration for Industry and Commerce, Shanghai Branch, had determined that the advertisements for our stock tracking software were considered false advertising. This negative publicity materially affected the sales of this product in the fourth quarter of 2007. Any failure to maintain and enhance our product or service brands or our corporate reputation in response to negative publicity or the other matters described above, may materially and adversely affect the market recognition of, and trust in, our products and services and the levels of sales and product returns and thus significantly harm our operating results. To our knowledge, we are not aware of any such negative publicity in relation to our products or services in 2009.

Furthermore, some of our customers reported that they have received phone calls from certain unidentified third parties impersonating our staffs. These unidentified individuals called our customers to request that they (i) modify their order because the ordered product was out of stock or (ii) reject an ordered product upon delivery because it was damaged. In some cases, these unidentified individuals delivered counterfeit or inferior products to our customers. We conducted internal investigation, which indicated that such events were not undertaken by our employees. We also have reported the case to the relevant authorities in November 2009 and investigation by relevant authorities is pending. We believe that we have taken the necessary steps to prevent similar events from recurring. However, there can be no assurance that we will be able to effectively prevent the recurrence of such events in the future. Although the total number of cases and the total amount involved in this malicious behavior were immaterial, in case such events recurs in the future, it could materially adversely affect our reputation among our customers and potential customers and our result of operations.



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*The slow-down of economic growth in China and the global economic downturn adversely affected, and could continue adversely affecting, our business and operations.*

The recent global economic downturn adversely affected the global economy, including China, where our primary business operations are located. The Chinese economy experienced a slowing of its growth rate, and the slow-down was exacerbated by the global crisis in the financial services and credit markets, which resulted in significant volatility and dislocation in the global capital markets. Although the Chinese economy has recovered recently, it is uncertain whether such recovery will continue. It is uncertain how long the global economic downturn will last. During 2009, we experienced reduced demand for some of our products and services, particularly our high-end products and products with high unit prices, and we expect that demand for these products and services will continue to remain low. As a result, we may need to lower the prices of certain of our products and services in order to maintain the attractiveness of our products and services, which could lead to reduced turnover and profit. For example, we offered lower priced models of our Ozing electronic learning products to our customers in 2009. Any persistent slow-down in China's economy could adversely affect our business and operations.

*Our business depends on our access to TV media time to market our products and services in China which is limited by PRC regulations. We do not generally have long-term contracts to purchase TV media time, and any regulatory or other disruption of our access to desired TV time slots could negatively impact the effectiveness of our TV direct sales platform.*

Our business is dependent on having access to media time to televise our TV direct sales programs. A significant portion of our direct sales, which accounted for 73.1%, 71.3% and 55.8% of our total net revenues in 2007, 2008 and 2009, respectively, are generated through our TV direct sales platform. In addition, our nationwide distribution network is significantly dependent on our TV direct sales platform since our distributors generally seek to distribute products and services that were or continue to be sold successfully through our TV direct sales programs.

Under PRC regulations, airtime used to broadcast retail sales programs is generally considered advertising time. PRC regulations restrict the overall daily TV advertising time and the amount of TV advertising time during certain time periods. New regulations and rules were issued in 2009 which posed tighter restrictions on TV advertising. The Circular on Strengthening the Administration of TV Direct Sales Advertising and Home Shopping Programs issued by the State Administration of Radio, Film and Television, or SARFT, on September 10, 2009 requires that TV direct sales advertising programs not be broadcasted on some specialized TV channels, including news channels and international channels, and TV home shopping channels and not be broadcasted on satellite TV channels during the period from 6:00pm to 12:00pm every day. The Administrative Measures on Advertising on Television or Radio issued by the SARFT on September 11, 2009 and effective as of January 1, 2010 further requires that the total airtime allocated to commercial advertising on each TV channel not exceed 12 minutes per hour and not exceed 18 minutes in total during the period from 7:00pm to 9:00pm. Violation of these time restrictions may result in a warning, an order to correct the violation, a fine of up to RMB20,000, the suspension of broadcasting relevant to advertising, the suspension of the operation of the TV channel where the relevant advertising is broadcast, or even the withdrawal of the TV station's operating license.

Our TV direct sales programs, which are typically five to ten minutes in length, are in most cases treated by TV stations as advertising for purposes of complying with these PRC regulations. Accordingly, adverse or unanticipated regulatory changes, including any change that limits the amount of time available for TV advertising generally or its availability to us, could significantly harm our business or limit our ability to operate. For example, the 2009 new regulations and rules described above have caused a strong increase in media price and as a result, we have to further lower our purchase of TV advertising time to focus on more cost effective channels and time slots and to better control our cost. Consistent with industry practice in China, our TV advertising purchase contracts are typically negotiated annually. We purchase TV advertising time directly from TV stations or TV advertising agencies that have exclusive rights to sell certain time slots for certain TV

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channels. Competition for attractive TV advertising time and for channels in China is intense, in part, due to the daily restrictions discussed above. Competitors for advertising time include other TV-based retail companies and companies seeking to advertise their own products and services. In addition, certain TV channels have in the past allocated, and might choose in the future to allocate, fewer time slots for TV direct sales programs. As our existing contracts expire, we may be unable to purchase or renew desired advertising time slots on desirable TV channels or at favorable price levels, if at all. Any significant increase in media price or decreases in our access to media time, including as result of any failure to renew or extend our existing contracts with TV stations or their advertising agencies, could negatively impact the effectiveness of our TV direct sales platform and our TV direct sales net revenues and total net revenues.

***Our advertising commitments represent our largest operating expenditure. However, our advertising commitments may not generate higher net revenues, thereby negatively impacting our overall profitability.***

The purchase of TV advertising time is our largest operating expenditure. A significant increase in the cost of media time could negatively impact our overall profitability. In 2009, we continued to selectively lower our purchase of TV advertising time and focused on more cost effective channels and time slots and adopted a more flexible manner in our procurement to achieve better cost control. We were also able to improve media efficiency by reducing the fixed portion of our advertising spending and continuing a more targeted airtime allocation scheme with channels that offered higher media returns.

Our TV advertising time purchase contracts typically require us to make full advance payment before broadcasting our TV direct sales programs. As of December 31, 2009, we had signed contracts to purchase \$52.9 million of TV advertising time for direct sales programs for 2010. Accordingly, if we fail to manage our media time efficiently or effectively, and our TV advertising efforts fail to generate sufficient return or profit potential, our results of operations and business performance may be materially and adversely affected. In addition, we may be unable to use all of our purchased time due to factors out of our control, such as preemption of our time by special programming events and programming overruns by relevant TV stations. In 2008, approximately 10.1% of our purchased TV advertising time was preempted by these TV stations due to special events such as the Beijing Olympic Games in August 2008, which significantly affected our sales performance in the third quarter. In 2009, approximately 4% of our purchased TV advertising time was preempted by these TV stations. Although these TV stations reimburse us or provide us alternative advertising time slots in the event of preemption, this might not fully compensate us for the loss of our desired time slots.

***Our joint sales arrangements constitute a substantial part of our business, and the termination of any of them could adversely affect our business, results of operations, financial condition and prospects.***

In 2009, we primarily focused on growing our proprietary branded products while continuing to develop joint sales opportunities, particularly for our cosmetics and cell phone products. Our joint sales arrangements generate direct sales revenues and additional payment streams through the sale of products or services of our joint sales partners and the additional payments we receive from our joint sales partners based on sales of featured products or services through their own distribution channels, which reduce our cost of direct sales revenues. Under some joint sales arrangements, our joint sales partners also share a portion of our advertising costs. We do not typically maintain contracts for over one-year with any of the parties with whom we have arrangements, and our ability to maintain and manage relationships with each of them is subject to various uncertainties, some of which are not within our control. Third parties with whom we engage in joint sales activities may decide to produce their own TV direct sales programs, or may decide to rely on the services of our competitors. If any of our joint sales arrangements terminates, our business, results of operations, financial condition and prospects could be adversely affected.

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*We rely on our nationwide distribution network for a significant portion of our revenues. Failure to maintain good distributor relations could materially disrupt our distribution business and harm our net revenues.*

Our business is significantly dependent on the performance of our distributors and our distribution sales account for an increasingly significant portion of our net revenues. In 2007, 2008 and 2009, 26.9%, 28.7% and 44.2%, respectively, of our net revenues were generated through our approximately 80 distributors. Our largest distributor accounted for approximately 5.7%, 1.8% and 2.5% of our gross revenues in 2007, 2008 and 2009, respectively. We do not maintain long-term contracts with our distributors. Maintaining relationships with existing distributors and replacing any distributor may be difficult or time consuming. Our failure to maintain good relationships with our distributors could materially disrupt our distribution business and harm our net revenues.

*We may be unable to effectively manage our nationwide distribution network. Any failure by our distributors to operate in compliance with our distribution agreements and applicable law may result in liability to us, may interrupt the effective operation of our distribution network, may harm our brands and our corporate image and may result in decreased sales.*

We have limited ability to manage the activities of our distributors, who are independent from us. In addition, our distributors or the retail outlets to which they sell our products and services may violate our distribution agreements with them or the sales agreements between our distributors and the retail outlets. Such violations may include, among other things:

failure to meet minimum sales targets for our products and services or minimum price levels for our products and services in accordance with relevant agreements;

failure to properly promote our products and services through local marketing media, including local TV and print media, violation of our media content requirements, or failure to meet minimum required media spending levels;

selling products and services that compete with our products and services, including product or service imitations, or selling our products and services outside their designated territory, possibly in violation of the exclusive distribution rights of other distributors;

providing poor customer service; or

violating PRC law in the marketing and sale of our products and services, including PRC restrictions on advertising content or product and service claims.

In particular, we have discovered that some of the retail outlets to which our distributors sell our products and services are selling imitation products that compete with our products, such as our Babaka branded posture correction product. Although we continue to rigorously monitor this situation and require our distributors to abide by their contractual obligation to eliminate any such violation by the retail outlets, we may be unable to police or stop violations such as the selling of imitation products or services by retail outlets.

If we determine to fine, suspend or terminate our distributors for acting in violation of our distribution agreements, or if the distributors fail to address material violations committed by any of their retail outlets, our ability to effectively sell our products and services in any given territory could be negatively impacted. In addition, these and similar actions could negatively affect our brands and our corporate image, possibly resulting in loss of customers and a decline in sales.

*Some of our distributors may compete with us in certain TV direct sales markets, possibly negatively affecting our direct sales in those markets.*

Several of our current distributors market and sell some of our and our competitors' products and services through their own TV direct sales platforms and call centers. Of those distributors, two of these distributors were



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among our five best-performing distributors in 2007 and 2008, and one was among our five best-performing distributors in 2009, with aggregate revenue contribution of approximately 2.7%, 1.7% and 2.0% of our gross revenues in 2007, 2008 and 2009, respectively. Each of these distributors is a party to our standard distribution arrangement and each operated its own TV direct sales platform prior to becoming our distributor. These distributors continue to operate their own TV direct sales platforms. In addition, some of our other distributors use edited versions of our TV direct sales programs to market our products on local TV stations and conduct TV direct sales activities through their own call-in numbers. These distributors' TV direct sales efforts may compete with and negatively affect our own TV direct sales in their respective territories.

***Certain of our distributors are beneficially owned by our employees. It may be difficult for us to effectively evaluate the performance of these distributors or to replace any of them if they are non-performing, underperforming or non-compliant with our distribution agreements.***

We have approximately 80 distributors constituting our nationwide distribution network that distribute our products and services across China. Some of our distributors are owned in part, or in some cases in whole, by certain of our employees or their family members. In 2007, 2008 and 2009, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 28.4%, 17.2% and 12.7% of our distribution gross revenues, respectively, or 7.6%, 4.9% and 5.6% of our total gross revenues, respectively. Certain of these distributors have been among our top distributors in 2007, 2008 and 2009. In addition, one distributor in 2007 was wholly owned by a relative of our chief executive officer. However, this distributor accounted for less than 2% of our distribution gross revenues in 2007, and the relative of our chief executive officer has ceased to hold an equity interest in the distributor since mid-2007. We entered into the distribution agreements with these related distributors on an arm's-length basis and the terms in the distribution agreements with these distributors are the same as those with our independent distributors. Nevertheless, the economic interests held by our employees in our distributors may make it difficult for us to effectively evaluate the performance of such distributors or fine, suspend or terminate a non-performing, under-performing or non-compliant distributor without harming our relationship with those employees.

***We may not realize the anticipated benefits of our potential future joint ventures, acquisitions or investments or be able to integrate any acquired employees, businesses, products or services, which in turn may negatively affect their performance and respective contributions to our results of operations.***

Since 2003, we have entered into seven joint ventures with other entities for our products and services, including our electronic learning product line as a means of acquiring managerial expertise and additional complementary distribution network infrastructure. In connection with these ventures, we also acquired services of certain management personnel, including Guoying Du, one of our executive officers who is currently in charge of our nationwide distribution network. We may continue to enter into similar joint ventures or make other acquisitions or investments to, among other things, acquire managerial expertise or additional complementary distribution network infrastructure or to secure exclusive product distribution rights for the products to be sold through our multiple sales platforms. Risks related to our existing and future joint ventures, acquisitions and investments include, as applicable:

our ability to enter into, exit or acquire additional interests in our joint ventures or other acquisitions or investments may be restricted by or subject to various approvals under PRC law or may not otherwise be possible, may result in a possible dilutive issuance of our securities or may require us to secure financing to fund those activities;

we may disagree with our joint venture partner(s) or other investors on how the venture or business investment should be managed and/or operated;

to the degree we wish to do so, we may be unable to integrate and retain acquired employees or management personnel; incorporate acquired products, services or capabilities into our business; integrate and support pre-existing manufacturing or distribution arrangements; consolidate duplicate

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facilities and functions; or combine aspects of our accounting processes, order processing and support functions; and

the joint venture or investment could suffer losses and we could lose our total investment, which would have a negative effect on our operating results.

Any of these events could distract our management's attention and result in our not obtaining the anticipated benefits of our joint ventures, acquisitions or investments and, in turn, negatively affect the performance of such joint ventures, acquisitions and investments and their respective contributions to our results of operations.

***Our failure to adequately manage our growth and expansion could negatively impact our ability to effectively operate our business, accurately report our financial results as a public company and attract and train our employees and management, which could hamper our business strategy and result in deterioration in our operating results.***

Our operations have grown rapidly, particularly in recent years. We grew from 128 employees in 2000, to 2,087 employees as of December 31, 2009. In particular, we added approximately 177 employees following our acquisition of Yiyang Yukang in December 2008. As of December 31, 2009, Yiyang Yukang had 216 employees in total. In addition, we purchased a fifty-year land use right of a piece of land in Qingpu district of Shanghai in the first quarter of 2009. We plan to use the land to establish a warehouse and a factory for manufacturing our proprietary branded products. We may not be able to successfully operate the factory built on such land due to, among others, our lack of prior experience. Our recent growth has resulted, and future growth could continue to result, in substantial demands being placed on our operational and administrative systems, our financial and management controls and resources, our management and our employee training capabilities. Any failure in these areas could significantly harm our ability to effectively operate our business, accurately report our financial results as a public company and attract and train our employees and management, which could hamper our business strategy and result in deterioration in our operating results.

***We depend on our senior management team, key personnel and skilled and experienced employees in all aspects of our business, and our business and operations may be severely disrupted and our performance negatively affected if we lose their services.***

Our future success significantly depends upon the continuing service of our senior management team, including James Yujun Hu, our CEO, Don Dongjie Yang, our president, Guoying Du, our vice president responsible for managing our nationwide distribution network, Ella Man Lin, our vice president responsible for product development and supplier and human resources management, David Chenghong He, our vice president responsible for management of our financial, logistics and payment systems and Kevin Guohui Hu, our vice president responsible for media purchasing, planning and management. If one or more members of our senior management team or other key employees are unable or unwilling to continue in their present position, we may not be able to replace them easily or at all, our business could be severely disrupted, and our financial condition and results of operations could be materially and adversely affected. We do not maintain key-man life insurance for any of our senior management.

To maintain our competitive position and expand our operations, we must attract, train and retain skilled and experienced employees in numerous areas, including product development, media procurement and call center operations. The monthly average turnover rate for our call centers ranged from 1.3% to 7.8% in 2007, 2.2% to 10.0% in 2008, and 2.7% to 9.5% in 2009, reflecting both voluntary terminations and termination of employees failing to meet our performance standards. Any inability to attract and retain a significant number of skilled and experienced employees in our call centers or other critical areas could seriously disrupt our business and operations and negatively affect our financial performance.



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***In fulfilling sales through our direct sales platforms, we face customer acceptance, delivery, payment and collection risks that could adversely impact our direct sales net revenues and overall operating results. We are dependent on China Express Mail Service Corporation, or EMS and local delivery companies, to make our product deliveries and from time to time we have been required to write off certain accounts receivable from them.***

We rely significantly on EMS, the largest national express mail service operated by the China Post Office, and to a lesser extent, local delivery companies, to deliver products sold through our direct sales platforms. EMS and local delivery companies made deliveries of products representing 76.1% and 19.1% of our direct sales gross revenues in 2007, respectively, 59.3% and 29.8% of our direct sales gross revenues in 2008, respectively, and 47.4% and 38.0% of our direct sales gross revenues in 2009, respectively. Although we have started offering credit card payment options for selected card holders, almost all of the products that we sell through our direct sales platforms are delivered and paid for by customers on a cash on delivery, or COD, basis. We rely on EMS and local delivery companies to remit customer payment collections to us. Of the total attempted product deliveries by EMS and local delivery companies on a COD basis, approximately 75%, 75% and 73% were successful in 2007, 2008 and 2009, respectively. Reasons for delivery failure primarily include customer refusal to accept a product upon delivery or failure to successfully locate the delivery address. Although we continue to explore alternative payment methods and expand our credit card payment options, we expect to continue to be dependent on COD customer payments for the foreseeable future.

EMS typically requires 30 days to remit to us the COD payments received from our customers. Of our total accounts receivable balance as of December 31, 2007, 2008 and 2009, \$8.3 million or 35.8%, \$9.0 million or 32.5%, and \$2.2 million or 12.8%, respectively, were due from EMS. In addition, from time to time, we have been required to write off certain EMS accounts receivable due to a difference between EMS's collections according to our records and cash amounts actually received by EMS according to their records. The total amount of EMS-related accounts receivable written off in 2007, 2008 and 2009 was approximately \$0.3 million in each year. We may be required to write off similar or higher amounts in the future. We do not maintain a long-term contract with EMS. Failure or inability to renew our contract with EMS could disrupt our business and operations and negatively affect our financial performance.

***We expect competition in China's consumer market to intensify. If we do not compete successfully against new and existing competitors, we may lose our market share, and our profitability may be adversely affected.***

Competition from current or future competitors could cause our products and services to lose market acceptance or require us to significantly reduce our prices or increase our promotional activities to maintain and attract customers. Many of our current or future competitors may have longer operating histories, better brand recognition and consumer trust, strong media management capabilities, better media and supplier relationships, a larger technical staff and sales force and/or greater financial, technical or marketing resources than we do. Because of our integrated vertical business model, we face competition from the following companies operating in our value chain:

other TV direct sales companies operating in China with generally similar business models to ours, including Moneng TV, Pacific Media and China SevenStar;

TV home shopping companies that operate across China or in large parts of China such as CCTV Home Shopping and Hunan TV Hapigo, and companies that operate on multiple channels in multiple provinces, such as Oriental CJ Home Shopping, U-you Home Shopping and TVSN;

numerous domestic and international sellers of consumer branded products that sell their products in China and which compete with our products, such as our Ozing electronic learning products which compete with electronic learning products from BBK, Noah and other brands, and our cell phone products which compete with similar products sold by local and international cell phone manufacturers;

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traditional retailers and distributors, as well as direct marketers such as Avon, operating in China which currently or in the future may offer competing products or services, including products or services under their own brand, or may otherwise offer or seek to offer small and medium manufacturers and suppliers distribution capabilities throughout China;

other Internet and e-commerce companies in China that offer consumer products online via an Internet platform, including eBay's China site, Alibaba's Tao Bao, and Dang Dang; and

companies that sell consumer products on multi media platforms, including Happy Tao Bao, which is the joint venture between Alibaba's Tao Bao and Hunan Satellite TV Station.

Particularly, we are facing more intense competition from TV home shopping companies, whose number has increased significantly during the past years in China. Many of these companies are supported by, or affiliated with, TV or radio stations and therefore may have access to cheaper TV air time than us.

In addition, large multi-national home shopping companies such as QVC may enter the China market directly or indirectly. Entry by these players becomes more likely if existing PRC restrictions on content, number of advertising hours per day and foreign ownership of TV stations are relaxed.

We also compete with companies that make imitations of our products at substantially lower prices, such as our Babaka branded posture correction products, which may be sold in department stores, pharmacies and general merchandise stores.

Being a cell phone manufacturer targeting mid- to high-end business users in China, our subsidiary Yiyang Yukang, competes with a small number of domestic cell phone manufacturers in China, such as Lenovo and TCL. We may be unable to successfully compete against new or existing direct or indirect competitors, which could cause us to lose our market share and adversely affect our profitability.

***Interruption or failure of our telephone system and management information systems could impair our ability to effectively sell and deliver our products and services or result in a loss or corruption of data, which could damage our reputation and negatively impact our results of operations.***

In 2007, 2008 and 2009, approximately 73.1%, 71.3% and 55.8% of our total net revenues, respectively, were generated through our direct sales platforms with orders processed by our call centers. Our call centers rely heavily on our telephone and management information systems, or MIS, to receive customer calls at our call centers, process customer purchases, arrange product delivery and assess the effectiveness of advertising placements and consumer acceptance of our products and services, among other things. As our business evolves and our MIS requirements change, we may need to modify, upgrade and replace our systems. We work closely with third-party vendors to provide telephone and MIS tailored to our specific needs. We are and will continue to be substantially reliant on these third-party vendors for the provision of maintenance, modifications, upgrades and replacements to our systems. If these third-party vendors can no longer provide these services, it may be difficult, time consuming and costly to replace them. Any such modification, upgrading or replacement of our systems may be costly and could create disturbances or interruptions to our operations. Similarly, undetected errors or inadequacies in our telephone and MIS may be difficult or expensive to timely correct and could result in substantial service interruptions.

From time to time, our computer systems experience short periods of power outage. Any telephone or MIS failure (including as a result of natural disaster or power outage), particularly during peak or critical periods, could inhibit our ability to receive calls and complete orders or evaluate the effectiveness of our promotions or consumer acceptance of our products and services or otherwise operate our business. These events could, in turn, impair our ability to effectively sell and deliver our products and services or result in the loss or corruption of customer, supplier and distributor data, which could damage our reputation and negatively impact our results of operations.

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*We may not be able to prevent others from unauthorized use of our intellectual property, which could harm our product brand, reputation and competitive position. In addition, we may have to enforce our intellectual property rights through litigation. Such litigation may result in substantial costs and diversion of resources and management attention.*

We rely on a combination of patent, copyright, trademark and unfair competition laws, as well as nondisclosure agreements and other methods to protect our intellectual property rights. In particular, we rely on the trademark law in China to protect our product brands. We currently maintain approximately 227 trademark registrations in China. The legal regime in China for the protection of intellectual property rights is still at a relatively early stage of development. Despite many laws and regulations promulgated and other efforts made by China over the years to enhance its regulation and protection of intellectual property rights, private parties may not enjoy intellectual property rights in China to the same extent as they would in many western countries, including the United States, and enforcement of such laws and regulations in China has not achieved the levels reached in those countries. Although the PRC State Council approved the State Outlines on the Protection of Intellectual Property on April 9, 2008 in an effort to protect intellectual property, the steps we have taken may still be inadequate to prevent the misappropriation of our intellectual property. Separately, we are in the process of applying for registration or transfer of approximately 81 trademarks in China, including trademarks for three of our best-selling product lines in 2009. We may be unable to enforce our proprietary rights in connection with these trademarks before such registrations or transfers are approved by the relevant authorities and it is possible that such registrations or transfers may not be approved at all. In addition, manufacturers or suppliers in China may imitate our products, copy our various brands and infringe our intellectual property rights. We have recently discovered unauthorized products in the marketplace that are counterfeit reproductions of our products sold by the retailers within our nationwide distribution network and by third parties in retail stores and on websites. The counterfeit products that we found include our Babaka posture correction products, one of our five best-selling products in 2009, our GPS products, and our oxygen generation products.

It is difficult and expensive to police and enforce against infringement of intellectual property rights in China. Imitation or counterfeiting of our products or other infringement of our intellectual property rights, including our trademarks, could diminish the value of our various brands, harm our reputation and competitive position or otherwise adversely affect our net revenues. We may have to enforce our intellectual property rights through litigation. Such litigation may result in substantial costs and diversion of resources and management attention.

*We have in the past been, currently are, and in the future may again be, subject to intellectual property rights infringement claims by third parties, which could be time-consuming and costly to defend or litigate, divert our attention and resources, or require us to enter into licensing agreements. These licenses may not be available on commercially reasonable terms, or at all.*

We have in the past been, currently are, and in the future may again be, the subject of claims for infringement, invalidity, or indemnification relating to other parties' proprietary rights. For example, in August 2008, Beijing Ren'ai filed a suit in the People's Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai Digital Technology Co., Ltd., or Beijing Sancai, and Beijing Zhidahengtong Technology Development Co., Ltd., or Beijing Zhidahengtong, alleging that the English programs we provided to the users of our electronic learning products infringed upon the copyright of Beijing Ren'ai. Beijing Ren'ai claimed damages of RMB2,000,000 (approximately \$293,000). The court ruled in favor of Ren'ai in the suits and awarded Ren'ai total compensation of RMB500,000 (approximately \$73,000). The defendants appealed to the Beijing First Intermediate People's Court in May 2009, which affirmed the decision of the People's Court of Beijing Haidian District on December 7, 2009.

In August 2009, Beijing Ren'ai filed a suit in the People's Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai and Beijing Zhidahengtong, alleging that the English programs we provided to the users of our electronic learning products infringed upon the copyright of Beijing Ren'ai. Beijing Ren'ai claimed damages of RMB2,000,000 (approximately \$293,000). The court ruled in favor of Ren'ai in the suit and awarded Ren'ai total compensation of RMB500,000 (approximately \$73,000). The defendants have appealed the court's decisions and the appeals are currently pending.

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We believe that the above legal proceedings will not have a material adverse effect on our financial conditions.

*We may from time to time become a party to legal proceedings which, if adversely decided, could materially adversely affect us.*

We may from time to time become a party to legal proceedings, defense of which may increase our expenses and divert management attention and resources. In addition, an adverse outcome in any such proceeding could have a material adverse effect on our business, results of operations and financial condition.

For example, in March 2009, we received a complaint from Advertising Broadcasting Center of Liaoning TV Station, or Liaoning TV, which filed a suit against Shanghai Acorn Advertising Broadcasting Co., Ltd., or Shanghai Advertising, claiming that Shanghai Advertising breached its advertisement broadcasting contract with Liaoning TV by not fully performing its payment obligation under the contract and asserted damages of approximately RMB19 million (approximately \$2.8 million). Liaoning TV further applied for provisional seizure of Shanghai Advertising's bank account in the same amount of its claim. In June 2009, the people's court ruled in favor of Liaoning TV and awarded Liaoning TV an aggregate payment of RMB10.9 million (approximately \$1.6 million). In July 2009, we appealed to the people's court at higher level, which affirmed the judgment in September 2009. On November 19, 2009 we paid Liaoning TV RMB10.9 million (approximately \$1.6 million), but we have applied for retrial of this case.

We do not believe that the above legal proceeding will have a material adverse effect on our business, results of operations or financial condition.

*We have limited general business insurance coverage and we may be subject to losses that might not be covered by our existing insurance policies, which may result in our incurring substantial costs and the diversion of resources.*

Insurance companies in China offer limited business insurance products and do not, to our knowledge, offer business liability insurance. While business interruption insurance is available to a limited extent in China, we have determined that the risks of disruption, cost of such insurance and the difficulties associated with acquiring such insurance on commercially reasonable terms make it impractical for us to subscribe for such insurance. As a result, except for all-risks insurance on finished goods inventory stored in our central warehouses, we do not have any business liability, disruption or litigation insurance coverage for our operations in China. Any business disruption or litigation may result in our incurring substantial costs and the diversion of resources.

*We do not carry product liability insurance coverage, and our sale of our and other parties' products could subject us to product liability claims and potential safety-related regulatory actions. These events could damage our brand and reputation and the marketability of the products that we sell, divert our management's attention and result in lower net revenues and increased costs.*

The manufacture and sale of our products, in particular, our posture correction and neck massager product lines in our health and wellness product category, and our sale of other parties' products could each expose us to product liability claims for personal injuries. Also, if these products are deemed by the PRC authorities to fail to conform to product quality and personal safety requirements in China, we could be subject to PRC regulatory action. Violation of PRC product quality and safety requirements by our or others' products sold by us may subject us to confiscation of the products, the imposition of penalties or an order to cease sales of the violating products or to cease operations pending rectification. If the offense is determined to be serious, our business license could be suspended and criminal liabilities could be imposed. We currently do not carry any product liability insurance coverage. Any product liability claim or governmental regulatory action could be costly and time-consuming to defend. If successful, product liability claims may require us to pay substantial damages. Also, a material design, manufacturing or quality failure in our and other parties' products sold by us, other safety issues or heightened regulatory scrutiny could each warrant a product recall by us and result in increased

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product liability claims. Furthermore, customers may not use the products sold by us in accordance with our product usage instructions, possibly resulting in customer injury. All of these events could materially harm our brand and reputation and marketability of our products, divert our management's attention and result in lower net revenues and increased costs.

*Any disruption of our or our manufacturing service providers' manufacturing operations could negatively affect the availability of our products and our net revenues derived therefrom.*

We manufactured almost 63.4% of the products we sell in terms of cost of revenues in 2009, with the balance provided by third-party suppliers and manufacturers in China. We purchase the materials we need to manufacture our products, including our electronic learning product line, from outside suppliers in China. Our largest supplier in 2009, which supplied cell phones, accounted for approximately 6.5% of our total cost of revenues in 2009. We typically purchase all production materials, including critical components such as flash memory, chipsets and LCD display screens for our electronic learning products, on a purchase order basis and do not have long-term contracts with our suppliers.

If we fail to develop or maintain our relationships with our suppliers, we may be unable to manufacture our products, and we could be prevented from supplying our products to our customers in the required quantities. Problems of this kind could cause us to experience loss of market share and result in decreased net revenues. In addition, the failure of a supplier to supply materials and components that meet our quality, quantity and cost requirements in a timely manner could impair our ability to manufacture our products or increase our costs, particularly if we are unable to obtain these materials and components from alternative sources on a timely basis or on commercially reasonable terms.

Other risks for the products manufactured by us, include, among others:

having too much or too little production capacity;

being unable to obtain raw materials on a timely basis or at commercially reasonable prices, which could adversely affect the pricing and availability of our products;

experiencing quality control problems;

accumulating obsolete inventory;

failing to timely meet demand for our products; and

experiencing delays in manufacturing operations due to understaffing during the peak seasons and holidays.

Currently, products manufactured and supplied by third parties for us primarily include our cell phones, cosmetics and collectibles. In 2009, we had one supplier regarding our cell phone products accounting for approximately 6.5% of our cost of revenues in the same period. We typically purchase these products on a purchase order basis and do not have long-term contracts with these suppliers. Some of our products are supplied by third-party manufacturers based on designs or technical requirements provided by us. These manufacturers may fail to produce products that conform to our requirements. In addition, for products manufactured or supplied by third-party manufacturers, we indirectly face many of the risks described above and other risks. For example, our third-party manufacturers may not continue to supply products to us of the quality and/or in the quantities we require. It may also be difficult or expensive for us to replace a third-party manufacturer.

*Our leases of land and manufacturing facilities in Beijing and Shanghai may not be in full compliance with PRC laws and regulations and we may be required to relocate our facilities, which may disrupt our manufacturing operations and result in decreased net revenues.*

Our manufacturing facilities for our oxygen generating products are built on a plot of land we leased from Beijing Tongzhou District Lucheng Town Chadao Village for a term of 30 years. Our posture correction product



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line and engine lubricant products, as well as one of our central warehouses, are built on a plot of land leased from Shanghai Huamin Economic Development Co., Ltd. The Beijing and Shanghai lands are collectively owned land and are not technically permitted to be leased to others for non-agricultural purposes such as commercial enterprises like ours under relevant PRC laws. The PRC land authority also has the power to order the lessor to terminate the lease with us, to confiscate any illegal gains or order the payment of fines. If our lease is terminated, we would be required to relocate our facilities. Although we believe that the relocation cost, if any, would not be significant, such relocation could disrupt our manufacturing operations and result in lower net revenues.

*We may require additional capital, which may not be available on commercially reasonable terms, or at all. Capital raised through the sale or issuance of equity securities may result in dilution to our shareholders. Failure to obtain such additional capital could have an adverse impact on our business strategies and growth prospects.*

We believe that our current cash and cash equivalents and cash flow from operations will be sufficient to meet our anticipated cash needs for the next 12 months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments, joint ventures or acquisitions we may decide to pursue. If these resources are insufficient to satisfy our cash requirements, we may seek to sell additional equity or debt securities or obtain a credit facility. The sale of additional equity securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financing covenants that would restrict our operations. Financing may be unavailable in amounts or on terms acceptable to us, or at all, which could have an adverse impact on our business strategies and growth prospects.

*We may incur impairment losses on our investments in equity securities.*

We have made non-controlling investments in the equity securities of a number of companies. Under U.S. generally accepted accounting principles that we are subject to, if there is a decline in the fair value of the shares we hold in these companies, or any other company we invest in, over a period of time, and we determine that the decline is other-than-temporary, we will need to record an impairment loss for the applicable fiscal period. We may incur expenses related to the impairment of existing or future equity investments. Any such impairment charge could have a material adverse effect on our business, financial condition, results of operations and prospects.

*Our asset impairment reviews may result in future write-downs.*

We are required, among other things, to conduct annual reviews of goodwill and test intangible assets and other long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. In connection with our business acquisitions, we make assumptions regarding estimated future cash flows and other factors to determine the fair value of goodwill and intangible assets. In assessing the useful lives of the intangible assets, we must make assumptions regarding their fair value, the recoverability of those assets and our ability to successfully develop and ultimately commercialize acquired technology. If those assumptions change in the future when we conduct our periodic reviews in accordance with applicable accounting standards, we may be required to record impairment charges. For example, we recorded a non-cash impairment charge of \$15.2 million in 2009 as a result of our valuation of distribution network from the acquisition of Yiyang Yukang, which was primarily caused by (i) overall under-performance in the mobile handsets business of Yiyang Yukang and (ii) Yiyang Yukang's change in business strategy to launch its proprietary Uking brand and changes incurred in the acquired distribution network. It is possible that future reviews will result in further write-downs of intangible assets and other long-lived assets.

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***We may be required to record additional significant charges to earnings from the declines in fair value of our investment in an index-linked structured note.***

Our investment policy and strategy attempt primarily to preserve capital and meet our liquidity requirements. We currently hold an index-linked structured note that we purchased from a bank in 2007 for a principal of \$10 million. The note matures in August 2019 and has a variable interest rate that is computed based on the number of days in which both the 3-month USD-LIBOR-BBA and the Nikkei 225 indices are above or within the stated ranges, respectively. The structured note contains an available-for-sale debt host security and an embedded derivative instrument that are reported within the same line on our consolidated balance sheets at the estimated fair value of the note. As of December 31, 2009, the estimated fair value of the structured note was \$6.6 million.

The net unrealized losses of the available-for-sale debt host security are recognized as accumulated other comprehensive income in equity unless there is a decline in fair value below cost that we consider as other-than-temporary, in which case the amount of the decline would be recognized as a loss and reflected in our statements of operations. We recognize other-than-temporary impairment in earnings if we have the intent to sell the note, or if it is more-likely-than-not that we will be required to sell the note before recovery of its amortized cost, or when we determine credit-related losses exist in our evaluation of the expected cash flows to be received. The changes in fair value of the embedded derivative are recognized in earnings in the period such changes occur. The losses incurred on this structured note are primarily related to the changes in the general global market conditions. If factors arise that would require us to account for declines in fair value of the available-for-sale debt host security as other-than-temporary or as the fair value of the embedded derivative further goes down, we will recognize the declines as additional realized losses with a charge to income, which could have a material adverse effect on our financial condition and operating results.

***Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act could have a material adverse effect on our business and operating results and stockholders could lose confidence in our financial reporting.***

Internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our operating results could be harmed. In October 2009, the SEC issued a final rule that requires all non-accelerated filers to begin complying with Section 404(b) of the Sarbanes-Oxley Act of 2002 beginning with their annual reports for fiscal years ending on or after June 15, 2010, instead of for fiscal years ending on or after December 15, 2009. Under the current SEC regulations, we are required to include a management report on internal controls over financial reporting in this Form 20-F, and we will be required to include an auditor's report on internal controls over financial reporting for our Form 20-F for the year ending December 31, 2010. While our management concluded that our internal controls over financial reporting were effective as of December 31, 2009, our management may later conclude that our internal controls are not effective. Moreover, even if our management concludes in the future that our internal controls are effective, our independent registered public accounting firm may disagree. If our independent registered public accounting firm is not satisfied with our internal controls over financial reporting or the level at which our internal controls over financial reporting are designed, documented, operated or reviewed, or if the independent registered public accounting firm interprets the requirements, rules or regulations differently than we do, then they may issue an adverse or qualified opinion. Failure to achieve and maintain an effective internal control environment could cause investors to lose confidence in our reported financial information, which could have a material adverse effect on our stock price.



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### **Risks Related to Our Industry**

*Our businesses and growth prospects are dependent upon the expected growth in China's consumer retail markets. Any future slowdown or decline in China's consumer retail markets could adversely affect our business, financial condition and results of operations.*

All of our net revenues are generated by sales of consumer products and services in China. The success of our business depends on the continued growth of China's consumer retail markets. The consumer retail markets in China are characterized by rapidly changing trends and continually evolving consumer preferences and purchasing patterns and power. China's TV direct sales market is expected to grow in line with expected growth in consumer disposable income and the economy in China generally. However, projected growth rates for the Chinese economy and China's consumer retail markets may not be realized, particularly in light of the current global economic crisis. Any slowdown or decline in China's consumer retail markets would have a direct adverse impact on us and could adversely affect our business, financial condition and results of operations.

*If infomercials and the products and services promoted on infomercials are not accepted by TV viewers in China, our ability to generate revenues and sustain profitability could be materially and adversely affected.*

In 2007, 2008 and 2009, we derived 73.1%, 71.3% and 55.8% respectively, of our total net revenues from our direct sales platforms. We expect that in the future a substantial portion of our future revenues and profits will continue to be dependent upon the receptivity of Chinese TV viewers to infomercials such as our TV direct sales programs and the products and services showcased therein. Many Chinese TV viewers are not accustomed to purchasing products or services directly from TV. As a result, TV viewers in China may be both more likely to mistrust infomercials as a commercial medium and less likely to purchase products or services from TV direct marketers such as us. If we are unable in the future to increase receptivity for our TV direct sales programs and the products and services showcased therein, our ability to generate revenue and sustain profitability could be materially and adversely affected.

### **Risks Related to the Regulation of Our Business**

PRC regulations relating to our industry are evolving. Any adverse or unanticipated regulatory changes, particularly those regarding the regulation of our direct sales business, could significantly harm our business or limit our ability to operate.

*We and our distributors are subject to various laws regulating our advertising, including the content of our TV direct sales programs, and any violation of these laws by us or our distributors could result in fines and penalties, harm our product or service brands and result in reduced net revenues.*

PRC advertising laws and regulations require advertisers and advertising operators to ensure that the content of the advertising they prepare, publish or broadcast is fair and accurate, is not misleading and is in full compliance with applicable laws. Specifically, we, as an advertiser or advertising operator, and our distributors, as advertisers, are each required to independently review and verify the content of our respective advertising for content compliance before displaying the advertising through TV sales programs, print media, radio or Internet portals. Moreover, the PRC unfair competition law prohibits us and our distributors from conveying misleading, false or inaccurate information with respect to quality, function, use, or other features of products or services, through advertising. Violation of these laws or regulations may result in penalties, including fines, confiscation of advertising income, orders to cease dissemination of the advertising, orders to publish an advertisement correcting the misleading information and criminal liabilities. In circumstances involving serious violations, the PRC government may suspend or revoke a violator's business license.

For advertising related to certain types of our products, such as those products constituting medical devices and health related products, we and our distributors must also file the advertising content with the provincial counterpart of the China's State Administration for Food and Drug, or SAFD, or other competent authorities, and

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obtain required permits and approvals for the advertising content from the SAFD or other competent authorities, in each case, before publication or broadcasting of the advertising. In addition, pursuant to the new Food Safety Law of the PRC effective from June 1, 2009, the contents of food advertisements should be true and no disease- prevention or remedial function should be mentioned. We endeavor to comply, and encourage our distributors to comply, with such requirements. However, we and our distributors may fail to comply with these and other laws. For example, the SAFD issued a circular on October 31, 2005 announcing that advertising placed in several local newspapers by us and one of our distributors for our sleeping aid product and oxygen generating devices violated the relevant laws by including unapproved content. These violations relating to our sleeping aid product advertising were considered serious violations by China's SAFD. The local SAFDs have ordered such advertising to be discontinued. Commencing on January 1, 2008, advertisements related to medical devices and health related foods are subject to the credit rating administration. The provincial counterpart of SAFD is responsible for collecting, recording, identifying and publishing the credit rating information of the advertiser. The credit rating of every advertiser will fall into good credit, dishonor credit or material dishonor credit and this rating is reviewed each year. An advertiser who receives a rating of dishonor credit or material dishonor credit may be ordered to improve its rating within a specified time limit and its business activities may be subject to special scrutiny if necessary. Therefore, any violations by us or our distributors relating to our oxygen generating devices and neck massaging products may result in SAFD imposing on us or our distributors a dishonor credit or material dishonor credit rating. Our and our distributors' past and future violations and a dishonor credit or material dishonor credit rating imposed upon us, if any, could seriously harm our corporate image, product or service brands and operating results.

Moreover, government actions and civil claims may be filed against us for misleading or inaccurate advertising, fraud, defamation, subversion, negligence, copyright or trademark infringement or other violations due to the nature and content of our TV direct sales programs or other advertising produced by us or our distributors. We have been fined by the relevant authorities for certain advertising that was considered misleading or false by the authorities, including our advertising for our electronic learning products. Historically, such fines have not been significant and related investigations into our advertising practices did not consume significant amounts of our management resources. In some cases, we were required to accept product returns. We may have to expend significant resources in the future in defending against such actions and these actions may damage our reputation, result in reduced net revenues, negatively affect our results of operations, and even result in our business licenses being suspended or revoked and in criminal liability for us and our officers and directors.

***Governmental actions to regulate TV and radio-based direct sales programs of medical devices and diet and slimming products will adversely impact sales of our branded neck massager product line and some of our other products and may adversely impact our future overall operating results.***

In July 2006, the State Administration of Radio, Film and Television, or SARFT, and the State Administration for Industry and Commerce, or SAIC, issued a circular temporarily prohibiting the broadcast of TV-and radio-based direct sales programs regarding pharmaceutical products, diet and slimming products, medical devices, breast enhancement products and height increasing products on and after August 1, 2006, pending adoption of new rules governing those direct sales activities. The Circular on Strengthening the Administration of TV Direct Sales Advertising and Home Shopping Programs, issued by the SARFT on September 10, 2009, prohibited the TV direct sales and home shopping programs advertising the pharmaceuticals, breast-enhancement products, diet and slimming products, and the medical devices which are implantable or need instruction by experts. Meanwhile, the Administrative Measures on Advertising on Television or Radio, issued by the SARFT on September 11, 2009 and effective as of January 1, 2010, prohibited the pharmaceutical and medical device or health related advertising programs to contain the recovery rate or efficiency rate or certification by the doctors, experts, patients or public figures. Furthermore, Criteria for the Examination and Publication of Medical Device Advertisements were issued by the Ministry of Health, the State Administration for Industry and Commerce, and the SFDA and became effective on May 20, 2009, which provided strict regulation on medical device advertisements publication. According to the Circular Concerning Further Severely Punishing Illegal Advertisements of Pharmaceuticals, Medical Devices and Health Food

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effective in February 2010, enterprises which publish the illegal advertisements will be severely punished. Consequently, we will be unable to broadcast TV-and radio-based direct sales programs for some of our products, primarily including our oxygen generating product and our branded neck massager product. For at least the near-term, our direct and distribution sales of these restricted products will be adversely impacted. The overall impact on our future operating results depends on, among other things, our success in promoting the products covered by the circular through other media channels; the degree to which distribution sales of our restricted products are impacted by the ban on TV direct sales programs; our ability to offset these decreased sales with sales of non-restricted products and services using our committed TV advertising time and the related sales price and margins of those non-restricted products and services; and the nature of, and restrictions imposed by, the future rules when adopted.

*If the PRC government takes the view that we did not obtain the necessary approval for our acquisition of Shanghai Advertising, we could be subject to penalties.*

On September 24, 2007, we acquired 100% of the legal ownership of Shanghai Advertising, which had been one of our affiliated entities, through Shanghai Acorn Enterprise Management Consulting Co., Ltd., or Acorn Consulting. At the time of our acquisition, the advertising industry was a restricted industry for foreign investment under the Guideline Catalogue of Foreign Investment Industries (2004 Revision). Strictly speaking, Acorn Consulting, as a domestic subsidiary of foreign invested enterprises, might have been required under PRC law to obtain the approval of the Ministry of Commerce, or MOFCOM, or its local counterpart to invest in restricted industries, such as the advertising industry. However, on October 31, 2007, the National Development and Reform Commission and MOFCOM jointly issued the Guideline Catalogue of Foreign Investment Industries (2007 Revision) which removed the advertising industry from the restricted list for foreign investment. The new guideline became effective as of December 1, 2007. As a permitted industry, approval of MOFCOM or its local counterpart is no longer required for a foreign invested enterprise or its domestic subsidiary to invest in advertising.

Based upon the published interpretation on the website of Shanghai Foreign Investment Commission, or SFIC, MOFCOM's local counterpart in Shanghai, and oral advice we received from SFIC prior to the acquisition, we believe that it was not necessary for us to seek such approval at the time when we made the acquisition. However, because our acquisition occurred prior to, yet approaching, the removal of the advertising industry from the restricted list for foreign investment, and we did not receive the approval of SFIC, we may be deemed not in strict compliance with the then effective rules and could be subject to penalties. We were advised by SFIC in an anonymous consultation prior to the acquisition that this acquisition was a purely domestic acquisition without any foreign-related issues. Based on the advice of SFIC, Pudong Administration of Industry and Commerce in Shanghai accepted the registration of such acquisition and issued a new business license to Shanghai Advertising on September 24, 2007. In addition, our PRC legal counsel, Commerce & Finance, has advised us that it is unlikely that we would be required by the PRC regulatory authorities, in particular SAIC and MOFCOM or their local counterparts, to seek such approval to make up for our deficiency, or that any penalties would be imposed upon us for failure to obtain such approval.

However, we cannot assure you that SAIC or MOFCOM will not take a different view from ours and we would not be subject to penalties that, if imposed, could have a material adverse effect on our business and results of operation.

*If the PRC government takes the view that our acquisition of Shanghai Advertising does not comply with PRC governmental restrictions on foreign investment in advertising, we could be subject to severe penalties.*

Direct investment by foreign investors in the advertising industry in China is subject to the Administrative Regulation on Foreign-Invested Advertising Enterprises jointly promulgated by MOFCOM and SAIC on March 2, 2004 and further revised on October 1, 2008. Under this advertising regulation, foreign investors are required to have had at least three years experience in directly operating an advertising business outside of China

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before they may receive approval to own 100% of an advertising business in China. Foreign investors that do not have three years experience are permitted to invest in advertising businesses, provided that such foreign investors have at least two years of direct operations in the advertising business outside of China and that such foreign investors may not own 100% of advertising businesses in China. Furthermore, all foreign invested advertising companies must obtain approval from SAIC or MOFCOM or their local counterparts.

On September 24, 2007, we acquired 100% of the legal ownership of Shanghai Advertising, which had been one of our affiliated entities, through Acorn Consulting. Pudong Administration of Industry and Commerce in Shanghai did not require us to show that Acorn Consulting had the requisite years of operating experience in an advertising business outside of China either before or after it accepted the registration of the acquisition and issued a new business license to Shanghai Advertising. Furthermore, we have been advised by our PRC legal counsel, Commerce & Finance, that, according to an anonymous consultation with SFIC, because our acquisition of Shanghai Advertising was completed through Acorn Consulting, a domestic subsidiary of foreign invested enterprises, the acquisition was not subject to the requirement that foreign investors have the requisite years of operating experience in an advertising business outside of China.

However, we cannot assure you that the PRC government will not take a different view from ours. If the PRC government determines that our acquisition of Shanghai Advertising violated the requirements on foreign investment or re-investment in advertising businesses in China, as neither Acorn Consulting nor its shareholders have the requisite years of experience in the advertising industry required of foreign investors, we could be subject to severe penalties including among others, the revocation of the business licenses of our related subsidiaries, discontinuance of our advertising operations, the imposition of conditions with which we or our PRC subsidiaries may be unable to comply, or the restructuring of Shanghai Advertising. The imposition of any of these penalties could result in a material adverse effect on our ability to do business.

***If the PRC government takes the view that the agreements that establish the structure for operating our TV and other direct sales business in China does not comply with PRC governmental restrictions on foreign investment in these areas, we could be subject to severe penalties***

Our direct sales business is regulated by MOFCOM and SAIC. Foreign investment in direct sales business is highly restricted and must be approved by MOFCOM. To address these restrictions, two affiliated Chinese entities, Shanghai Acorn Network Technology Development Co., Ltd., or Shanghai Network, and Beijing Acorn Trade Co., Ltd., or Beijing Acorn, hold the licenses required to operate our direct sales business. Until we obtain MOFCOM's approval to operate our direct sales business, we must continue to rely on these affiliated entities to sell our products to the customers.

Our two affiliated Chinese entities are currently owned by two PRC citizens, Don Dongjie Yang, our president and one of our directors, and David Chenghong He, one of our executive officers. We have entered into contractual arrangements with these affiliated entities pursuant to which our wholly owned subsidiary, Acorn Information Technology (Shanghai) Co., Ltd., or Acorn Information, provides technical support and operation and management services to these affiliated entities. In addition, we have entered into agreements with these affiliated entities and Don Yang and David Chenghong He, as their shareholders, providing us substantial ability to control each of these affiliated entities. For detailed descriptions of these contractual arrangements, see Item 4.C, Information on the Company Organizational Structure .

If we, Acorn Information, or any of our affiliated entities are found to be in violation of any existing or future PRC laws or regulations or fail to obtain or maintain any of the required licenses, permits or approvals, the relevant PRC regulatory authorities would have broad discretion in dealing with these violations, including, among others:

revoking the business and operating licenses of Acorn Information and our affiliated entities;

discontinuing or restricting the operations of Acorn Information and our affiliated entities;

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imposing conditions or requirements with which we, Acorn Information or our affiliated entities may be unable to comply; or

requiring us or Acorn Information or our affiliated entities to restructure the relevant ownership structure or operations.

***The contractual arrangements with our two affiliated Chinese entities and their shareholders, Don Dongjie Yang and David Chenghong He, which relate to critical aspects of our operations, may not be as effective in providing operational control as direct ownership. In addition, these arrangements may be difficult and costly to enforce under PRC law.***

We rely on contractual arrangements with our two affiliated entities in China, collectively owned 100% by Don Dongjie Yang, our president and one of our directors, and David Chenghong He, one of our executive officers, to operate our business. For a description of these contractual arrangements, see Item 4.C, Information on the Company Organizational Structure . These contractual arrangements may not be as effective as direct ownership in providing us control over our affiliated entities. Direct ownership would allow us, for example, to directly exercise our rights as a shareholder to effect changes in the board of each affiliated entity, which, in turn, could effect changes, subject to any applicable fiduciary obligations, at the management level. However, under the current contractual arrangements, as a legal matter, if any affiliated entity or Don Dongjie Yang or David Chenghong He fails to perform its or his respective obligations under these contractual arrangements, we may have to incur substantial costs and expend significant resources to enforce those arrangements, and rely on legal remedies under PRC law. These remedies may include seeking specific performance or injunctive relief, and claiming damages, any of which may not be effective. For example, if either Don Dongjie Yang or David Chenghong He refuses to transfer his equity interest in any affiliated entity to us or our designee when we exercise the purchase option pursuant to these contractual arrangements, or if either Don Dongjie Yang or David Chenghong He otherwise acts in bad faith toward us, we may have to take legal action to compel him to fulfill his contractual obligations. In addition, as each of our two affiliated entities is jointly owned and effectively managed by Don Dongjie Yang and David Chenghong He, it may be difficult for us to change our corporate structure or to bring claims against any affiliated entity or Don Dongjie Yang or David Chenghong He if any of them fails to perform its or his obligations under the related contracts or does not cooperate with any such actions by us.

All of these contractual arrangements are governed by PRC laws and provide for the resolution of disputes through arbitration in the PRC. Accordingly, these contracts would be interpreted in accordance with PRC laws and any disputes would be resolved in accordance with PRC legal procedures. The legal environment in the PRC is not as developed as in other jurisdictions, such as the United States. As a result, uncertainties in the PRC legal system could limit our ability to enforce these contractual arrangements. In the event we are unable to enforce these contractual arrangements, which relate to critical aspects of our operations, we may be unable to exert effective control over our operating entities, and our ability to conduct our business may be negatively affected.

***Our corporate structure may limit our ability to receive dividends from, and transfer funds to, our PRC subsidiaries, which could restrict our ability to act in response to changing market conditions and reallocate funds from one affiliated PRC entity to another in a timely manner.***

We are a Cayman Islands holding company and substantially all of our operations are conducted through our 14 PRC subsidiaries and two Chinese affiliated entities. We may rely on dividends and other distributions from our PRC subsidiaries to provide us with our cash flow and allow us to pay dividends on the shares underlying our ADSs and meet our other obligations. Current regulations in China permit our PRC subsidiaries to pay dividends to us only out of their accumulated distributable profits, if any, determined in accordance with their articles of association and PRC accounting standards and regulations. The ability of these subsidiaries to make dividends and other payments to us may be restricted by factors that include changes in applicable foreign exchange and other laws and regulations. In particular, under PRC law, these operating subsidiaries may only pay dividends after 10% of their net profit has been set aside as reserve funds, unless such reserves have reached at

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least 50% of their respective registered capital. Such reserve may not be distributed as cash dividends. In addition, if any of our 14 PRC operating subsidiaries incur debt on its own behalf in the future, the instruments governing the debt may restrict its ability to pay dividends or make other payments to us. Moreover, the profit available for distribution from our Chinese operating subsidiaries is determined in accordance with generally accepted accounting principles in China. This calculation may differ from that performed in accordance with U.S. GAAP. As a result, we may not have sufficient distributions from our PRC subsidiaries to enable necessary profit distributions to us or any distributions to our shareholders in the future, which calculation would be based upon our financial statements prepared under U.S. GAAP.

Distributions by our PRC subsidiaries to us other than as dividends may be subject to governmental approval and taxation. Any transfer of funds from our company to our PRC subsidiaries, either as a shareholder loan or as an increase in registered capital, is subject to registration or approval of Chinese governmental authorities, including the relevant administration of foreign exchange and/or the relevant examining and approval authority. In addition, it is not permitted under Chinese law for our PRC subsidiaries to directly loan funds to each other. Therefore, it is difficult to change our capital expenditure plans once the relevant funds have been remitted from our company to our PRC subsidiaries. These limitations on the free flow of funds between us and our PRC subsidiaries could restrict our ability to act in response to changing market conditions and reallocate funds from one Chinese subsidiary to another in a timely manner.

### **Risks Relating to China**

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

All of our business operations are conducted in China and all of our revenues are derived from our marketing and sales of consumer products and services in China. Accordingly, our results of operations, financial condition, and future prospects are subject to a significant degree to economic, political and social conditions in China. The Chinese economy differs from the economies of most developed countries in many respects, including the amount of government involvement, level of development, growth rate, control of foreign exchange and allocation of resources. While the Chinese economy has experienced significant growth in the past three decades, growth has been uneven, both geographically and among various sectors of the economy. The PRC government has implemented various measures to encourage foreign investment and sustainable economic growth and to guide the allocation of financial and other resources, which have for the most part had a positive effect on our business and growth. However, we cannot assure you that the PRC government will not repeal or alter these measures or introduce new measures that will not have a negative effect on us. For example, our financial condition and results of operation may be adversely affected by changes in tax regulations applicable to us. In addition, since early 2004, the PRC government has implemented certain measures to control the pace of economic growth. Such measures may cause a decrease in the level of economic activity in China, including a decline in individual spending activities, which in turn could adversely affect our results of operational and financial condition.

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

In particular, our business is primarily dependent upon the economy and the business environment in China. Our growth strategy is based upon the assumption that demand in China for our products and services will continue to grow with the Chinese economy. However, the growth of the Chinese economy has been uneven across geographic regions and economic sectors, and experienced an economic slowdown in 2009 as a result of

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the global economic crisis. Several years ago the Chinese economy also experienced deflation, which may reoccur in the foreseeable future. We cannot assure you that the Chinese economy will continue to grow, that if there is growth, such growth will be steady and uniform, or that if there is a slowdown, such slowdown will not have a negative effect on our business.

China's social and political conditions are also not as stable as those of the United States and other developed countries. Any sudden changes to China's political system or the occurrence of widespread social unrest could have negative effects on our business and results of operations. In addition, China has contentious relations with some of its neighbors, most notably Taiwan. A significant further deterioration in such relations could have negative effects on Chinese economy and lead to changes in governmental policies that would be adverse to our business interests.

***The discontinuation of any of the preferential tax treatments and government subsidies available to us in China could materially and adversely affect our results of operations and financial condition.***

Under PRC laws and regulations effective until December 31, 2007, our operating subsidiaries, Acorn International Electronic Technology (Shanghai) Co., Ltd., Shanghai HJX, Zhuhai Acorn Electronic Technology Co., Ltd. and Beijing Acorn Youngleda Oxygen Generating Co., Ltd. enjoyed preferential tax benefits afforded to foreign-invested manufacturing enterprises and had been granted a two-year exemption from enterprise income tax beginning from their first profitable year and a 50% reduction of enterprise income tax rate for three years thereafter. The definition of a manufacturing enterprise under PRC law was vague and was subject to discretionary interpretation by the PRC authorities. If we were to be deemed not qualified in the past or if the tax preferential treatments enjoyed by us in accordance with local government rules or policies were deemed in violation of national laws and regulations and were abolished or altered, we would be subject to the standard statutory tax rate, which was 33% for calendar years ended on or before December 31, 2007 and is 25% for calendar years starting on or after January 1, 2008, and we could be required to repay the income tax for the previous three years at the applicable non-preferential tax rate. Additionally, our subsidiaries also received tax holidays and subsidies for certain taxes paid by us. These incentives were granted by local government agencies and may be deemed inappropriate by the central government. In addition, China passed a new Enterprise Income Tax Law, or the New EIT Law, and its implementing rules, both of which became effective on January 1, 2008. Some of our preferential tax treatments could be discontinued or phased out under the New EIT Law. Loss of any preferential tax treatments and subsidies could have material and adverse effects on our results of operations and financial condition. See Item 5.A, Operating and Financial Review and Prospects Operating Results Taxation .

***Under China's New EIT Law, we may be classified as a resident enterprise of China. Such classification could result in unfavorable tax consequences to us and our non-PRC shareholders.***

The New EIT Law provides that enterprises established outside China whose de facto management are located in China are considered resident enterprises and will generally be subject to the uniform 25% enterprise income tax rate as to their global income. Under the implementation rules, de facto management is defined substantial and overall management and control over such aspects as the production and business, personnel, accounts and properties of an enterprise. In addition, a tax circular issued by the State Administration of Taxation on April 22, 2009 regarding the standards used to classify certain Chinese-invested enterprises established outside of China as resident enterprises clarified that dividends and other income paid by such resident enterprises will be considered to be PRC source income, subject to PRC withholding tax, currently at a rate of 10%, when recognized by non-PRC enterprise shareholders. This recent circular also subjects such resident enterprises to various reporting requirements with the PRC tax authorities. Under the implementation rules to the New EIT Law, a de facto management body is defined as a body that has material and overall management and control over the manufacturing and business operations, personnel and human resources, finances and other assets of an enterprise. In addition, the tax circular mentioned above details that certain Chinese-invested enterprises will be classified as resident enterprises if the following are located or resident in China: senior management personnel and departments that are responsible for daily production, operation and management;

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financial and personnel decision making bodies; key properties, accounting books, company seal, and minutes of board meetings and shareholders meetings; and half or more of the senior management or directors having voting rights.

Currently, there are no detailed rules or precedents governing the procedures and specific criteria for determining de facto management bodies which are applicable to our company or our overseas subsidiary. If the PRC tax authorities determine that our Cayman Islands holding company is a resident enterprise for PRC enterprise income tax purposes, a number of unfavorable PRC tax consequences could follow. First, we may be subject to enterprise income tax at a rate of 25% on our worldwide taxable income as well as PRC enterprise income tax reporting obligations. In our case, this would mean that income such as interest on offering proceeds and other non-China source income would be subject to PRC enterprise income tax at a rate of 25%, in comparison to no taxation in the Cayman Islands. Second, although under the New EIT Law and its implementation rules dividends paid to us from our PRC subsidiaries would qualify as tax-exempt income, we cannot guarantee that such dividends will not be subject to a 10% withholding tax, as the PRC foreign exchange control authorities, which enforce the withholding tax, have not yet issued guidance with respect to the processing of outbound remittances to entities that are treated as resident enterprises for PRC enterprise EIT purposes. Finally, if our Cayman Islands holding company is deemed to be a PRC tax resident enterprise, a 10% withholding tax shall be imposed on dividends we pay to our non-PRC shareholders and with respect to gains derived from our non-PRC shareholders transferring our shares or ADSs. Moreover, according to Tentative Measure of Withholding at Source of Non-resident Enterprise Income Tax promulgated by the State Administration of Taxation and effected on January 1, 2009, any form of capital income such as dividends, interest, rents, franchise royalties and income from transferring assets gained by non-resident enterprises derived from the PRC, shall be withheld at the source. Any enterprise or individual who has the obligation to pay the relevant proceeds to non-resident enterprise shall have obligation to withhold the relevant tax from any paid or due amount each time they make such taxable income to non-resident enterprise. Similar results would follow if our BVI holding company is considered a PRC resident enterprise.

***The contractual arrangements entered into among Acorn Information, each of our consolidated affiliated entities and their shareholders and those arrangements entered into between us or one of our Chinese subsidiaries and an entity affiliated with us may be subject to audit or challenge by the Chinese tax authorities. A finding that we, Acorn Information, our consolidated affiliated entities or any of our Chinese subsidiaries owe additional taxes could substantially reduce our net earnings and the value of your investment.***

Under PRC laws and regulations, arrangements and transactions among related parties may be subject to audit or challenge by the PRC tax authorities. The new EIT Law became effective on January 1, 2008 and provides authority for the PRC tax authority to make special adjustments to taxable income as well as new reporting requirements. In particular, an enterprise must submit its annual tax return together with information on related party transactions to the tax authorities. The tax authorities may impose reasonable adjustments on taxation if they have identified any related party transactions that are inconsistent with arm's-length principles. In addition, the PRC tax authorities recently issued Implementation Measures for Special Tax Adjustments (Trial) which set forth tax-filing disclosure and contemporaneous documentation requirements, clarify the definition of related party, guide the selection and application of transfer pricing methods, and outline the due process procedures for transfer pricing investigation and assessment. We could face material and adverse tax consequences if the PRC tax authorities determine that the contractual arrangements entered into between us or one of our PRC subsidiaries and an entity affiliated with us do not represent arm's-length prices and as a result, adjust any of the income in the form of a transfer pricing adjustment. A transfer pricing adjustment could, among other things, result in a reduction of expense deductions for PRC tax purposes recorded by us, our consolidated affiliated entities, or our PRC subsidiaries or an increase in taxable income, all of which could increase our tax liabilities. In addition, the PRC tax authorities may impose late payment fees and other penalties on us, our consolidated affiliated entities or our PRC subsidiaries for under-paid taxes.



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

The PRC legal system is a civil law system based on written statutes. Unlike common law systems, it is a system in which decided legal cases have little precedential value. In 1979, the PRC government began to promulgate a comprehensive system of laws and regulations governing economic matters in general. The overall effect of legislation over the past three decades has significantly enhanced the protections afforded to various forms of foreign investment in China. 11 of our 14 PRC operating subsidiaries are foreign invested enterprises incorporated in China. They are subject to laws and regulations applicable to foreign investment in China in general and laws and regulations applicable to foreign-invested enterprises in particular. However, these laws, regulations and legal requirements change frequently, and their interpretation and enforcement involve uncertainties. For example, we may have to resort to administrative and court proceedings to enforce the legal protection that we enjoy either by law or contract. However, since PRC administrative and court authorities have significant discretion in interpreting and implementing statutory and contractual terms, it may be more difficult to evaluate the outcome of administrative and court proceedings and the level of legal protection we enjoy than in more developed legal systems. In addition, such uncertainties, including the inability to enforce our contracts, could materially and adversely affect our business and operations. Furthermore, the PRC legal system is based in part on government policies and internal rules (some of which are not published on a timely basis or at all) that may have a retroactive effect. As a result, we may not be aware of our violation of these policies and rules until some time after the violation. In addition, any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention. Furthermore, intellectual property rights and confidentiality protections in China may not be as effective as in the United States or other countries. Accordingly, we cannot predict the effect of future developments in the PRC legal system, particularly with regard to the media, advertising and retail industries, including the promulgation of new laws, changes to existing laws or the interpretation or enforcement thereof, or the preemption of local regulations by national laws. These uncertainties could limit the legal protections available to us, and our foreign investors, including you.

***Restrictions on the convertibility of Renminbi into foreign currency may limit our ability to make dividends or other payments in U.S. dollars or fund possible business activities outside China.***

All of our net revenues are currently generated in Renminbi. Any future restrictions on currency exchanges may limit our ability to use net revenues generated in Renminbi to make dividends or other payments in U.S. dollars or fund possible business activities outside China. Under current Chinese regulations, Renminbi may be freely converted into foreign currency for payments relating to current account transactions, which include among other things dividend payments and payments for the import of goods and services, by complying with certain procedural requirements. Our Chinese subsidiaries may also retain foreign exchange in their respective current account bank accounts, subject to a cap set by the PRC State Administration of Foreign Exchange, or SAFE, or its local counterpart, for use in payment of international current account transactions. Although the PRC government introduced regulations in 1996 to allow greater convertibility of Renminbi for current account transactions, we cannot assure you the Chinese regulatory authorities will not limit or eliminate our ability to purchase and retain foreign currencies for current account transactions in the future.

Conversion of Renminbi into foreign currencies, and of foreign currencies into Renminbi, for payments relating to capital account transactions, which principally include investments and loans, generally requires the approval of SAFE and other relevant Chinese governmental authorities. In particular, if one subsidiary borrows foreign currency loans from us or other foreign lenders, these loans must be registered with SAFE or its local counterparts, and if we finance such subsidiary by means of additional capital contributions, these capital contributions must be approved by certain government authorities including MOFCOM or its local counterparts. In addition, pursuant to the Notice of the General Affairs Department of the State Administration of Foreign Exchange on the Relevant Operating Issues concerning the Improvement of the Administration of Payment and Settlement of Foreign Currency Capital of Foreign-funded Enterprises which was effective from Aug. 29, 2008, the RMB fund from the settlement of foreign currency capital of a foreign-funded enterprise shall be used within the business scope as approved by the examination and approval department of the government, and shall not be

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used for domestic equity investment unless it is otherwise provided for in its approved business scope. Restrictions on the convertibility of the Renminbi for capital account transactions could affect the ability of our Chinese subsidiaries to make investments overseas or to obtain foreign exchange through debt or equity financing, including by means of loans or capital contributions from us.

***Because our revenues are generated in Renminbi and our results are reported in U.S. dollars, devaluation of the Renminbi could negatively impact our results of operations.***

Because all of our net revenues are generated in Renminbi, appreciation or depreciation in the value of the Renminbi relative to the U.S. dollar will affect our financial results reported in U.S. dollar terms without giving effect to any underlying change in our business or results of operations. Fluctuations in the exchange rate will also affect the relative value of any dividend we issue that will be exchanged into U.S. dollars and earnings from and the value of any U.S. dollar-denominated investments we make in the future. Since we rely entirely on dividends paid to us by our PRC operating subsidiaries, and since our net revenues are generated in Renminbi while our results are reported in U.S. dollars, any significant devaluation of Renminbi would have a material adverse effect on our net revenues and financial condition, and the value of, and any dividends payable on, our ADSs in foreign currency terms.

Since July 2005, the Renminbi has no longer been pegged to the U.S. dollar. Although currently the Renminbi exchange rate versus the U.S. dollar is restricted to a rise or fall of no more than 0.5% per day and the People's Bank of China, or PBOC, regularly intervenes in the foreign exchange market to prevent significant short-term fluctuations in the exchange rate, the Renminbi may appreciate or depreciate significantly in value against the U.S. dollar in the medium to long term. Moreover, it is possible that in the future Chinese authorities may lift restrictions on fluctuations in the Renminbi exchange rate and lessen intervention in the foreign exchange market.

Very limited hedging transactions are available in China to reduce our exposure to exchange rate fluctuations. To date, we have not entered into any hedging transactions in an effort to reduce our exposure to foreign currency exchange risk. While we may decide to enter into hedging transactions in the future, the availability and effectiveness of these hedges may be limited and we may not be able to successfully hedge our exposure at all. In addition, our currency exchange losses may be magnified by PRC exchange control regulations that restrict our ability to convert Renminbi into foreign currency.

***You may experience difficulties in effecting service of legal process, enforcing foreign judgments or bringing original actions in China based on United States or other foreign laws against us, our management or the experts named in the annual report.***

We conduct all of our operations in China and all of our assets are located in China. In addition, almost all of our directors and executive officers reside within China. As a result, it may not be possible to effect service of process within the United States or elsewhere outside China upon some of our directors and senior executive officers, including with respect to matters arising under U.S. federal securities laws or applicable state securities laws. Moreover, our PRC legal counsel, Commerce & Finance, has advised us that the PRC currently does not have treaties with the United States or many other countries providing for the reciprocal recognition and enforcement of judgment of courts.

***Regulations relating to offshore investment activities by PRC residents may increase the administrative burden we face and create regulatory uncertainties that could restrict our overseas and cross-border investment activity, and a failure by our shareholders who are PRC residents to make any required applications and filings pursuant to such regulations may prevent us from being able to distribute profits and could expose our PRC resident shareholders to liability under PRC law.***

A regulation known as Notice 75 was promulgated by the SAFE in October 2005 and requires registration with the local SAFE in connection with direct or indirect offshore investment by PRC residents. Notice 75 applies not only to our shareholders who are PRC residents but also to our prior and future offshore acquisitions.

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Notice 75 retroactively requires registration by March 31, 2006 of direct or indirect investments previously made by PRC residents in offshore companies. If a PRC shareholder with a direct or indirect stake in an offshore parent company fails to make the required SAFE registration, the PRC subsidiaries of such offshore parent company may be prohibited from making distributions of profit to the offshore parent and from paying the offshore parent proceeds from any reduction in capital, share transfer or liquidation in respect of the PRC subsidiaries. Further, failure to comply with the various SAFE registration requirements described above could result in liability under PRC law for violation of the relevant rules relating to transfers of foreign exchange.

We have already notified our shareholders, and the shareholders of the offshore entities in our corporate group, who are PRC residents to urge them to make the necessary applications and filings, as required under Notice 75. However, as a result of the newness of the notices and uncertainty concerning the reconciliation of the notices with other approval requirements, it remains unclear how the two notices, and any future legislation concerning offshore or cross-border transactions, will be interpreted, amended and implemented by the relevant government authorities. We understand that the relevant shareholders have registered their offshore investments in us with Shanghai SAFE, where most of our PRC subsidiaries are located. We are committed to complying, and to ensuring that our shareholders who are subject to the regulation comply, with the relevant rules. However, we cannot assure you that all of our shareholders who are PRC residents will comply with our request to make or obtain any applicable registrations or approvals required by the regulation or other related legislation. The failure or inability of our PRC resident shareholders to receive any required approvals or make any required registrations may limit our PRC subsidiaries' ability to make distributions or pay dividends or affect our ownership structure, as a result of which our acquisition strategy and business operations and our ability to distribute profits to you could be materially and adversely affected.

Upon the completion of our acquisition of Yiyang Yukang in December 2008, shareholders of Yiyang Yukang became our shareholders. To our knowledge, some of the prior shareholders of Yiyang Yukang did not file applications for SAFE registration, which may adversely affect our ability to distribute dividends to our shareholders as stated above. As advised by our PRC legal counsel, Commerce & Finance, a separate registration in respect of Notice 75 is not applicable to our acquisition of Yiyang Yukang, and our obligation under Notice 75 after the acquisition would be to update our original registration to include Yiyang Yukang as one of our PRC subsidiaries.

***A failure by PRC individuals who hold shares or share options granted pursuant to an employee share option or share incentive plan to make any required applications and filings could expose us and our PRC individual option holders to liability under PRC law.***

On January 5, 2007, SAFE issued the Implementation Rules of the Administrative Measures for Individual Foreign Exchange, or the Individual Foreign Exchange Rules. This regulation requires PRC individuals who are granted shares or share options pursuant to an employee share option or share incentive plan by an overseas listed company to register with SAFE and complete certain other procedures related to the share option or share incentive plan through relevant PRC subsidiary or a qualified agent. Our PRC employees who have been granted share options are subject to the Individual Foreign Exchange Rules. If we or our PRC employees fail to comply with this regulation, we or our PRC option holders may be subject to fines and legal sanctions.

***The enforcement of new labor contract law and increase in labor costs in the PRC may adversely affect our business and our profitability.***

China adopted a new labor contract law and its implementation rules effective on January 1, 2008 and September 18, 2008, respectively. The new labor contract law and its implementation rules impose more stringent requirements on employers with regard to, among others, minimum wages, severance payment and non-fixed term employment contracts, time limits for probation period as well as the duration and the times that an employee can be placed on a fixed term employment contract. Due to the limited period of effectiveness of the new labor contract law and its implementation rules and the lack of clarity with respect to their implementation

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and potential penalties and fines, it is uncertain how they will impact our current employment policies and practices. We cannot assure you that our employment policies and practices do not, or will not, violate the new labor contract law or its implementation rules and that we will not be subject to related penalties, fines or legal fees. Compliance with the new labor contract law and its implementation rules may increase our operating expenses, in particular our personnel expenses, as the continued success of our business depends significantly on our ability to attract and retain qualified personnel. In the event that we decide to terminate some of our employees or otherwise change our employment or labor practices, the new labor contract law and its implementation rules may also limit our ability to effect those changes in a manner that we believe to be cost-effective or desirable, which could adversely affect our business and results of operations.

*Any future outbreak of H1N1, avian flu, or severe acute respiratory syndrome in China, or similar adverse public health developments, may severely disrupt our business and operations and reduce the market for our products and services.*

Adverse public health epidemics or pandemics could disrupt businesses and national economies in China. For example, from December 2002 to June 2003, China and certain other countries experienced an outbreak of a new and highly contagious form of atypical pneumonia now known as severe acute respiratory syndrome, or SARS. On July 5, 2003, the World Health Organization declared that the SARS outbreak had been contained. However, a number of isolated new cases of SARS were subsequently reported, most recently in central China in April 2004. During May and June of 2003, many businesses in China were closed by the PRC government to prevent transmission of SARS. Moreover, some Asian countries, including China, have recently experienced incidents of the A(H1N1) strain of influenza, or Influenza A virus subtype H1N1. We are unable to predict the effect, if any, that influenza may have on our business. Any future outbreak of SARS, A(H1N1) or similar adverse public health developments may, among other things, significantly disrupt our ability to adequately staff our business, restrict the level of economic activity in affected areas and have a material adverse effect on our business, financial condition, results of operations and prospects.

*Natural disasters could disrupt the Chinese economy and our business.*

In early 2008, a series of severe snow storms swept through most provinces in China, among which Hunan, Hubei, Henan, Shandong, Jiangsu, Anhui and Shanghai were hardest hit. Disruption of transportation as a result of the snow storm adversely affected our ability to successfully deliver our products to our customers and the customers' willingness to accept our products and services.

In addition, in May 2008, a major earthquake struck Wenchuan in the Sichuan province in southwestern China, causing significant damage to the area, including Chengdu. The earthquake and its aftershocks caused great loss of life, injuries, property loss and disruption to the local economy. As a result of the earthquake, we experienced disruptions in our order fulfillment and deliveries to Sichuan and the western China region. In addition, our advertising time was suspended for three days during the memorial period following the earthquake. Since the date of the earthquake, our advertising time has been further disrupted and we have experienced a decline in the viewership and response rate of our infomercials. This earthquake or future geological occurrences could impact our business and the Chinese economy. A significant earthquake or other geological disturbance in any of China's other more populated cities and financial centers could severely disrupt the Chinese economy, undermine investor confidence and have a material adverse effect on our business, financial condition, results of operations and prospects.

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**Risks Relating to Our ADSs**

*We may be classified as a passive foreign investment company or PFIC for U.S. federal tax purposes for a given taxable year pursuant to an annual factual determination made after the close of the given taxable year; pursuant to a determination made in 2010 we believe we were classified as a PFIC for the 2009 taxable year.*

Depending upon the value of our ADSs or ordinary shares and the nature of our assets and income over time, we could be classified as a PFIC by the United States Internal Revenue Service, or IRS, for U.S. federal income tax purposes. We will be classified as a PFIC in any taxable year if either: (a) the average quarterly value of our gross assets that produce passive income or are held for the production of passive income is at least 50% of the average quarterly value of our total gross assets or (b) 75% or more of our gross income for the taxable year is passive income. According to these technical rules, we would likely become a PFIC for a given taxable year if our market capitalization were to decrease significantly while we hold substantial cash and cash equivalents in that year.

If we are classified as a PFIC in any taxable year in which you hold our ADSs or ordinary shares and you are a U.S. Holder, subject to certain exceptions described in Item 10.E, *Additional Information Taxation U.S. Federal Income Taxation Passive Foreign Investment Company*, you would generally be taxed at higher ordinary income rates, rather than lower capital gain rates, if you dispose of ADSs or ordinary shares for a gain in a later year, even if we are not a PFIC in that year. In addition, a portion of the tax imposed on your gain would be increased by an interest charge. Moreover, if we were classified as a PFIC in any taxable year, you would not be able to benefit from any preferential tax rate with respect to any dividend distribution that you may receive from us in that year or in the following year. Finally, you would also be subject to special U.S. tax reporting requirements.

Our PFIC status for the current taxable year 2010 will not be determinable until after the close of the taxable year ending December 31, 2010. Because we currently hold, and expect to continue to hold, a substantial amount of cash and other passive assets and, because the value of our assets is likely to be determined in large part by reference to the market prices of our ADSs or ordinary shares, which are likely to fluctuate, there can be no assurance that we will not be classified as a PFIC in 2010 and any future taxable year. Based on a determination made in 2010 with respect to the 2009 taxable year, we believe we were classified as a PFIC for the 2009 taxable year. U.S. Holders are urged to consult their independent tax advisors about the application of the PFIC rules and certain elections that may help them relieve any adverse U.S. federal income tax consequences for their particular circumstances for the 2009 taxable year. For more information regarding such elections, please consult Item 10.E, *Additional Information Taxation U.S. Federal Income Taxation Passive Foreign Investment Company* and your independent tax advisor.

*The sale, deposit, cancellation and transfer of the ADSs issued after an exercise of rights may be restricted under applicable U.S. securities laws.*

If we offer holders of our ordinary shares any rights to subscribe for additional shares or any other rights, the depository may make these rights available to holders of our ADSs if it is lawful and reasonably practicable to do so. However, the depository may allow rights that are not distributed or sold to lapse. In that case, holders of our ADSs will receive no value for them. In addition, U.S. securities laws may restrict the sale, deposit, cancellation and transfer of the ADSs issued after exercise of rights. Under the deposit agreement, the depository will not distribute rights to holders of ADSs unless the distribution and sale of rights and the securities to which these rights relate are either exempt from registration under the Securities Act with respect to holders of ADSs, or are registered under the provisions of the Securities Act. We can give no assurance that we can establish an exemption from registration under the Securities Act, and we are under no obligation to file a registration statement with respect to these rights or underlying securities or to endeavor to have a registration statement declared effective. Accordingly, holders of our ADSs may be unable to participate in our rights offerings and may experience dilution of their holdings as a result.

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### ***The trading prices of our ADSs may be volatile, which could result in substantial losses to investors.***

The trading prices of our ADSs may be volatile and could fluctuate widely in response to factors such as variations in our financial results, announcements of new business initiatives by us or by our competitors, recruitment or departure of key personnel, distributors and suppliers, changes in the estimates of our financial results or changes in the recommendations of any securities analysts electing to follow our securities or the securities of our competitors. In addition to market and industry factors, the price and trading volume of our ADSs may be highly volatile for specific business reasons. Any of these factors may result in large and sudden changes in the trading volume and price for our ADSs.

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

Our amended and restated memorandum and articles of association include provisions that could limit the ability of others to acquire control of us, modify our structure or cause us to engage in change-of-control transactions. These provisions could have the effect of depriving our shareholders of an opportunity to sell their shares at a premium over prevailing market prices by discouraging third parties from seeking to obtain control of us in a tender offer or similar transaction.

For example, our board of directors has the authority, without further action by our shareholders, to issue preferred shares in one or more series and to fix the powers and rights of these shares, including dividend rights, conversion rights, voting rights, terms of redemption and liquidation preferences, any or all of which may be greater than the rights associated with our ordinary shares. Preferred shares could thus be issued quickly with terms calculated to delay or prevent a change in control or make removal of management more difficult. In addition, if our board of directors issues preferred shares, the market price of our ordinary shares may fall and the voting and other rights of the holders of our ordinary shares may be adversely affected.

Our amended and restated memorandum and articles of association provide for a staggered board, which means that our directors, excluding our chief executive officer, are divided into three classes, with one-third of our board, excluding our chief executive officer, standing for election every year. Our chief executive officer at all times serves as a director, and has the right to remain a director, so long as he remains our chief executive officer. This means that, with our staggered board, at least two annual shareholders' meetings, instead of one, are generally required in order to effect a change in a majority of our directors. Our staggered board can discourage proxy contests for the election of our directors and purchases of substantial blocks of our shares by making it more difficult for a potential acquirer to take control of our board in a relatively short period of time.

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

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

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The Cayman Islands courts are unlikely:

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

to entertain original actions brought against us or our directors or officers predicated upon the securities laws of the United States or any state in the United States.

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

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

We are incorporated in the Cayman Islands, and conduct substantially all of our operations in China through our subsidiaries established in China. Most of our directors and officers reside outside the United States and substantially all of the assets of those persons are located outside the United States. As a result, it may be difficult or impossible for our shareholders to bring an action against us or against these individuals in the Cayman Islands or in China in the event that our shareholders believe that their rights have been infringed under the applicable securities laws or otherwise. Even if our shareholders are successful in bringing an action of this kind, the laws of the Cayman Islands and of China may render them unable to enforce a judgment against our assets or the assets of our directors and officers.

Unlike many jurisdictions in the United States, Cayman Islands law does not specifically provide for shareholder appraisal rights on a merger or consolidation of a company. This may make it more difficult to assess the value of any consideration shareholders may receive in a merger or consolidation or to require that the offeror give additional consideration if the shareholders believe the consideration offered is insufficient.

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

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

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

Cayman Islands companies may not have standing to initiate a derivative action in a federal court of the United States. As a result, our shareholders' ability to protect their interests if they are harmed in a manner that would otherwise enable them to sue in a U.S. federal court may be limited.

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

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

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

Under the deposit agreement for the ADSs, the depositary gives us a discretionary proxy to vote our ordinary shares underlying the ADSs at shareholders' meetings if holders of our ADSs do not vote, unless:

we have failed to timely provide the depositary with our notice of meeting and related voting materials;

we have instructed the depositary that we do not wish a discretionary proxy to be given;

we have informed the depositary that there is substantial opposition as to a matter to be voted on at the meeting;

a matter to be voted on at the meeting would have a material adverse impact on shareholders; or

voting at the meeting is made on a show of hands.

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

***Holders of ADSs may not receive distributions on our ordinary shares or any value for them if it is illegal or impractical for us to make them available.***

The depositary of our ADSs pays holders of our ADSs the cash dividends or other distributions it or the custodian for our ADSs receives on our ordinary shares or other deposited securities after deducting its fees and





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expenses. Holders of our ADSs receive these distributions in proportion to the number of our ordinary shares their ADSs represent. However, the depository is not responsible if it is unlawful or impractical to make a distribution available to any holders of ADSs. For example, it would be unlawful to make a distribution to a holder of ADSs if it consists of securities that require registration under the Securities Act but that are not properly registered or distributed pursuant to an applicable exemption from registration. The depository is not responsible for making a distribution available to any holders of ADSs if any government approval or registration is required for such distribution. We have no obligation to take any other action to permit the distribution of our ADSs, ordinary shares, rights or anything else to holders of our ADSs. This means that holders of our ADSs may not receive the distributions we make on our ordinary shares or any value for them if it is illegal or impractical for us to make them available. These restrictions may have a material and adverse effect on the value of the holders' ADSs.

*Holders of our ADSs may be subject to limitations on transfer of their ADSs.*

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

**ITEM 4. INFORMATION ON THE COMPANY**

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

We commenced operations in 1998 through Beijing Acorn Trade Co., Ltd., or Beijing Acorn, and in 2000, two other operating companies, Shanghai Acorn Network Co., Ltd., or Shanghai Acorn, and Shanghai Acorn Trade and Development Co., Ltd., or Shanghai Trade, were established and commenced business operations. Prior to January 1, 2005, our business was operated through Beijing Acorn, Shanghai Acorn and Shanghai Trade, including their subsidiaries. To enable us to raise equity capital from investors outside of China, we established a holding company structure by incorporating China DRTV Inc., or China DRTV, in the British Virgin Islands on March 4, 2004. Commencing on January 1, 2005, our business was conducted through China DRTV and its subsidiaries and affiliated entities. In connection with our initial public offering, we incorporated Acorn International in the Cayman Islands on December 20, 2005 as our listing vehicle. On March 31, 2006, Acorn International became our ultimate holding company when it issued shares to the existing shareholders of China DRTV in exchange for all of the shares that these shareholders held in China DRTV. For additional information on our organizational structure, see Item 4.C, Information on the Company Organizational Structure .

Our principal executive offices are located at 18/F, 20th Building, 487 Tianlin Road, Shanghai 200233, People's Republic of China, and our telephone number is (86 21) 5151-8888. Our website address is <http://www.chinadrvtv.com>. The information on our website does not form a part of this annual report. In May 2007, we completed our initial public offering, which involved the sale by us and certain of our shareholders of 8,855,000 ADSs, representing 26,565,000 ordinary shares. Our agent for service of process in the United States is CT Corporation System, located at 111 Eighth Avenue, New York, New York 10011.

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### **B. Business Overview**

#### **Overview**

We are a leading integrated multi-platform marketing company in China with a proven track record of developing, promoting and selling consumer products and services. Our two primary sales platforms are our TV direct sales platform and our nationwide distribution network. We believe that we operate one of the largest TV direct sales businesses in China in terms of revenues, and we believe we were one of the first companies in China to use TV direct sales programs, often referred to as TV infomercials, in combination with a nationwide distribution network to market and sell products and services to consumers. Our significant TV air time presence allows us to test-market, promote and sell products and services in China's geographically dispersed and fragmented consumer market. We seek to maximize sales penetration of our products and services that have strong sales and brand development potential by distributing them through our nationwide distribution network. In 2006, we also began using our TV direct sales platform to promote and sell third-party branded products and services pursuant to joint sales arrangements and marketing services arrangements. During the year ended December 31, 2009, we primarily focused on growing our proprietary branded products, such as Ozing electronic learning products, while continuing to develop joint sales and marketing services arrangements as sources of complementary revenue streams. In addition, our non-TV direct sales platform contributed to a significant portion of our revenues from direct sales in 2009, and we expect our non-TV direct sales platform, in particular the third-party bank channel sales, to be of higher growth potential and growing importance to our business in the future.

Using our integrated TV direct sales and nationwide distribution network platforms, we have developed several leading proprietary brands, including Ozing electronic learning products, Babaka posture correction products and Meijin electronic dictionaries. In addition, we have expanded into other forms of direct selling, such as third-party bank channel sales, outbound calls, catalogs and Internet sales, to further strengthen our promotional efforts and generate additional revenue opportunities from our existing customer base. We believe our vertically integrated direct sales operations, which include product development, TV and other direct sales and marketing, call center operations, and order fulfillment and delivery, combined with our nationwide distribution network, allow us to effectively reach consumers and maximize sales throughout China.

A key contributing factor to the success of our TV direct sales platform is our significant TV air time presence. Our TV direct sales programs, which are typically five to ten minutes in length, are currently aired on five nationwide China Central Television, or CCTV, channels, 24 national satellite TV channels, one international satellite channel operating in China and four local channels. Sales generated through our TV direct sales platform accounted for a significant portion of our direct sales net revenues, which in turn comprised 73.1%, 71.3% and 55.8% of our net revenues in 2007, 2008 and 2009, respectively. The decrease in 2008 and 2009 primarily reflects our strategy to selectively lower our purchase of TV advertising time to focus on more cost effective channels and time slots and to adopt a more flexible manner in our procurement to achieve better cost control. We also purchase TV advertising time for brand promotion advertising to enhance brand awareness of our proprietary products and services. Despite the higher per minute media cost and our reduced total advertising time purchased in 2009 as compared to 2008, our profit per media cost went up from 1.43 in 2008 to 1.81 in 2009, reflecting our improved media efficiency as a result of our more flexible media buying plan and a more targeted airttime allocation scheme with channels that offer higher media returns.

We have three call centers in Shanghai, Beijing and Wuxi which process telephone orders generated by our direct sales programs and gather real-time data to help analyze the effectiveness of our advertising spending and to adjust our products and services offerings. Our call centers operate 24 hours per day. Each of our call centers also places outbound calls to selected customers to market our products and services. In addition, our call center sales representatives are trained to identify and act upon cross-selling opportunities while processing customer orders. As of December 31, 2009, we had 1,058 sales representatives and 94 customer service representatives. In 2007, 2008 and 2009, our sales representatives collectively processed an average of approximately 18,800, 20,000 and 20,400 incoming calls per day generated from our TV and other direct sales platforms, respectively.

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Products sold through our TV direct sales platform and other direct sales platforms are delivered to our customers primarily by national express mail and local delivery companies. In addition to outbound calls, our third-party bank channel sales grew significantly as number of domestic banks cooperated with us increased from four in 2007 to 26 in 2009. As of December 31, 2009, revenues contributed by our third-party bank channel sales accounted for approximately 18.0% of our revenues from direct sales in 2009.

Our nationwide distribution network extends across all provinces and allows us to reach approximately 20,000 retail outlets covering nearly all of the cities and counties in China. We typically grant our distributors the exclusive right to distribute selected products and services in their respective territories. We work closely with and support our distributors to expand their retail outlet reach, extend our product and service lifecycles and maximize our sales by promoting our brands through our TV direct sales platform, advertising in local print media and other joint promotional efforts. In 2007, 2008 and 2009, sales generated through our nationwide distribution network accounted for 26.9%, 28.7% and 44.2% of our net revenues, respectively.

In selecting new products and services to be offered via our multiple sales platforms, we seek to identify offerings in underserved market segments with potential national appeal for which we believe our sales platforms and marketing and branding expertise can create value. We identify new products and services through a standardized selection process and typically source them from small and medium-sized suppliers and manufacturers in China. We also identify products and services from more established third-party companies that we believe we can successfully market through our TV direct sales platform. We typically focus on marketing and sales of a limited number of featured product lines and services at any given time, and our TV direct sales programs allow us to promote our specific products and services by highlighting their unique value to consumers as well as creating brand awareness. Featured offerings in 2009 included electronic learning products, cell phones, cosmetics products, health and wellness products, electronic dictionaries and auto care products. In addition, we offer over 1,300 products via our catalogs and the Internet.

On December 24, 2008, we completed our acquisition of Yiyang Yukang, a cell phone producer and distributor in China and former third-party supplier of our cell phone products. We acquired Yiyang Yukang with an aim to build and develop our own cell phone brands, as well as to take advantage of Yiyang Yukang's nationwide distribution network to facilitate sales of our featured cell phone products. Due to a change in strategy for this acquired business and its underperformance in 2009, we have adopted a more prudent approach on costs control as well as in developing our proprietary branded cell phone products. In addition, we disposed of a 33% equity interest in Shanghai Yimeng Software Technology Co., Ltd., or Shanghai Yimeng, our subsidiary engaged in the development and marketing of CPS stock tracking software. Upon completion of the disposal, Shanghai Yimeng is now 18% owned by us and ceased to be a subsidiary of our company. We currently do not have significant influence on Shanghai Yimeng's operation.

During the first quarter of 2009, we obtained a fifty-year land use right of a piece of land in Qingpu district of Shanghai for aggregate consideration of approximately RMB51.2 million (approximately \$7.5 million). We plan to use the land to establish a warehouse and a factory for manufacturing our proprietary branded products. The construction started on November 26, 2009 and has not completed yet.

### **Our Multiple Sales Platforms**

Our two primary sales platforms are our TV direct sales platform and our nationwide distribution network, and we have expanded into other forms of direct selling, including third-party bank channel sales, outbound call sales, catalog sales and Internet sales, and other direct sales through print media and radio to maximize media effectiveness. We believe our nationally televised TV direct sales programs help build strong brand awareness among China's consumers and generate significant demand for the products and services featured in those programs. Our nationwide distribution network, coupled with local marketing efforts, helps us to further enhance the awareness of and demand for our products and services, thereby broadening our customer reach and enhancing the penetration of those products and services on a nationwide basis within a short period of time.

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**Direct Sales Platforms**

***TV Direct Sales Platform***

Our TV direct sales platform is our primary sales platform and accounted for a significant portion of our direct sales net revenues, which in turn accounted for 73.1%, 71.3% and 55.8% of our net revenues in 2007, 2008 and 2009, respectively. We expect that our TV direct sales will account for a decreased portion of our direct sales net revenues, primarily due to the changing regulatory environment as a result of the new laws and regulations promulgated by relevant PRC authorities on TV advertising and the decrease in our advertising time purchase as a result of continuing increase of media price in China.

We generally focus our TV direct sales marketing efforts on approximately four to six featured product or service lines to maximize awareness of these featured offerings and to generate strong consumer demand. Our TV direct sales programs, which are generally five to ten minutes in length, consist of in-depth demonstrations and explanations of the product or service in an entertaining and informative manner, and provide phone numbers for customers to call in order to make further inquiries or to purchase the product or service. In addition to explaining the functionality of a product or service in the programs, we also highlight the value proposition of that product or service. Our TV direct sales programs typically feature one or more spokespersons or celebrity personalities and employ a variety of formats, including studio programs and reality shows, which we believe help to demonstrate the features and functions of the products or services that we are marketing. Our TV direct sales programs for new products and services are broadcast on national and/or local TV channels depending on the features of the products or services during selected time slots to ensure sufficiently broad and targeted viewer coverage.

A critical component to the success of our TV direct sales platform is our ability to efficiently access media channels and manage our media time. Our TV direct sales programs are currently broadcast on 34 channels, including five CCTV channels, 24 national satellite TV channels, one international satellite TV channel operating in China and four local channels in China. Since commencing our operations in 1998, we have formed close and strong relationships with various CCTV and national satellite channels, as well as several TV advertising agencies that have exclusive rights to sell certain advertising time slots for certain CCTV and national satellite channels, and we have been purchasing advertising time on several CCTV channels and national satellite channels for over five years. We purchase advertising time from the TV stations directly or through their advertising agencies. We primarily purchase non-prime time broadcast time slots for our TV direct sales programs. We believe our relationships with various CCTV and satellite channels, coupled with the scale of our operations and sales track record, help us to secure desired broadcast time slots on the channels we target. In 2007, 2008 and 2009, we produced and broadcasted over 890,000, 590,000 and 410,000 minutes of TV direct sales programs, respectively, corresponding to over 285, 189 and 132 hours per week, respectively. Despite the higher per minute media cost and our reduced total advertising time purchased in 2009 as compared to 2008, our profit per media cost went up from 1.43 in 2008 to 1.81 in 2009, reflecting our improved media efficiency.

If a TV direct sales program for a specific product or service achieves satisfactory results during the initial test-marketing phase, we may elect to include that product or service in our TV direct sales platform for full-scale marketing and selling. If selected for full-scale marketing, a TV direct sales program for a product or service will then be frequently broadcast on several TV channels in various time slots. We then track the success of a TV direct sales program in various time slots on various TV channels with data on our profitability relative to our marketing expenses, on a weekly basis, and we adjust the frequency of the broadcast of the TV direct sales program and the content of the program, its broadcast time slots and the TV channels on which the program airs to create a broadcasting schedule that maximizes the overall profitability of the TV direct sales program.

We also use purchased TV advertising time to broadcast brand promotion advertising. Our brand promotion advertisements are typically five to 60 seconds long and, rather than focusing in depth on product or service features or benefits in depth, are designed to increase general brand awareness. We significantly expanded our TV brand promotion advertising beginning in 2005 in conjunction with our increased distribution activities,

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using TV brand promotion advertising to enhance brand awareness for our Ozing branded electronic learning products and, to a lesser extent, our posture correction product lines. Since 2007, however, we have changed our strategy to focus more of our advertising spending on our TV direct sales programs and to reduce the amount of purchased TV advertising time dedicated solely to brand promotion advertising. In 2009, we broadcasted TV brand promotion advertising on 9 TV channels. Consistent with industry practice in China, our TV advertising time purchase agreements are typically negotiated annually and are non-exclusive. We intend to seek to maximize media efficiency by continuing our more flexible media buying plan and our more targeted airtime allocation scheme with channels that offer higher media returns.

In 2006, we began entering into joint sales arrangements and marketing services arrangements to leverage our TV direct sales platform. Under a joint sales arrangement, we make TV direct sales of third-party branded products and services. During 2009, our cell phone products and cosmetic products were the two major categories of products subject to joint sales arrangements. We had a total consideration (recorded as a reduction to our cost of direct sales revenues) of RMB2.8 million (\$0.4 million) for our joint sales arrangements in 2009. In addition, under our marketing services arrangements, we provide a marketing plan, related TV advertising time and call center support to our marketing customers for a fixed fee. We did not recognize any revenue from our marketing service arrangements in 2009. As described above, we have returned to our historic emphasis on growing our proprietary branded products since 2009, but we intend to continue to develop joint sales and marketing services arrangements as sources of complementary revenue streams.

***Other Direct Sales Platforms***

Our other direct sales platforms currently include third-party bank channel sales, our outbound call sales, catalog sales and Internet sales. We also market and directly sell through print media and radio. From the second half of 2009, sales from our other direct sales platforms have undergone a strong increase. We believe such increase is mainly attributable to our effective utilization of our customer database. As of December 31, 2009, our database contained approximately 11 million names of individual customers, the majority of whom have placed orders to us or made calls to our call centers in the past 12 years. We expect that the number of customers in our data base will continue to grow and sales from our other direct sales platforms will be of higher growth potential and growing importance to our business in the future. We expect that our non-TV direct sales will account for an increased portion of our direct sales net revenues.

***Third Party Banks.*** In 2007, we began relationships with four established domestic banks through which we directly market products through specialized catalogs to credit card holders of these banks. As of December 31, 2009, we have established relationships with 26 domestic banks. As part of these arrangements, customers can use their credit cards from these banks to purchase our products and to make payments on a zero interest and zero fee installment basis. Our third-party bank channel sales are increasingly important to our direct sales platform, and revenue contributed by our third-party bank channel sales in 2009 accounted for approximately 18.0% of our revenue from direct sales.

***Outbound Calls.*** We began our outbound call direct sales in the fourth quarter of 2004. As of December 31, 2009, our 519 specialized outbound call center sales representatives utilize our customer database to target calls at customer subgroups identified by us as likely purchasers of particular products or services. Our outbound call direct sales are increasingly important to our direct sales platform, and revenue contributed by our outbound call sales in 2009 accounted for approximately 12.2% of our revenue from direct sales.

***Catalogs.*** In February 2005, we began marketing our products through print catalogs. We currently offer over 320 products via our catalogs, of which approximately 40 are our branded products and the remainder are third-party products. Our catalogs are currently distributed together with the products purchased and shipped to our new customers. In addition, we also track customers who have previously purchased products from us and distribute our catalog to them after their initial purchase. We issued six catalogs in 2009. Our catalog sales are increasingly important to our direct sales platform, and revenue contributed by our catalog sales in 2009 accounted for approximately 2.5% of our revenue from direct sales.

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**Internet.** We began marketing our products through the Internet in December 2006. We currently offer over 1,400 products via our website, of which approximately 77 are our branded products and the remainder are third- party products.

### ***Customer Loyalty Initiatives***

We also market the products and services sold through our direct sales platforms through our customer loyalty program. Our current customer loyalty program includes coupon discounts and membership points. Coupon discounts are given to customers whose purchases individually or together meet or exceed a certain transaction value. These coupons, which can be applied to future purchases of products marketed in our catalogs, range from approximately RMB20 to RMB300 (or approximately \$3 to \$44). Membership points are awarded to customers when they purchase products or services through our direct sales programs. Customers are awarded membership points based on the type of product or service purchased with point values around 10% of retail price, with every ten points equaling RMB1 (approximately \$0.15). Customers can use these membership points to partially or fully offset the cost of future product or service purchases.

### **Nationwide Distribution Network**

Our nationwide distribution network is one of our two primary sales platforms. We use our nationwide distribution network to distribute a select number of our product and services promoted through our TV direct sales programs which we believe offer sufficient profit potential and may be developed as a national product brand. Our distribution network broadens our customer reach and enhances the penetration of those products and services on a nationwide basis within a short period of time. In December of 2008, we acquired Yiyang Yukang. Following the acquisition, our network covers all provinces in China through approximately 80 distributors, which allows us to reach approximately 20,000 retail outlets covering nearly all of the cities and the counties in China. These retail outlets include bookstores, pharmacies, specialty retail chains and department stores. In 2007, 2008 and 2009, sales generated through our nationwide distribution network accounted for 26.9%, 28.7% and 44.2% of our net revenues, respectively. We typically provide our distributors with the exclusive right to distribute selected products and services in their respective territories. In 2007, 2008 and 2009, sales generated by our top five distributors accounted for 7.0%, 7.7% and 9.8% of our gross revenues, respectively.

We support the products and services selected for distribution through our nationwide distribution network with marketing campaigns utilizing a combination of our TV direct sales programs and brand promotion advertising to reinforce "As Seen on TV" in-store signage, as well as local print media, marketing events and radio advertising. In addition, we also require our distributors to engage in their own marketing efforts. Promotional efforts by our distributors primarily consist of local print advertising and TV advertising programs. To ensure the consistency of our product and service messages and to maximize branding effectiveness, we provide our distributors with marketing materials. We also reimburse certain distributors, such as distributors of our electronic learning product lines, for a portion of their local product promotion expenses.

Integrating our national TV direct sales programs and brand promotion advertising with our follow-on local advertising campaigns has been an effective marketing strategy for us. Our national TV direct sales programs and brand promotion advertising create initial product and service brand awareness, and our nationwide local advertising campaigns help to broaden the reach of our marketing efforts and extend the lifecycles of our products and services. Our ability to build leading brands, together with our marketing resources and expertise, enable us to successfully identify and introduce potential new products and services from small and medium- sized suppliers and manufacturers in China.

Our distribution agreements are typically negotiated and entered into on an annual or semi-annual basis and are designed to provide incentives for our distributors to improve their sales performance, encourage them to promote our brands, and protect the value of those brands. For example, our distributors are required to meet the

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monthly and annual sales volume target for our selected featured products and services and, in the case of electronic learning products and electronic dictionary products distribution, we provide sales incentives in the form of cash rebates to the distributors that meet or exceed our sales targets. We also require our distributors to ensure that the retail prices of our products and services sold through their retail outlets are not lower than the retail prices for the same products and services sold through our TV direct sales platform, or the minimum retail prices set by us. In addition, we typically require our distributors of electronic learning products and electronic dictionary products to fully settle their payment obligations before we deliver new products to them. Our distributors may not sell competing products and services in their respective territories. Furthermore, distributors of our electronic learning products and electronic dictionary products must also incur minimum marketing expenditures provided in our distribution agreements. We regularly monitor and review our distributors' sales performance and their compliance with the terms of our agreements.

Several of our distributors, including two of which were among our top five distributors in 2007 and 2008 and one of which was among our top five distributors in 2009, market and sell some other companies' products and services through their own TV direct sales platforms. Each of these distributors operated their own TV direct sales platforms independent of our operations prior to becoming our distributors. In addition, some of our distributors use edited versions of our TV direct sales programs to market our products and services on local TV stations and conduct TV direct sales activities through their own call-in numbers. These distributors have each entered into our standard distribution arrangements, which include provisions prohibiting sales of competing products and services, selling our products and services outside their distribution territories, or selling our products and services to consumers at prices below our price for those products and services. See Item 3.D, **Key Information Risk Factors Risks Relating to Our Business** Some of our distributors may compete with us in certain TV direct sales markets, possibly negatively affecting our direct sales in those markets .

We are generally responsible for delivering at our own cost the products to the distributors from our warehouses to a destination close to our distributors. We engage local logistics companies to make these deliveries with the amount paid for delivery typically based upon the transport distance. We generally allow the distributors to exchange any defective products they receive from us. Our distributors typically have their own product exchange or return policy. We are not responsible for any exchange or return of products by retailers who purchase our products from the distributors.

Some of our distributors are owned in part, or in some cases in whole, by certain of our employees or their family members. These employees, none of whom are executive officers, are currently responsible for various functions or operations relating to our nationwide distribution business. In 2007, 2008 and 2009, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 28.4%, 17.2% and 12.7% of our distribution gross revenues, respectively, or 7.6%, 4.9% and 5.6% of our total gross revenues, respectively. Certain of these distributors have been among our top distributors in 2007, 2008 and 2009. In addition, one distributor in 2007 was wholly owned by a relative of our chief executive officer. However, this distributor accounted for less than 2% of our distribution gross revenues in 2007, and the relative of our chief executive officer has ceased to hold an equity interest in the distributor since mid-2007. We entered into the distribution agreements with these related distributors on an arm's-length basis and the terms in the distribution agreements with these distributors are the same as those with our independent distributors. Nevertheless, the economic interests held by our employees in our distributors may make it difficult for us to effectively evaluate the performance of such distributors or fine, suspend or terminate a non-performing, under-performing or non-compliant distributor without harming our relationship with those employees. See Item 3.D, **Key Information Risk Factors Risks Relating to Our Business** Certain of our distributors are beneficially owned by our employees. It may be difficult for us to effectively evaluate the performance of these distributors or to replace any of them if they are non-performing, under-performing or non-compliant with our distribution agreements .



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### **Our Products and Services**

We offer over 1,400 products and services through our multiple sales platforms, approximately 5% of which are sold primarily through our TV direct sales platform, nationwide distribution network or both with the remaining products and services sold through our third-party bank channel sales, outbound calls, catalogs or the Internet. Our recently featured product categories include cell phones, electronic learning products, health and wellness products, cosmetics products, consumer electronics products, electronic dictionary products and auto care products, all of which are primarily sold through our TV direct sales platform, nationwide distribution network, or both. We periodically develop and introduce new and upgraded products and services under the same product brand to develop such brand into a product or service line. For a variety of reasons, including margin constraints, we do not actively market all of our featured product lines and services through our nationwide distribution network. We also sell other products including auto care, beauty and household products primarily through our catalogs, the Internet, outbound calls and cross-selling. We own the exclusive distribution rights in China to most of our current featured product lines and services.

### ***Recent Featured Product Categories***

We generally focus on marketing and selling four to six featured product lines at any one time through our TV direct sales platform and a limited number of products and services through our nationwide distribution network. In 2009, we featured products in the following categories and under the following proprietary and third-party brands:

*Electronic Learning Products* featuring the Ozing brand name accounted for 20.2%, 20.0% and 30.2% of our gross revenues in 2007, 2008 and 2009, respectively.

Our primary Ozing branded product is a multi-functional handheld electronic device with a screen display that provides lessons for independent English learning. We began marketing and selling our first Ozing product, targeted at middle and high school students, in December 2003. The retail prices for our Ozing products ranged from RMB798 to RMB1,499 per unit in 2007, RMB599 to RMB1,499 per unit in 2008 and RMB698 to RMB1,498 (or approximately \$102 to \$220) per unit in 2009.

*Cell Phone Products* featuring the Gionee, K-touch, Lenovo, Nokia and Konka brand names and China Unicom's CDMA services and CDMA cell phones from China Unicom's partners accounted for 42.4%, 24.0% and 21.3% of our gross revenues in 2007, 2008 and 2009, respectively.

Since April 2006, we have entered into a number of joint sales arrangements and marketing services arrangements with a number of different cell phone manufacturers for the Gionee, K-touch, Lenovo, Nokia and Konka branded cell phones. In November 2007, we entered into a joint sales arrangement with Gionee to promote and market its cell phone products via our direct sales platform and under which Gionee shares part of our advertising costs for their featured cell phone products. We also sell cell phone products manufactured by Yiyang Yukang under its proprietary Uking brand. The retail prices for the cell phone products that we market ranged from RMB558 to RMB4,960, RMB599 to RMB7,410 per unit in 2008 and RMB499 to RMB5,340 (or approximately \$73 to \$783) per unit in 2009.

*Cosmetics Products* featuring the Aoya, Cobor, Dr Cell and Softto brand names. We began marketing and selling our cosmetics products in the third quarter of 2007. Cosmetic products accounted for 10.1% and 15.7% of our gross revenues in 2008 and 2009. The retail prices for our cosmetics products ranged from RMB48 to RMB1,288 per unit in 2007, RMB79 to RMB1,980 per unit in 2008 and RMB39 to RMB2,016 (or approximately \$6 to \$296) per unit in 2009. In November 2009, we entered into an exclusive distribution agreement with Guthy-Renker to market Sheer Cover® branded cosmetics in China with a term of one year, which may be further extended based on meeting first year's designated sales levels. Pursuant to the exclusive distribution agreement, we are entitled to sell such products through all our available distribution channels including both TV and non-TV direct sales.

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*Health and Wellness Products* featuring the Babaka, Zehom and Youngleda brand names accounted for 10.3%, 15.3% and 10.4% of our gross revenues in 2007, 2008 and 2009, respectively.

We began marketing and selling our first Babaka branded posture correction product in December 2004 and our first Youngleda branded portable mechanized oxygen generating device in November 2000. We have introduced product upgrades and extensions relating to these original products and developed each brand into a propriety branded product line. Our health and wellness product lines are primarily targeted at elderly persons, working professionals and young consumers. The retail prices for these products ranged from approximately RMB128 to RMB1,980 per unit in 2007 and RMB86 to RMB3,495 per unit in 2008 and RMB98 to RMB3,495 (or approximately \$14 to \$513) per unit in 2009.

*Electronic Dictionary Products* featuring the Meijin brand name, which we introduced in July 2007, accounted for 2.4%, 6.1% and 6.3% of our total gross revenues in 2007, 2008 and 2009, respectively. The retail prices for our electronic dictionary products ranged from RMB498 to RMB1,298 per unit in 2007, RMB598 to RMB898 per unit in 2008 and RMB268 to RMB1,580 (or approximately \$39 to \$232) per unit in 2009;

*Auto Care Products* featuring Energy, Austin and Quixx brand names, which we introduced in the third quarter and fourth quarter of 2009, accounted for 2.5% of our total gross revenues in 2009. The auto care products are sold through both our direct sales platform and our distribution network. The retail prices for our auto care products ranged from RMB 30 to RMB3,580 (or approximately \$4 to \$525) per unit in 2009.

Our five best-selling products and product lines in 2007, 2008 and 2009 are set forth below:

| Product  | Brand  | 2007              |              |      | 2008              |              |      | 2009              |              |      |
|--|--|-------------------|--------------|------|-------------------|--------------|------|-------------------|--------------|------|
|  |  | Revenues          | percentage   | Rank | Revenues          | Percentage   | Rank | Revenues          | Percentage   | Rank |
| (in thousands, except percentages and ranks)   |  |                   |              |      |                   |              |      |                   |              |      |
| Electronic learning product                    | Ozing  | 50,151            | 20.2%        | 2    | 46,939            | 20.0%        | 2    | \$ 86,964         | 30.2%        | 1    |
| Cell phone                                     | Amoi, Gionee, K-touch, Lenovo, Nokia & Konka     | \$ 105,563        | 42.4%        | 1    | \$ 56,242         | 24.0%        | 1    | \$ 61,277         | 21.3%        | 2    |
| Cosmetic products                              | Aoya, Cobor, Dr Cell, Softto and CMM brand names |                   |              |      | 23,726            | 10.1%        | 4    | \$ 45,149         | 15.7%        | 3    |
| Posture correction product                     | Babaka   | 16,175            | 6.5%         | 4    | 28,598            | 12.2%        | 3    | \$ 23,821         | 8.3%         | 4    |
| Electronic dictionary                          | Meijin   |                   |              |      |                   |              |      | \$ 18,259         | 6.3%         | 5    |
| GPS  | Eroda  | 6,727             | 2.7%         | 5    | 17,193            | 7.3%         | 5    |                   |              |      |
| Collectibles                                   |  | 19,332            | 7.8%         | 3    |                   |              |      |                   |              |      |
| <b>Total top five</b>                          |  | <b>\$ 197,948</b> | <b>79.5%</b> |      | <b>\$ 172,698</b> | <b>73.7%</b> |      | <b>\$ 235,470</b> | <b>81.8%</b> |      |
| Other products and marketing services revenues |  | \$ 50,914         | 20.5%        |      | \$ 61,649         | 26.3%        |      | \$ 52,312         | 18.2%        |      |
| Total gross revenues                           |  | \$ 248,862        | 100.0%       |      | \$ 234,347        | 100.0%       |      | \$ 287,782        | 100.0%       |      |
| Total sales tax                                |  | \$ (825)          |              |      | \$ (209)          |              |      | \$ (196)          |              |      |
| Total revenues, net                            |  | \$ 248,037        |              |      | 234,138           |              |      | \$ 287,586        |              |      |

**New Products and Services**

We seek to identify new products and services that offer sufficient profit opportunities and address consumers' changing needs. Since 2000, we have successfully introduced 22 branded product lines, including 13 proprietary branded product lines and nine third-party branded product lines, many of which began as a single

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product and became one of our five best-selling products in later periods. In 2009, we introduced 2 new products for full-scale sales and marketing. In the future, we will continue to seek to diversify our product and service offerings and our customer base, encourage repeat purchases by our existing customers, and create recurring revenue opportunities. For example, in early 2008, we launched a complete cosmetics product line under the Cobor brand and in the third quarter of 2009, we introduced Austin and Quixx branded auto care products, all of which turned out to be very successful products in the fourth quarter of 2009. We also plan to introduce new products and services that we believe will offer longer product lifecycles and enjoy broad consumer appeal.

### **Product Development**

We employ a rigorous and systematic approach to identifying and developing products. Our product development process comprises product identification, pre-testing preparation and test-marketing for marketing through our TV direct sales channels. We generally test the market potential and customer appeal of our products and services by broadcasting our TV direct sales programs on specific channels for a designated period of time. During the test marketing period, we closely evaluate customer feedback and sales of the relevant product and service through our call centers. Products that meet certain pre-defined standards are launched on a national scale. Products and services that do not meet our pre-defined standards may undergo a change in marketing strategy and be retested, or may be removed from our product portfolio.

In 2009, we test-marketed over 80 new or upgraded products over our TV direct sales platform, of which 23 progressed from the test marketing stage to full-scale sales and marketing. We employ a similar testing process when determining which products to move from our TV direct sales platform to our nationwide distribution platform. We typically test-distribute our featured products in one distributor's territory for period of a few weeks before introducing these products into our nationwide distribution network for full-scale distribution.

### ***Product Identification***

We typically seek to identify consumer products that we believe offer good value and quality, are not widely available, and can generate sufficient profit potential. Our success in developing leading product brands and our ability to enable China's small and medium-sized suppliers and manufacturers to cost-effectively sell products throughout China have provided us with access to a large pool of potential products from these suppliers and manufacturers. Historically, many of our best-selling products were products that had initially been marketed and sold in China by small and medium-sized suppliers and manufacturers on a more limited basis.

In addition to identifying new products and services through external sources, we also focus on our internal product development efforts relating to our existing product and service portfolio. These products, with their existing brand awareness and consumer acceptance, provide significant opportunities to introduce upgraded products and related new products under the same brand. We also utilize our nationwide distribution network management team, with their unique product and market knowledge, to assist in identifying, developing and sourcing new complementary products.

### ***Pre-testing Preparation***

During our pre-testing preparation phase, our product development team analyzes and identifies a product's unique features and value proposition to formulate a marketing and distribution strategy, including setting a selling price for the test-marketing phase, a sales target and a weekly marketing plan. Our in-house product development team works with independent production companies to produce TV direct sales programs tailored for each product and service. To ensure service quality and assist in gathering consumer feedback, our product development team concurrently provides our call center employees with training and sales scripts to assist them in receiving purchase order calls in response to our TV test-marketing activities.

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### ***Test Marketing***

The test-marketing phase usually lasts from one to three weeks, during which time our test TV direct sales programs are aired during targeted broadcast time slots on selected TV channels. During the test-marketing phase, we gather and analyze real-time data and consumer feedback collected by our call centers through designated test numbers. Using this data and feedback, we attempt to predict the demand, growth potential and anticipated selling prices of the products and services. In analyzing the data to determine whether we should move a product or service into full-scale marketing on our TV direct sales platform, we focus on key benchmarks, including, most importantly, estimated profitability relative to our media expenses. We then determine whether the product has the potential to be developed into a proprietary branded product line so that its lifecycle can be prolonged by introducing it into our nationwide distribution network.

### **Call Center Operations**

Our direct sales businesses and media purchase activities are supported by our call centers located in Beijing, Shanghai and Wuxi. Our call center in Wuxi began operation in 2009 and we plan to shift more outbound calls and after-sales services to our Wuxi call center going forward to capitalize on its lower labor costs than in Beijing and Shanghai. Our call centers process telephone orders generated by our direct sales programs and gather real-time data to help us analyze the effectiveness of our advertising spending and adjust our offerings. Each of our call centers also places outbound calls to selected customers to market our products and services. As of December 31, 2009, we had 1,058 dedicated sales representatives. In 2007, 2008 and 2009, our call centers processed an average of approximately 18,800, 20,000 and 20,400 incoming calls per day, respectively, for products and services marketed through our multiple sales platforms. To effectively convert in-bound calls to customer orders, our sales representatives follow a prepared script that covers frequently asked questions to guide the sales call. Our call center supervisors closely monitor calls received and revise and update the scripts based on their assessment of the script's effectiveness during the customer calls and in response to customer feedback. Our sales representatives are also trained to promote, cross-sell or upsell complementary and/or additional products and services.

We constantly and systematically seek to evaluate and improve the cost-effectiveness of our direct sales operations. Performance metrics we track and analyze on a daily basis include the number of calls successfully connected to a sales representative per call placed to our call center and the number of successfully completed orders per call connected. We seek to increase the rate of successfully completed orders per call connected by directing customer calls to our call center sales representatives with specialized product and service training and knowledge about the specific product and service.

Our call centers also collect real-time data to help us to continually analyze the effectiveness of our advertising spending and product and service offerings. We regularly track and analyze real-time data generated through our call center operations to ensure the cost-effectiveness of our media purchases. We use call center-generated real time data to adjust our TV sales program product and service mix, broadcast time slots and channels to maximize the profitability of our TV direct sales operations.

### **Order Fulfillment**

The majority of products sold by us through our direct sales platforms, including TV direct sales, third party bank channel sales, catalog sales and Internet sales, are delivered to our customers throughout China by EMS, the largest national express mail service operated by the China Post Office, and local delivery companies. We generally guarantee our products will be delivered to our customers within seven days of the date of receiving the order. In 2007, 2008 and 2009, of the total attempted product deliveries by EMS and local delivery companies on a cash-on-delivery, or COD, basis, approximately 75%, 75% and 73% were successful, respectively. Reasons for delivery failure primarily include customers' refusal to accept a product upon delivery, which tend to occur more frequently with products that have higher average selling prices, or failure to successfully locate the delivery address. We are responsible for delivery and handling fees regardless of whether the delivery is successful. We

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have found that, in general, the shorter the delivery time, the lower the likelihood that the customer will refuse to accept the product upon delivery. As a result, local delivery companies enjoy a slightly higher delivery success rate than EMS due to a faster delivery time. EMS and local delivery companies are responsible for returning to us any undelivered products. It generally takes EMS two to three weeks, and local delivery companies seven days, to return the undelivered products to us.

In 2007, 2008 and 2009, approximately 99.5%, 93.1% and 89.6% of our direct sales were settled on a COD basis by our customers. We recently expanded our payment options to include payments through credit cards on a zero interest and zero fee installment payment basis. The decrease in settlement on a COD basis in 2009 was due to the increasing use of alternative payment methods, which include postal wire payments and payment by credit card. For customers settling through COD, either EMS or the local delivery company is responsible for collecting and wiring to us these cash amounts on a periodic basis once collected. EMS and local delivery companies generally charge us delivery fees based upon weight of the products and distance of delivery. Additionally, EMS charges a processing fee based upon the sales price. Three of our local delivery companies charge a lower processing fee based upon the sales price, while the other companies do not charge us such fee. It typically takes on average over 30 days for us to receive payments from EMS compared to an average of seven days from local delivery companies. Of our total accounts receivable balance as of December 31, 2007, 2008 and 2009, \$8.3 million, or 35.8%, \$9.0 million, or 32.5% and \$2.2 million, or 12.8%, respectively, was due from EMS.

In 2007, 2008 and 2009, approximately 76.1%, 59.3% and 47.4% of our direct sales gross revenues resulted from products delivered by EMS, respectively, and approximately 19.1%, 29.8% and 38.0% of our direct sales gross revenues resulted from products delivered by local delivery companies, respectively.

### **Customer Service, Product Warranties and Return Policies**

We believe emphasizing customer service will enhance our products and service brand image, facilitate cross-selling opportunities and generate customer loyalty and repeat purchasing behavior. Our customer service centers within our Beijing, Shanghai and Wuxi call centers are currently staffed with approximately 94 customer service representatives working ten hours a day to provide quality customer services to our customers. In addition, most of our distributors generally provide their own customer services in their respective territories.

Our customer service representatives are primarily responsible for answering our customers' product and service-related inquiries, providing product and service information and handling product returns and customer complaints. To ensure superior customer service, we place significant emphasis on personnel selection and training. Our customer service representatives undergo product-specific and service-specific training to allow them to answer product-related and service-related questions, proactively educate potential customers about the benefits of our products and services and promptly resolve customer problems. We also provide customer service training to some of our distributors for products and services sold through our nationwide distribution network.

Under our policies, our direct sales customers generally may return products from us within seven days after delivery if there is a quality defect or if a product fails to meet its specifications. In most cases, product exchanges are allowed within a month of delivery. Our warranties generally provide for repair of product defects within one year at no cost to the customers. Product returns from our multiple sales platforms were insignificant in 2007, 2008 and 2009. To the extent that the manufacturer of the defective product is a third party, the manufacturer is obligated to either repair the defective product or reimburse us for any related expenses. Our distributors are allowed to exchange any defective products they receive from us. The number of products exchanged by our distributors due to defects was insignificant in 2007, 2008 and 2009.

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### **Supply and Inventory**

#### ***Supply***

We manufacture a significant portion of the proprietary products we currently offer in terms of net revenues. The remaining products, including third-party products promoted by us pursuant to joint sales arrangements, are primarily sourced through third-party suppliers. Our manufacturing operations involve mainly assembly processes and generally only require us to deploy a limited amount of capital. Most of the components we use in our products are readily available in the market.

We began our manufacturing operations in 2000 with the production of our oxygen generating devices. Beginning in 2005, we expanded our manufacturing operations to manufacture substantially all of our electronic learning products and posture correction product lines. After the completion of our acquisition of Yiyang Yukang, we further expanded its manufacturing capacity to manufacture Yiyang Yukang's cell phone products. We purchase consumer electronics products and neck massager products from third-party manufacturers under exclusive supply or distribution arrangements. For some of our products, we provide designs or technical requirements to our third-party suppliers.

We believe that if we decide to discontinue our manufacturing operations for any of our products for any reason, we would be able to subcontract the manufacturing of these products on commercially reasonable terms within a reasonable period of time.

#### ***Inventory Control***

We closely monitor our inventory and sales levels at all of our sales and marketing platforms. In general, before or during our test-marketing stage, we do not acquire any sizable inventory position in a product. Except for our electronic learning product and electronic dictionary products, for which we maintained an average of two weeks of inventory in 2009, we generally maintain one week of inventory for finished products. Our product and media departments adjust our inventory levels based on the weekly sales forecasts they jointly develop. When a product is no longer sold through our TV direct sales programs and/or our nationwide distribution network, our inventory of that product is generally limited.

For our electronic learning product and electronic dictionary products, our product and media departments prepare a monthly production plan based on monthly sales forecasts and we procure the required raw material based on the production plan. Our monthly procurement plan is subject to bi-weekly adjustment to give us flexibility to cancel a portion of our orders if sales do not meet expectations.

### **Majority-Owned Subsidiaries**

To acquire managerial expertise and additional complementary distribution network infrastructure or secure exclusive product distribution rights, we have formed certain majority-owned subsidiaries. We currently have one majority-owned PRC operating subsidiary, which is engaged in developing and/or selling our electronic dictionaries. We may form other majority-owned subsidiaries in the future.

In these arrangements, we typically receive at least majority control of the related joint venture and exclusive distribution rights to distribute a product through the subsidiary in exchange for our agreement to market and sell the product through our multiple sales platforms, a minority equity stake and cash consideration. These majority-owned subsidiaries typically involve limited capital investment. To date, our most successful venture has been our electronic learning product-related subsidiary in which we acquired rights to the electronic learning products and the services of Guoying Du, one of our current executive officers, and his management team. We entered into this arrangement in December 2003 and in July 2005, we acquired the remaining 49% of this company. Following this transaction, we promoted Guoying Du to head our nationwide distribution network. For a description of the acquisition, see Item 7.B, Major Shareholders and Related Party Transactions Related Party Transactions .

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### **Acquisition of Yiyang Yukang**

On December 24, 2008, we completed our acquisition of 100% of the equity interests of Yiyang Yukang, a cell phone producer and distributor in China and former third-party supplier of our cell phone products, by acquiring its offshore holding company. Pursuant to the definitive agreement entered into on December 18, 2008, we acquired Yiyang Yukang for initial stock and cash consideration totaling \$9.9 million. Additional consideration was payable under earn-out payments based on performance of the business contingent on Yiyang Yukang meeting certain earnings targets in 2008, 2009 and 2010. An earn-out payment consisting of cash and stock consideration in an aggregate amount of \$10.0 million was made in respect of 2008 and the first quarter of 2009. No earn-out payment was made in respect of 2009 and no earn-out is expected to be paid with respect to 2010. Our total expenses related to the acquisition were \$0.7 million.

Yiyang Yukang produces, processes and markets communication equipment, targeting mid-to-high end business users in China. Approximately 20% of our cell phone products sold through our direct sales platforms were sourced from Yiyang Yukang in 2008. We acquired Yiyang Yukang with an aim to build and develop our own cell phone brands, as well as to take advantage of Yiyang Yukang's nationwide distribution network to facilitate sales of our featured cell phone products. In 2009, sales of Yiyang Yukang branded cell phones totaled \$28.1 million (with all sales being distribution sales). Due to Yiyang Yukang's change in strategy and its underperformance, in 2009 we incurred a \$15.2 million intangibles impairment charge.

### **Divestment in Shanghai Yimeng**

In June 2009, we disposed of a 33% equity interest in Shanghai Yimeng Software Technology Co., Ltd., or Shanghai Yimeng, a company engaged in the development and marketing of CPS stock tracking software, to focus on core competency and enhance operating efficiency. Consideration for the disposal was \$10.5 million in cash. As a result, Shanghai Yimeng is now 18% owned by us and ceased to be a subsidiary of our company. We currently do not have significant influence on Shanghai Yimeng's operation. Our historical financial statements were recasted to give effect to the deconsolidation and historical results related to that business are reflected as discontinued operations.

### **Competition**

Because of our integrated vertical business model, we face competition from the following companies operating in our value chain:

other TV direct sales companies operating in China with generally similar business models to ours, including Moneng TV, Pacific Media and China SevenStar;

TV home shopping companies that operate across China or in large parts of China such as CCTV Home Shopping and Hunan TV Happigo, and companies that operate on multiple channels in multiple provinces, such as Oriental CJ Home Shopping, U-you Home Shopping and TVSN;

domestic and international sellers of consumer branded products that sell their products in China and which compete with our products, such as our Ozing electronic learning products which compete with electronic learning products under the BBK, Noah and other brands, and our cell phone products which compete with similar products sold by local and international cell phone manufacturers;

traditional retailers and distributors, as well as direct marketers, such as Avon, operating in China which currently or in the future may offer competing products and services, including products and services under their own brand, or may otherwise offer or seek to offer small and medium manufacturers and suppliers distribution capabilities throughout China;

other Internet and e-commerce companies in China that offer consumer products online via an Internet platform, including eBay's China site, Alibaba's Tao Bao, and Dang Dang; and

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companies that sell consumer products on multi media platforms, including Happy Tao Bao, which is the joint venture between Alibaba's Tao Bao and Hunan TV Station.



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Particularly, we are facing more intense competition from TV home shopping companies in China, number of which has increased significantly in 2009. Many of them are supported by, or affiliated with, TV or radio stations and therefore, may have access to cheaper TV air time than us.

In addition, large multi-national home shopping companies, such as QVC, may enter the China market directly or indirectly. Entry by these players becomes more likely if existing PRC restrictions on content, number of advertising hours per day and foreign ownership of TV stations are relaxed.

We also compete with companies that make imitations of our products at substantially lower prices, such as our Babaka branded posture correction products, which are often sold in department stores, pharmacies and general merchandise stores. See Item 3.D, **Key Information Risk Factors Risks Relating to Our Business**. We may not be able to prevent others from unauthorized use of our intellectual property, which could harm our product brand, reputation and competitive position. In addition, we may have to enforce our intellectual property rights through litigation. Such litigation may result in substantial costs and diversion of resources and management attention.

Upon completion of our acquisition of Yiyang Yukang in December 2008, Yiyang Yukang became one of our subsidiaries. As a cell phone producer targeting mid-to-high end business users in China, we believe that Yiyang Yukang competes primarily with a small number of domestic cell phone producers in China, such as Lenovo and TCL, on the basis of the ability to achieve effective cost control.

We believe we compete primarily on the basis of the effectiveness of our sales and distribution channels in reaching customers and generating customer appeal for our products and services. We believe we also compete primarily on the basis of the ability to secure significant TV and other media access on a nationwide basis and to effectively manage the TV advertising time and other media resources, such as newspaper and radio advertising that we secure. In particular, we believe our TV media access and management experience helps us to be one of the largest TV direct sales operators in China in terms of revenues, and to maximize the effectiveness of our TV direct sales programs, reduce our risk of product or service failure and minimize associated costs. In addition, we believe we also compete primarily on the basis of our ability to identify and develop product and service brands, which helps to attract new product proposals from independent third parties and product suppliers who otherwise often lack the marketing or distribution capabilities and/or resources required to effectively market and sell their products or develop their own product brands. We also compete on the basis of product quality, price, and quality of our customer service, retail outlet coverage of our nationwide distribution network and speed of delivery. We believe we compete favorably on the basis of each of these factors. However, many of our current or future competitors may have longer operating histories, better brand recognition, greater levels of consumer trust, stronger media management capabilities, better media and supplier relationships, a larger technical staff and sales force and/or greater financial, technical or marketing resources than we do.

## **Seasonality**

Certain of our products are subject to seasonality, such as our electronic learning products and posture correction product lines and to a lesser extent, our electronic dictionary products. Sales for these products are typically higher around our first and third fiscal quarters which correspond to the end and beginning of school semesters in China, respectively. Other than seasonality related to these and certain of our other products, our business generally has not been seasonal.

## **Intellectual Property**

We rely on a combination of copyright, trademark, patent, unfair competition laws, as well as nondisclosure agreements and other methods to protect our intellectual property rights. We maintain approximately 227 trademark registrations and are in the process of applying for registrations or transfer for approximately 81 trademarks in China. We own seven invention, utilities and packaging design patents in China pertaining to our sleeping aid products, neck protected pillow, body relaxing chairs, posture correction products and engine lubricant products.

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The legal regime in China for the protection of intellectual property rights is still at a relatively early stage of development. Despite many laws and regulations promulgated and other efforts made by China over the years to enhance its regulation and protection of intellectual property rights, private parties may not enjoy intellectual property rights in China to the same extent as they would in many western countries, including the United States, and enforcement of such laws and regulations in China have not achieved the levels reached in those countries. Therefore, it is difficult and expensive to police and enforce against infringement of intellectual property rights in China. Imitation or counterfeiting of our products or other infringement of our intellectual property rights, including our trademarks, could diminish the value of our various brands or otherwise adversely affect our net revenues. See Item 3.D, **Key Information Risk Factors Risks Relating to Our Business** We may not be able to prevent others from unauthorized use of our intellectual property, which could harm our product brand, reputation and competitive position. In addition, we may have to enforce our intellectual property rights through litigation. Such litigation may result in substantial costs and diversion of resources and management attention.

We have in the past been, currently are, and in the future may again be, the subject of claims for infringement, invalidity, or indemnification relating to other parties' proprietary rights. For example, in August 2008, Beijing Ren'ai filed a suit in the People's Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai Digital Technology Co., Ltd., or Beijing Sancai, and Beijing Zhidahengtong Technology Development Co., Ltd., or Beijing Zhidahengtong, alleging that the English programs we provide to the users of our electronic learning products infringe upon the copyright of Beijing Ren'ai. Beijing Ren'ai claimed damages of RMB2,000,000 (approximately \$293,000). The court ruled in favor of Ren'ai in the suits and awarded Ren'ai total compensation of RMB500,000 (approximately \$73,000). The defendants appealed to the Beijing First Intermediate People's Court in May 2009, which affirmed the decision of the People's Court of Beijing Haidian District on December 7, 2009.

In August 2009, Beijing Ren'ai filed a suit in the People's Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai and Beijing Zhidahengtong, alleging that the English programs we provide to the users of our electronic learning products infringe upon the copyright of Beijing Ren'ai. Beijing Ren'ai claimed damages of RMB2,000,000 (approximately \$293,000). The court ruled in favor of Ren'ai in the suits and awarded Ren'ai total compensation of RMB500,000 (approximately \$73,000). The defendants have appealed the court's decisions and the appeals are currently pending.

We believe that the above legal proceedings will not have a material adverse effect on our financial conditions. See Item 3.D, **Key Information Risk Factors** We have in the past been, currently are, and in the future may again be, subject to intellectual property rights infringement claims and other litigations by third parties, which could be time-consuming and costly to defend or litigate, divert our attention and resources, or require us to enter into licensing agreements. These licenses may not be available on commercially reasonable terms, or at all.

## **Management Information System**

Our management information system and technology infrastructure is designed to support our key operations. Full redundancy design and data backup are built into our systems. We also have an uninterruptible power supply that can provide up to four hours of power in case of power outage to allow full functioning of our call center and customer services operations during that period.

Our major system modules and functions, which facilitate various aspects of our business, include the following:

- call center business management system, which facilitates automatic incoming call connection to available sales representatives or customer service representatives, data collection and organization of information received through call center representatives' caller interactions, processing of after-sales service issues and monitoring of call center representatives for training and quality assurance purposes;

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outbound call management system, which facilitates automatic outgoing dialing processes from a predetermined subgroup derived from our database and matches calls with available representatives;

database management system, which facilitates the collection and updating of customer information;

short message service, or SMS, system, which supports SMS product order confirmation and advertising;

TV direct sales monitoring system, which facilitates monitoring and analysis of TV direct sales programs, including timing, quality and effectiveness; and

database backup.

In addition, our four warehouses are connected to a central inventory management system through virtual private network connections. Reports are generated and reconciled daily to provide management with up-to-date inventory information.

We believe our information technology system is one of the key tools with which we are able to identify market trends and demands early.

### **Chinese Government Regulations**

The PRC government extensively regulates the industries in which we operate our business. We operate our direct sales and advertising businesses in China under a legal regime consisting of the State Council, which is the highest authority of the executive branch of the PRC central government, and several ministries and agencies under its authority including, among others, the State Administration for Industry and Commerce, or SAIC, the Ministry of Commerce, or MOFCOM, the State Administration for Radio, Film and Television, or SARFT, the State Administration for Food and Drug, or SAFT and the Ministry of Industry and Information Technology, or MIIT.

In the opinion of our PRC legal counsel, Commerce & Finance, except as disclosed in Item 3.D, **Key Information Risk Factors Risks Related to the Regulation of Our Business** If the PRC government takes the view that we did not obtain the necessary approval for our acquisition of Shanghai Advertising, we could be subject to penalties , and as disclosed in Item 3.D, **Key Information Risk Factors Risks Related to the Regulation of Our Business** If the PRC government takes the view that our acquisition of Shanghai Advertising does not comply with PRC governmental restrictions on foreign investment in advertising, we could be subject to severe penalties , (1) the ownership structures of our directly owned PRC subsidiaries comply with existing PRC laws and regulations; and (2) the ownership structure of our affiliated entities and our contractual arrangements with our affiliated entities and their shareholders are valid, binding and enforceable, and do not and will not result in a violation of existing PRC laws and regulations.

The TV direct sales industry and other direct sales industries in China are still in their infancy and the competitive landscape and range of products being offered continue to evolve rapidly. There are substantial uncertainties regarding the interpretation and application of existing or proposed PRC laws and regulations. We cannot assure you that the PRC regulatory authorities would find that our corporate structure and our business operations comply with PRC laws and regulations. If the PRC government finds us to be in violation of PRC laws and regulations, we may be required to pay fines and penalties, obtain certain licenses, approvals, or permits and change, suspend or discontinue our business operations until we comply with applicable laws.

The following discussion sets forth a summary of what we believe are the most significant regulations or requirements that affect our business activities in China and our shareholders' right to receive dividends and other distributions from us.

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### **Regulatory Requirements for Foreign Participation**

#### ***Direct Sales and Wholesale Distribution Businesses***

Foreign investments in direct sales and wholesale businesses are both principally governed by the Administrative Measures on Foreign Investment in Commercial Sector promulgated by the Ministry of Commerce, or the Commercial Sector Measures, on April 16, 2004. The Commercial Sector Measures lowered the previous thresholds for foreign investors to enter the commercial sector in China and completely removed the previous restrictions on the location of and maximum foreign shareholding percentage in foreign-invested commercial enterprises as of December 11, 2004. Under the Commercial Sector Measures, the establishment of a foreign-invested direct sales (including direct sales via TV, telephones, mail and Internet) or wholesale distribution enterprise must obtain approval from MOFCOM or its authorized local counterparts. On September 12, 2008, MOFCOM authorized its Provincial counterparts to approve the establishment or modification of a foreign-invested commercial enterprise except the one engaged in direct sale via TV, phones, mail, Internet, vender and other non-store methods or distribution of audio-visual products, books, newspapers and magazines which still should be approved by MOFCOM.

Under the PRC Law on Sino-foreign Equity Joint Venture Enterprises (revised in 2001), the PRC Law on Sino-foreign Cooperative Joint Venture Enterprises (revised in 2000), and the PRC Law on Wholly Foreign- owned Enterprises (revised in 2000), a foreign-invested enterprise is allowed to sell its self-produced products. Our distribution of our proprietary branded products is primarily conducted by our indirect subsidiaries which manufacture these proprietary branded products and sell such products as their self-produced products. Under the PRC laws, sellers of special products, such as medicine, medical devices and health protection products, are required to review the necessary manufacturing permits provided by the manufacturers.

#### ***Advertising Services***

Until recently, the advertising industry was a restricted industry for foreign investment under the Guideline Catalogue of Foreign Investment Industries (2004 Revision). However, on October 31, 2007, the National Development and Reform Commission and MOFCOM jointly issued the Guideline Catalogue of Foreign Investment Industries (2007 Revision) that removed the advertising industry from the restricted list for foreign investment. The new guideline became effective as of December 1, 2007. As a permitted industry, approval of MOFCOM or its local counterpart is no longer required for a foreign invested enterprise or its domestic subsidiary to invest in advertising.

Direct investment by foreign investors in the advertising industry in China is further subject to the Administrative Regulation on Foreign-Invested Advertising Enterprises jointly promulgated by MOFCOM and SAIC on March 2, 2004 and further revised on October 1, 2008. Under this advertising regulation, foreign investors are required to have had at least three years experience in directly operating an advertising business outside of China before they may receive approval to own 100% of an advertising business in China. Foreign investors that do not have three years experience are permitted to invest in advertising businesses, provided that such foreign investors have at least two years of direct operations in the advertising business outside of China and that such foreign investors may not own 100% of advertising businesses in China. Furthermore, all foreign invested advertising companies must obtain approval from SAIC or MOFCOM or their local counterparts.

On April 11, 2006, SAIC and MOFCOM also issued a Notice on the Issues Concerning Foreign Investors Establishing Foreign-Invested Advertising Enterprises through Equity Merger and Acquisition requiring that foreign-invested advertising enterprises that are established by foreign investors through equity mergers or acquisitions also satisfy the conditions of the Administrative Regulation on Foreign-Invested Advertising Enterprises.

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### ***Our Direct Sales Operations***

Due to the complicated and lengthy approval process and MOFCOM's uncertain position towards approving investment in direct sale business by foreign investors under the Commercial Sector Measures, our direct sales business is currently conducted by our consolidated affiliated enterprises owned by Don Dongjie Yang and David Chenghong He - Shanghai Network and Beijing Acorn. As domestic companies, these companies are not subject to the Commercial Sector Measures, but they are controlled by us through a set of contractual arrangements. See Item 4.C, *Information on the Company - Organizational Structure*. In the opinion of our PRC legal counsel, Commerce & Finance:

The ownership structures of Acorn Information, Shanghai Network and Beijing Acorn are in compliance with existing PRC laws and regulations; and

Our contractual arrangements among Acorn Information, Shanghai Network and Beijing Acorn and their shareholders are valid, binding and enforceable, and do not and will not result in a violation of existing PRC laws and regulations.

We have been advised by our PRC legal counsel, Commerce & Finance, however, that there are uncertainties regarding the interpretation and application of current and future PRC laws and regulations. Accordingly, there can be no assurance that the PRC regulatory authorities, in particular SAIC and MOFCOM, which regulate foreign investment in direct sales companies, will not in the future take a view that is contrary to the above opinions of our PRC legal counsel. If the current agreements that establish the structure for conducting our PRC direct sales business were found to be in violation of existing or future PRC laws or regulations, we may be required to restructure our ownership structure and operations in China to comply with PRC laws and regulations, or we could be subject to severe penalties. See Item 3.D, *Key Information - Risk Factors - Risks Related to the Regulation of Our Business*. If the PRC government takes the view that the agreements that establish the structure for operating our TV and direct sales business in China do not comply with PRC governmental restrictions on foreign investment in these areas, we could be subject to severe penalties.

### ***Our Advertising Operations***

On September 24, 2007, we acquired 100% of the legal ownership of Shanghai Advertising, which had been one of our affiliated entities, through Shanghai Acorn Enterprise Management Consulting Co., Ltd., or Acorn Consulting. At the time of our acquisition, the advertising industry was still a restricted industry for foreign investment under the Guideline Catalogue of Foreign Investment Industries (2004 Revision), and required the approval of Shanghai Foreign Investment Commission, or SFIC, MOFCOM's local counterpart in Shanghai. However, we completed the registration of such acquisition with Pudong Administration of Industry and Commerce in Shanghai on September 24, 2007 without SFIC's approval based on SFIC's advice that this acquisition was a purely domestic acquisition without any foreign related issues. Our PRC legal counsel, Commerce & Finance, has advised us that it is unlikely that we would be required by the PRC regulatory authorities, in particular SAIC and MOFCOM, both as regulators of foreign investment, to seek such approval to make up for our deficiency or any penalties would be imposed upon us for failure to obtain such approval. However, we cannot assure you that SAIC or MOFCOM will not take a different view from ours. See Item 3.D, *Key Information - Risk Factors - Risks Related to the Regulation of Our Business*. If the PRC government takes the view that we did not obtain the necessary approval for our acquisition of Shanghai Advertising, we could be subject to penalties.

We have been further advised by Commerce & Finance that, according to an anonymous consultation with SFIC, because our acquisition of Shanghai Advertising was completed through Acorn Consulting, a domestic subsidiary of foreign invested enterprises, the acquisition was not subject to the requirement that foreign investors have the requisite years of operating experience in an advertising business outside of China. Similarly, Pudong Administration of Industry and Commerce in Shanghai did not require us to show that Acorn Consulting had the requisite years of operating experience either before or after it accepted the registration of the acquisition and issued a new business license to Shanghai Advertising on September 24, 2007. However, we cannot assure

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you that the PRC government will not take a different view from ours. If the PRC government determines that we did not obtain the requisite approval or that this acquisition violated the requirements on foreign investment or re-investment in advertising businesses in China, we may be subject to severe penalties including, among others, the revocation of the business licenses of our related subsidiaries, discontinuation of our advertising operations, the imposition of conditions with which we or our PRC subsidiaries may be unable to comply, and the restructuring of Shanghai Advertising. The imposition of any of these penalties could result in a material adverse effect on our ability to conduct our business. See Item 3.D, **Key Information Risk Factors Risks Related to the Regulation of Our Business**. If the PRC government takes the view that our acquisition of Shanghai Advertising does not comply with PRC governmental restrictions on foreign investment in advertising, we could be subject to severe penalties.

***Our Wholesale Distribution Operations***

Historically, our wholesale distribution business was conducted through our two affiliated entities, Shanghai Acorn Network Technology Development Co., Ltd. and Beijing Acorn Trade Co., Ltd. due to the complicated approval process and MOFCOM's uncertain position toward approving investment in wholesale distribution business by foreign investors. On December 5, 2007, we received approval from Shanghai Qingpu People's government approving our setup of Acorn Trade (Shanghai) Co. Ltd., or Acorn Trade, a PRC subsidiary wholly-owned by China DRTV, to conduct our wholesale distribution business. A valid business license was issued by Shanghai Administration of Industry and Commerce on December 13, 2007.

**Regulation of Manufacturing and Sale of Special Consumer Products**

Some of the products we offer through our direct sales platforms and some of the proprietary branded products we manufacture and sell are categorized as medical devices. Therefore, we are required to comply with relevant PRC laws and regulations regarding the manufacture and sale of medical devices.

In the PRC, medical devices are classified into three different categories for regulation and supervision by SAFD, depending on the degree of risk associated with each medical device and the extent of regulation needed to ensure safety and proper operation of the product. Class I includes medical devices posing a low risk to the human body, whose operation and safety can be assured through routine inspection. Class II includes those with medium risk to the human body, which warrant a greater degree of regulation. Class III includes those devices that pose a potential high risk to the human body, are implanted in the human body, or are used to support or sustain life, and therefore are subject to tight regulation. All the medical devices that we manufacture belong to Class II above. Under PRC laws and regulations, manufacturers of Class II medical devices must apply to the provincial-level SAFD for a valid Medical Device Manufacturing Enterprise License and Class II medical device operators must hold a valid Medical Device Operation Enterprise License, with limited exceptions. In addition, manufacturers of Class II medical devices must register their manufactured Class II medical devices with SAFD at the provincial level and obtain a Medical Device Registration Certificate. Violation of these provisions may result in fines, termination of operations, confiscation of illegal income, or in the most serious cases, criminal prosecution.

Our oxygen generating device manufacturing and distribution subsidiary, Beijing Youngleda, holds a valid Medical Device Manufacturing Enterprise License, which expires on July 13, 2010. Another of our subsidiaries, Acorn International Electronic Technology (Shanghai) Co., Ltd. holds a valid Medical Device Manufacturing Enterprise License that expires on August 2, 2010, a valid Medical Device Operation Enterprise License that expires on November 13, 2012 and a Medical Device Registration Certificate for a neck massager with a valid term of four years from July 21, 2009. Another of our subsidiaries, Shanghai HJX Digital Technology Co., Ltd, holds a valid Medical Device Operation Enterprise License that expires on March 14, 2015. Another of our subsidiaries, Acorn Trade (Shanghai) Co., Ltd., holds a valid Medical Device Operation Enterprise License that expires on March 20, 2013. Separately, our two direct sale affiliated entities Shanghai Network and Beijing Acorn, hold valid Medical Device Operation Enterprise Licenses, which expire on March 14, 2015 and

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July 3, 2010, respectively. In addition, Zhuhai Acorn Electronic Technology Co., Ltd. holds a Medical Device Manufacturing Enterprise License expiring on November 24, 2011 and a Medical Device Registration Certificate for an oxygen generating device with a valid term that expires on February 6, 2011. We are also in the process of renewing other expired licenses and certificates that are required for our operation and products.

### **Regulation of Internet Content Providers**

We currently operate [www.chinadrtv.com](http://www.chinadrtv.com) through which our customers can familiarize themselves with our products. We are required to comply with the Administrative Measures on Internet Content Services issued by the State Council on September 25, 2000 and the Administrative Measures on Internet Pharmaceuticals Information Services issued by SAFD on July 8, 2004 in our operation of the website.

Under the Administrative Measures on Internet Content Services, Internet content providers must apply for a Telecommunications and Information Services Operating License, or ICP License, or a Value-added Telecommunications Business Permit for Internet Information Service if they are deemed to be an operating business. Internet content providers not deemed to be operating businesses are only required to file a registration with the relevant information industry authorities. The online dissemination of information regarding medical devices must also be approved by SAFD at the provincial level and validated by an Internet Pharmaceuticals Information Service Qualification Certificate issued by SAFD. Violation of these provisions will result in a warning, an order to rectify within a certain period, a fine, or the closing of the website.

We currently hold a Trans-regional Value-added Telecommunications Business Permit for Internet Information Service issued by MIIT, which expires on November 25, 2010 and an Internet Pharmaceuticals Information Service Qualification Certificate, which expires on May 9, 2011.

### **Regulation of Advertising Activities**

The principal regulations governing advertising businesses in China include the Advertising Law (1994) and the Advertising Administrative Regulations (1987) and Implementing Rules on the Advertising Administrative Regulations (2004 Revision). SARFT and SAIC are the main responsible regulatory authorities in China overseeing the entire advertising industry. SAIC has the authority to make administrative rules to regulate advertising activities, register or approve the establishment of advertising companies, and examine and oversee daily advertising activities to ensure relevant regulations are not violated. In addition to supervision by SAIC, SARFT sets technical standards for broadcasting, regulates signal landings among different broadcasting networks and monitors the operations of all TV and radio stations. Due to the politically sensitive nature of China's media industry, the contents of TV and radio programs must go through a lengthy approval process prior to broadcasting. Contents of advertisements, which are regulated to a lesser extent, must be approved by the TV or radio stations carrying the advertisements and proper advertising committee(s), effectively eliminating the possibility of broadcasting real-time, live advertising programs. The current regulations also prohibit private enterprises from owning or operating a TV or radio station.

#### ***Business License for Advertising Companies***

Companies that engage in advertising activities must obtain from the SAIC or its local branches a business license with advertising business specifically included in the business scope. A company conducting advertising activities without such a license may be subject to penalties, including fines, confiscation of advertising income and an order to cease advertising operations. Our subsidiary Shanghai Advertising has obtained a business license with advertising specifically included in the business scope from the local branch of SAIC.

#### ***Advertising Airtime***

Since the Chinese government imposes strict regulations on TV station/channel ownership and operations, TV home shopping companies can only purchase blocks of airtime for product advertising as opposed to

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engaging in long-term channel leasing agreements as in some other countries. In addition to regulating TV station ownership, SARFT also sets regulatory standards on the amount of advertising time allowed on TV broadcasting.

Airtime used to broadcast TV direct sales programs and TV home shopping programs is typically considered to be advertising time. On September 10, 2009, the State Administration of Radio, Film and Television, or SARFT, issued the Circular on Strengthening the Administration of TV Direct Sales Advertising and Home Shopping Programs, which requires that TV direct sales advertising programs not be broadcasted on some specialized TV channels, including news channels and international channels, and TV home shopping channels and not be broadcasted on satellite TV channels during the period from 6:00pm to 12:00pm every day. The Administrative Measures on Advertising on Television or Radio issued by the SARFT on September 11, 2009 and effective as of January 1, 2010 further requires that the total airtime allocated to commercial advertising on each TV channel not exceed 12 minutes per hour and not exceed 18 minutes in total during the period from 7:00pm to 9:00pm. Violation of these time restrictions may result in a warning, an order to correct the violation, a fine of up to RMB20,000, the suspension of broadcasting relevant to advertising, the suspension of the operation of the TV channel where the relevant advertising is broadcast, or even the withdrawal of the TV station's operating license.

Under current PRC law, advertising operators can only sell advertising airtime to advertisers and are not allowed to sell to other advertising operators.

***Advertising Content***

PRC advertising laws and regulations set forth certain content requirements for advertisements in China, which include prohibition on, among other things, misleading content, superlative wording, socially destabilizing content, or content involving obscenities, superstition, violence, discrimination, or infringement of the public interest. Advertising for medical devices, health and wellness and other special products are subject to stricter regulation which prohibits any unscientific assertions or assurances in terms of effectiveness or usage, comparison with other similar products in terms of effectiveness or safety, and reference to medical research institutes, academic institutions, medical organizations, experts, doctors, or patients regarding the effectiveness or safety of the products advertised. In addition, all advertising relating to medical devices, health and wellness agrochemicals, as well as other advertisements that are subject to censorship by administrative authorities pursuant to relevant laws and regulations, must be submitted to the relevant administrative authorities for content review and approval prior to dissemination. Furthermore, SARFT and SAIC have issued a circular temporarily prohibiting, after August 1, 2006, the advertising of pharmaceutical products, diet and slimming products, medical devices, breast enhancement products and height increasing products in the form of TV- and radio-based direct sales programs pending adoption of new government rules. On September 10, 2009, the Circular on Strengthening the Administration of TV Direct Sales Advertising and Home Shopping Programs was issued by the SARFT, prohibiting the TV direct sales and home shopping programs to advertise pharmaceuticals, breast-enhancement products, diet and slimming products, and medical devices which are implantable or need instruction by experts. Meanwhile, the Administrative Measures on Advertising on Television or Radio, issued by the SARFT on September 11, 2009 and effective as of January 1, 2010, prohibited the pharmaceutical and medical device or health related advertising program to contain the recovery rate or efficiency rate or certification by the doctors, experts, patients or public figures. Furthermore, Criteria for the Examination and Publication of Medical Device Advertisements were issued by the Ministry of Health, the State Administration for Industry and Commerce, the SFDA and became effective on May 20, 2009, which provided strict regulation on medical device advertisements publication. According to the Circular Concerning Further Severely Punishing Illegal Advertisements of Pharmaceuticals, Medical Devices and Health Food effective in February 2010, enterprises which published the illegal advertisements will be severely punished. See Item 3.D, *Key Information Risk Factors Risks Related to the Regulation of Our Business* Governmental actions to regulate TV- and radio-based direct sales programs of medical devices and diet and slimming products will adversely impact sales of our branded neck massager product line and some of our other products and may adversely impact our future overall operating results .



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Entities whose products are to be advertised, or advertisers, entities offering advertising services such as linking advertisers with TV stations or newspapers, or advertising operators, and disseminators are all required by PRC laws and regulations to ensure that the content of advertising they produce or disseminate is true and in full compliance with applicable laws and regulations. In providing advertising services, advertising operators and disseminators must review the prescribed supporting documents provided by advertisers and verify that the content of advertising complies with applicable laws and regulations. In addition, prior to disseminating advertisements for certain commodities which are subject to government censorship and approval, advertising disseminators are obligated to check the relevant approval documents for those advertisements. Violation of these regulations may result in penalties, including fines, confiscation of advertising income, orders to cease dissemination of the advertising, orders to publish a correction of the misleading information and criminal punishment. In circumstances involving serious violations, SAIC or its local counterparts may revoke the violator's licenses or permits for advertising business operations. Furthermore, advertisers, advertising operators, and disseminators may be subject to civil liability if they infringe on the legal rights and interests of third parties in the course of their advertising business.

Beginning on January 1, 2008, advertisers dealing with advertisements that relate to pharmaceuticals, medical devices and health related foods are subject to a credit rating. SAFD and its local branches will annually collect information relating to the advertiser's record of compliance with the relevant advertising regulations in respect of the above products, and grade the credit of distributors based on the collected information. The credit rating of each advertiser will be either good credit, dishonor credit, or material dishonor credit. Any violations of related laws and regulations within one year by the advertising operator may result in a rating of dishonor credit or material dishonor credit for that year. Distributors with dishonor credit or material dishonor credit may be ordered to take corrective measures and may be subject to special supervision and/or public disclosure of their credit ratings.

In addition, PRC unfair competition law prohibits us and our distributors from conveying misleading, false or inaccurate information with respect to product quality, production, functionality, or other features, through advertising.

We have employed advertising industry professionals who will examine the content of our advertising and who will apply for the necessary approvals and permits for advertising certain special consumer products. In addition, our advertising channels, such as TV stations, newspapers, and radio stations, employ advertising inspectors who are trained to review advertising content for compliance with relevant laws and regulations. However, we cannot assure you that all of our advertising is in compliance with relevant PRC laws and regulations, nor can we assure you that the advertising our distributors place on local media networks complies with relevant PRC laws and regulations. In the past, we have been fined for certain advertising that is considered misleading or false by authorities. In some cases, we were required to accept product returns. Moreover, the SAFD issued a circular on October 31, 2005 announcing that advertising placed in several local newspapers by us and one of our distributors for our sleeping aid products and oxygen generating devices violated the relevant laws by including unapproved content. These violations for the sleeping aid products advertising were considered by SAFD to be a serious violation. The local SAFDs have ordered such advertising to be discontinued for use. As of January 1, 2008, any violation of advertising regulations relating to our sleeping aid product and oxygen generating devices by us or our distributors may result in SAFD issuing a rating to us or our distributors of dishonor credit or material dishonor credit. See Item 3.D, Key Information Risk Factors Risks Related to the Regulation of Our Business We and our distributors are subject to various laws regulating our advertising, including the content of our TV direct sales programs, and any violation of these laws by us or our distributors could result in fines and penalties, harm our product or service brands and result in reduced net revenues .

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***Foreign Exchange Control and Administration***

Foreign exchange in China is primarily regulated by:

The Foreign Currency Administration Rules (1996), as amended; and

The Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules. Under the Foreign Currency Administration Rules, Renminbi is convertible for current account items, including the distribution of dividends, interest payments, and trade and service-related foreign exchange transactions. Conversion of Renminbi into foreign currency for capital account items, such as direct investment, loans, investment in securities, and repatriation of funds, however, is still subject to the approval of SAFE.

Under the Administration Rules, foreign-invested enterprises may only buy, sell, and remit foreign currencies at banks authorized to conduct foreign exchange transactions after providing valid commercial documents and, in the case of capital account item transactions, only after obtaining approval from SAFE. Capital investments directed outside of China by foreign-invested enterprises are also subject to restrictions, which include approvals by SAFE, and the State Reform and Development Commission.

We receive a portion of our revenue in Renminbi, which is currently not a freely convertible currency. Under our current structure, our income will be primarily derived from dividend payments from our subsidiaries in China.

The value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China. On July 21, 2005, the PRC government changed its policy of pegging the value of the Renminbi to the U.S. dollar. Under the new policy, the Renminbi will be permitted to fluctuate within a band against a basket of certain foreign currencies. This change in policy resulted initially in an approximately 2.0% appreciation in the value of the Renminbi against the U.S. dollar. There remains significant international pressure on the PRC government to adopt a substantial liberalization of its currency policy, which could result in a further and more significant appreciation in the value of the Renminbi against the U.S. dollar.

***Regulation of Foreign Exchange in Certain Onshore and Offshore Transactions***

In January and April 2005, the PRC State Administration of Foreign Exchange, or SAFE, issued two rules that require PRC residents to register with and receive approvals from SAFE in connection with their offshore investment activities. SAFE has announced that the purpose of these regulations is to achieve the proper balance of foreign exchange and the standardization of the cross-border flow of funds.

On October 21, 2005, SAFE issued the Notice on Issues Relating to the Administration of Foreign Exchange in Fund-raising and Reverse Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 75, which became effective as of November 1, 2005. Notice 75 replaced the two rules issued by SAFE in January and April 2005 mentioned above. According to Notice 75:

prior to establishing or assuming control of an offshore company for the purpose of financing that offshore company with assets or equity interests in an onshore enterprise in the PRC, each PRC resident, whether a natural or legal person, must complete the overseas investment foreign exchange registration procedures with the relevant local SAFE branch;

an amendment to the registration with the local SAFE branch is required to be filed by any PRC resident that directly or indirectly holds interests in that offshore company upon either (1) the injection of equity interests or assets of an onshore enterprise to the offshore company, or (2) the completion of any overseas fund raising by such offshore company; and

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an amendment to the registration with the local SAFE branch is also required to be filed by such PRC resident when there is any material change involving a change in the capital of the offshore company, such as (1) an increase or decrease in its capital, (2) a transfer or swap of shares, (3) a merger or division, (4) a long-term equity or debt investment, or (5) the creation of any security interests over the relevant assets located in China.

Moreover, Notice 75 applies retroactively. As a result, PRC residents who have established or acquired control of offshore companies that have made onshore investments in the PRC in the past are required to complete the relevant overseas investment foreign exchange registration procedures by March 31, 2006. Under the relevant rules, failure to comply with the registration procedures set forth in Notice 75 may result in restrictions being imposed on the foreign exchange activities of the relevant onshore company, including the payment of dividends and other distributions to its offshore parent or affiliate and the capital inflow from the offshore entity, and may also subject relevant PRC residents to penalties under PRC foreign exchange administration regulations.

As a Cayman Islands company, and therefore a foreign entity, if Acorn International purchases the assets or an equity interest of a PRC company owned by PRC residents in exchange for our equity interests, such PRC residents will be subject to the registration procedures described in Notice 75. Moreover, PRC residents who are beneficial holders of our shares are required to register with SAFE in connection with their investment in us.

As a result of the uncertainties relating to the interpretation and implementation of Notice 75, we cannot predict how these regulations will affect our business operations or strategies. For example, our present or future PRC subsidiaries' ability to conduct foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, may be subject to compliance with such SAFE registration requirements by relevant PRC residents, over whom we have no control. In addition, we cannot assure you that any such PRC residents will be able to complete the necessary approval and registration procedures required by the SAFE regulations. We require all shareholders in Acorn International who are PRC residents to comply with any SAFE registration requirements and we understand that the relevant shareholders have registered their offshore investment in us with Shanghai SAFE, but we have no control over either our shareholders or the outcome of such registration procedures. Such uncertainties may restrict our ability to implement our acquisition strategy and adversely affect our business and prospects. See Item 3.D, *Key Information Risk Factors Risks Relating to China Regulations relating to offshore investment activities by PRC residents may increase the administrative burden we face and create regulatory uncertainties that could restrict our overseas and cross-border investment activity, and a failure by our shareholders who are PRC residents to make any required applications and filings pursuant to such regulations may prevent us from being able to distribute profits and could expose our PRC resident shareholders to liability under PRC law*.

***Regulation of Overseas Listings***

On August 8, 2006, six PRC regulatory agencies, including MOFCOM, the State Assets Supervision and Administration Commission, or SASAC, the State Administration for Taxation, SAIC, the CSRC, and SAFE, jointly adopted the Regulation on Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, or the New M&A Rule, which became effective on September 8, 2006. This New M&A Rule, among other things, purports to require offshore SPVs formed for listing purposes and controlled directly or indirectly by PRC companies or individuals, such as our company, to obtain the approval of the CSRC prior to publicly listing their securities on an overseas stock exchange.

***Dividend Distributions***

Pursuant to the Foreign Currency Administration Rules promulgated in 1996 and amended in 1997 and various regulations issued by SAFE and other relevant PRC government authorities, the PRC government imposes controls on the convertibility of RMB into foreign currencies and, in certain cases, the remittance of currency out of China.

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The principal regulations governing the distribution of dividends paid by wholly foreign-owned enterprises and Sino-foreign joint equity enterprise enterprises include:

The Wholly Foreign-Owned Enterprise Law (1986), as amended in 2000;

The Wholly Foreign-Owned Enterprise Law Implementing Rules (1990), as amended in 2001;

The Sino-foreign Joint Equity Enterprise Law (1979), as amended in 2001;

The Sino-foreign Joint Equity Enterprise Law Implementing Rules (1983), as amended in 2001; and

Company Law of the PRC (2005).

Under these regulations, foreign-invested enterprises in China may pay dividends only out of their accumulated profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, a foreign-invested enterprise in China is required to set aside at least a certain percentage of its after-tax profit based on PRC accounting standards each year to its general reserves. These reserves are not distributable as cash dividends. The board of directors of a foreign-invested enterprise has the discretion to allocate a portion of its after-tax profits to employee welfare and bonus funds. These funds, however, may not be distributed to equity owners except in the event of liquidation.

### **C. Organizational Structure**

We commenced operations in 1998 through Beijing Acorn, and in 2000, we established and commenced business operations for two other operating companies, Shanghai Acorn Network Co., Ltd., or Shanghai Acorn, and Shanghai Acorn Trade and Development Co., Ltd., or Shanghai Trade.

Prior to January 1, 2005, our business was operated through Beijing Acorn, Shanghai Acorn and Shanghai Trade, including their subsidiaries. Each of these three operating companies, referred to as the combined entities, was under common management, was operated on an integrated basis and was beneficially owned by the same shareholders and, with limited exception, in the same shareholding percentages. To enable us to raise equity capital from investors outside of China, we established a holding company structure by incorporating China DRTV in the British Virgin Islands on March 4, 2004. In 2004, China DRTV formed four PRC subsidiaries and two consolidated PRC affiliated entities. As part of a restructuring to implement an offshore holding company structure to comply with PRC laws imposing restrictions on foreign ownership in direct sales, wholesale distributor and advertising businesses, each of the combined entities, including their subsidiaries, transferred to China DRTV's newly created consolidated subsidiaries and affiliated entities, by means of an asset transfer and liability assumption, substantially all their assets and liabilities at their net book values, *except that* (a) the assets and liabilities of one of the combined entities' subsidiaries were transferred through the transfer to China DRTV of all of that subsidiary's capital stock, and (b) after one of the three pre-restructuring operating companies, Beijing Acorn, transferred certain of its assets to two of China DRTV's subsidiaries, its shareholders transferred their equity interests in Beijing Acorn to two PRC individuals, with Beijing Acorn becoming an additional China DRTV affiliated entity. Commencing on January 1, 2005 our business was conducted through China DRTV and its subsidiaries and, until recently, our three affiliated entities. Other than Beijing Acorn and the other transferred subsidiary, each of the pre-restructuring companies previously engaged in the business was liquidated. We have determined that no change in basis in the assets transferred in connection with the restructuring is appropriate as the transfers constituted a transfer of net assets by entities under common control.

In connection with our initial public offering, we incorporated Acorn International, Inc. in the Cayman Islands on December 20, 2005 as our listing vehicle. Acorn International Inc. became our ultimate holding company when it issued shares to the existing shareholders of China DRTV on March 31, 2006 in exchange for all of the shares that these shareholders held in China DRTV. In September 2007, we entered into a share purchase agreement to acquire MK AND T Communications Limited. The acquisition was completed in November 2008. In October 2007, we formed two Hong Kong subsidiaries wholly-owned by China DRTV,



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Bright Rainbow Investments Limited and Emoney Investments Limited. On December 13, 2007, we formed Acorn Trade (Shanghai) Co., Ltd., a PRC subsidiary wholly-owned by China DRTV, through which we conduct our wholesale distribution business. Prior to this, our wholesale distribution business was conducted through our two affiliated entities, Shanghai Network and Beijing Acorn. In April, 2008, we transferred 100% of the ownership interest in Shanghai HJX to Bright Rainbow Investments Limited. In December 2008, we acquired 100% of the equity interests of Yiyang Yukang, a cell phone producer and distributor in China and former third- party supplier of our cell phone products, which is now a subsidiary of the Company. Please refer to Item 4.B., Information on the Company Acquisition of Yiyang Yukang for further details. In February 2010, Emoney Investments Limited was deregistered.

Shanghai Network and Beijing Acorn, our two affiliated entities, are currently owned by two PRC citizens, Don Dongjie Yang, our president, and David Chenghong He, one of our executive officers. Shanghai Network is primarily engaged in our TV direct sales business throughout China except for Beijing. Beijing Acorn is primarily engaged in our TV direct sales business in Beijing. We have entered into contractual arrangements with these two affiliated entities pursuant to which our wholly owned subsidiary, Acorn Information Technology (Shanghai) Co., Ltd., provides technical support and management services to these affiliated entities. In addition, we have entered into agreements with these two affiliated entities and their shareholders, Don Dongjie Yang and David Chenghong He, providing us with the ability to effectively control each of these affiliated entities. Accordingly, we have consolidated historical financial results of these two affiliated entities in our financial statements as variable interest entities pursuant to U.S. GAAP. In September 2007, we acquired the legal ownership of Shanghai Acorn Advertising Broadcasting Co., Ltd, or Shanghai Advertising, which was previously one of our affiliated entities owned by Don Dongjie Yang and David Chenghong He.

In the opinion of our PRC legal counsel, Commerce & Finance, except as disclosed in Item 3.D., Key Information Risk Factors Risks Related to the Regulation of Our Business If the PRC government takes the view that we did not obtain the necessary approval for our acquisition of Shanghai Advertising, we could be subject to penalties and as disclosed in Item 3.D, Key Information Risk Factors Risks Related to the Regulation of Our Business If the PRC government takes the view that our acquisition of Shanghai Advertising does not comply with PRC governmental restrictions on foreign investment in advertising, we could be subject to severe penalties , (1) the ownership structures of our directly owned PRC subsidiaries comply with existing PRC laws and regulations and (2) the ownership structures of our two affiliated entities and our contractual arrangements with these affiliated entities and their shareholders are valid, binding and enforceable, and do not and will not result in a violation of existing PRC laws and regulations.

We have been advised by our PRC legal counsel, Commerce & Finance, however, that there are uncertainties regarding the interpretation and application of current and future PRC laws and regulations with respect to these matters. Accordingly, we cannot assure you that the PRC regulatory authorities, in particular SAIC and MOFCOM, which regulate foreign investment in direct sales, wholesale distribution and advertising companies, will not in the future take views that are contrary to the above opinions of our PRC legal counsel. If the current agreements that establish the structure for conducting our PRC direct sales business were found to be in violation of existing or future PRC laws or regulations, we may be required to restructure our ownership structure and operations in China to comply with PRC laws and regulations, or we could be subject to severe penalties. See Item 3.D, Key Information Risk Factors Risks Related to the Regulation of Our Business If the PRC government takes the view that the agreements that establish the structure for operating our TV and other direct sales business in China do not comply with PRC governmental restrictions on foreign investment in these areas, we could be subject to severe penalties .

In June 2009, we disposed of 33% equity interest in Shanghai Yimeng for a consideration of \$10.5 million in cash. After the divestment, we own 18% of Shanghai Yimeng and it is no longer our subsidiary. We currently do not have significant influence on Shanghai Yimeng s operation.

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The following diagram illustrates our current corporate structure and the place of formation, ownership interest and affiliation of each of our subsidiaries and the two affiliated entities as of the date of this 20-F<sup>(1)</sup>:

- (1) For risks related to our current corporate structure, see Item 3.D, Key Information Risk Factors Risks Related to the Regulation of Our Business .

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- (2) Agreements that provide us with effective control over Shanghai Acorn Network Technology Development Co., Ltd. and Beijing Acorn Trade Co., Ltd. include equity pledge agreements, irrevocable powers of attorney, a loan agreement, operation and management agreements and exclusive purchase agreements.
- (3) The economic benefits of Shanghai Acorn Network Technology Development Co., Ltd. and Beijing Acorn Trade Co., Ltd. accrue to Acorn Information Technology (Shanghai) Co., Ltd.
- (4) The Zhuhai Sunrana Bio-Tech Co., Ltd. is currently under the liquidation process.

### **Material Operating Entities**

MOFCOM, or its local counterpart, reviews the application and issues the requisite approval for business operations by foreign entities. Our direct sales business is considered commercial trading and, until 2004, foreign investment in commercial trading was highly restricted by PRC regulations. By December 2004, MOFCOM had significantly reduced these restrictions. Nevertheless, to directly operate our direct sales business, we still need to obtain MOFCOM's approval. Therefore, our direct sales business is currently conducted by our consolidated affiliated entities, Shanghai Network and Beijing Acorn, which hold the necessary licenses to conduct our direct sales business, through contractual arrangements between Acorn Information, our wholly owned subsidiary in China, and these two consolidated affiliated entities. Our wholesale business is currently conducted by Acorn Trade (Shanghai) Co., Ltd.

Our direct sales business, and our advertising operations in support of our direct sales business, are regulated by SAIC. All of our advertising business operations, which include design, production and publication of TV and other advertising, are conducted by Shanghai Advertising, which used to be one of our affiliated entities. In September 2007, we acquired 100% of the legal ownership of Shanghai Advertising through Shanghai Acorn Enterprise Management Consulting Co., Ltd. The Pudong Administration of Industry and Commerce in Shanghai issued a new business license for Shanghai Advertising to conduct our advertising operations following the acquisition.

In addition, Shanghai HJX, Acorn International Electronic Technology (Shanghai) Co., Ltd., Beijing Acorn Youngleda Oxygen Generating Co., Ltd., or Beijing Youngleda, Zhuhai Acorn Electronic Technology Co., Ltd. and Yiyang Yukang manufacture and distribute through our nationwide distribution network most of our electronic learning products, posture correction products, oxygen generating devices and cell phones, and each provides technical support and after-sales services for such products. The direct sales of our consumer electronics products and other health and wellness products are primarily conducted through Shanghai Network and Beijing Acorn.

### **Contractual Arrangements with the Consolidated Affiliated Entities and their Shareholders**

Our relationships with the two affiliated entities and their shareholders are governed by a series of contractual arrangements. Under PRC law, each of the affiliated entities is an independent legal person and none of them is exposed to liabilities incurred by the other party. Other than pursuant to the contractual arrangements between our wholly owned subsidiary, Acorn Information, and these two affiliated entities, these affiliated entities do not transfer any other funds generated from their operations to us. These contractual arrangements are as set forth below.

Each of our contractual arrangements with these two affiliated entities and their shareholders can only be amended with the approval of our audit committee or another independent body of our board of directors. See Item 7.B, Major Shareholders and Related Party Transactions Related Party Transactions for further information on our contractual arrangements with these parties.

### ***Agreements that Provide Effective Control and an Option to Acquire Shanghai Network and Beijing Acorn***

These agreements provide us with effective control over these two affiliated entities and their shareholders, Don Dongjie Yang, our president and one of our directors, and David Chenghong He, one of our executive



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officers. They include irrevocable powers of attorney, a loan agreement, equity pledge agreements, and operation and management agreements. Under the exclusive purchase agreements, we also have exclusive options to purchase the equity interests of the affiliated entities.

*Irrevocable Powers of Attorney.* Under irrevocable powers of attorney, each of the two shareholders of Shanghai Network and Beijing Acorn, Don Dongjie Yang and David Chenghong He, has granted to designees of Acorn Information, James Yujun Hu, our chief executive officer, and Guoying Du, one of our executive officers, the power to exercise all voting rights of such shareholder in the shareholders' meetings, including but not limited to the power to determine the sale or transfer of all or part of such shareholder's equity interest in, and appoint the directors of, Shanghai Network and Beijing Acorn. These irrevocable powers of attorney have terms of ten years and will automatically renew for another ten years unless terminated by Acorn Information in writing three months prior to their expiry.

*Loan Agreement.* Under the loan agreement among Acorn Information and the shareholders of these two affiliated entities, Don Dongjie Yang and David Chenghong He, Acorn Information made an interest-free loan to Don Dongjie Yang and David Chenghong He in an aggregate amount of \$16.2 million and agreed to make additional interest-free loans not exceeding approximately \$4.2 million to Don Dongjie Yang and David Chenghong He. The loan is to be used primarily for capital investments by the shareholders in Shanghai Network and Beijing Acorn. The loan can only be repaid by the shareholders' transfer of their interests in Shanghai Network and Beijing Acorn to Acorn Information or its designee when permissible under PRC law. The initial term of the loan is ten years and will automatically be renewed for another ten years absent a written termination notice from Acorn Information.

*Operation and Management Agreements.* Under the operation and management agreements among Acorn Information, the two shareholders and each of the affiliated entities, the parties have agreed that Acorn Information will provide guidance and instructions on daily operations and financial affairs of each of these two affiliated entities. The agreements also state that each of the directors, general managers and other senior management personnel of these affiliated entities will be appointed as nominated by Acorn Information. Acorn Information has the authority to exercise the voting rights on behalf of the two shareholders at the shareholder meetings of the two affiliated entities. Acorn Information has agreed to provide security for contracts, agreements or other transactions entered into by these two affiliated entities with third parties, provided that these affiliated entities shall provide counter-security for Acorn Information using their accounts receivable or assets. In addition, each of these affiliated entities agreed not to enter into any transaction that could materially affect its respective assets, obligations, rights or operations without prior written consent from Acorn Information. The terms of these agreements are ten years and will automatically renew for another ten years absent a written termination notice by Acorn Information.

*Equity Pledge Agreements.* Under the equity pledge agreements among Acorn Information and the two shareholders of the affiliated entities, each of Don Dongjie Yang and David Chenghong He has pledged all of his equity interests in Shanghai Network and Beijing Acorn to Acorn Information to guarantee the performance of the two affiliated entities under the operation and management agreements and the exclusive technical services agreements as described below, as well as their personal obligations under the loan agreements. Each of the shareholders also agrees not to transfer, assign or, pledge his interests in any of these affiliated entities without the prior written consent of Acorn Information. If any of these affiliated entities or either of the two shareholders breaches its respective contractual obligations thereunder, Acorn Information, as pledgee, will be entitled to certain rights, including but not limited to the right to sell the pledged equity interests. The terms of these agreements are ten years and will automatically renew for another ten years absent written termination notice by Acorn Information three months prior to their expiry.

*Exclusive Purchase Agreements.* Pursuant to the exclusive purchase agreements among Acorn Information and each of Shanghai Network and Beijing Acorn and their shareholders, Don Dongjie Yang and David Chenghong He, each of the two shareholders has irrevocably granted Acorn

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Information or its designee an exclusive option to purchase at any time if and when permitted under PRC law, all or any portion of their equity interests in Shanghai Network and Beijing Acorn for a price that is the minimum amount permitted by PRC law. The terms of these agreements are ten years and will automatically renew for another ten years absent a written termination notice by Acorn Information three months prior to their expiry.

***Technical Services Agreements that Transfer Economic Benefits from Shanghai Network and Beijing Acorn to Us***

Acorn Information has entered into a technical service agreement with each of the affiliated entities to transfer economic interests in these entities to us. Pursuant to the technical service agreements, Acorn Information is the exclusive provider of technical support and consulting services to the two affiliated entities in exchange for service fees. Under these agreements, each of the affiliated entities may not, among other things, dispose of its assets, dissolve, liquidate, merge with any third parties, provide security to any third parties, distribute dividends, engage in transactions with any of its affiliates, make external investment or conduct any business outside of the ordinary course of their respective businesses without the prior consent of Acorn Information. The term of these agreements is ten years and will automatically renew for another ten years unless terminated by Acorn Information.

**D. Property, Plant and Equipment**

We are headquartered in Shanghai and have leased an aggregate of approximately 14,236 square meters of office and call center spaces in Beijing, Shanghai and Wuxi. Our leases are typically for a term from one to five years. We entered into multiple office building purchase agreements for office building on Tianlin Road, Shanghai in 2007, in order to accommodate our growing number of employees and expanding operations. The relocation to the new facility completed in January 2009. Our four central warehousing hubs cover approximately 7,239 square meters and are subject to varying lease terms. We typically enjoy a priority right to renew our leases for our warehouses.

Our manufacturing facilities in Beijing, Shanghai, Shenzhen and Zhuhai occupy an aggregate of approximately 17,252 square meters. Our manufacturing facilities in Beijing and Zhuhai are used for the production of our oxygen generating device product line, our manufacturing facilities in Shanghai are used for the production of our posture correction and engine lubricant product lines, and our manufacturing facility in Shenzhen is used for the production of our electronic learning product line. As of December 31, 2009, our production capacity was 5,000 units per day for our electronic learning products, 8,000 units per day for our posture correction products, and an aggregate of 4,000 units per day for our Uking cell phones. In 2009, the manufacturing facilities producing our electronic learning products operated at or near capacity. In 2009, the daily utilization rate for the manufacturing facilities producing our posture correction products and Uking cell phones ranged from 50% to 80% and 50% to 67%, respectively. Factors affecting utilization rates are primarily demand from our customers as well as our ability to manage the production facilities and product flows efficiently.

Uncertainty exists as to our right to use the land on which our manufacturing facilities are built in Beijing and Shanghai. For additional information regarding this uncertainty, see Item 3.D, Key Information Risk Factors Risks Related to Our Business Our leases of land and manufacturing facilities in Beijing and Shanghai may not be in full compliance with PRC laws and regulations and we may be required to relocate our facilities, which may disrupt our manufacturing operations and result in decreased net revenues .

During the first quarter of 2009, we obtained a fifty-year land use right of a piece of land in Qingpu district of Shanghai for aggregate consideration of approximately RMB51.2 million (approximately \$7.5 million). We plan to use the land to establish a warehouse and a factory for manufacturing our proprietary branded products. The construction started on November 26, 2009 and has not completed yet.

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**ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not applicable.

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

The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this annual report on Form 20-F. This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Exchange Act. For more information regarding forward-looking statements, see Forward-Looking Statements. In evaluating our business, you should carefully consider the information provided under Item 3.D, Key Information Risk Factors. We caution you that our businesses and financial performance are subject to substantial risks and uncertainties.

**A. Operating Results**

**Overview**

We are a leading integrated multi-platform marketing company in China with a proven track record of developing, promoting and selling consumer products and services. Historically, we have sold our products primarily through our TV direct sales platform and our nationwide distribution network. More recently, we have expanded into other direct sales platforms, such as third-party bank channel sales, outbound calls, catalogs and Internet sales. We believe that we operate one of the largest TV direct sales businesses in China in terms of revenues. Through our TV direct sales platform, we market our own proprietary products and services as well as third-party products and services. Our nationwide distribution network extends across all provinces and allows us to reach approximately 20,000 retail outlets, covering nearly all cities and counties in China. We typically grant our distributors the exclusive right to distribute selected products and services within their respective territories.

We believe our nationally televised TV direct sales programs allow us to build strong product and service brand awareness among China's consumers and to generate significant demand for the products and services that we market within a short period of time. Our non-TV direct sales platforms enable us to reach out to a larger customer base and to lessen our reliance on advertising expenditures for TV time purchases. Our nationwide distribution network, coupled with local marketing efforts, helps further enhance the awareness of, and demand for, marketed products and services, thereby broadening our customer reach and enhancing our product and service penetration on a nationwide basis.

Supporting our direct sales platforms are our call centers, located in Beijing, Shanghai and Wuxi. As of December 31, 2009, our call centers were staffed by 1,058 sales representatives and 94 customer service personnel. Our call centers operate 24 hours per day. In 2007, 2008 and 2009, our call centers processed on average approximately 18,800, 20,000 and 20,400 incoming calls per day generated from our TV and other direct sales platforms, respectively.

On December 24, 2008, we acquired 100% of the equity interest of Yiyang Yukang, a cell phone producer and distributor in China and former third-party supplier of our cell phone products for initial stock and cash consideration totaling \$9.9 million. Additional consideration was payable under three separate earn-out payments based on Yiyang Yukang's meeting certain earnings targets in 2008, 2009 and 2010. As Yiyang Yukang met the first earn-out target for the year 2008 and the first quarter of 2009, an earn-out payment consisting of cash and stock consideration in an aggregate amount of \$10.0 million was made in 2009 accordingly. No earn-out payment was made in respect of 2009 and no earn-out is expected to be paid with respect to 2010. In 2009, sales of Yiyang Yukang totaled \$28.1 million (with all sales being distribution sales). Due to Yiyang Yukang's change in strategy and its underperformance, in 2009 we incurred a \$15.2 million intangibles impairment charge. We also sell Yiyang Yukang branded products through our direct sales platforms.

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As described in greater detail below, the discussion of our operating results contains our recasted consolidated financial statements for the years ended December 31, 2007 and 2008 to reflect the deconsolidation of our previous subsidiary, Shanghai Yimeng, in 2009 as a discontinued operation. In June 2009, we disposed of a 33% equity interest in Shanghai Yimeng, which was engaged in the development and marketing of CPS stock tracking software. After the divestment, we own 18% of Shanghai Yimeng and it is no longer our subsidiary. We currently do not have significant influence on Shanghai Yimeng's operation. See Note 4 to the consolidated financial statements for the years ended December 31, 2007, 2008 and 2009.

Our net revenues, which include direct sales net revenues and distribution net revenues, were \$248.0 million, \$234.1 million and \$287.6 million in 2007, 2008 and 2009, respectively. Direct sales net revenues, which include both net proceeds from products and services sold through our TV direct sales programs and net proceeds from products and services sold through our other direct sales platforms, declined from \$181.3 million in 2007 to \$166.9 million in 2008, and \$160.4 million in 2009. Recently, we have begun to develop our non-TV direct sales channels with gross revenues from non-TV direct channels increasing from approximately \$53 million in 2008 to approximately \$72 million in 2009, driven primarily by increased sales through third-party bank channels. We expect the relative contribution of non-TV direct sales to increase over time.

Distribution net revenues, which are derived from sales of products and services to our distributors, increased from \$66.7 million in 2007 to \$67.2 million in 2008 and to \$127.2 million in 2009.

Our net revenues and operating income in any period are largely driven by our direct sales and distribution platforms and our product and service mix, advertising expenses, and events occurring in the period. In 2009, our total net revenues increased to \$287.6 million, up 22.8% from \$234.1 million in 2008. Of our total net revenues in 2009, our direct sales net revenues declined to \$160.4 million, down 3.9% from \$166.9 million in 2008, and our distribution net revenues increased to \$127.2 million, up 89.4% from \$67.2 million in 2008. The net increase of \$53.5 million in total net revenues in 2009 primarily reflected increased cosmetic product sales through our direct sales platforms, strong direct and distribution sales of our Ozing electronic learning products and distribution sales of Yiyang Yukang's mobile handsets following the acquisition at the end of 2008, partially offset by decreased TV direct sales net revenues (particularly cell phone direct sales) as a result of reduced purchased TV advertising time, intensified TV direct sales competition in China and the impact of the global economic slowdown on consumer spending and confidence in China.

Sales of our Ozing electronic learning products, our top selling product line in 2009, increased from \$46.9 million in 2008 to \$87.0 million in 2009. We sell our Ozing branded electronic learning products both through our TV direct sales platform and our distribution network. The increase in sales in 2009 was primarily due to our strategy to market several lower-priced products and to provide distributors higher sales discounts. Distribution sales of our electronic learning products also benefited from the increased brand recognition generated through our TV direct sales programs. Sales of our cell phones increased to approximately \$61.3 million in 2009, compared to \$56.3 million in 2008, reflecting \$28.1 million in cell phone sales through the Yiyang Yukang distribution network offset by a \$23.0 million decline in direct cell phone sales. The decline in our direct sales of cell phones primarily reflects intensified competition of TV direct sales of cell phone products in China. Our other featured products in 2009 consist of our cosmetics products, auto-care products and Meijin electronic dictionary products, which increased approximately \$21.4 million, \$5.0 million and \$4.0 million, respectively, in 2009 compared to 2008. The increase in sales of our cosmetics products and our Meijin electronic dictionary was primarily due to the increased media allocation to cosmetics products and the competitive pricings and our effective management of distribution network of our electronic dictionary products.

We had operating losses of \$7.5 million in 2009 compared to operating losses of \$29.6 million in 2008. This loss was due largely to the \$15.2 million Yiyang Yukang-related impairment charge.

Our product and service revenues are driven significantly by our spending on advertising, particularly our TV direct sales programs. Our total advertising expenses decreased from \$75.0 million in 2007 to \$73.4 million

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in 2008 and to \$61.0 million in 2009. The largest component of our total advertising expenses, constituting over 80% of total advertising expenses in each of 2007, 2008 and 2009, is purchased TV advertising time. Purchased TV direct sales advertising expenses decreased by 12.0% from \$67.3 million in 2007 to \$59.2 million in 2008 and decreased by 13.3% to \$51.3 million in 2009. The decrease of total advertising expenses in 2009 reflects our strategy beginning in 2008 to selectively lower our TV advertising time purchases to focus on more cost effective channels and time slots and to adopt a more flexible manner in our procurement by entering into contracts with shorter terms to achieve better cost control.

We use purchased TV advertising time to broadcast both our TV direct sales programs and our brand promotion advertising. The number of TV channels on which we broadcast TV direct sales programs decreased from 61 in 2007 to 46 in 2008 and to 34 in 2009. In 2009, we broadcast brand promotion advertising on 9 of the TV channels on which we broadcast TV direct sales programs.

As of December 31, 2009, our commitments to purchase TV advertising time in 2010 were approximately \$52.9 million. Actual TV advertising commitments could, however, vary significantly. We may purchase additional broadcasting time throughout the year. Also, we may be unable to use all of our purchased time due to various factors, many of which are out of our control, such as preemption of our purchased time by special programming events, programming overruns by TV stations and changes in available advertising minutes provided by TV stations, as well as suspension of our advertising time due to natural disasters such as the major earthquake that struck Wenchuan in the Sichuan province in May 2008. In addition, the accounting for advertising time will vary based on the structure of our joint sales and marketing services arrangements described below. For example, TV advertising expenses paid by us may be reflected as either a cost of direct sales revenues (e.g., marketing services arrangements that involve limited or no direct sales with marketing customers paying a fixed fee, such as our previous arrangement with China Unicom), or as advertising expenses (which may be reduced by shared advertising costs under joint sales arrangements, such as our previous arrangement with Gionee pursuant to which Gionee shared a certain percentage of our advertising costs for their featured cell phone products). In addition to our TV brand promotion advertising, we also promote brands through print and other media.

The number of inbound calls generated through our direct sales platforms received by our call centers has continued to increase, with inbound calls in 2007, 2008 and 2009 totaling approximately \$6.9 million, \$7.3 million and \$7.5 million, respectively. The conversion rate for inbound calls, which is the percentage of inbound calls that result in product or service purchase orders, was 16.8%, 23.2% and 30.1% in 2007, 2008 and 2009, respectively. The increase in conversion rate in 2009 was primarily due to increased sales of certain product categories that generally have higher conversion rates, as well as the lower average selling prices of certain products. In calculating our conversion rate and inbound calls, we exclude calls generated under our marketing services arrangements, such as our prior arrangements with China Unicom. We believe the primary factors impacting our conversion rate for any given period are the average selling price of our products and services, our product mix, and the length and content of our TV direct sales programs. We seek to improve our conversion rate with improved sales training for our sales representatives and performance-related personnel management.

Beginning in 2006, we have entered into joint sales arrangements and marketing services arrangements. In addition to generating TV direct sales revenues for us, the joint sales partners agree to pay us an amount based on the number of units sold by them through their own distribution networks. These additional payments have been recorded as reductions to cost of direct sales revenues. In 2007, we also entered into a number of joint sales arrangements pursuant to which our joint sales partners share the cost of advertising expenses for their featured products or services rather than paying an additional amount based on sales of their featured products or services through their own distribution channels. The shared advertising expenses payments have been recorded as reductions to advertising expenses. During 2009, our cell phone products and cosmetics products were the two major categories of products subject to joint sales arrangements. In 2009, the reduction in cost of direct sales revenues and advertising expenses were \$0.4 million and \$9.8 million, respectively, due to our accounting for joint sales arrangements.

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The Chinese economy has recently experienced a slowing of its growth rate as a result of the recent global economic crisis. While it remains uncertain whether slowing economic growth in China could result in our customers reducing their spending, we expect that demand for products with high unit prices, such as our cell phones or consumer electronics products, may continue to decline. We expect this situation will continue for the foreseeable future, and we may need to lower the prices of certain of our products and services, particularly our high-end products and products with high unit prices, which could lead to reduced sales and profit. In response to changing customer preferences, we successfully marketed a lower-priced V1 model of our Ozing product through our TV direct sales platform and our distribution network, leading to a strong growth in sales volume of our Ozing products.

We intend to continue to grow our business across products and platforms and intend to focus in the near term on successfully developing and marketing proprietary branded products and services offering high margins and recurring revenue streams. We will continue to focus on growing our proprietary branded products such as Ozing and Meijin, and to develop our continuity business led by cosmetics products and our newly launched auto care products. We also expect to continue expanding our non-TV direct sales platforms, particularly the third-party bank channels, to lessen our reliance on advertising expenditures for TV advertising purchases and to enhance our overall platform attractiveness and effectiveness. Our longer term goal is to be the leading integrated cross-media marketer of consumer products and services in China and to be the marketing and distribution partner of choice for both well-established and promising new businesses in China. Related challenges include the evolving nature of the TV direct sales industry and our business model and a continuously evolving competitive landscape. To address these challenges, among other things, we regularly evaluate developments and the competitive landscape in the consumer retail market in China (including the TV direct sales market in China and worldwide). In turn, as appropriate, we adjust our product and service offerings, sales and marketing efforts and business strategy. We undertake these adjustments in connection with constant evaluation of our media allocation for each product and service to maximize return on our media purchase expenditures. For example, we track and analyze data generated through our call center operations. Using this data, we adjust the products and services we promote on TV, the frequency and time slots of our TV direct sales programs, as well as the TV channels on which we broadcast our programs on a weekly basis.

**Revenues**

|                         | 2007           |                               | For the years ended December 31,<br>2008       |                               | 2009           |                               |
|-------------------------|----------------|-------------------------------|--|-------------------------------|----------------|-------------------------------|
|                         | Amount         | % of total<br>revenue,<br>net | Amount<br>(in U.S. dollars, except percentage) | % of total<br>revenue,<br>net | Amount         | % of total<br>revenue,<br>net |
| <b>Revenues:</b>        |                |                               |  |                               |                |                               |
| Direct sales, net       | \$ 181,319,805 | 73.1%                         | \$ 166,947,475                                 | 71.3%                         | \$ 160,357,948 | 55.8%                         |
| Distribution sales, net | 66,717,204     | 26.9%                         | 67,189,946                                     | 28.7%                         | 127,227,672    | 44.2%                         |
| Total revenues, net     | \$ 248,037,009 | 100.0%                        | \$ 234,137,421                                 | 100.0%                        | \$ 287,585,620 | 100.0%                        |

Our net revenues consist of direct sales net revenues and distribution net revenues. Direct sales net revenues represent product and service sales through our TV direct sales programs and our other direct sales platforms, including third-party bank channel sales, sales realized through our outbound calls, catalog sales and Internet sales. To date, a significant portion of our direct sales net revenues have been generated from our TV direct sales platform. However, our non-TV direct sales have grown at a faster pace than our TV direct sales in 2009, primarily due to our effective utilization of our customer database and our choice to reduce our use of TV media time as a result of the changed regulatory environment. As we continue to develop other direct sales platforms, we expect our third-party bank channel sales, outbound calls sales, Internet sales and catalog sales to continue to increase in absolute numbers and as a percentage of our revenues in 2010. Our marketing services revenues,

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which we started generating in 2006 as part of our direct sales net revenues, totaled \$16.0 million, \$3.2 million and nil in 2007, 2008 and 2009, respectively.

Distribution net revenues represent product and service sales to the distributors that constitute our nationwide distribution network. We sell products and services to our distributors at a discount to the retail price for the same product or service when sold by us through our TV direct sales programs or the retail price set by us. The percentage of our total net revenues generated through our nationwide distribution network was 26.9% in 2007, 28.7% in 2008 and 44.2% in 2009.

The percentage of our total net revenues attributable to direct sales and distribution revenues will vary from period to period based on, among other things, the amount of our TV advertising time dedicated to our or third-party products and services, joint sales and marketing services arrangements, and sales generated by us through our TV direct sales programs, our non-TV direct sales channels and our nationwide distribution network.

Our total net revenues are presented net of certain adjustments, including sales and business taxes, cash rebates on distribution sales, costs of cash coupon discounts and membership points on direct sales. Sales and business taxes totaled approximately \$0.8 million in 2007, \$0.2 million in 2008 and \$0.2 million in 2009. We net the cash rebates used in connection with promotional distribution sales activities and the cash coupon discounts and membership points used in connection with our customer loyalty program for direct sales against revenue at the time revenue is recorded.

Direct sales net revenues for 2007, 2008 and 2009 have been adjusted based on our actual unsuccessful product deliveries experience.

Some of our distributors are owned in part, or in some cases in whole, by certain of our employees or their family members. In 2007, 2008 and 2009, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 28.4%, 17.2% and 12.7% of our distribution gross revenues or 7.6%, 4.9% and 5.6% of our total gross revenues, respectively. Certain of these distributors were among our top distributors in 2007, 2008 and 2009.

We generally focus on marketing and selling four to six featured product lines at any one time through our TV direct sales platform, and a limited number of products and services through our nationwide distribution network. Consequently, we have been, and expect to continue to be, dependent on a limited number of featured product lines to generate a large percentage of our net revenues. Currently, our featured products are offered in the following categories or under the following brands:

*Electronic Learning Products* featuring the Ozing brand name accounted for 20.2%, 20.0% and 30.2% of our gross revenues in 2007, 2008 and 2009, respectively.

Our primary Ozing branded product is a multi-functional handheld electronic device with a screen display that provides lessons for independent English learning. We began marketing and selling our first Ozing product, targeted at middle and high school students, in December 2003. The retail prices for our Ozing products ranged from RMB798 to RMB1,499 per unit in 2007, RMB599 to RMB1,499 per unit in 2008 and RMB698 to RMB1,498 (or approximately \$103 to \$220) per unit in 2009.

*Cell Phone Products* featuring the Gionee, K-touch, Lenovo, Nokia and Konka brand names and China Unicom's CDMA services and CDMA cell phones from China Unicom's partners accounted for 42.4%, 24.0% and 21.3% of our gross revenues in 2007, 2008 and 2009, respectively. Since April 2006, we have entered into a number of joint sales arrangements and marketing services arrangements with a number of different cell phone manufacturers for the Gionee, K-touch, Lenovo, Nokia and Konka branded cell phones. In November 2007, we entered into a joint services arrangement with Gionee to promote and market its cell phone products via our direct sales platforms and under which Gionee shares part of our advertising costs for their featured cell phone products. We also sell cell

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phone products manufactured by Yiyang Yukang under its proprietary Uking brand. The retail prices for the cell phone products that we market ranged from RMB558 to RMB4,960, RMB599 to RMB7,410 per unit in 2008 and RMB499 to RMB5,340 (or approximately \$73 to \$783) per unit in 2009.

*Cosmetics Products* featuring the Aoya, Cobor, Dr Cell and Softto brand names. We began marketing and selling our cosmetics products in the third quarter of 2007. Cosmetic products accounted for 10.1% and 15.7% of our gross revenues in 2008 and 2009, respectively. The retail prices for our cosmetics products ranged from RMB48 to RMB1,288 per unit in 2007, RMB79 to RMB1,980 per unit in 2008 and RMB39 to RMB2,016 (or approximately \$6 to \$296) per unit in 2009. In November 2009, we entered into an exclusive distribution agreement with Guthy-Renker to market Sheer Cover® branded cosmetics in China with a term of one year, which may be further extended based on our meeting first year's designated sales levels. Pursuant to the exclusive distribution agreement, we are entitled to sell such products through all our available distribution channels including both TV and non-TV direct sales.

*Health and Wellness Products* featuring the Babaka, Zehom and Youngleda brand names accounted for 10.3%, 15.3% and 10.4% of our gross revenues in 2007, 2008 and 2009, respectively.

We began marketing and selling our first Babaka branded posture correction product in December 2004 and our first Youngleda branded portable mechanized oxygen generating device in November 2000. We have introduced product upgrades and extensions relating to these original products and developed each brand into a propriety branded product line. Our health and wellness product lines are primarily targeted at elderly persons, working professionals and young consumers. The retail prices for these products ranged from approximately RMB128 to RMB1,980 per unit in 2007 and RMB86 to RMB3,495 per unit in 2008 and RMB98 to RMB3,495 (or approximately \$14 to \$513) per unit in 2009.

*Electronic Dictionary Products* featuring the Meijin brand name, which we introduced in July 2007, accounted for 2.4%, 6.1% and 6.3% of our total gross revenues in 2007, 2008 and 2009, respectively. The retail prices for our electronic dictionary products ranged from RMB498 to RMB1,298 per unit in 2007, RMB598 to RMB898 per unit in 2008 and RMB268 to RMB1,580 (or approximately \$39 to \$232) per unit in 2009.

*Auto Care Products* featuring Energy, Austin and Quixx brand names, which we introduced in the second half of 2009, accounted for 2.5% of our total gross revenues in 2009. The auto care products are sold through both our direct sales platforms and our distribution network. The retail prices for our auto care products ranged from RMB30 to RMB3,580 (or approximately \$4 to \$525) per unit in 2009.

Our three best-selling product lines accounted for an aggregate of 70.4%, 56.2% and 67.2% of our total gross revenues in 2007, 2008 and 2009, respectively.

We select products and services sold through our TV direct sales programs, which we believe offer sufficient profit potential and can be built into a national brand, for sale through our nationwide distribution network.

We offer over 1,400 products and services through our multiple sales platforms, approximately 5% of which are sold primarily through our TV direct sales platform, nationwide distribution network or both, with the remaining sold through our third-party bank channel sales, outbound calls, catalogs and the Internet. In addition to the six product lines we presently feature, we sell other products and services, including consumer electronics and collectibles products, primarily through our third-party bank channel, outbound calls, catalogs and the Internet. We periodically develop and introduce related new and upgraded products and services under the same product or service brand.

Our ability to maintain or grow our revenue depends on our ability to successfully identify, develop, introduce and distribute in a timely and cost-effective manner new and appealing product and service offerings,



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including new and upgraded products and services. We employ a systematic identification and development process. After a potential featured product or service has been identified and tested, we evaluate a number of key benchmarks, particularly estimated profitability relative to our media expenses, in determining whether to conduct full-scale sales and marketing. We also seek to diversify our product and service offerings by adding products and services that offer recurring revenue opportunities.

In 2007, we began relationships with four established domestic banks through which we directly market to credit card holders of these banks with specialized catalogs. As of December 31, 2009, we have established relationships with 26 established domestic banks. As part of these arrangements, customers can use their credit cards from these banks to purchase our products and make payments on a zero interest and zero fee installment basis. During such process, the banks would conduct credit investigations to ensure the credit card holders' ability to pay. Third-party bank channel sales are of growing importance to our direct sales platforms, and revenues contributed by our third-party bank channel sales in 2009 accounted for approximately 18.0% of our revenues from direct sales. We have integrated our credit card payment system into other existing sales channels such as television, the Internet and catalogues.

In July 2006, the State Administration for Radio, Film and Television, or SARFT, and the State Administration for Industry and Commerce, or SAIC, issued a circular temporarily prohibiting the broadcast of TV- and radio-based direct sales programs regarding pharmaceutical products, diet and slimming products, medical devices, breast enhancement products and height increasing products on and after August 1, 2006, pending adoption of new rules governing those direct sales activities. The Circular on Strengthening the Administration of TV Direct Sales Advertising and Home Shopping Programs, issued by the SARFT on September 10, 2009, prohibits the TV direct sales and home shopping programs advertising the pharmaceuticals, breast-enhancement products, diet and slimming products, and the medical devices which are implantable or need instruction by experts. Consequently, we are unable to broadcast TV- and radio-based direct sales programs for some of our products, primarily our oxygen generating product and Zehom neck massager, which were two of our high margin products. Our net revenues from sales of our neck massager product declined from \$3.9 million in 2007 to \$2.4 million in 2008 and to \$1.5 million in 2009, respectively. We believe stricter regulation is beneficial for our industry and business in the long term since it will enhance the overall reputation of the TV direct sales industry by more closely regulating promoted products and marketing practices. However, at least in the near term, our sales of the products covered by the circulars have been, and we expect will continue to be, adversely impacted as a result of this prohibition. In 2008, distribution sales of our Zehom neck massager products further decreased by 60.1% to \$1.1 million from \$2.7 million in 2007. In 2009, distribution sales of our neck massager products decreased by 63.6% to \$0.4 million from \$1.1 million in 2008, largely due to a lack of TV direct sales program marketing support. The overall impact on our future operating results depends on, among other things, our success in promoting the products covered by the circulars through other media channels, the degree to which distribution sales of our restricted products continue to be impacted by the ban on TV direct sales programs, our ability to offset these decreased sales with sales of non-restricted products (including newly developed products) using our committed TV advertising time and the related sales price and margins of those non-restricted products, and the nature of, and restrictions imposed by, the future rules when adopted.

During the second half of 2006, several articles appeared in the Chinese media that, among other things, questioned the pricing and quality of our products, in particular targeting our electronic learning products. Some of these articles we believe contained false or misleading information regarding our products and market practices. We took marketing and other efforts to protect our product brands and to correct or respond to these articles and related customer concerns and these activities appear to have stopped. However, this negative media coverage had, and may continue to have, an adverse effect on our direct and distribution sales of our electronic learning products and other products or services. We are not aware of any such negative publicity in relation to our products or services in 2009.

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In any period, a number of factors, including the following, will impact our net revenues and the portion thereof generated by our direct sales and distribution platforms:

the mix of TV direct sales programs, including the portion thereof dedicated to products and services marketed by us pursuant to joint sales and marketing services arrangements, and brand promotion advertising;

the mix of products and services selected by us for marketing through our TV direct sales programs, our non-TV direct sales channels and our nationwide distribution network and their average selling prices;

the mix of our non-TV versus TV direct sales platforms;

new product or service introductions by us or our competitors and our ability to identify new products and services;

the availability of competing products and services and possible reductions in the sales price of our products and services over time in response to competitive offerings or in anticipation of our introduction of new or upgraded offerings;

seasonality with respect to certain of our products, such as our electronic learning products, for which sales are typically higher around our first and third fiscal quarters corresponding with the end and beginning of school semesters in China, respectively.

a product's connection to a one-time event, such as our Olympic collectible products, for which sales decreased significantly following the 2008 Olympic Games;

the cycles of our products and services featured in our TV direct sales programs, with such sales typically growing rapidly over the initial promotional period and then declining over time, sometimes precipitously in a short period of time;

the market of certain featured products becoming saturated over time;

discounts offered to our distributors as part of incentive plans to stimulate sales;

the success of our distributors in promoting and selling our products locally;

the potential negative impact distributor sales may have on our own direct sales efforts;

any requirement to suspend or terminate a particular TV direct sales program, including in response to regulatory actions;

new laws, regulations or rules promulgated by the PRC government governing the TV direct sales industry;

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negative publicity about our products and services;

natural disasters, such as the severe snow storms or earthquake experienced by China in 2008;

the amount and timing of operating expenses incurred by us, including our media procurement expenses, inventory-related losses, bad debt expense, product returns and options grants to our employees;

gains and losses related to our investments in marketable securities; and

the level of advertising and other promotional efforts by us and our competitors in a particular period.

For a detailed discussion of the factors that may cause our net revenues to fluctuate, see Item 3.D, **Key Information Risk Factors Risks Relating to Our Business**. Our operating results fluctuate from period to period, making our results difficult to predict. Our operating results for a particular period could fall below our expectations or the expectations of investors or any market analyst that may issue reports of analyses regarding our ADSs, resulting in a decrease in the price of our ADSs.

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### **Cost of Revenues**

Cost of revenues represents our direct costs to manufacture, purchase or develop products or services sold by us to consumers or our distributors. For a particular product or service, the related cost of revenues is the same regardless of whether sold by us directly to consumers or to our distributors. The most significant factor in determining cost of revenues as a percentage of revenue in any period is our product or service mix for the period. For example, our cell phone or electronic learning product products currently have a higher per unit cost of revenues than our other products, such as our cosmetic products.

Cost of revenues does not include advertising or other selling and marketing expenditures. These expenditures are incurred for the benefit of each of our sales and distribution platforms and, as such, are treated as operating expenses and not as a cost of revenues. As described below under *Critical Accounting Policies*, however, certain payments received under our joint sales arrangements may reduce our cost of revenues or advertising expenses. In evaluating the performance of our sales and distribution platforms, you should consider our advertising and other selling and marketing expenses and income from operations.

For marketing services arrangements, the related cost of revenues reflects the cost of the TV advertising time used to run the related TV direct sales programs.

In June 2009, we reduced our equity ownership interest in Shanghai Yimeng, our subsidiary engaged in the development and marketing of CPS stock tracking software, from 51% to 18%. As a result of the related sale, we no longer consolidate the financial results of Shanghai Yimeng with ours. As CPS stock tracking software generally had higher gross margin than most of our proprietary products, the deconsolidation of Shanghai Yimeng negatively impacted on our overall gross margin when we recast our historical financial statements to reflect their business as discontinued operations.

### **Operating (Expenses) Income**

Our operating (expenses) income consist of advertising expenses, other selling and marketing expenses, general and administrative expenses, impairment of goodwill and intangible assets, and other operating income, net.

### ***Advertising Expenses***

Advertising expenses consist primarily of the expenses of purchasing our advertising media, mostly the expense of TV advertising time and, to a significantly lesser extent, non-TV media, primarily newspaper advertising space. Advertising expenses also include payments to reimburse certain of our distributors for a portion of their local TV, print media and other advertising-related expenses in support of our products and services distributed by them. To date, we have not deferred any advertising expenses, and all such advertising expenses have been recognized as incurred. If we defer revenues in a period, our operating margins will be initially adversely impacted as we recognize the advertising expense in full in the period it is incurred and will in a later period be favorably impacted as we recognize deferred revenue without the offsetting advertising expense.

We use our purchased TV advertising time to broadcast our TV direct sales programs and our brand promotion advertising. Advertising expenses for TV direct sales programs accounted for \$67.3 million, or 89.8%, \$59.2 million, or 80.6%, and \$51.3 million, or 84.1%, of total advertising expenses incurred in 2007, 2008 and 2009, respectively. TV advertising time dedicated to TV direct sales programs decreased from over 890,000 minutes in 2007 to approximately 590,000 minutes in 2008, and 410,000 minutes in 2009. The decrease in 2008 and 2009 primarily reflects our strategy to selectively lower our purchase of TV advertising time to focus on more cost effective channels and time slots and to adopt a more flexible manner in our procurement by entering into contracts with shorter terms to achieve better cost control. TV brand promotion advertising expenses accounted for \$4.3 million, or 5.7%, and \$12.0 million, or 16.4%, and \$7.8 million, or 12.8%, of our total advertising expenses incurred in 2007, 2008 and 2009, respectively. The decrease in 2009 primarily reflects a more efficient and focused media procurement of our TV direct sales advertising. The increase in 2008 reflects

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our TV brand promotion advertisements for our electronic learning products and posture correction products broadcasted in the first quarter of the year. In 2008, we engaged in brand promotion advertising primarily to support electronic learning products and posture correction products. In 2007, we engaged in brand promotion advertising primarily to support our electronic learning products, neck massager and posture correction product lines.

Except where the cost of TV advertising time is treated as a cost of direct sales revenues under a marketing services arrangement, advertising expenses include the cost of the TV advertising time used to broadcast all TV direct sales programs. Payments received from our joint sales partners to share a portion of the related TV advertising cost are recorded as a reduction to our TV advertising expense. In 2009, we received \$9.8 million in payments based on advertising costs shared by our joint sales arrangements, which reduced our advertising expenses. Our TV direct sales programs are typically five to ten minutes in length, focus on the features and benefits of the products and services being marketed and encourage consumers to call our call centers to purchase those products and services. Our brand promotion advertisements are typically five to 60 seconds long and, rather than focusing on product or service features or benefits, are designed to increase general brand awareness for the marketed products or services. In addition to our TV brand promotion advertising, we also promote brands through print and other media, primarily newspaper and radio advertising. Our total advertising expenses for non-TV brand promotion advertising for 2007, 2008 and 2009 included an aggregate of \$2.6 million, or 3.4%, \$1.9 million, or 2.6%, and \$1.5 million, or 2.4%, respectively, which primarily was used to support our Ozing electronic learning products, Babaka posture correction products and Uking cell phones in 2009.

We also reimburse certain of our distributors for a portion of their local TV, print media and other advertising-related expenses in support of the products that they distribute for us. Our total advertising expenses in 2007, 2008 and 2009 included \$0.8 million or 1.1%, \$0.3 million or 0.4% and \$0.4 million or 0.7%, of these distributor reimbursements, respectively, primarily related to our oxygen generating devices, neck massager, posture correction, electronic learning products and Uking cell phones.

During 2007, 2008 and 2009, our TV brand promotion advertisements were broadcasted on eight, six and nine channels, respectively.

We typically enter into TV advertising time purchase agreements for our TV direct sales programs in advance and prior to the beginning of each year, with such agreements generally having a term of one year. Starting from 2008, we have adopted a more flexible approach to TV advertising time procurement, pursuant to which we may enter into contract with a shorter term with TV channels. We typically prepay for a large portion of our TV advertising time for our TV direct sales programs. We believe our ability to prepay for our advertising expenses has been a competitive advantage. As of December 31, 2007, 2008 and 2009, we had a prepaid advertising balance of \$23.2 million, \$16.8 million and \$10.0 million respectively. We enter into our advertising agreements typically near the end of each year and consequently our prepaid balance is usually highest at year-end.

Our advertising cost per minute (based on aggregate expenditures and ignoring the impact of payments made under our joint sales and marketing services arrangements) varies depending on the channel, with certain CCTV channels, which generally have a broader reach, being more expensive. Our average per minute advertising cost for TV direct sales programs in 2007, 2008 and 2009 was approximately \$75, \$99 and \$165, respectively. In addition, average per minute charges can vary significantly by channel, with some channels increasing their rates annually. In particular, we have experienced more significant rate increases on some of our national satellite channels, compared to our other channels, as their reach and ratings have increased. In 2009, our top five TV channels in terms of amount of TV direct sales program advertising expenditures accounted for approximately 49.5% of our total TV direct sales program advertising expenditures and approximately 37.1% of our total TV direct sales program advertising minutes. In contrast, in 2009, our top five TV channels by total TV direct sales program advertising minutes accounted for approximately 59.0% of our total TV direct sales program advertising minutes and 32.8% of our total TV direct sales program advertising expenditures.

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### ***Other Selling and Marketing Expenses***

Other selling and marketing expenses consist primarily of costs related to product delivery, salary and benefits for our call center sales and marketing personnel, and the production of our TV direct sales programs and other advertising. On the other hand, amortization charges related to intangible assets acquired in our December 2008 acquisition of Yiyang Yukang have been included in other selling and marketing expenses in 2009. See Note 3 to our consolidated financial statements.

We rely significantly on EMS, and to a lesser extent, local delivery companies, to deliver our products sold by us to consumers and to collect related payments in connection with products delivered on the basis of a cash on delivery, or COD, payment method. EMS and local delivery companies made deliveries of products representing 76.1% and 19.1% of our direct sales gross revenues in 2007, 59.3% and 29.8% of our direct sales gross revenues in 2008, and 47.4% and 38.0% of our direct sales gross revenues in 2009, respectively. We are responsible for the delivery and handling fee regardless whether the delivery is successful.

In 2009, the increase in other selling expenses was primarily due to increased amortization of acquired intangible assets as a result of acquisition of Yiyang Yukang, as well as an increase in delivery charges associated with our direct sales and distribution sales.

### ***General and Administrative Expenses***

General and administrative expenses consist primarily of compensation and benefits for general management and finance and administrative personnel costs, depreciation and amortization with respect to equipment used for general corporate purposes, professional fees, lease, allowances for doubtful accounts and other expenses for general corporate purposes.

General and administrative expenses were \$26.1 million in 2007, \$27.7 million in 2008 and \$31.2 million in 2009, which increases primarily reflect higher salaries and benefits for our employees and our research and development expenses.

In addition, the increase in general and administrative expenses in 2008 also reflects the increase in our bad debt provision related to the shared advertising expenses receivable from one of our joint sales partners and our research and development expenses. We did not record any such bad debt provision in 2009.

The total amount of EMS-related accounts receivable written off in 2007, 2008 and 2009 was approximately \$0.3 million in each year.

### ***Impairment of Goodwill and Intangible Assets***

Impairment losses of intangible assets for the full year 2009 totaled \$15.2 million, which reflected primarily the impairment loss caused by (i) overall under-performance in the mobile handsets business of Yiyang Yukang and (ii) Yiyang Yukang's change in business strategy to launching its proprietary Uking brand and changes incurred in the acquired distribution network. In addition, as result of the Yiyang Yukang intangible assets impairment charge, the Company reversed a \$3.3 million deferred tax liability in 2009.

Impairment losses of goodwill and intangible assets were \$8.7 million in 2008, which consisted of \$1.1 million of impairment loss on intangible assets and \$7.6 million of impairment loss on goodwill referred to our net loss position and changes in circumstances that indicate the carrying amount of our goodwill and intangible assets may not be recoverable.

### ***Other Operating Income, Net***

Other operating income, net consists primarily of government subsidies. We receive government subsidies from local government agencies for certain taxes paid by us, including value-added, business and income taxes.

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**Taxation**

We are incorporated in the Cayman Islands and are not subject to tax in this jurisdiction. Our subsidiaries China DRTV and Smooth Profit are incorporated in BVI and are not subject to tax in this jurisdiction. Our subsidiaries Bright Rainbow Investments Limited, MK AND T Communications Limited, Acorn Hong Kong Holdings Limited and U King Communication Equipment (Hong Kong) Limited are incorporated in Hong Kong and are subject to statutory income tax on their Hong Kong sourced income. Our other subsidiaries and affiliated companies are PRC companies. In addition to enterprise income tax, our PRC subsidiaries and affiliated companies are subject to a 17% value added tax, or VAT, on sales in accordance with relevant PRC tax laws. VAT taxes payable are accounted for through the balance sheet and do not have an income statement effect. The statutory income tax rate applicable to PRC companies was 33% for calendar years ended on or before December 31, 2007 and is 25% for calendar years starting on or after January 1, 2008.

In 2007, our PRC subsidiaries are subject to Corporate Income Tax ( CIT ) on the taxable income in accordance with the Enterprise Income Tax Law and the Income Tax Law of the PRC concerning Foreign Investment Enterprise and Foreign Enterprises (collectively PRC Corporate Income Tax Laws ), respectively.

On March 16, 2007, the PRC government promulgated Law of the People's Republic of China on Enterprise Income Tax ( New EIT Law ), which is effective from January 1, 2008. Under the New EIT Law, domestically owned enterprises and foreign-invested enterprises are subject to a uniform tax rate of 25%. While the New EIT Law equalizes the tax rates for domestically-owned and foreign-invested companies, preferential tax treatment would continue to be given to companies in certain encouraged sectors and to enterprises classified as high and new technology companies, whether domestically-owned or foreign-invested enterprises. The New EIT Law also provides a five-year transition period starting from its effective date for those enterprises which were established before the promulgation date of the New EIT Tax Law and which were entitled to a preferential tax treatment such as a reduced tax rate or a tax holiday. The tax rate of such enterprises will transition to the uniform tax rate of 25% within a five-year transition period and the tax holiday, which has been enjoyed by such enterprises before the effective date of the New EIT Law, may continue to be enjoyed until the end of the holiday.

For 2007, 2008 and 2009, several of our PRC subsidiaries and affiliated companies benefited from the following special tax rates or incentives:

Shanghai Advertising registered in Pudong New District, Shanghai of the PRC, is subject to 15% CIT in 2007, 18% CIT in 2008 and 20% CIT in 2009 pursuant to the local tax preferential arrangement.

Shanghai HJX, Acorn Electronic, Shanghai An-Nai-Chi, Beijing Youngleda and Zhuhai Acorn registered in the Old Districts of the PRC, are subject to 27% CIT in 2007 as qualified foreign-invested manufacturing enterprises.

Acorn Information, registered in Pudong New District, Shanghai of the PRC, is subject to 15% CIT in 2007 pursuant to the local tax preferential arrangement.

Zhuhai Sunrana registered in Zhuhai Specific Economic Zone of the PRC, is subjected to 15% CIT in 2007 pursuant to the local tax preferential arrangement. Starting from January 1, 2008, Zhuhai Sunrana is subject to the preferential five-year transition period tax rates under the New EIT Law and 2008 and 2009 applicable CIT rate is 18% and 20%, respectively.

Beijing HJZX, as a recognized high and new technology company and registered in Zhongguancun technology zone in Beijing of the PRC, is subject to 15% CIT in 2007.

The Group's remaining PRC subsidiaries are subject to the statutory rate of 33% in 2007 in accordance with the PRC Corporate Income Tax Laws, and 25% in 2008 and 2009 in accordance with the New EIT Law.

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Shanghai HJX, Acorn Electronic, Shanghai An-Nai-Chi, Beijing Youngleda, Yiyang Yukang and Zhuhai Acorn, as foreign-invested manufacturing enterprises which are scheduled to operate for at least ten years, are entitled to a two-year exemption and three-year 50% reduction starting from the first profit making year after absorbing all prior years' tax losses, which can be carried forward for five years (the Tax Holiday ). Under the New EIT Law, enterprises not generating profits before 2008 are required to commence the Tax Holiday beginning January 1, 2008.

Acorn Information, as a recognized software company, is eligible for the Tax Holiday from 2005.

Acorn Consulting, as a recognized new service company, is entitled to CIT exemption in 2007.

Beijing HJZX, as a recognized high and new technology company and registered in Zhongguancun technology zone in Beijing of the PRC, is entitled to CIT exemption in 2007.

Shanghai Network, as a recognized new trading company, is entitled to CIT exemption in 2007.

Effective on January 1, 2007, we adopted the provisions of ASC740-10, Income Taxes - Overall (previously FASB Interpretation No. 48, Accounting For Uncertainty in Income Taxes - an Interpretation of SFAS No. 109 ). Based on our analyses under ASC740-10, we have made our assessment of the level of authority for each tax position (including the potential application of interest and penalties) based on the technical merits, and have measured the unrecognized benefits associated with the tax positions. As of December 31, 2007, 2008 and 2009, we had unrecognized tax benefits of approximately nil, \$3.1 million and \$3.1 million, respectively.



**Table of Contents****Results of Operations**

The following table sets forth our consolidated statements of operations by amount and as a percentage of our total net revenues for 2007, 2008 and 2009:

|   | 2007      |                                | For the years ended December 31<br>2008              |                                | 2009       |                                |
|---|-----------|--------------------------------|--|--------------------------------|------------|--------------------------------|
|   | Amount    | % of total<br>revenues,<br>net | Amount<br><br>(in thousands, except for percentages) | % of total<br>revenues,<br>net | Amount     | % of total<br>revenues,<br>net |
| <b>Condensed Consolidated<br/>Statements of Operations Data</b>     |           |                                |  |                                |            |                                |
| Revenues:   |           |                                |  |                                |            |                                |
| Direct sales, net   | \$ 81,320 | 73.1%                          | \$ 166,947   | 71.3%                          | \$ 160,358 | 55.8%                          |
| Distribution sales, net   | 66,717    | 26.9%                          | 67,190   | 28.7%                          | 127,228    | 44.2%                          |
| Total revenues, net   | 248,037   | 100.0%                         | 234,137  | 100.0%                         | 287,586    | 100.0%                         |
| Cost of revenues:   |           |                                |  |                                |            |                                |
| Direct sales  | 85,982    | 34.7%                          | 83,301   | 35.6%                          | 67,531     | 23.5%                          |
| Distribution sales  | 37,366    | 15.1%                          | 37,326   | 15.9%                          | 83,097     | 28.9%                          |
| Total cost of revenues  | 123,348   | 49.7%                          | 120,627  | 51.5%                          | 150,628    | 52.4%                          |
| Gross profit  | 124,689   | 50.3%                          | 113,510  | 48.5%                          | 136,958    | 47.6%                          |
| Operating (expenses) income   |           |                                |  |                                |            |                                |
| Advertising expenses  | (74,966)  | (30.2)%                        | (73,381)   | (31.3)%                        | (61,048)   | (21.2)%                        |
| Other selling and marketing expenses                                | (29,250)  | (11.8)%                        | (38,317)   | (16.4)%                        | (42,956)   | (14.9)%                        |
| General and administrative expenses                                 | (26,100)  | (10.5)%                        | (27,747)   | (11.9)%                        | (31,196)   | (10.8)%                        |
| Impairment of goodwill and intangible assets                        |           |                                | (8,668)  | (3.7)%                         | (15,248)   | (5.3)%                         |
| Other operating income, net   | 3,144     | 1.3%                           | 5,039  | 2.2%                           | 6,004      | 2.1%                           |
| Total operating (expenses) income                                   | (127,172) | (51.3)%                        | (143,074)  | (61.1)%                        | 144,444    | 50.2%                          |
| Loss from operations  | (2,483)   | (1.0)%                         | (29,564)   | (12.6)%                        | (7,486)    | (2.6)%                         |
| Other (expenses) income   | 13,711    | 5.5%                           | (667)  | (0.3)%                         | 1,651      | 0.6%                           |
| Total income tax (expenses) benefits                                | 13        | 0.0%                           | (5)  | 0.0%                           | 2,539      | 0.9%                           |
| Income (loss) from continuing operations                            | 11,241    | 4.5%                           | (30,236)   | (12.9)%                        | (3,296)    | (1.1)%                         |
| Income from discontinued operations                                 | 14,474    | 5.8%                           | 8,274  | 3.5%                           | 15,363     | 5.3%                           |
| Net income (loss) <sup>(1)</sup>                                    | 25,715    | 10.4%                          | (21,962)   | (9.4)%                         | 12,067     | 4.2%                           |
| Net income (loss) attributable to non-controlling interest          | (7,063)   | (2.8)%                         | (3,629)  | (1.5)%                         | (184)      | (0.1)%                         |
| Net income (loss) attributable to Acorn International, Inc          | 18,652    | 7.5%                           | (25,591)   | (10.9)%                        | 11,883     | 4.1%                           |
| Deemed dividend on Series A convertible redeemable preferred shares | (54)      | 0.0%                           |  |                                |            |                                |

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|  |           |      |             |         |           |      |
|--|-----------|------|-------------|---------|-----------|------|
| Net income (loss) attributable to holders of ordinary shares | \$ 18,598 | 7.5% | \$ (25,591) | (10.9)% | \$ 11,883 | 4.1% |
|--|-----------|------|-------------|---------|-----------|------|

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|   | For the years ended December 31 |                          |  |                          |         |                          |
|---|---------------------------------|--------------------------|--|--------------------------|---------|--------------------------|
|   | 2007                            |                          | 2008   |                          | 2009    |                          |
|   | Amount                          | % of total revenues, net | Amount<br>(in thousands, except for percentages) | % of total revenues, net | Amount  | % of total revenues, net |
| (1) Includes share-based compensation of: |                                 |                          |  |                          |         |                          |
| Other selling and marketing expenses      | (423)                           | (0.2)%                   | (292)  | (0.1)%                   | (94)    | (0.0)%                   |
| General and administrative expenses       | (6,096)                         | (2.5)%                   | (2,997)  | (1.3)%                   | (1,751) | (0.6)%                   |

The following table sets forth our three best-selling product lines on a gross revenues basis and as a percentage of total gross revenues for the indicated periods, together with a reconciliation to our net revenues for all products:

| Product  | Brand  | 2007              |              |      | 2008              |              |      | 2009              |              |      |
|--|--|-------------------|--------------|------|-------------------|--------------|------|-------------------|--------------|------|
|  |  | Revenues          | percentage   | Rank | Revenues          | percentage   | Rank | Revenues          | percentage   | Rank |
| (in thousands, except percentages and ranks)   |  |                   |              |      |                   |              |      |                   |              |      |
| Cell phone                                     | Amoi, Gionee, K-touch, Lenovo, Nokia & Konka | \$ 105,563        | 42.4%        | 1    | \$ 56,242         | 24.0%        | 1    | \$ 61,277         | 21.3%        | 2    |
| Electronic learning product                    | Ozing  | 50,151            | 20.2%        | 2    | 46,939            | 20.0%        | 2    | \$ 86,964         | 30.2%        | 1    |
| Posture correction product                     | Babaka                                       |                   |              |      | 28,598            | 12.2%        | 3    |                   |              |      |
| Cosmetic Product                               | Aoya, Cobor, Dr Cell, Softto and CMM         |                   |              |      |                   |              |      | \$ 45,149         | 15.7%        | 3    |
| Collectibles                                   |  | 19,332            | 7.8%         | 3    |                   |              |      |                   |              |      |
| <b>Total top three</b>                         |  | <b>\$ 175,046</b> | <b>70.4%</b> |      | <b>\$ 131,779</b> | <b>56.2%</b> |      | <b>\$ 193,390</b> | <b>67.2%</b> |      |
| Other products and marketing services revenues |  | \$ 73,816         | 29.6%        |      | \$ 102,567        | 43.8%        |      | \$ 94,392         | 32.8%        |      |
| Total gross revenues                           |  | \$ 248,862        | 100%         |      | \$ 234,346        | 100%         |      | \$ 287,782        | 100%         |      |
| Total sales tax                                |  | \$ (825)          |              |      | \$ (209)          |              |      | \$ (196)          |              |      |
| Total revenues, net                            |  | \$ 248,037        |              |      | \$ 234,137        |              |      | \$ 287,586        |              |      |

In evaluating the success of our overall sales and marketing efforts, we consider aggregate total sales through our integrated direct sales and nationwide distribution platforms, as well as the various payments generated by our joint sales and marketing services arrangements. For example, distribution sales of our electronic learning product line benefit significantly from our TV direct sales programs and our TV brand promotion advertising. Some products, such as our consumer electronics products and collectibles, are sold primarily or exclusively through our direct sales platforms.

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The following table sets forth our three best-selling product lines for our direct sales platforms and distribution network by gross revenues and as a percentage of applicable total direct gross revenues and total distribution gross revenues for the indicated periods, together with a reconciliation to net direct sales revenues and net distribution sales revenues:

| Product  | Brand  | 2007              |              |      | 2008             |              |      | 2009             |              |      |
|--|--|-------------------|--------------|------|------------------|--------------|------|------------------|--------------|------|
|  |  | Revenues          | percentage   | Rank | Revenues         | percentage   | Rank | Revenues         | percentage   | Rank |
| <b>Direct Sales:</b>                           |  |                   |              |      |                  |              |      |                  |              |      |
| Cell phone                                     | Amoi, Gionee, K-touch, Lenovo, Nokia & Konka | \$ 104,675        | 57.5%        | 1    | \$ 56,200        | 33.6%        | 1    | \$ 33,179        | 20.7%        | 2    |
| Posture correction product                     | Babaka                                       | 9,403             | 5.2%         | 3    | 19,225           | 11.5%        | 3    |                  |              |      |
| Electronic learning device                     | Ozing  |                   |              |      |                  |              |      | \$ 21,862        | 13.6%        | 3    |
| Cosmetics products                             | Aoya, Cobor, Dr Cell, Sofitto and CMM        |                   |              |      | 23,399           | 14.0%        | 2    | \$ 44,182        | 27.5%        | 1    |
| Collectibles                                   |  | 19,235            | 10.6%        | 2    |                  |              |      |                  |              |      |
| <b>Direct Sales-total top three</b>            |  | <b>\$ 133,313</b> | <b>73.2%</b> |      | <b>\$ 98,824</b> | <b>59.1%</b> |      | <b>\$ 99,223</b> | <b>61.8%</b> |      |
| Other products and marketing services revenues |  | \$ 48,826         | 26.8%        |      | \$ 68,332        | 40.9%        |      | \$ 61,331        | 38.2%        |      |
| Total gross revenues                           |  | \$ 182,139        | 100%         |      | \$ 161,156       | 100%         |      | \$ 160,554       | 100%         |      |
| Total sales tax                                |  | \$ (819)          |              |      | \$ (209)         |              |      | \$ (196)         |              |      |
| Total revenues, net                            |  | \$ 181,320        |              |      | \$ 166,947       |              |      | \$ 160,358       |              |      |

| Product  | Brand  | 2007             |              |      | 2008             |              |      | 2009              |              |      |
|--|--|------------------|--------------|------|------------------|--------------|------|-------------------|--------------|------|
|  |  | Revenues         | percentage   | Rank | Revenues         | percentage   | Rank | Revenues          | percentage   | Rank |
| <b>Distribution Sales:</b>                     |  |                  |              |      |                  |              |      |                   |              |      |
| Electronic learning product                    | Ozing  | \$ 43,175        | 64.7%        | 1    | \$ 35,727        | 53.2%        | 1    | \$ 65,103         | 51.2%        | 1    |
| Posture correction product                     | Babaka                                       | \$ 6,772         | 10.1%        | 2    | \$ 9,374         | 14.0%        | 3    |                   |              |      |
| Cell phone                                     | Amoi, Gionee, K-touch, Lenovo, Nokia & Konka |                  |              |      |                  |              |      | \$ 28,098         | 22.1%        | 2    |
| Electronic dictionary                          | Meijin                                       | \$ 5,820         | 8.7%         | 3    | \$ 13,897        | 20.7%        | 2    | \$ 18,223         | 14.3%        | 3    |
| <b>Distribution sales-total top three</b>      |  | <b>\$ 55,767</b> | <b>83.6%</b> |      | <b>\$ 58,998</b> | <b>87.8%</b> |      | <b>\$ 111,424</b> | <b>87.6%</b> |      |
| Other products and marketing services revenues |  | \$ 10,956        | 16.4%        |      | \$ 8,192         | 12.2%        |      | \$ 15,804         | 12.4%        |      |
| Total gross revenues                           |  | \$ 66,723        | 100%         |      | \$ 67,190        | 100%         |      | \$ 127,228        | 100%         |      |
| Total sales tax                                |  | \$ (6)           |              |      | \$ (0)           |              |      | \$ 0              |              |      |
| Total revenues, net                            |  | \$ 66,717        |              |      | \$ 67,190        |              |      | \$ 127,228        |              |      |

**Comparison of Years Ended December 31, 2007, December 31, 2008 and December 31, 2009****Revenues**

Our total net revenues decreased from \$248.0 million in 2007 to \$234.1 million in 2008 and increased to \$287.6 million in 2009, or a 5.6% decrease and a 22.8% increase, respectively. The net increase of \$53.5 million in total net revenues in 2009 primarily reflects the increased sales of our cosmetics products through our direct sales platforms, the strong sales performance of our Ozing electronic learning products through our direct TV and distribution network and the consolidation of Yiyang Yukang's mobile handset sales into our financial results, partially offset by a decrease in our direct sales net revenues as a result of our lower advertising expenses and reduction in purchased TV advertising time. In 2009, sales of our electronic learning products, which became our top product line in terms of percentage of total net revenues, increased from \$46.9 million in 2008 to \$87.0 million in 2009.



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million in 2009, among which a RMB\$10.7 million increase was from our direct sales and a \$29.4 million increase was from our distribution sales. This increase in sales in 2009 was primarily due to our pricing strategy to market several lower-priced products and to provide distributors higher sales discounts. In addition, sales of our electronic learning products through our distribution network benefitted from the advertising programs for our TV direct sales, as such programs helped strengthen brand recognition among customers. Sales of our cell phones increased to approximately \$61.3 million in 2009, compared to \$56.3 million in 2008, reflecting \$28.1 million in cell phone sales through the Yiyang Yukang distribution network offset by a \$23.1 million decline in direct cell phone sales. The decline in our direct sales of cell phones primarily reflects intensified competition of TV direct sales of cell phone products in China. Our other featured products in 2009 consist of our cosmetics products, auto care products and Meijin electronic dictionary products, which increased approximately \$21.4 million, \$5.0 million and \$4.0 million, respectively, in 2009 compared to 2008. The increase in sales of our cosmetics products and our Meijin electronic dictionary was primarily due to the increased allocation to cosmetic products and the competitive pricings and our effective management of distribution network of our electronic dictionary products.

The net decrease of \$13.9 million in total net revenues in 2008 primarily reflects a \$52.5 million decrease in sales of cell phones and collectibles, with sales of cell phones and collectibles generating revenues of \$72.4 million in 2008 compared to \$124.9 million in 2007. The decrease in sales of cell phones was primarily due to intensified competition for our cell phone products, and a decrease in the average selling price of our cell phones as a result of the short lifecycle of cell phone products and our strategy to cope with the weakened purchasing power of our customers. The decrease in sales of collectibles was primarily due to decreased demand following the conclusion of the 2008 Beijing Olympics. The net decrease of \$13.9 million in total net revenues in 2008 was partially offset by increases of \$16.5 million, \$10.5 million and \$8.2 million in sales of our cosmetics, GPS products and electronic dictionaries, respectively, reflecting a significant increase in revenues from these products, particularly our newly introduced cosmetics products.

Direct sales net revenues decreased from \$181.3 million in 2007 to \$166.9 million in 2008 and to \$160.4 million in 2009, or a 7.9% decrease and a 3.9% decrease, respectively. The net decrease of \$6.5 million in direct sales net revenues in 2009 primarily reflects an overall decline in TV direct sales following a reduction in advertising expenditures and a \$23.0 million decrease in sales of cell phones through our TV direct sales platform primarily due to intensified competition, partially offset by an increase of approximately \$13.8 million in non-TV direct sales from 2008. The increase in non-TV direct sales was primarily due to our third-party bank channel sales, which accounted for approximately 18.0% of our net revenues from direct sales, up from 7.9% in 2008. In 2009, direct sales net revenues also benefitted from an increase in our conversion rate from 23.2% in 2008 to 31.0% in 2009. From a product mix perspective, our top three direct sales products in 2009 were cosmetics products, cell phones and electronic learning products, which accounted for \$99.2 million, or 61.8%, of our direct sales net revenues in 2009. Our top three direct sales products in 2008 were cell phones, cosmetics products and posture correction product, which accounted for \$98.8 million, or 59.1% of our direct sales net revenues in 2008. The net decrease of \$14.4 million in direct sales net revenues in 2008 primarily reflects a \$51.6 million decrease in sales of cell phones and collectibles, with sales of cell phones and collectibles generating revenues of \$72.3 million in 2008 compared to \$123.9 million in 2007. The decrease in sales of cell phones in 2008 was primarily due to intensified competition of TV direct sales of cell phone products, and a decrease in the average selling price of our cell phones as a result of the short lifecycle of cell phone products and our strategy to cope with the weakened purchasing power of our customers. The decrease in sales of collectibles was primarily due to decreased demand following the conclusion of the 2008 Beijing Olympics. The net decrease of \$14.4 million in direct sales net revenues in 2008 was partially offset by increases of \$16.4 million, \$10.8 million and \$0.1 million in sales of our cosmetics, GPS products and Meijin electronic dictionary products, respectively, reflecting an increase of 236.0%, 171.4% and 49.0% compared to 2007, respectively. The increase in sales of these products was primarily due to significant increase in sales of certain branded cosmetic products that were not part of our product mix in 2007, increased media spending on our Eroda satellite navigation system product, and sales of our Meijin electronic dictionary which was not part of product mix until the second quarter of 2007.

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Distribution sales net revenues increased from \$66.7 million in 2007 to \$67.2 million in 2008 and increased to \$127.2 million in 2009, or a 0.7% increase and a 89.3% increase, respectively. The net increase of \$60.0 million in distribution sales net revenues in 2009 was primarily due to the strong sales performance of our Ozing electronic learning products, with sales of Ozing electronic learning products generating revenues of \$65.1 million in 2009 compared to \$35.7 million in 2008, and the consolidation of Yiyang Yukang's mobile handsets sales into our financial results. This increase in sales of Ozing electronic learning products through our distribution platform in 2009 was primarily due to our pricing strategy to market several lower-priced products and to provide distributors higher sales discounts. In addition, sales of our electronic learning products through our distribution network benefitted from the advertising programs for our TV direct sales, as such programs helped strengthen brand recognition among customers. From a product mix perspective, our top three distribution sales products in 2009 were our Ozing electronic learning product, cell phones and Meijin electronic dictionary, which accounted for \$111.4 million, or 87.6% of our distribution sales gross revenues in 2009. Our top three distribution sales products in 2008 were our Ozing electronic learning product, Meijin electronic dictionary and Babaka posture correction products, which accounted for \$59.0 million, or 87.8% of our distribution sales gross revenues in 2008. The net increase of \$0.5 million in distribution sales net revenues in 2008 was primarily due to slight increases in sales of our Meijin electronic dictionary and Babaka posture correction products, with sales of these two products generating \$23.3 million distribution sales revenues in 2008 compared to \$12.6 million in 2007. The increase in sales of these products was primarily due to increased demand for these products and our Meijin electronic dictionary which was not part of product mix until the second quarter of 2007. The net increase of \$0.5 million in distribution sales net revenues in 2008 was partially offset by a decrease in sales of the Ozing electronic learning product of \$7.5 million from \$43.2 million in 2007 to \$35.7 million in 2008.

***Cost of Revenues***

Our cost of revenues is primarily dependent upon the mix of products and units sold during the relevant period.

Total cost of revenues decreased from \$123.3 million in 2007 to \$120.6 million in 2008 and increased to \$150.6 million in 2009. As a percentage of total net revenues, total cost of revenues was 49.7%, 51.5% and 52.4% in 2007, 2008 and 2009, respectively. The overall increase in cost of revenues in 2009 was primarily driven by the increased costs for distribution sales, reflecting a larger percentage of cell phone sales which generally have higher products costs. The overall decrease in cost of revenues in 2008 was primarily driven by the lower volume of sales of our cell phone products.

Direct sales cost of revenues decreased from \$86.0 million in 2007 to \$83.3 million in 2008 and to \$67.5 million in 2009, or a 3.1% decrease and a 19.0% decrease, respectively. The overall decrease in 2008 and 2009 primarily reflects lower sales volume of our cell phone products that generally have higher product costs and higher sales volume of cosmetics products with lower product costs.

Distribution cost of revenues decreased from \$37.4 million in 2007 to \$37.3 million in 2008 and increased to \$83.1 million in 2009 or a 0.3% decline and a 122.8% increase, respectively. The increase in 2009 primarily reflects the consolidation of Yiyang Yukang's cost of revenues relating to cell phones, which have high product costs, into our financial results. The decrease in 2008 primarily reflected our decision in the fourth quarter of 2007 to terminate our prior distribution incentive plan, which offered distributors higher discounts. Such measure improved the gross margins of our Ozing electronic learning products and Meijin electronic dictionary in 2008.

**Table of Contents****Gross Profit and Gross Margin**

The following table sets forth gross profits and gross margins (being gross profit divided by the related net revenues) for our direct sales and distribution sales platforms:

|                         | For the years ended December 31, |              |                                   |              |                       |              |
|-------------------------|----------------------------------|--------------|-----------------------------------|--------------|-----------------------|--------------|
|                         | 2007                             | 2008         |                                   | 2009         |                       |              |
|                         | Gross profit                     | Gross margin | Gross profit<br>(in U.S. dollars) | Gross margin | Gross profit          | Gross margin |
| Direct sales, net       | \$ 95,337,653                    | 52.6%        | \$ 83,646,739                     | 50.1%        | \$ 92,826,982         | 57.9%        |
| Distribution sales, net | 29,351,165                       | 44.0%        | 29,863,732                        | 44.4%        | 44,130,740            | 34.7%        |
| <b>Total</b>            | <b>\$ 124,688,818</b>            | <b>50.3%</b> | <b>\$ 113,510,471</b>             | <b>48.5%</b> | <b>\$ 136,957,722</b> | <b>47.6%</b> |

Changes in our gross margins from period to period are driven by changes in the products and services that we sell and the platforms through which we sell them.

We are generally able to maintain stable margins for our individual product lines. Although we discount the prices of individual products as competition enters the market over time, this discounting is typically done in conjunction with our introduction of an upgraded or replacement product with improved features and functions and similar or better pricing. If we are unable to maintain satisfactory gross profits relative to our media expenses, we replace or cease marketing such product.

In addition to product and service mix-related variations, the difference between the sales price charged by us to our TV direct sales customers and what we charge our distributors for the same product or service accounts for a large portion of the difference in gross margins on direct sales and on distribution sales.

Total gross profits decreased from \$124.7 million in 2007 to \$113.5 million in 2008 and increased to \$137.0 million in 2009, or a 9.0% decrease and a 20.7% increase, respectively. The \$23.5 million increase in total gross profits in 2009, which reflects a \$9.2 million increase in direct sales gross profits and an \$14.3 million increase in distribution sales gross profits, due primarily to increased sales in our higher margin cosmetics products, which accounted for 24.8% of our gross profits in 2009, compared to 16.7% in 2008. Our three best-selling product lines in 2009, electronic learning products, cell phones and cosmetic products, collectively accounted for approximately 69.2% of our gross profit for the same period. The \$11.2 million decrease in total gross profits in 2008 reflects a \$11.7 million decrease in direct sales gross profits, partially offset by a \$0.5 million increase in distribution sales gross profits. Our three best-selling product lines in 2008, our cell phones, electronic learning products and posture correction product lines, collectively accounted for approximately 55.0% of our gross profit for the same period. Our overall gross margin decreased from 50.3% in 2007 to 48.5% in 2008 and to 47.6% in 2009. The gross margin decrease in 2009 was primarily due to our increased sales of lower margin mobile handsets from the consolidation of sales of Yiyang Yukang, as well as margin compression of Ozing and Meijin products due primarily to increased discounts provided to distributors and increased flash memory costs beginning in the third quarter of 2009. The gross margin decrease in 2008 was primarily due to a decline in the gross margin of our cell phone products due to our strategy of lowering the price of handset units to stimulate sales, partially offset by a favorable impact of terminating prior distribution discount incentive programs and higher gross margins of our electronic learning products.

The \$9.2 million, or 11.0% increase, in gross profits from direct sales in 2009 reflects increased sales of our higher margin cosmetics products. The \$11.7 million, or 12.3% decrease in gross profits from direct sales in 2008 reflects a decrease in our sales of our cell phone product lines.

Gross margin on direct sales decreased from 52.6% in 2007 to 50.1% in 2008 and increased to 57.9% in 2009. The increase in gross margin on direct sales in 2009 was primarily due to increased sales of our cosmetics



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products. The decrease in gross margin on direct sales in 2008 was primarily due to a decline in the gross margin of our cell phone products due to our strategy of lowering the price of handset units to stimulate sales.

The \$14.3 million increase in gross profits from distribution sales in 2009 primarily reflects the consolidation of gross profits of Yiyang Yukang. The \$0.5 million increase in gross profits from distribution sales in 2008 primarily reflects an increase in revenues due to the discontinuation of a discount incentive program for distributors.

Gross margin on distribution sales increased slightly from 44.0% in 2007 to 44.4% in 2008 and decreased to 34.7% in 2009, due primarily to the consolidation of Yiyang Yukang in 2009, as well as margin compression of Ozing and Meijin products due primarily to increased discounts provided to distributors and increased flash memory costs beginning in the third quarter of 2009.

### **Operating (Expense) Income**

Our total operating (expense) income increased from \$127.2 million in 2007 to \$143.1 million in 2008 and to \$144.4 million in 2009. Of the total increase in 2009, \$4.7 million was attributable to increase in other selling and marketing expenses; a \$3.4 million reflected an increase in general and administrative expenses; and \$6.6 million increase in impairment charges of goodwill and intangible assets. These increases were offset by a \$12.3 million decrease in advertising expenses and a \$1.0 million increase in other operating income, net. Of the total increase in 2008, \$9.0 million was attributable to an increase in other selling and marketing expenses; \$1.6 million reflected an increase in general and administrative expenses; \$8.7 million was due to impairment charges of goodwill and intangible assets; and \$3.3 million reflected our share-based compensation charges. These increases were partially offset by a \$1.6 million decrease in advertising expenses and \$1.9 million increase in other operating income, net. Total operating expense, as a percentage of total net revenue, increased from 51.3% in 2007 to 61.1% in 2008 and decreased to 50.2% in 2009.

### ***Advertising Expenses***

Our advertising expenses decreased from \$75.0 million in 2007 to \$73.4 million in 2008 and to \$61.0 million in 2009. As a percentage of total net revenues, advertising expenses increased from 30.2% in 2007 to 31.3% in 2008 and decreased to 21.2% in 2009. The overall decrease in advertising expenses in 2009 primarily reflects our strategy to improve media efficiency by reducing the fixed portion of advertising spending. The overall decrease in advertising expenses in 2008 primarily reflects our change in strategy in relation to TV advertising time procurement to achieve better cost control, and the decrease in TV advertising time as a result of the conclusion of the 2008 Beijing Olympics and the major earthquake that struck Wenchuan in the Sichuan province.

Advertising expenses related to purchased TV direct sales advertising time decreased from \$67.3 million in 2007 to \$59.2 million in 2008 and to \$51.3 million in 2009, or 12.0% and 13.3% decrease, respectively. The decrease in purchased TV advertising expenses in 2008 and 2009 reflects our reduced amount of TV advertising time and the increasing percentages of sales generated from and advertising expenditure in our other direct sales platforms, including third-party bank channel, catalogs and Internet sales.

### ***Other Selling and Marketing Expenses***

Our other selling and marketing expenses increased from \$29.3 million in 2007 to \$38.3 million in 2008 and to \$43.0 million in 2009, or 30.7% growth and 12.3% growth, respectively. Our other selling and marketing expenses as a percentage of our total net revenues was 11.8%, 16.4% and 14.9% in 2007, 2008 and 2009, respectively. The increase in other selling and marketing expenses is primarily attributable to the growth of our direct sales platform and reflects increasing expenditures in advertising production, deliveries, and salaries and commissions for our call center personnel. The increase in 2009 primarily relates to increased amortization of

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acquired intangible assets as a result of the acquisition of Yiyang Yukang and increased delivery charges related to our direct sales and distribution sales. Of the total increase in 2008, approximately \$3.4 million related to increased marketing and promotion expenses, \$2.0 million was attributable to increased salaries and benefits primarily due to the growth of third-party bank channel sales and our call center operations, and \$5.2 million was attributable to increased packing fees and delivery and handling fees resulting from the increase in total number of products sold.

### ***General and Administrative Expenses***

Our general and administrative expenses increased from \$26.1 million in 2007 to \$27.7 million in 2008 and to \$31.2 million in 2009, or 6.1% growth and 12.6% growth, respectively. Our general and administrative expenses as a percentage of total net revenues was 10.5%, 11.9% and 10.8% in 2007, 2008 and 2009, respectively. Of the total \$3.5 million increase in 2009, \$2.5 million was attributable to an increase in bad debt, \$2.1 million was attributable to an increase in research and development costs, \$1.3 million was attributable to an increase in employee payroll, partially offset by a \$5.5 million decrease in bad debt provision and a \$1.2 million decrease in share based compensation costs. Of the total \$1.6 million increase in 2008, \$2.1 million was attributable to increased research and consulting fees, \$1.0 million was attributable to an increased bad debt provision, \$0.6 million was attributable to increased depreciation and amortization and \$0.5 million was attributable to increased rental and office fees, partially offset by the \$3.1 million decrease in share-based compensation as compared to 2007. The increase in bad debt provision was primarily related to the shared advertising expenses receivable from one of our joint sales partners.

### ***Impairment of Goodwill and Intangible Assets***

Impairment losses of intangible assets for the full year 2009 totaled \$15.2 million, which consisted of an impairment loss for intangible assets from the acquisition of Yiyang Yukang, which was primarily caused by (i) overall under-performance in the mobile handsets business of Yiyang Yukang and (ii) Yiyang Yukang's change in business strategy to launching its proprietary Uking brand and changes incurred in the acquired distribution network. In addition, as result of the Yiyang Yukang intangible assets impairment charge, we reversed a \$3.3 million deferred tax liability in 2009.

Impairment losses of goodwill and intangible assets in 2008 were \$8.7 million, which consisted of \$1.1 million of impairment loss on intangible assets and \$7.6 million of impairment loss on goodwill. In the third quarter of 2008, pursuant to our accounting policy, we evaluated our goodwill and long-lived assets for impairment. We determine the fair value of goodwill and intangibles using the income approach. The income approach includes the use of a weighted average of multiple discounted cash flow scenarios, which requires the use of unobservable inputs, including assumptions of projected revenues, expenses, capital spending, and other costs, as well as a discount rate calculated based on the risk profile of our industry. Estimates of projected revenues, expenses, capital spending, and other costs are prepared by management. We recorded a \$8.7 million impairment charge on our goodwill and other assets during the third quarter of 2008 to write down these balances to their fair values. Changes in management estimates to the unobservable inputs in our valuation models would change the valuation. The estimated projected revenue is the assumption that most significantly affects the fair value determination.

### ***Other Operating Income, Net***

Other operating income, net was \$3.1 million, \$5.0 million and \$6.0 million in 2007, 2008 and 2009, respectively. A majority of other operating income, net in those periods related to our receipt of subsidies from local government agencies for certain taxes paid, including value-added, business and income taxes. We may not be able to enjoy such government subsidies in the future. See Item 3.D, Key Information Risk Factors The discontinuation of any of the preferential tax treatments and government subsidies available to us in the PRC

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could materially and adversely affect our results of operations and financial condition . Other operating income, net also includes miscellaneous commission income.

**Loss from Operations**

Loss from operations decreased from 2.5 million in 2007 to \$29.6 million in 2008 and to \$7.5 million in 2009. As a percentage of total net revenues, loss from operations increased from 1.0% in 2007 to 12.6% in 2008 and decreased from 12.6% to 2.6% in 2009. In 2009, we recognized impairment losses of intangible assets in an aggregate amount of \$15.2 million compared to impairment losses of goodwill and intangible assets of \$8.7 million and nil in 2008 and 2007, respectively, and we recognized \$1.8 million in share-based compensation charges compared to \$3.3 million in 2008 and \$6.5 million in 2007.

**Other (Expenses) Income**

Other (expenses) income was \$13.7 million, \$(0.7) million and \$1.7 million, in 2007, 2008 and 2009, respectively. In 2007, 2008 and 2009, other expenses income included \$4.1 million, \$2.1 million and \$1.5 million, in interest income, and \$8.9 million, \$(2.2) million and \$0.4 million, in investment gain (loss) respectively.

In 2009, we recorded a \$1.3 million loss in investment gain (loss) due to the change in fair value of the embedded derivative in our investment in an index-linked structured note, compared to a loss of \$3.3 million in 2008. See Item 5.B. Critical Accounting Policies Derivative Instruments for details.

**Income Tax (Expenses) Benefits**

We had a net tax benefit of \$12,949 in 2007, a net tax expense of \$4,968 in 2008 and a net tax benefit of \$2.5 million in 2009. Because of various special tax rates and incentives in China, our taxes have been relatively low. Our effective income tax rate for 2007, 2008 and 2009 was 0%, 0% and 44% respectively.

**Income from Discontinued Operations, Net of Taxes**

In June 2009, in order to focus on our core competency and enhance operating efficiency, we sold 33% of our equity interests in Shanghai Yimeng, our former subsidiary engaged in development and marketing CPS stock tracking software. Shanghai Yimeng was established in December 2005 with 51% of its equity interests held by us and 49% by Shanghai Yimeng Digital Technology Co., Ltd., a third party. We sold the 33% equity interest to a shareholder of Shanghai Yimeng Digital Technology Co., Ltd. for a total cash consideration of \$10.5 million. The resulting gain on disposition of \$16.4 million was included in income from discontinued operations for the year ended December 31, 2009. The income tax expenses on the gain of disposition was \$2.0 million. There were no remaining assets or liabilities associated with discontinued operations in our consolidated balance sheet as of December 31, 2009.

Accordingly, the discontinued operations were retrospectively reflected for all the years presented in our consolidated statements of operations. The following shows summarized operating results reported as discontinued operations for the years ended December 31, 2007, 2008, and 2009:

|   | Years ended December 31, |               |               |
|---|--------------------------|---------------|---------------|
|   | 2007                     | 2008          | 2009          |
| Net revenues  | \$ 14,260,446            | \$ 16,530,024 | \$ 7,447,940  |
| Income from discontinued operations before income taxes | \$ 13,156,605            | \$ 9,036,863  | \$ 841,559    |
| Gain on disposition of discontinued operations          |                          |               | 16,366,355    |
| Income tax (expenses) benefits                          | 1,317,054                | (763,234)     | (1,845,225)   |
| Income from discontinued operations                     | \$ 14,473,659            | \$ 8,273,629  | \$ 15,362,689 |

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Income from discontinued operations in 2009, which represents income generated from Shanghai Yimeng, net of tax, in the six months ended June 30, 2009 before our deconsolidation, was \$15.4 million and excluding gain on deconsolidation, was \$1.0 million, as compared to \$8.3 million in 2008. Income from discontinued operations decreased to \$8.3 million in 2008 as compared to \$14.5 million in 2007, mainly attributable to the underperforming stock market in 2008 due to global financial crisis and the decreased sales of our CPS stock tracking software as a result.

**Net Income Attributable to Non-controlling Interests**

Net income attributable to non-controlling interests consist of the 49% or less outside ownership interests in our majority-owned subsidiaries. In 2007, 2008 and 2009, the non-controlling interests totaled \$7.1 million, \$3.6 million and \$0.2 million, respectively, primarily reflecting net income generated by Shanghai Yimeng, which ceased to be our subsidiary since June 2009.

**Net Income (Loss) Attributable to Acorn International, Inc**

As a result of the foregoing, net income decreased from \$18.7 million in 2007 to a \$25.6 million net loss in 2008 and increased to \$11.9 million in net income in 2009. As a percentage of total net revenues, net income was 7.5%, 10.9% and 4.1% in 2007, 2008 and 2009, respectively.

**B. Liquidity and Capital Resources**

|   | For the years ended December 31, |                        |              |
|---|----------------------------------|------------------------|--------------|
|   | 2007                             | 2008<br>(in thousands) | 2009         |
| Cash and cash equivalents                           | \$ 148,743.2                     | \$ 147,648.8           | \$ 142,952.9 |
| Net cash provided by operating activities           | 20,471.9                         | 20,858.9               | 27,804.6     |
| Net cash used in investing activities               | (29,556.7)                       | (12,567.5)             | (24,297.0)   |
| Net cash provided by (used in) financing activities | 111,894.3                        | (15,915.6)             | (8,227.4)    |
| <i>Operating Activities</i>                         |                                  |                        |              |

As of December 31, 2009, we had \$143.0 million in cash, cash equivalents, restricted cash and short-term investments. Net cash provided by operating activities increased from \$20.5 million in 2007 to \$20.9 million in 2008 and to \$27.8 million in 2009. These amounts were adjusted for non-cash items such as share-based compensation, goodwill and intangible assets impairment losses, gain or loss on change in fair value of derivative assets, depreciation and amortization and changes in various assets and liabilities such as accounts receivables, inventories, prepaid advertising and other expenses and other current assets and accounts payable. The increase in 2009 was primarily attributable to our net income from our operations. The increase in 2008 was primarily attributable to proceeds from sales of trading securities.

Share-based compensation, a non-cash expense, totaled \$6.5 million in 2007, \$3.3 million in 2008 and \$1.8 million in 2009.

Impairment losses of intangible assets for the full year 2009 reflected a \$15.2 million of impairment loss on intangible assets. In the fourth quarter of 2009, some impairment indicators including overall under-performance in the mobile handsets business, and Yiyang Yukang's change in business strategy to launching proprietary Uking brand and changes incurred in the acquired distribution network, were noted and we evaluated our long-lived assets for impairment. As a result of the evaluation, we recorded a \$15.2 million impairment charge on our other intangible assets during the fourth quarter of 2009 to write down these balances to their fair values. Impairment losses of goodwill and intangible assets in 2008 were \$8.7 million, which consisted of \$1.1 million of impairment loss on intangible assets and \$7.6 million of impairment loss on goodwill referred to our net loss

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position and changes in circumstances that indicate the carrying amount of our goodwill and intangible assets may not be recoverable. In addition, we had a loss on change in fair value of derivative assets of \$1.3 million in 2009, compared with a loss of \$3.3 million in 2008.

***Investing Activities***

Investing activities include purchases of property and equipment, purchases of equity investments in connection with establishment of joint ventures, acquisition of equity interest in a subsidiary, purchases of intangible assets and purchase and disposal of investments in structured notes. Net cash used in investing activities was \$29.6 million, \$12.6 million and \$24.3 million, in 2007, 2008 and 2009, respectively. Net cash used in investing activities in 2009 reflected the deconsolidation of Shanghai Yimeng at \$23.6 million in cash, our purchase of property and equipment for \$3.1 million and \$3.9 million investment in affiliates, partially offset by our redemption of one structure note for \$10.0 million. In 2007, we purchased two structured notes for \$10.0 million each, which we mark-to-market. Net cash used in investing activities in 2008 reflects expenditures used in the acquisition of subsidiary for \$7.0 million and in purchase of property and equipment for \$2.9 million. Net cash used in investing activities in 2007 reflects our purchase of office space on Tianlin Road in Shanghai for RMB51.5 million (or approximately \$7.5 million) and purchase of two structured notes for \$20.0 million.

***Financing Activities***

Financing activities include proceeds from issuance of capital and stock redemptions, exercise of stock options and SARs, capital contribution from non-controlling interest, as well as the earn-out payment in respect of 2008 and the first quarter of 2009 we made in connection with our acquisition of Yiyang Yukang. For 2009, we used \$2.3 million to repurchase 639,266 of our outstanding ADSs and paid out \$6.7 million as first earn-out payment in connection with our acquisition of Yiyang Yukang. For 2008, we used \$16.4 million to repurchase 1,949,747 of our outstanding ADSs. For 2007, we used \$6.8 million to repurchase 683,000 of our outstanding ADSs, received a \$9.3 million subscription receivable, and also received \$108.9 million in proceeds from our initial public offering, net of issuance costs of \$4.3 million.

We believe that our current cash and cash equivalents and cash flows from operations will be sufficient to meet our anticipated cash needs for the next 12 months. We may, however, require additional cash resources due to changed business conditions or other future developments, including any investments, joint ventures or acquisitions we may decide to pursue. If these resources are insufficient to satisfy our cash requirements, we may seek to sell additional equity or debt securities or obtain a credit facility. The current global liquidity and credit crisis since the second half of 2008 has been having a significant negative impact on the financing abilities of businesses worldwide, including that of our company. If we are not able to generate sufficient cash flow to meet our obligations, we may need to restructure, sell assets, reduce or delay capital investments, or seek additional equity or debt financing. The sale of additional equity securities could result in additional dilution to our shareholders. The incurrence of indebtedness would result in increased debt service obligations and could result in operating and financing covenants that would restrict our operations. A shortage of such funds could in turn impose limitations on our ability to plan for, or react effectively to, changing market conditions or to expand through organic and acquisitive growth, thereby reducing our competitiveness. We cannot assure you that future financing will be available in amounts or on terms acceptable to us, if at all.

***Capital Expenditures***

Our capital expenditures totaled \$9.2 million, \$2.9 million and \$3.1 million, in 2007, 2008 and 2009, respectively. Our capital expenditures consisted principally of the purchases of property and equipment, investments in buildings related to expansions and upgrades to our call centers and offices and purchases of management information systems. In 2008, our capital expenditures primarily consisted of office decoration of two floors (approximately 3,900 square meters) of a building located on Tianlin Road, Shanghai which we

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purchased as office space pursuant to a purchase agreement executed in September 2007 for RMB51.5 million. During the first quarter of 2009, we obtained a fifty-year land use right of a piece of land in Qingpu district of Shanghai for aggregate consideration of RMB51.2 million (approximately \$7.5 million). We plan to use the land to establish a warehouse and a factory for manufacturing our proprietary branded products. The construction started on November 26, 2009 and has not completed yet. We expect to use proceeds from our initial public offering and cash generated from operating activities to fund these planned capital expenditures.

### **Critical Accounting Policies**

We prepare our financial statements in conformity with U.S. GAAP, which requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities on the date of the financial statements and the reported amounts of net revenues and expenses during the financial reporting period. We continually evaluate these estimates and assumptions based on the most recently available information, our own historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Since the use of estimates is an integral component of the financial reporting process, actual results could differ from those estimates. Some of our accounting policies require higher degrees of judgment than others in their application. We consider the policies discussed below to be critical to an understanding of our financial statements as their application places the most significant demands on our management's judgment.

### ***Revenue Recognition***

We recognize net revenue for sales through our direct sales platforms upon delivery of the products to, and acceptance by, our customers. These revenues are recognized net of sales tax incurred. We rely significantly on EMS and local delivery companies to deliver products sold through our direct sales platforms. It generally takes one to seven days for a product to be delivered by EMS and local delivery companies, with these companies regularly reporting to us product delivery status. For unsuccessful deliveries, EMS and local delivery companies are required to return the undelivered products to us. It generally takes EMS two to three weeks, and local delivery companies seven days, to return the undelivered products to us. Direct sales revenues are adjusted based on actual unsuccessful product deliveries experience.

Our customer loyalty program for direct sales includes coupon discounts and membership points. We net the cost of these promotional activities against revenue at the time revenue is recorded. We use historical trend experience to accrue costs associated with cash coupon discounts and membership points.

Pursuant to joint sales arrangements, we generate direct sales revenues from the sale of a featured product or service through our TV direct sales programs. Our joint sales partner also sells the featured product or service through its own distribution channels. In exchange for the sales support provided by our TV direct sales programs, we also receive additional payments based on sales through our sales partners' own distribution channels. These payments are recorded as a reduction to cost of direct sales revenues via a reduction in the purchase price of the products purchased by us from our sales partners, similar to a vendor rebate. Payments received from our joint sales partners to share a portion of the related TV advertising expense under certain joint sales arrangements are recorded as a reduction to our TV advertising expense.

Under our marketing services arrangements, we provide a TV direct sales marketing plan, the related TV advertising time and call center support in exchange for a fixed fee, which is included in our direct sales net revenues. Marketing services revenues are recognized ratably over the contractual period of the arrangements. The related costs, including TV advertising expenses, are classified as cost of direct sales net revenues.

We recognize net revenues for products sold through our nationwide distribution network when products are delivered to and accepted by our distributors. The distributor agreements do not provide discounts, chargebacks, price protection and stock rotation rights. However, certain distributor agreements provided performance-based

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cash rebates which were net against revenue at the time revenue was recorded. Accordingly, we record the revenues when products are delivered to and accepted by the distributors as there are no future remaining obligations.

In June 2009, we discontinued our stock tracking software business (Shanghai Yimeng) and included its results prior to the disposition and a gain from disposition in income from discontinued operations in our consolidated statements of operations. Prior to the disposal, we generated revenue from annual subscription fees from subscribers for our stock tracking software, which included access to our initial software CD containing data analysis tools and services. Upon receipt by us or one of our distributors of the upfront cash payments from the subscriber, we provided an access code to the subscriber and activated the subscriber's account when the subscriber first logs on. This commenced the one-year subscription period and the full payment was deferred and recognized ratably over the one-year subscription period. After the initial subscription period, users could subscribe for additional one-year renewal periods. The pricing of the initial subscription fee and renewal fee was the same regardless of whether it was sold by us or through our distribution network. Because the data services were essential to the functionality of the software analysis tools, we recognized revenue ratably over the one-year subscription period. For 2009, we recognized \$7.4 million net subscription revenue in income from discontinued operations. There was no deferred revenue balance on our consolidated balance sheet as of December 31, 2009 due to deconsolidation of Shanghai Yimeng.

***Impairment of Long-lived Assets***

We evaluate our long-lived assets and finite-lived intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. When these events occur, we measure impairment by comparing the carrying amount of the assets to future undiscounted net cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected undiscounted cash flow is less than the carrying amount of the assets, we recognize an impairment loss based on the fair value of the assets. The determination of fair value of the intangible and long lived assets acquired involves certain judgments and estimates. These judgments can include, but are not limited to, the cash flows that an asset is expected to generate in the future. This analysis also relies on a number of factors, including changes in strategic direction, business plans, regulatory developments, economic and budget projections, technological improvements, and operating results. Any write-downs would be treated as permanent reductions in the carrying amounts of the assets and an operating loss would be recognized.

In 2009, as a result of reduced expectations of future cash flows from Yiyang Yukang distribution network, we determined that the carrying amount of the distribution network was not recoverable and recorded an impairment charge of \$15.2 million for the year ended December 31, 2009. We applied the income approach multi-period excess earning method to estimate the fair value of the distribution network. Calculating the fair value of the distribution network requires the input of significant estimates and assumptions, some of which are unobservable. The significant estimates and assumptions include business assumption, weighted average cost of capital, terminal growth rate, discount rate, return on contributory asset, attrition rate and tax amortization benefit.

***Fair Value of Derivative Instruments***

Our investment policy and strategy is aimed primarily at preserving capital and meeting our liquidity requirements. We currently hold investments in securities that meet the definition of a derivative instrument, including investments in share options of a Japanese public company and an index-linked structured note that contains an embedded derivative. Derivative instruments are recognized as assets or liabilities and measured at fair value initially and at the end of each reporting period. Changes in fair value of the derivatives are recorded in our consolidated statements of operations. Our derivative instruments do not qualify for hedge accounting.

In 2007, we purchased two index-linked structured notes from two banks for a principal of \$10 million each. We redeemed one structured note in 2009. The remaining note matures in August 2019 and has a variable interest

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rate that is computed based on the number of days in which both the 3-month USD-LIBOR-BBA and the Nikkei 225 indices are above or within the respective stated ranges. The structured note contains an available-for-sale debt host security and an embedded derivative instrument that are reported within the same line on our consolidated balance sheets at the estimated fair value of the note. The embedded derivative is bifurcated from the host contract for separate accounting. The net unrealized losses of the available-for-sale debt host security are recognized as accumulated other comprehensive income in equity unless there is a decline in fair value below cost that we consider as other-than-temporary, in which case the amount of the decline would be recognized as a loss and reflected in our statements of operations. The changes in fair value of the embedded derivative is recognized in earnings in the period such changes occur.

As of December 31, 2009, the estimated fair value of the structured note was \$6.6 million. We determined the fair value of the structured note using a discounted cash flow projection on principal and interest based on assumptions supported by quoted market prices or rates, adjusted for the specific features of this instrument. The fair value of the structured note including the embedded derivative, was measured using estimates and assumptions including comparable bonds issued by the same issuer, risk-free interest rates, global banking industry bond yield curve, data on the indices, volatilities and dividend yield. Changes in management estimates to the unobservable inputs in our valuation models would change the valuation of the investment. The embedded derivative was valued at \$0.7 million as of December 31, 2009. In 2009, we recorded a loss of \$1.3 million due to changes in fair value of the embedded derivative, which was included in other income (expense) in the consolidated statements of operations.

***Impairment of Available-for Sale Securities***

Available-for-sale securities are presented at fair value on our balance sheet, with gains and losses recorded to accumulated other comprehensive income (loss) until realized. We determine the realized gains and losses on sales of available-for-sale securities using the specific identification cost method. Available-for-sale securities are subject to a periodic impairment review to determine if the investment is other than-temporarily impaired, in which case we would write down the investment to its fair value and establish that amount as its new cost basis. The new cost basis will not be changed for subsequent recoveries in fair value. We review several factors to determine whether a loss is other-than-temporary. These factors include, but are not limited to, the: (1) nature of the investment; (2) cause and duration of the impairment; (3) extent to which fair value is less than cost; (4) financial conditions and near term prospects of the issuers; and (5) our ability to hold the security for a period of time sufficient to allow for any anticipated recovery of its amortized cost or fair value.

On April 1, 2009, we adopted an amendment to ASC 320-10, Investments in Debt and Equity Securities Overall (previously FASB Staff Position FAS 115-2 and 124-2), regarding the other-than-temporary impairment model for debt securities. The amended guidance requires that we recognize other-than-temporary impairment in earnings if we have the intent to sell the debt security or if it is more-likely-than-not that we will be required to sell the debt security before recovery of its amortized cost basis. Additionally, we are required to evaluate expected cash flows to be received and determine if credit-related losses on debt securities exist, which are considered to be other-than-temporary impairment recognized in earnings. We determined that credit-related losses with respect to the structured note debt host were insignificant and did not recognize credit-related losses in earnings or make any adjustments to the cumulative net unrealized loss of \$80,058 included in accumulated other comprehensive income in the consolidated balance sheet.

We measure the fair value of our available-for-sale securities using quoted prices for securities with similar characteristics and other observable inputs (such as interest rates that are observable at commonly quoted intervals) and we consider the effect of our counterparties credit standings in these fair value measurements. Determining the observable market values most relevant to the measurement of the fair value of marketable securities and the further counterparty credit risk adjustment to those values, if needed, requires significant judgment. Changes in market conditions can also significantly affect the fair value measurements from period to period and can cause realized values to vary significantly from previous estimates.



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

The costs of share-based payments are recognized in our consolidated financial statements based on their grant-date fair value over the requisite service period. Except for the options granted in May 2009 for which the binomial option pricing model is used, we determine fair value of our share options as of the grant date using the Black-Scholes-Merton option pricing model. We make a number of assumptions in determining the grant-date fair value including the maturity of the options, the expected volatility of our future ordinary share price, the risk free interest rate and the expected dividend rate. Determining the value of our share-based compensation expense in future periods also requires the input of highly subjective assumptions around estimated forfeitures. We estimate our forfeitures based on past employee retention rates, our expectations of future retention rates, and we will prospectively revise our forfeiture rates based on actual history.

### ***Allowance for Doubtful Accounts***

We maintain allowances for doubtful accounts primarily based on the age of receivables and factors surrounding the credit risk of specific customers. If there is a deterioration of a major customer's creditworthiness or actual defaults are higher than our historical experience, we may need to maintain additional allowances.

### ***Income taxes***

Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Current income taxes are provided for in accordance with the laws of the relevant taxing authorities. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on the characteristics of the underlying assets and liabilities, or the expected timing of their use when they do not relate to a specific asset or liability.

We periodically evaluate the likelihood of the realization of deferred tax assets, and reduce the carrying amount of these deferred tax assets by a valuation allowance to the extent we believe a portion will not be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience by taxing jurisdiction, expectations of future taxable income, the carry-forward periods available to us for tax reporting purposes, and other relevant factors.

We recognize the impact of an uncertain income tax position at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant tax authority. We classify interests and penalties related to income tax matters in income tax expense.

### ***Fair Value Measurements***

On January 1, 2008, we adopted ASC 820-10, Fair Value Measurements and Disclosures Overall (previously SFAS No. 157, Fair Value Measurements) for our assets and liabilities that are measured at fair value on a recurring basis. On January 1, 2009, we further adopted ASC 820-10 for our nonfinancial assets and nonfinancial liabilities that are measured at fair value on a nonrecurring basis. We make estimates regarding valuation of assets and liabilities measured at fair value in preparing the consolidated financial statements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date.

In determining fair value, we use various valuation approaches. A hierarchy for inputs is used in measuring fair value that maximizes the use of observable prices and inputs and minimizes the use of unobservable prices and inputs by requiring that the observable inputs be used when available. The hierarchy is broken down into three levels, wherein Level 1 uses observable prices in active markets for identical assets and liabilities, and

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Level 3 consists of valuation techniques that incorporate significant unobservable inputs and therefore require the greatest use of judgment. In periods of market dislocation, such as those experienced in fiscal 2008, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from Level 1 to Level 2 or Level 2 to Level 3. In addition, a continued downturn in market conditions could lead to further declines in the valuation of many instruments. For further information on the fair value definition, Level 1, Level 2 and Level 3 hierarchy, and related valuation techniques, see Notes 2(d) and 7 to the consolidated financial statements.

Upon deconsolidation of Shanghai Yimeng in June 2009, we retained 18% equity interests in Shanghai Yimeng with a negative carrying amount of \$0.6 million and accounted for the retained investment using the cost method of accounting. The 18% equity interest investment was recorded at the fair value of \$4.2 million on the date of deconsolidation. We applied the income approach in measuring the equity value of Shanghai Yimeng using significant estimates and assumptions, some of which are unobservable. The significant estimates and assumptions include business assumption, weighted average cost of capital and terminal growth rate.

### **C. Research and Development**

We spent \$0.05 million, \$0.8 million and \$2.2 million, in research and development in 2007, 2008 and 2009, respectively. The increase in research and development expenses in 2009 was primarily due to our increased investment in research and development of Ozing and Meijin product lines.

### **D. Trend Information**

Other than as disclosed elsewhere in this annual report, we are not aware of any trends, uncertainties, demands, commitments or events for the period from January 1, 2007 to December 31, 2009 that are reasonably likely to have a material adverse effect on our revenues, income, profitability, liquidity or capital resources, or that caused the disclosed financial information to be not necessarily indicative of future operating results or financial conditions.

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

The affiliated companies in which we have non-significant influence are accounted for using cost method of accounting. Dividends received that are distributed from the net accumulated earnings of the investee will be recognized in our consolidated statements of operations. Dividends received in excess of earnings will be recorded as reductions of cost of the investment. A series of operating losses of the investee or other factors may indicate that a decrease in value of the investment has occurred which is other-than-temporary and should accordingly be recognized.

The affiliated companies in which we have significant influence are accounted for using equity method of accounting. The share of earnings or losses of the investee will be recognized in our consolidated statements of operations and adjusts the carrying amount of the investment. Dividends received will reduce the carrying amount of the investment. A series of operating losses of the investee or other factors may indicate that a decrease in value of the investment has occurred which is other-than-temporary and should accordingly be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method accounting.

In July 2008, we invested in 30% of the equity interests in Kela (Hong Kong) Jewelry Investment Limited ( Kela ) for cash consideration of \$1.2 million. In October 2009, we increased our investment in Kela from 30% to 35%. As we have the ability to exercise significant influence over Kela, we account for this investment using the equity method of accounting. Our equity in losses of Kela in 2008 and 2009 were \$40,939 and \$12,351, respectively, and were recognized in the other expenses in our consolidated statements of operations.

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In June 2009, we invested in 26% of the equity interests in KYOBI Cosmetics (Hong Kong) Co., Limited ( KYOBI ) for cash consideration of \$1.2 million. As we have the ability to exercise significant influence over KYOBI, we account for this investment using the equity method of accounting. Our equity in losses of KYOBI in 2009 was \$403,986 and was recognized in the other expenses in the consolidated statement of operations.

In June 2009, we sold 33% equity interest in Shanghai Yimeng, a company which previously was a 51% equity-owned consolidated subsidiary of ours. After the sale, we retained 18% equity interests in Shanghai Yimeng and do not have the ability to exercise significant influence over Shanghai Yimeng's operational and financial policies and activities. We account for the retained investment using the cost method of accounting. The retained 18% investment was recorded at the fair value of \$4.2 million on the date we deconsolidated Shanghai Yimeng.

As part of our ongoing business, we generally do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which are often established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Save as disclosed above, all of our subsidiaries and joint ventures are at least 51% majority owned by us. These subsidiaries and our affiliated companies are fully included in our financial statements.

**F. Tabular Disclosure of Contractual Obligations**

A summary of our contractual obligations at December 31, 2009 is as follows:

| Contractual obligations   | Total                | Payments due by period |                     |                   |                      |
|---------------------------|----------------------|------------------------|---------------------|-------------------|----------------------|
|                           |                      | Less than<br>1 year    | 1-3<br>years        | 3-5<br>years      | More than<br>5 years |
| Operating leases*         | \$ 3,446,204         | \$ 1,969,552           | \$ 1,316,313        | \$ 131,708        | \$ 28,631            |
| Advertising commitments** | 52,859,954           | 52,859,954             |                     |                   |                      |
| <b>Total</b>              | <b>\$ 56,306,158</b> | <b>\$ 54,829,506</b>   | <b>\$ 1,316,313</b> | <b>\$ 131,708</b> | <b>\$ 28,631</b>     |

\* Operating leases are for office premises and buildings.

\*\* Contractual advertising commitments, of which \$9.8 million were prepaid as of December 31, 2009.

**G. Recently Issued Accounting Pronouncements**

In June 2009, the FASB issued amendments to ASC 860-10, Transfers and Servicing Overall (previously SFAS No. 166, Accounting for Transfers of Financial Assets ). The amendments limit the circumstances in which a financial asset, or a portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented, and/or when the transferor has continuing involvement with the transferred financial asset. The new guidance in ASC 860-10 is effective for financial asset transfers occurring after the beginning of an entity's first fiscal year that begins after November 15, 2009, or January 1, 2010 for companies reporting earnings on a calendar-year basis. The adoption of this new guidance is not expected to have a material impact on our financial position, results of operations or cash flows.

In June 2009, the FASB issued amendments to ASC 810-10, Consolidation Overall (previously SFAS 167, Amendments to FASB Interpretation No. 46(R) ). This accounting standard eliminates exceptions of the previously issued pronouncement to consolidating qualifying special purpose entities, contains new criteria for determining the primary beneficiary, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. This accounting standard also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity's

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status as a variable interest entity, a company's power over a variable interest entity, or a company's obligation to absorb losses or its right to receive benefits of an entity must be disregarded in applying the provisions of the previously issued pronouncement. This accounting standard will be effective for the Group's fiscal year beginning January 1, 2010. The adoption of this new guidance is not expected to have a material impact on our financial position, results of operations or cash flows.

In August 2009, the FASB issued Accounting Standards Update (ASU) 2009-05, Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value. ASU 2009-05 amends ASC 820-10, Fair Value Measurements and Disclosures - Overall, for the fair value measurement of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure the fair value using (1) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets or (2) another valuation technique that is consistent with the principles of Topic 820. It also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability and that both a quoted price in an active market for the identical liability at measurement date and that the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. The provisions of ASU 2009-05 are effective for the first reporting period (including interim periods) beginning after January 1, 2010. Early application is permitted. The adoption of this new guidance is not expected to have a material impact on our financial position, results of operations or cash flows.

In October 2009, the FASB issued ASU 2009-13, Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements (previously EITF 08-1, Revenue Arrangements with Multiple Deliverables). This ASU addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Specifically, this guidance amends the criteria for separating consideration in multiple-deliverable arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on: (a) vendor-specific objective evidence; (b) third-party evidence; or (c) estimates. This guidance also eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. In addition, this guidance significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements. This accounting standard will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. We are currently evaluating the impact of adoption on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends ASC 820 (formerly SFAS 157) to add new requirements for disclosures about (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in Level 3 fair value measurements, and (4) the transfers between Levels 1, 2, and 3. The guidance in ASU 2010-06 is effective for the first reporting period beginning after December 15, 2009, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. In the period of initial adoption, entities will not be required to provide the amended disclosures for any previous periods presented for comparative purposes. However, those disclosures are required for periods ending after initial adoption. Early adoption is permitted. We are currently evaluating the impact of adoption on its consolidated financial statements.

**Table of Contents****ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****A. Directors and Senior Management**

The following table sets forth certain information relating to our directors and executive officers as of the date of this annual report. The business address of each of our directors and executive officers is 18/F, 20th Building, 487 Tianlin Road, Shanghai 200233, People's Republic of China.

| Name               | Age | Position/Title  |
|--------------------|-----|---|
| James Yujun Hu     | 46  | Chairman of the board of directors, chief executive officer |
| Don Dongjie Yang   | 42  | Director, president   |
| Guoying Du         | 36  | Director, vice president                                    |
| Robert W. Roche    | 47  | Director  |
| Andrew Y. Yan      | 52  | Director  |
| Denny Lee          | 42  | Independent Director  |
| Ying Wu            | 50  | Independent Director  |
| Joe Zhixiong Zhou  | 48  | Independent Director  |
| Hongbing Lv        | 45  | Independent Director  |
| David Chenghong He | 45  | Vice president, chief financial officer                     |
| Ella Man Lin       | 38  | Vice president  |
| Kevin Guohui Hu    | 46  | Vice president  |

*James Yujun Hu* is chairman of the board of directors and chief executive officer of our company. Mr. Hu has been our chief executive officer since he joined us in 1999. Prior to joining us, Mr. Hu worked at HACI Group Co., Ltd. from 1998 to 1999 as general manager. From 1996 to 1998, Mr. Hu served as the executive vice president at TVS, one of China's first TV home shopping companies. During his three years of employment with TVS, Mr. Hu established China's first nationwide TV home shopping network. Mr. Hu also worked at Guangzhou Broadcasting Equipment Company as chief economist from 1987 to 1996. Mr. Hu received a bachelor's degree in Microwave Engineering and a master's degree in Business Administration from Xidian University.

*Don Dongjie Yang* is a co-founder, director and the president of our company. Mr. Yang was our chief executive officer and president before James Yujun Hu joined us and is currently responsible for our call center operations and development of new business opportunities. Prior to co-founding our company in 1998, Mr. Yang was a partner of J&J Partners from 1996 to 1997. He also acted as general manager of Bei Shang Printing Co., Ltd. from 1993 to 1995. Mr. Yang studied Law at Peking University from 1986 to 1989.

*Guoying Du* is a director and vice president of our company. He is currently responsible for our nationwide distribution business. Prior to his appointment as vice president in 2005, Mr. Du was the general manager of Shanghai HJX, one of our subsidiaries, starting in 2004. Mr. Du served as general manager of Beijing BABAKA Technology Development Co., Ltd. from 1997 to 2004. During the period from 1995 to 1997, Mr. Du worked with Huasheng Industrial Trading Co., Ltd. as a manager. Mr. Du graduated from Henan Normal University in 1994 majoring in Chinese Literature.

*Robert W. Roche* is a co-founder and director of our company. He is also the co-founder and chairman of Oak Lawn Marketing, Inc., a Japan-based company that engages in the TV home shopping business. Mr. Roche is a founding member of the American Business Community of Nagoya. He is also the first governor from Chubu of the American Chamber of Commerce in Japan. Mr. Roche currently also serves on the board of Redhorse Automotive and is the chairman of the American Chamber of Commerce in Shanghai. Mr. Roche received his bachelor's degree in Economics and Japanese Studies from Illinois State University in 1985 and a J.D. degree from the University of Denver in 1988.

*Andrew Y Yan* is a director of our company. He is the managing partner of SAIF Partners III and SB Asia Investment Fund II L.P., and president & executive managing director of Softbank Asia Infrastructure Fund.

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Before joining Softbank Asia Infrastructure Fund in 2001, Mr. Yan was a managing director and the head of the Hong Kong office of Emerging Markets Partnership from 1994 to 2001. From 1993 to 1994, he was the director responsible for strategic planning and business development for the Asia Pacific region at Sprint International Corporation. Mr. Yan also worked as a research fellow at the Hudson Institute in Washington, D.C., the World Bank and the State Commission for Economic Restructuring of the State Council of the PRC. Mr. Yan was voted by the China Venture Capital Association as The Venture Investor of the Year in both 2004 and 2007. He was also selected as one of the Fifty Finest Private Equity Investors in the World by the Private Equity International in 2007; No 1 Venture Capitalist of the Year by Forbes (China) in 2008 and 2009. He was the Venture Capital Professional of the Year by Asia Venture Capital Journal in 2009. Mr. Yan is the Independent Non-executive Director of China Resources Land Ltd. and Fosun International Ltd; Non-executive Director of Digital China Holdings Ltd. and MOBI Development Co., Ltd; and Director of Giant Interactive Group Inc., ATA Inc. and Eternal Asia Supply Chain Co. Ltd. (all 7 companies are listed in the Hong Kong Stock Exchange, NYSE, NASDAQ or Shenzhen Stock Exchange). He also holds directorship in several SAIF portfolio companies. Mr. Yan received a master of arts degree from Princeton University as well as a bachelor's degree in Engineering from the Nanjing Aeronautic Institute in the PRC.

*Denny Lee* is an independent director of our company. Mr. Lee was the chief financial officer of NetEase.com Inc., a Nasdaq-listed company and one of the China's leading Internet and online game services providers from 2001 to 2007. Prior to joining NetEase, Mr. Lee worked in the Hong Kong office of KPMG for more than ten years where he specialized in auditing international clients. Mr. Lee currently serves on the board of directors of NetEase, and also serves as an independent director and chairman of the audit committees of three NYSE listed companies, New Oriental Education & Technology Group Inc. and Gushan Environmental Energy Limited and Concord Medical Services Holdings Limited. Mr. Lee graduated from Hong Kong Polytechnic University and majored in accounting. Mr. Lee is a member of the Chartered Association of Certified Accountants and the Hong Kong Institution of Certified Public Accountants.

*Ying Wu* is an independent director of our company. Mr. Wu is a venture partner of CTC Capital since January 2010. Mr. Wu served as the general partner of CTC Capital from October 2007 to December 2009. Prior to joining CTC Capital, Mr. Wu served as UTStarcom, Inc.'s executive vice president and board vice chairman from October 1995 to June 2007. Mr. Wu also served as the president and chief executive officer of one of UTStarcom's subsidiaries from October 1995 to June 2007. Mr. Wu was a co-founder of, and from February 1991 to September 1995 served as senior vice president of, StarCom Network Systems, Inc., a company that marketed and distributed third party telecommunications equipment. In September 1995, StarCom Network Systems merged with Unitech Telecom to form UTStarcom. From 1988 to 1991, Mr. Wu served as a member of the technical staff of Bellcore Laboratories. From 1987 to 1988, Mr. Wu served as a consultant at AT&T Bell Laboratories. Mr. Wu also is an independent director of Huayi Brothers Media Corporation, a China listed company, an independent director of Focus Media Holding Ltd., a NASDAQ listed company, and an independent director of Joyoung Co, Ltd. He holds a B.S. in Electrical Engineering from Beijing Industrial University and an M.S. in Electrical Engineering from the New Jersey Institute of Technology.

*Joe Zhixiong Zhou* is an independent director of our company. He is a founder and managing partner of *Keytone* Ventures and an affiliate partner of Kleiner Perkins Caufield & Byers (KPCB) China Fund. From March 2007 to March 2008, he was a managing partner of KPCB China Fund. Prior to that time, he was a partner with SAIF Partners, managing SB Asia Infrastructure Fund and SB Asia Investment Fund II L.P. from 2001 to 2006. Mr. Zhou worked for Softbank China Venture Capital as head of its Beijing office. From 1995 to 1999, Mr. Zhou was a vice president in UTStarcom (China) Co, Ltd., a Softbank investment in China. Prior to 1995, Mr. Zhou worked for Lepton Inc as a project manager and for AI&I Bell Laboratories as a technical consultant. Mr. Zhou received a bachelor's degree in Semiconductors from Beijing Polytechnic University in 1982, and a master's degree in Electrical Engineering from the New Jersey Institute of Technology in 1990.

*Hongbing Lv* is an independent director of our company. Mr. Lv has been the chief executive partner of Grandall Legal Group since 2002. Mr. Lv served as the president of the Shanghai Bar Association from 2005 to

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2008, and has been a vice president of the All China Lawyers Association since 2008. Mr. Lv has been a member of the expert committee for companies listed on Shanghai Stock Exchange since 2003, and was a member of the expert committee for companies listed on Shenzhen Stock Exchange from 2006 to 2008. From 2003 to 2004, Mr. Lv served as a full-time member of the sixth Issuing and Approving Committee of the China Securities Regulatory Commission. Mr. Lv also has been an arbitrator of the Shanghai Arbitration Commission, China International Economic and Trade Arbitration Commission and Shanghai Finance Arbitration Institute since 1999, 2001 and 2007, respectively. Mr. Lv is professor at East China University of Political Science and Law, Shanghai Institute of Foreign Trade and Shanghai University of Political Science and Law. Mr. Lv is an independent director of Shanghai Aerospace Automobile Electromechanical Co., Ltd., Shanghai Metersbonwe Fashion and Accessories Co., Ltd., Shanghai Dazhong Public Utilities (Group) Co., Ltd., Shanghai Jiaoda Onlly Co., Ltd., Shanghai Pudong Road & Bridge Construction Company Limited, which are all Chinese A share listed companies, and Shimao Property Holdings Limited, which is a HK listed company. He is an outside director of Shanghai Electric Group Company Limited, Shanghai Pharmaceutical (Group) Co., Ltd. and Shanghai Bailian Group Co., Ltd. Mr. Lv holds a master's degree and a bachelor's degree in law from East China University of Political Science and Law.

*David Chenghong He* is a vice president of our company and is currently acting as our chief financial officer since the resignation of Gordon Xiaogang Wang. Mr. He has been our vice president in charge of financial management since he joined us in 2000, and is currently responsible for the management of our financial systems, logistics and payment systems. Prior to joining us, Mr. He served as the vice president in charge of finance at TVS, one of the China's first TV home shopping companies. From 1987 to 1997, Mr. He worked at China Huajing Electronic Co., Ltd. as manager of the finance department. Mr. He received a bachelor's degree in Information Engineering and a master's degree in Business Administration from Xidian University. He is also a registered public accountant in Canada.

*Ella Man Lin* is a vice president of our company. Ms. Lin joined us in 2000 and has been responsible for our product development, supplier management and human resources management since that time. Prior to joining us, she served as the manager of the human resources department at TVS, one of China's first TV home shopping companies. From 1994 to 1996, Ms. Lin headed Guangzhou Broadcasting Equipment Company TV sales in Sichuan province. Ms. Lin received a bachelor's degree in Applied Electronics from Chengdu University of Electronic Science & Technology in 1994, and an EMBA from Hong Kong University of Science and Technology in 2006.

*Kevin Guohui Hu* is a vice president of our company. Mr. Hu was the general manager of our media department before his promotion to vice president in 2005. He is currently responsible for our media purchasing, planning and management. Prior to joining us in 2000, Mr. Hu served as the general manager in charge of media and assistant president at TVS, one of China's first TV home shopping companies. Mr. Hu's prior working experience includes employment with Unrise Department Co., Ltd. from 1995 to 1996, Hengyang Steel Tube Company from 1989 to 1995, and Oxygen Company of Panzhihua Steel Group from 1983 to 1989. Mr. Hu received a bachelor's degree in Chemistry from Central South University in 1983.

## **B. Compensation**

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

In 2009, the aggregate cash compensation earned by our executive officers, including all of our directors, was approximately \$1.5 million. For information regarding options granted to officers and directors, see [Equity Incentive Plans](#). We do not pay or set aside any amounts for pensions, retirement or other benefits for our officers and directors.

### **Equity Incentive Plans**

The board of directors of China DRTV adopted a 2005 Equity Incentive Plan, or the 2005 Plan, on March 18, 2005. On June 30, 2005, the board of China DRTV approved a 2005 Equity Incentive Plan B, or the

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2005 Plan B, in connection with China DRTV's acquisition of the 49% non-controlling interest of Shanghai HJX not already owned by China DRTV at that time. On March 31, 2006, Acorn International assumed all of the options that had been granted under the 2005 Plan and the 2005 Plan B in connection with its acquisition of all of the outstanding shares of China DRTV in exchange for the issuance of shares by Acorn International to the shareholders of China DRTV. The board of directors of China DRTV terminated the 2005 Plan and the 2005 Plan B after the assumption by Acorn International of all of the options that had been granted under the 2005 Plan and the 2005 Plan B. Our 2006 Equity Incentive Plan, or the 2006 Plan, was adopted by the board of directors of Acorn International on May 1, 2006.

All of our incentive plans are intended to promote our success and to increase shareholder value by providing an additional means to attract, motivate, retain and reward selected directors, officers, employees and other eligible persons.

Each of our incentive plans permits us to issue options to purchase our ordinary shares and to issue stock appreciation rights, or SARs, which entitle the SAR holder to acquire the benefit of any appreciation in the value of the underlying ordinary shares. Options and SARs granted under our incentive plans generally do not vest unless the grantee remains employed by us or in service with us on the given vesting date. However, in circumstances where there is a death or disability of the grantee, or a change in the control of our company, the vesting will be accelerated to permit immediate exercise of all options and SARs granted to a grantee. In addition, the vesting of options and SARs held by a director who is appointed by the holders of our preferred shares who terminates his service will be accelerated to permit immediate exercise of all options and SARs granted to such director upon termination of that director's service with us.

Generally, to the extent that an outstanding option or SAR initially granted under the 2005 Plan, the 2005 Plan B or the 2006 Plan has not vested by the date when the grantee's employment or service with us terminates, the option or SAR will terminate and become unexercisable, except as described above.

Initially, the number of ordinary shares reserved under the 2005 Plan was 7,250,000. Upon attainment of certain financial benchmarks meant to measure business performance, which were set forth in our share subscription agreement with SB Asia Investment Fund II L.P. and other parties thereto, we approved an amendment to the 2005 Plan on November 4, 2005 to increase the number of ordinary shares reserved under the 2005 Plan by 1,350,000. As a result, an aggregate of 8,600,000 ordinary shares were reserved under the 2005 Plan. Under the 2005 Plan, we granted:

options to purchase 6,663,964 ordinary shares to certain of our directors, officers and employees on March 18, 2005. Each of these options has an exercise price of \$1.58 per share and vest as to 25% of the options on the grant date and, except as described below, the remaining 75% of these options vest in 36 equal monthly installments thereafter.

options to purchase 371,945 ordinary shares to one of our officers and one of our employees on September 1, 2005. Each of these options has an exercise price of \$1.66 per share and vest as to 25% of the options on the grant date and the remaining 75% of these options vest in 36 equal monthly installments thereafter.

options to purchase 1,350,000 ordinary shares to our directors, officers and employees on November 4, 2005. At the time of the grant, each of these options had an exercise price of \$5.00 per share and was fully vested.

An aggregate of 815,366 ordinary shares were reserved under the 2005 Plan B. On August 20, 2005, we granted options to purchase a total of 667,117 ordinary shares under the 2005 Plan B to certain officers and employees. Each of these options has an exercise price of \$1.66 per share and vest as to 25% of these options became vested on the grant date and the remaining 75% of these options vest in 36 equal monthly installments thereafter.



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An aggregate of 24,133,000 ordinary shares were reserved under the 2006 Plan, of which 9,053,026 are subject to issuance upon exercise of options originally granted under the 2005 Plan and the 2005 Plan B, which were assumed by Acorn International.

On May 1, 2006 we granted under the 2006 Plan:

SARs with respect to 3,260,000 of our ordinary shares to certain directors, officers, employees and consultants, or A-type SARs. At the time of grant, each of these A-type SARs had an exercise price of \$7.00 per ordinary share and vest as to 25% of these grants of A-type SARs on the grant date and the remaining 75% of the A-type SARs vest in 36 equal monthly installments from May 2006 thereafter.

SARs with respect to 1,580,000 ordinary shares to certain directors, officers, employees and consultants, or B-type SARs, subject to certain performance vesting requirements. Each of these B-type SARs had an exercise price of \$7.00 per ordinary share. In addition to the requirement that the grantee remains under our employment or in service with us on the given vesting date, the vesting of each B-type SARs was subject to our satisfaction of a certain performance target. Because we did not meet the agreed performance target for the vesting of B-type SARs, the B-type SARs that we issued were forfeited.

SARs with respect to 1,580,000 ordinary shares to certain directors, officers, employees and consultants, or C-type SARs, subject to vesting requirements. Each of these C-type SARs had an exercise price of \$7.00 per ordinary share. In addition to the requirement that the grantee remains under our employment or in service with us on the given vesting date, the vesting of each C-type SARs was subject to our satisfaction of a certain performance target. Because we did not meet the agreed performance target for the vesting of C-type SARs, the C-type SARs that we issued were forfeited.

On July 6, 2006, we granted SARs with respect to 370,000 of our ordinary shares under the 2006 Plan to certain directors, officers, employees and consultants. At the time of grant, each of these SARs had an exercise price of \$7.00 per ordinary share. SARs with respect to 257,500 shares were fully vested at the time of grant with the remaining SARs to be vested in 36 equal monthly installments beginning in July 2006.

On September 27, 2006, we modified the exercise price of options granted on November 4, 2005 from \$5.00 per ordinary share to \$3.00 per ordinary share, and A-type SARs granted on May 1, 2006 and SARs granted on July 6, 2006 from \$7.00 per ordinary share to \$3.50 per ordinary share. On the same date, we granted additional A-type SARs with respect to 2,076,100 of our ordinary shares under the 2006 Plan to certain directors, officers, employees and consultants. Each of these A-type SARs has an exercise price of \$3.50 per ordinary share and vested as to 25% of these A-type SARs on the grant date and the remaining 75% of the A-type SARs vest in 36 equal monthly installments beginning in September 2006 thereafter.

On April 3, 2007, we granted Plan A-type SARs with respect to 1,030,000 of our ordinary shares under the 2006 Plan and D-type SARs with respect to 750,000 of our ordinary shares to certain directors, officers and employees. The vesting of our D-type SARs was subject to our satisfaction of a certain performance target. We subsequently met the target and all of the D-type SARs have vested. Of the 1,030,000 A-type SARs, 25% of these grants were fully vested at the time of grant and the remaining 75% to be vested in 36 equal monthly installments beginning in April 2007. Each of these A-type SARs and D-type SARs has an exercise price of \$4.50 per share.

On April 16, 2007, we granted A-type SARs with respect to 85,000 of our ordinary shares under the 2006 Plan to certain employees. Each of these SARs has an exercise price of \$4.50 per share and vest as to 25% of these A-type SARs on the grant date and the remaining 75% of these A-type SARs vest in 36 equal monthly installments beginning in April 2007.

On May 1, 2009, we granted stock options with respect to 900,000 of our ordinary shares under the 2006 Plan to the management of Yiyang Yukang. Each of these options has an exercise price of \$2 per share and vest

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as to approximately 33% of these options on the grant date and the remaining approximately 67% of these options vest in two years depending on the performance of Yiyang Yukang in 2009 and 2010. As Yiyang Yukang's performance in 2009 fell short, approximately 33% of these options have been canceled.

Each of the above SARs will be settled upon exercise solely in ordinary shares. Upon exercise, a holder of an SAR will receive ordinary shares having a market price, on the date of exercise, equal to the excess of the fair market value of our ordinary shares on the date of exercise over the exercise price of the applicable SAR.

Our board of directors may amend, alter, suspend, or terminate the 2006 Plan at any time, provided, however, that our board of directors must first seek the approval of the participants in the 2006 Plan if such amendment, alteration, suspension or termination would adversely affect the rights of participants under any option granted prior to that date. The 2006 Plan will terminate on April 30, 2016 without further action by our board of directors.

The table below sets forth, as of the date of this annual report, the option and SAR grants made to our directors and executive officers, under the 2006 Plan (including prior year grants of options covered under this plan) that are currently outstanding:

| Name                              | Ordinary Shares<br>Underlying Outstanding<br>Option/SARs | Exercise<br>Price<br>(\$/Share) | Grant Date         | Expiration Date    |
|-----------------------------------|--|---------------------------------|--------------------|--------------------|
| James Yujun Hu                    | 850,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                                   | 140,000  | 3.00                            | November 4, 2005   | November 4, 2015   |
|                                   | 240,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                                   | 125,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                                   | 210,000 <sup>(4)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |
| Don Dongjie Yang                  | 1,320,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                                   | 180,000  | 3.00                            | November 4, 2005   | November 4, 2015   |
|                                   | 280,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                                   | 146,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                                   | 285,000 <sup>(5)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |
| Guoying Du                        | 150,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                                   | 323,117  | 1.66                            | August 20, 2005    | August 19, 2015    |
|                                   | 90,000   | 3.00                            | November 4, 2005   | November 4, 2015   |
|                                   | 200,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                                   | 444,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                                   | 210,000 <sup>(6)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |
| Robert W. Roche                   | 50,000   | 3.50                            | July 6, 2006       | July 6, 2012       |
|                                   | 18,000   | 3.50                            | September 27, 2006 | September 27, 2012 |
| Andrew Y. Yan <sup>(1)</sup>      | 329,482  | 1.58                            | March 18, 2005     | March 18, 2015     |
| Denny Lee                         | 50,000   | 3.50                            | July 6, 2006       | July 6, 2012       |
|                                   | 18,000   | 3.50                            | September 27, 2006 | September 27, 2012 |
| Ying Wu                           | 35,000   | 3.50                            | July 6, 2006       | July 6, 2012       |
|                                   | 13,000   | 3.50                            | September 27, 2006 | September 27, 2012 |
| Joe Zhixiong Zhou <sup>(2)</sup>  | 329,482  | 1.58                            | March 18, 2005     | March 18, 2015     |
| David Chenghong He <sup>(3)</sup> | 790,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                                   | 110,000  | 3.00                            | November 4, 2005   | November 4, 2015   |
|                                   | 200,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                                   | 104,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                                   | 210,000 <sup>(6)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |



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| Name            | Ordinary Shares<br>Underlying Outstanding<br>Option/SARs | Exercise<br>Price<br>(\$/Share) | Grant Date         | Expiration Date    |
|-----------------|--|---------------------------------|--------------------|--------------------|
| Ella Man Lin    | 790,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                 | 120,000  | 3.00                            | November 4, 2005   | November 4, 2015   |
|                 | 200,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                 | 104,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                 | 210,000 <sup>(6)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |
| Kevin Guohui Hu | 100,000  | 1.58                            | March 18, 2005     | March 18, 2015     |
|                 | 50,000   | 1.66                            | August 20, 2005    | August 19, 2015    |
|                 | 50,000   | 3.00                            | November 4, 2005   | November 4, 2015   |
|                 | 200,000  | 3.50                            | May 1, 2006        | May 1, 2012        |
|                 | 104,000  | 3.50                            | September 27, 2006 | September 27, 2012 |
|                 | 210,000 <sup>(6)</sup>                                   | 4.50                            | April 3, 2007      | April 3, 2013      |

- (1) Andrew Y. Yan resigned from our board of directors on June 15, 2006. All of Mr. Yan's options vested immediately upon his resignation. He was re-appointed as our director on December 4, 2006.
- (2) All of Mr. Zhou's options became fully vested as approved by our board of directors on August 15, 2006.
- (3) David Chenghong He resigned from our board of directors on July 5, 2006.
- (4) Includes 245,000 ordinary shares underlying A-type SARs, of which 5,000 ordinary shares underlying A-type SARs were cancelled on April 16, 2007, and 180,000 ordinary shares underlying D-type SARs. 210,000 ordinary shares underlying A-type SARs have been transferred to his spouse.
- (5) Includes 165,000 ordinary shares underlying A-type SARs and 120,000 ordinary shares underlying D-type SARs.
- (6) Includes 120,000 ordinary shares underlying A-type SARs and 90,000 ordinary shares underlying D-type SARs.

For risks related to registrations required of our PRC option holders, see Item 3.D, Key Information Risk Factors Risks Relating to China. A failure by PRC individuals who hold shares or share options granted pursuant to an employee share option or share incentive plan to make any required applications and filings could expose our PRC individual option holders to liability under PRC law.

**Employment Agreements**

We have entered into employment agreements with each of our executive officers. Pursuant to these employment agreements, we may terminate their employment for cause at any time, without notice or remuneration, for certain acts, including, but not limited to, acts of personal dishonesty in connection with an executive officer's employment by us which are intended to result in the executive officer's substantial personal enrichment or reasonably likely to materially harm us, any conviction of a crime which our board of directors reasonably believes has had or will have a material detrimental effect on our reputation or business, willful misconduct that is materially injurious to us, or continued violations of an executive officer's obligations to us after we have delivered a written demand for compliance. Pursuant to these employment agreements, an executive officer may terminate his or her employment upon a material reduction of, or removal from, his or her duties, position or responsibilities without the executive officer's express written consent, a material reduction of the executive officer's compensation or benefits, a material reduction of the facilities and perquisites available to the executive officer without express prior written consent, or the relocation of the executive officer to a facility or location more than 50 miles from his or her current location without his or her express prior written consent, but in each case only if we fail to cure these issues within a reasonable time. Upon the occurrence of any events giving rise to a termination by an executive officer of his or her employment, the departing executive officer will be entitled to receive a severance payment equal to one year of his or her annualized base salary. An executive officer may also terminate his or her employment for other reasons or no reason at all after providing at least 30 days prior written notice in which case the departing executive officer will not be entitled to receive any

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severance payments. We may terminate the employment of any of our executive officers without cause by giving him or her at least 30 days prior written notice. In the case of termination without cause, the executive officer will be entitled to a severance payment in an amount equal to one year of his or her annualized base salary.

Each executive officer has agreed to hold, both during and after his or her employment agreement expires or is terminated, in strict confidence and not to use, except for our benefit (including our affiliated entities and our subsidiaries), any proprietary or confidential information, including technical data and trade secrets of our company or the confidential information of any third party, including our affiliated entities and our subsidiaries, that we receive. Each executive officer has also agreed to disclose to us and hold in trust for us all of the inventions, ideas, designs and trade secrets conceived of by him or her during the period that he or she is employed by us, and to assign all of his or her interests in such intellectual property to us. In addition, each executive officer has agreed that, while employed by us and for a period of two years after termination of his or her employment, he or she will not:

serve, invest or assist in any business that competes with any significant aspect of our business or our affiliated entities' business; or

solicit, induce, recruit or encourage any person to terminate his or her employment or consulting relationship with us or our affiliated entities.

## **C. Board Practices**

### **Duties of Directors**

Under Cayman Islands law, our directors have a duty of loyalty to act honestly and in good faith with a view to our best interests. Our directors also have a duty to exercise the care, diligence and skills that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to us, our directors must ensure compliance with our amended and restated memorandum and articles of association. We have the right to seek damages if a duty owed to us by our directors is breached.

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

convening shareholders' meetings and reporting its work to shareholders at such meetings;

implementing shareholders' resolutions;

determining our business plans and investment proposals;

formulating our profit distribution plans and loss recovery plans;

determining our debt and finance policies and proposals for the increase or decrease in our registered capital and the issuance of debentures;

formulating our major acquisition and disposition plans, and plans for merger, division or dissolution;

proposing amendments to our amended and restated memorandum and articles of association; and

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exercising any other powers conferred by the shareholders meetings or under our amended and restated memorandum and articles of association.

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

We currently have nine directors on our board of directors. We have a staggered board of directors, which means our directors, excluding our chief executive officer, are divided into three classes, with a portion of our board of directors standing for election every year. At the 2010 annual general meeting, the terms of office of Guoying Du, Denny Lee and Don Dongjie Yang will expire. At the 2011 annual general meeting, the terms of office of Joe Zhixiong Zhou and Andrew Y. Yan will expire. At the 2012 annual general meeting, the terms of office of Robert W. Roche, Hongbing Lv and Ying Wu will expire. Our chief executive officer will have the right to remain a director so long as he continues to serve as our chief executive officer.

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

### **Board Committees**

Our board of directors has established an audit committee, a compensation committee and a corporate governance and nominating committee.

#### *Audit Committee*

Our audit committee consists of Denny Lee, Joe Zhixiong Zhou and Hongbing Lv. Denny Lee is the chairman of our audit committee and is a director with accounting and financial management expertise as required by the corporate governance rules of the New York Stock Exchange, or the NYSE Rules. Each member of our audit committee satisfies the independence requirements of the NYSE Rules and meets the criteria for independence set forth in Section 10A(m)(3) of the U.S. Securities Exchange Act of 1934, or the Exchange Act.

The audit committee oversees our accounting and financial reporting processes and the audits of the financial statements of our company. Our audit committee is responsible for, among other things:

selecting the independent auditor and pre-approving auditing and non-auditing services permitted to be performed by the independent auditor;

at least annually, obtaining and reviewing the independent auditor's report describing its internal quality-control procedures, any material issues raised by the most recent internal quality control review, or peer review, of the independent auditors and all relationships between the independent auditors and our company;

setting clear hiring policies for employees or former employees of the independent auditors;

reviewing with the independent auditors any audit problems or difficulties the independent auditor may have encountered in the course of its work, and management's response;

reviewing and approving all proposed related party transactions, as defined in Item 404 of Regulation S-K under the U.S. securities laws;

reviewing and discussing the annual audited financial statements with management and the independent auditors;

reviewing and discussing with management and the independent auditors major issues regarding accounting principles and financial statement presentations;

reviewing reports prepared by management or the independent auditors relating to significant financial reporting issues and judgments made in connection with the preparation of our financial statements;

reviewing with management and the independent auditors the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on our financial statements;

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discussing policies with respect to risk assessment and risk management;

reviewing major issues as to the adequacy of our internal controls and any special audit steps adopted in light of material control deficiencies;

obtaining and timely reviewing reports from the independent auditor regarding all critical accounting policies and practices to be used by our company, all alternative treatments of financial information within U.S. GAAP that have been discussed with management, and all other material written communications between the independent auditor and management;

establishing procedures for the receipt, retention and treatment of complaints received from our employees regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by our employees of concerns regarding questionable accounting or auditing matters;



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reviewing and reassessing the adequacy of our audit committee charter at least annually and recommending any changes to our board of directors;

meeting separately and periodically with management, the internal auditors and the independent auditors;

reporting regularly to the full board of directors; and

exercising such other powers and performing such other duties as may from time to time be delegated to the audit committee by our board of directors.

Denny Lee simultaneously serves on the audit committees of more than three public companies. Our board believes such simultaneous service would not impair the ability of Denny Lee to effectively serve on our audit committee.

***Compensation Committee***

Our current compensation committee consists of Joe Zhixiong Zhou, Ying Wu and Andrew Y. Yan. Ying Wu is the chairman of our compensation committee. Each member of our compensation committee (except for Andrew Y. Yan) satisfies the independence requirements of the NYSE Rules.

Our compensation committee is responsible for, among other things:

reviewing and approving corporate goals and objectives relevant to the compensation of our chief executive officer, evaluating the performance of our chief executive officer in light of those goals and objectives, reporting the results of such evaluation to our board of directors, and determining (either as a committee or with our board of directors) our chief executive officer's compensation level based on this evaluation;

at least annually, reviewing and approving all compensation arrangements with our chief executive officer and our other senior executive officers;

reviewing and making recommendations to our board of directors with respect to our compensation for executive officers other than our chief executive officer, incentive-compensation plans and equity-based plans, and overseeing the administration of these plans; and

periodically reviewing the compensation of our directors and making recommendations to our board of directors with respect thereto.

***Corporate Governance and Nominating Committee***

Our corporate governance and nominating committee consists of Ying Wu, Robert W. Roche and James Yujun Hu. Ying Wu is the chairman of this committee. Two of the three members of our corporate governance and nominating committee, Robert W. Roche and James Yujun Hu, do not satisfy the independence requirements of the NYSE Rules.

Our corporate governance and nominating committee is responsible for, among other things:

identifying and recommending to our board of directors candidates for election or re-election to the board of directors, or for appointment to fill any vacancy;

identifying and recommending directors to fill vacancies on any committee of the board of directors; and

overseeing our system of corporate governance, including developing and recommending to our board of directors a set of corporate governance guidelines, reviewing and reassessing the adequacy of the guidelines at least annually, and recommending to our board of directors for approval any such changes to the guidelines as the committee believes are appropriate.

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### **Corporate Governance**

Our board of directors has adopted a code of ethics, which is applicable to our senior executive and financial officers. In addition, our board of directors has adopted a code of conduct, which is applicable to all of our directors, officers and employees. Our code of ethics and our code of conduct are publicly available on our website at <http://www.ir-site.com/acorn/index.asp>.

In addition, our board of directors has adopted a set of corporate governance guidelines. The guidelines reflect certain guiding principles with respect to our board of directors' structure, procedures and committees. The guidelines are not intended to change or interpret any law or our amended and restated memorandum and articles of association. As a foreign private issuer with shares listed on the New York Stock Exchange (the "NYSE"), we are subject to corporate governance requirements imposed by the NYSE. Please refer to Item 16.G., "Corporate Governance" for further details.

### **Remuneration and Borrowing**

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

### **Qualification**

There is no shareholding qualification for directors.

### **Summary of Corporate Governance Differences**

As a foreign private issuer with shares listed on the NYSE, we are required by Section 303A.11 of the NYSE's Listed Company Manual to disclose any significant ways in which our corporate governance practices differ from those followed by U.S. domestic companies under NYSE listing standards. A summary of the differences between our current corporate governance practices and the NYSE corporate governance requirements applicable to domestic U.S. companies can be found on our website at <http://www.ir-site.com/acorn/index.asp>.

### **D. Employees**

As of December 31, 2007, 2008 and 2009, we had 1,778, 1,937 and 2,087 employees, respectively. The most labor intensive area of operation is our call center operations, which employed approximately 50.7% of our total employees in 2009. The salary for call center employees includes a base salary plus a variable amount based on an incentive bonus structure. The following table sets forth the number of our employees categorized by our areas of operation and as a percentage of our total workforce as of December 31, 2009:

|  | Number of<br>employees | Percentage<br>of total |
|--|------------------------|------------------------|
| <b>Operations</b>                              |                        |                        |
| Call center                                    | 1,032                  | 49.5%                  |
| Inbound call center                            | 513                    | 24.6%                  |
| Outbound call center                           | 519                    | 24.9%                  |
| Distribution management                        | 222                    | 10.6%                  |
| Manufacturing                                  | 96                     | 4.6%                   |
| Management and administration                  | 178                    | 8.5%                   |
| Product development                            | 95                     | 4.6%                   |
| Customer service                               | 94                     | 4.5%                   |
| Order fulfillment                              | 124                    | 6.0%                   |
| Sales and marketing (including media planning) | 30                     | 1.4%                   |
| Yiyang Yukang                                  | 216                    | 10.3%                  |
| Total:   | 2,087                  | 100.0%                 |



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From time to time, we also employ part-time employees and independent contractors to support the monitoring and analysis of our TV direct sales program broadcasting timing and quality.

Although we undertake a rigorous selection process for our call center employees, the turnover rate for our two call centers was approximately 33% in 2007, 59% in 2008 and 68% in 2009 reflecting both voluntary terminations and termination of employees failing to meet our performance standards.

**E. Share Ownership**

The following table sets forth information with respect to the beneficial ownership of our ordinary shares as of March 31, 2010:

each of our directors and executive officers;

each person known to us to own beneficially more than 5% of our ordinary shares; and

Beneficial ownership includes voting or investment power with respect to the securities. Except as indicated below, and subject to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all ordinary shares shown as beneficially owned by them. The percentage of beneficial ownership is based on 88,856,915 ordinary shares outstanding as of March 31, 2010, taking into consideration options and SARs exercisable by such person within 60 days of March 31, 2010.

Upon the exercise of any vested SAR, the holder is entitled to receive ordinary shares having a value equal to the difference between the market price of our ordinary shares on the exercise date and the exercise price of the SAR. The number of shares acquired upon exercise of vested SARs is based on the SARs exercise price and the trading price per ADS as of March 31, 2010.

| Name   | Shares beneficially owned as of March 31, 2010 |         |
|--|--|---------|
|  | Number   | Percent |
| <b>Directors and Executive Officers</b>        |  |         |
| Robert W. Roche <sup>(1)</sup>                 | 15,805,585                                     | 17.79%  |
| Don Dongjie Yang <sup>(2)</sup>                | 8,093,656                                      | 8.96%   |
| James Yujun Hu <sup>(3)</sup>                  | 4,357,657                                      | 4.85%   |
| David Chenghong He <sup>(4)</sup>              | 2,286,108                                      | 2.55%   |
| Ella Man Lin <sup>(5)</sup>                    | 2,296,111                                      | 2.56%   |
| Guoying Du <sup>(6)</sup>                      | 1,360,147                                      | 1.52%   |
| Kevin Guohui Hu <sup>(7)</sup>                 | 1,030,379                                      | 1.16%   |
| Andrew Y. Yan                                  | *  | *       |
| Denny Lee                                      | *  | *       |
| Ying Wu  | *  | *       |
| Joe Zhixiong Zhou                              | *  | *       |
| <b>Principal Shareholders</b>                  |  |         |
| SB Asia Investment Fund II L.P. <sup>(8)</sup> | 21,141,312                                     | 23.79%  |
| Acorn Composite Corporation <sup>(9)</sup>     | 13,054,539                                     | 14.69%  |
| D.Y. Capital, Inc. <sup>(10)</sup>             | 6,593,656                                      | 7.42%   |

\* Upon exercise of options and SARs currently exercisable or vested within 60 days after March 31, 2010, would beneficially own less than 1% of our ordinary shares.

(1) Includes (i) 1,846,291 ordinary shares held by The Grand Crossing Trust, which is an irrevocable trust for the benefit of Mr. Roche's children, (ii) 12,053,094 ordinary shares and 333,815 ADSs held by Acorn Composite Corporation, which is a company owned by Mr. Roche, (iii) 5,400 ADSs held by Robert Roche Trust, which is a trust for the benefit of Mr. Robert W. Roche and (iv) 296,185 ADSs held by Moore Bay Trust, which is a charitable trust with Robert Roche's children being the beneficiaries of the remainder. The voting agreement among James Yujun Hu, The Grand Crossing Trust and Acorn Composite Corporation dated July 6, 2006 has been revoked by

Mr. Roche in November 2008.

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- (2) Includes 6,593,656 ordinary shares held by D.Y. Capital, Inc, a company owned by Mr. Yang, as well as 1,500,000 ordinary shares issuable upon exercise of options held by Mr. Yang.
- (3) Includes 3,367,657 ordinary shares held by WiseSight Investment, Ltd., a company incorporated in the British Virgin Islands wholly owned by Mr. Hu, as well as 990,000 ordinary shares issuable upon exercise of options held by Mr. Hu. In addition, Mr. Hu transferred 3,367,656 ordinary shares and half of the options and SARs held by him to his spouse on March 23, 2009. Mr. Hu disclaims beneficial ownership of the ordinary shares and the options and SARs transferred to his spouse.
- (4) Includes 1,386,108 ordinary shares held by Broad Sky Holdings, Ltd., a company owned by Mr. He, as well as 900,000 ordinary shares issuable upon exercise of options held by Mr. He.
- (5) Includes 1,386,111 ordinary shares held by Lynman Investment, Ltd., a company owned by Ms. Lin, as well as 910,000 ordinary shares issuable upon exercise of options held by Ms. Lin.
- (6) Includes 797,030 ordinary shares held by HJX Holdings Ltd., a company owned by Mr. Du, as well as 563,117 ordinary shares issuable upon exercise of options held by Mr. Du.
- (7) Includes 830,379 ordinary shares held by National Glory Holdings, Ltd., a company owned by Mr. Hu, as well as 200,000 ordinary shares issuable upon exercise of options held by Mr. Hu.
- (8) Includes 20,591,970 ordinary shares and 183,114 ADSs. Mr. Yan is the sole shareholder of SAIF II GP Capital Ltd., the sole general partner of SAIF Partners II L.P., which is the sole general partner of SAIF II GP L.P., which is in turn the sole general partner of SB Asia Investment Fund II L.P., our shareholder. The voting agreement among James Yujun Hu and SB Asia Investment Fund II L.P. dated March 30, 2007 has been revoked by SB Asia Investment Fund II L.P. in November 2008.
- (9) Includes 12,053,094 ordinary shares and 333,815 ADSs. Acorn Composite Corporation is a U.S. company owned by Mr. Roche. Its address is 350 S. Central St, Suite 500, Reno, NV 89501, USA.
- (10) D.Y. Capital, Inc., a company incorporated in the British Virgin Islands, is wholly owned by Mr. Yang.

None of our existing shareholders has voting rights that differ from the voting rights of other shareholders. According to our register of members for our ordinary shares, there are 155 record holders in the United States. Citibank, N.A. has advised us that, as of February 26, 2010, 12,133,310 ADSs, representing 36,399,930 underlying ordinary shares, were held of record by Cede & Co. and two other registered shareholders domiciled in the United States. We have no further information as to ADSs held, or beneficially owned, by U.S. persons. To our knowledge, we are not owned or controlled, directly or indirectly, by another corporation, by any foreign government or by any other natural or legal persons, severally or jointly. We are not aware of any arrangement which may at a later date result in a change of control of our company.

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

**A. Major Shareholders**

Please refer to Item 6.E, Directors, Senior Management and Employees Share Ownership .

**B. Related Party Transactions**

**Contractual Agreements with Affiliated Entities and their Shareholders**

Historically, PRC law has restricted, and continues to restrict to a certain extent, foreign equity ownership of companies that are engaged in direct sales businesses. To comply with these restrictions, we operate our direct sales business in China through a series of contractual arrangements with Shanghai Network and Beijing Acorn and their shareholders, Don Dongjie Yang, our president and one of our directors, and David Chenghong He, one of our executive officers. See Item 4.C, Information on the Company Organizational Structure .

**Private Placement**

Pursuant to the terms of the Investors Rights Agreement, dated March 31, 2006, among our Company, all of our then existing shareholders and SB Asia Investment Fund II L.P., or SAIF, holders representing at least 25% of our registrable securities outstanding, and certain holders of ordinary shares under certain circumstances

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are entitled to demand registration on a form other than Form F-3, of registrable securities then outstanding, or registration on a Form F-3, Form S-3, or any successor or comparable forms for a registration in a jurisdiction other than the United States, under certain circumstances. Registrable securities are ordinary shares not previously sold to the public and issued or issuable to holders of our preferred shares, including (i) ordinary shares issued upon conversion of our preferred shares, and (ii) ordinary shares issued as share dividends and similar distributions to holders of our preferred shares. These holders are also entitled to piggyback registration rights, whereby they may require us to register all or any part of the registrable securities they hold at the time we register any of our ordinary shares.

We are generally required to bear all of the registration expenses incurred in connection with one demand registration on a form other than Form F-3 or Form S-3, and unlimited Form F-3, Form S-3 and piggyback registrations.

The foregoing demand, Form F-3, Form S-3 and piggyback registration rights will terminate on the fourth anniversary of our initial public offering.

## **Relationships with our Distributors**

### ***Certain of our Employees Hold Equity Interests in our Distributors***

We have approximately 80 distributors constituting our nationwide distribution network that distribute our products and services across China. Some of our distributors are owned in part, by certain of our employees or their family members. In 2007, 2008 and 2009, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 28.4%, 17.2% and 12.7% of our distribution gross revenues, or 7.6%, 4.9% and 5.6% of our total gross revenues, respectively. Certain of these distributors have been among our top distributors in 2007, 2008 and 2009. In addition, one distributor in 2007 was wholly owned by a relative of our chief executive officer. However, this distributor accounted for less than 2% of our distribution gross revenues in each of those years and the relative of our chief executive officer has ceased to hold an equity interest in the distributor since mid-2007. We entered into the distribution agreements with these related distributors on an arm's-length basis and the terms in the distribution agreements with these distributors are the same as those with our independent distributors. However, the economic interests held by our employees in our distributors may make it difficult for us to effectively evaluate the performance of such distributors or fine, suspend or terminate a non-performing, under-performing or non-compliant distributor without harming our relationship with those employees.

## **Loan to Executive Officer**

In connection with our acquisition of the 49% non-controlling interest in Shanghai HJX, the minority equity holders of Shanghai HJX negotiated a separate right to acquire from us 8,042,838 ordinary shares. PRC foreign exchange rules adopted in early 2005 require that PRC residents obtain approval from the relevant State Administration of Foreign Exchange, or SAFE, prior to the receipt of their offshore interests. A lack of implementing rules at the time of the transaction, however, prevented the minority equity holders from obtaining the approval from the relevant SAFE authority. Consequently, we agreed to issue the shares to an intermediary company, Yue-Teng, Inc. or Yue-Teng, in exchange for a promissory note in the amount of \$9.3 million. At the time of that agreement, Yue-Teng and we also entered into an agreement with Guoying Du, one of the largest holders of the minority equity interest and our executive officer responsible for managing our nationwide distribution network, pursuant to which Guoying Du, on behalf of the minority equity holders, could acquire the shares from Yue-Teng in exchange for a promissory note in the amount of \$9.3 million once permitted by PRC law. Following changes in PRC Law permitting the minority equity holders to acquire the shares, Guoying Du and the former Shanghai HJX equity holders formed a BVI Company, HJX Holdings Ltd., or HJX, and another individual, who is a family member of Guoying Du, formed another BVI Company, DHM Capital Ltd., or DHM. On March 28, 2006, DHM and HJX acquired all of the 8,042,838 ordinary shares from Yue-Teng. As a result, HJX, in which Guoying Du then owned a 41.8% equity interest, became our shareholder and, as



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consideration for the shares, HJX issued a promissory note in our favor for \$9.3 million. We accepted this promissory note and cancelled the promissory note Yue-Teng had previously executed in our favor for the same amount. On March 23, 2007, in connection with HJX's exchange of 2,738,678 of our ordinary shares in return for the 58.2% interest in HJX and the subsequent transfer of 96,733 of our ordinary shares by HJX, the \$9.3 million promissory note was split among HJX and four other shareholders. HJX and the four other shareholders participated in our initial public offering as selling shareholders and repaid the promissory note in full to us with the sale proceeds of their shares as part of the offering.

### **Joint Venture**

In August 2004, we entered into an agreement with one of our pre-restructuring subsidiaries, Shanghai Acorn Bio-products Co., Ltd., or Shanghai Bio, to form a PRC joint venture, Shanghai An-Nai-Chi. We held a 51% interest in Shanghai An-Nai-Chi and Shanghai Bio held a 49% interest in the joint venture. According to an agreement dated February 28, 2006, Shanghai Bio transferred its 49% interest in the joint venture to Shanghai Jia Guan Hang Automobile Maintenance Products Co., Ltd., or Jia Guan Hang, a company jointly owned by three of our employees, including Zheng Wang, the deputy general manager of Shanghai An-Nai-Chi, for approximately \$1.0 million. Shanghai An-Nai-Chi is the entity responsible for the production, marketing and sale of our engine lubricant product line. We have no side agreement with Jia Guan Hang. We believe that although Jia Guan Hang is a company owned by our employees, it is an independent minority shareholder in the joint venture. On October 10, 2009, China DRTV, Inc., or China DRTV, and Jia Guan Hang entered into an agreement with Shanghai Jingzhi Investment Co. Ltd., or Jingzhi Investment, pursuant to which the registered capital of An-Nai-Chi was increased from \$1.9 million to \$2.92 million, and the contribution of newly-increased capital was made by Jingzhi Investment. Jingzhi Investment obtains 35% of the legal ownership of Shanghai An-Nai-Chi. Accordingly, China DRTV's ownership of Shanghai An-Nai-Chi was diluted from 51% to 33.15%. Shanghai An-Nai-Chi ceased to be a subsidiary of our company.

### **Employment Agreements**

See Item 6.B, Directors, Senior Management and Employee Compensation Employment Agreements .

### **Share Options**

See Item 6.B, Directors, Senior Management and Employee Compensation Equity Incentive Plans .

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

Not applicable.

## **ITEM 8. FINANCIAL INFORMATION**

### **A. Consolidated statements and other financial information.**

We have appended consolidated financial statements filed as part of this annual report. See Item 18, Financial Statements .

### **Legal Proceedings**

We may from time to time become a party to various legal or administrative proceedings arising in the ordinary course of our business. For example, in December 2008, we filed a suit against Amoi Electronics Co., Ltd., or Amoi, in Shanghai Pudong New District People's Court for breach of contract by Amoi. Our suit claimed unpaid TV advertisement fees in the amount of approximately RMB7.0 million (approximately \$1.0 million). The court ruled in favor of us and awarded us RMB7.0 million. In addition, in January 2009, we filed a separate

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suit against Amoi in Xiamen Haicang People’s Court for breach of contract by Amoi. Our suit claimed unpaid TV advertisement fees in the amount of approximately RMB1.5 million (approximately \$0.2 million), for which Amoi was responsible under the contract. The court ruled in favor of us and awarded us RMB1.5 million. On Sep 15, 2009, Xiamen intermediate people’s court decided to accept the application for reorganization of Amoi. On Nov 23, 2009, Xiamen intermediate people’s court approved the reorganization plan of Amoi. According to the reorganization plan, approximately 20% of the litigation awards can be realized. In February 2010, we received such awards both in the form of cash and shares. In addition, Amoi may relist its shares on Shanghai Stock Exchange soon.

In March 2009, we received a complaint from Advertising Broadcasting Center of Liaoning TV Station, or Liaoning TV, which filed a suit against Shanghai Acorn Advertising Broadcasting Co., Ltd., or Shanghai Advertising, claiming that Shanghai Advertising breached its advertisement broadcasting contract with Liaoning TV by not fully performing its payment obligation under the contract and asserted damages of approximately RMB19 million (approximately \$2.8 million). Liaoning TV further applied for provisional seizure of Shanghai Advertising’s bank account in the same amount of its claim. In June 2009, the people’s court ruled in favor of Liaoning TV and awarded Liaoning TV an aggregate payment of RMB10.9 million (approximately \$1.6 million). In July 2009, we appealed to the people’s court at higher level, which affirmed the judgment in September 2009. We have applied for retrial of this case.

We have in the past been, currently are, and in the future may again be, the subject of claims for infringement, invalidity, or indemnification relating to other parties’ proprietary rights. For example, in August 2008, Beijing Ren’ai filed a suit in the People’s Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai Digital Technology Co., Ltd., or Beijing Sancai, and Beijing Zhidahengtong Technology Development Co., Ltd., or Beijing Zhidahengtong ((2008) HaiMinChuZi No. 22768), alleging that the English programs we provide to the users of our electronic learning products infringe upon the copyright of Beijing Ren’ai. Beijing Ren’ai claimed damages of RMB2,000,000 (approximately \$293,000). The court ruled in favor of Ren’ai in the suits and awarded Ren’ai total compensation of RMB500,000 (approximately \$73,000). The defendants, including us, appealed to the Beijing First Intermediate People’s Court in May 2009, which affirmed the ruling of the People’s Court of Beijing Haidian District in December 2009.

In August 2009, Beijing Ren’ai filed a suit in the People’s Court of Beijing Haidian District against Shanghai HJX, Beijing Sancai Digital Technology Co., Ltd., or Beijing Sancai, and Beijing Zhidahengtong Technology Development Co., Ltd., or Beijing Zhidahengtong ((2009) HaiMinChuZi No. 21798), alleging that the English programs we provide to the users of our electronic learning products infringe upon the copyright of Beijing Ren’ai. Beijing Ren’ai claimed damages of RMB 2,000,000 (approximately \$293,000). The court ruled in favor of Ren’ai in the suits and awarded Ren’ai total compensation of RMB 500,000 (approximately \$73,000). The defendants, including us, have appealed the court’s decisions and the appeals are currently pending.

We believe that the above legal proceedings will not have a material adverse effect on our financial conditions. See Item 3.D, Key Information Risk Factors We have in the past been, currently are, and in the future may again be, subject to intellectual property rights infringement claims and other litigations by third parties, which could be time-consuming and costly to defend or litigate, divert our attention and resources, or require us to enter into licensing agreements. These licenses may not be available on commercially reasonable terms, or at all.

**Dividend Policy**

We have no present plan to pay any dividends on our ordinary shares. We currently intend to retain most, if not all, of our available funds and any future earnings to operate and expand our business. On January 1, 2005, we declared and paid dividends of \$1.1 million to our shareholders. In 2006, 2007 and 2008, we did not declare any dividends. On December 18, 2009, we declared special dividends to our shareholders in the amount of \$29.3 million, which was paid on January 20, 2010.

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Our board of directors has complete discretion on whether to pay dividends, subject to the approval of our shareholders. Even if our board of directors decides to pay dividends, the form, frequency and amount will depend upon our future operations and earnings, capital requirements and surplus, general financial condition, contractual restrictions and other factors that the board of directors may deem relevant. If we pay any dividends, we will pay our ADS holders to the same extent as holders of our ordinary shares, subject to the terms of the deposit agreement, including the fees and expenses payable thereunder. Cash dividends on our ordinary shares, if any, will be paid in U.S. dollars.

Current regulations in China permit our PRC subsidiaries to pay dividends to us only out of their respective accumulated distributable profits, if any, determined in accordance with their articles of association and PRC accounting standards and regulations. The ability of these subsidiaries to make dividends and other payments to us may be restricted by factors that include changes in applicable foreign exchange laws and other laws and regulations. In particular, under Chinese law, these operating subsidiaries may only pay dividends after 10% of their net profit has been set aside as reserve funds, unless such reserves have reached at least 50% of their respective registered capital. Such reserve may not be distributed as cash dividends. In addition, if any of our 17 PRC operating subsidiaries incur debt on their own behalf in the future, the instruments governing the debt may restrict their ability to pay dividends or make other payments to us.

**B. Significant Changes**

Except as disclosed elsewhere in this annual report, we have not experienced any significant changes since the date of our audited consolidated financial statements included in this annual report.

**Table of Contents****ITEM 9. THE OFFER AND LISTING****A. Offering and listing details.****Price Range of Our ADSs**

Our ADSs are listed for trading on the New York Stock Exchange under the symbol `ATV`, and have been listed since May 3, 2007. The following table sets forth the high and low daily closing trading prices of our ADSs on the New York Stock Exchange for the periods indicated:

|                                | Price per ADS (US\$) |      |
|--------------------------------|----------------------|------|
|                                | High                 | Low  |
| <b>Annual:</b>                 |                      |      |
| 2007                           | 30.80                | 8.90 |
| 2008                           | 9.47                 | 3.90 |
| 2009                           | 5.98                 | 2.97 |
| <b>Quarterly:</b>              |                      |      |
| First Quarter, 2008            | 10.05                | 6.90 |
| Second Quarter, 2008           | 8.16                 | 6.86 |
| Third Quarter, 2008            | 7.35                 | 5.26 |
| Fourth Quarter, 2008           | 5.74                 | 1.29 |
| First Quarter, 2009            | 4.49                 | 2.71 |
| Second Quarter, 2009           | 4.77                 | 3.08 |
| Third Quarter, 2009            | 4.79                 | 3.46 |
| Fourth Quarter, 2009           | 6.63                 | 4.58 |
| First Quarter, 2010            | 7.13                 | 4.88 |
| <b>Monthly</b>                 |                      |      |
| November 2009                  | 5.89                 | 5.09 |
| December 2009                  | 5.79                 | 4.58 |
| January 2010                   | 5.94                 | 4.88 |
| February 2010                  | 7.13                 | 5.74 |
| March 2010                     | 6.59                 | 4.99 |
| April 2010                     | 5.03                 | 4.35 |
| May 2010 (through May 5, 2010) | 4.33                 | 4.16 |

**B. Plan of Distribution**

Not applicable.

**C. Markets**

See Item 9.A above.

**D. Selling Shareholders**

Not applicable.

**E. Dilution**

Not applicable.

**F. Expenses of the Issue**

Not applicable.

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**ITEM 10. ADDITIONAL INFORMATION**

**A. Share Capital**

Not applicable.

**B. Memorandum and Articles of Association**

We incorporate by reference into this annual report the description of our amended and restated memorandum and articles of association contained in our registration statement on Form F-1 (File No. 333-141860) originally filed with the SEC on April 3, 2007, as amended.

**C. Material Contracts**

We have not entered into any material contracts other than in the ordinary course of business and other than those described in Item 4, Information on the Company or elsewhere in this annual report on Form 20-F.

**D. Exchange Controls**

Foreign exchange in China is primarily regulated by:

the Foreign Currency Administration Rules (1996), as amended; and

the Administration Rules of the Settlement, Sale and Payment of Foreign Exchange (1996), or the Administration Rules.

Under the Foreign Currency Administration Rules, Renminbi is convertible for current account items, including the distribution of dividends, interest payments, and trade and service-related foreign exchange transactions. Conversion of Renminbi into foreign currency for capital account items, such as direct investment, loans, investment in securities, and repatriation of funds, however, is still subject to the approval of SAFE.

Under the Administration Rules, foreign-invested enterprises may only buy, sell, and remit foreign currencies at banks authorized to conduct foreign exchange transactions after providing valid commercial documents and, in the case of capital account item transactions, only after obtaining approval from SAFE. Capital investments directed outside of China by foreign-invested enterprises are also subject to restrictions, which include approvals by SAFE, and the State Reform and Development Commission.

We receive our revenue in Renminbi, which is currently not a freely convertible currency. Under our current structure, our income will be primarily derived from dividend payments from our subsidiaries in China.

The value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the People's Bank of China. On July 21, 2005, the PRC government changed its policy of pegging the value of the Renminbi to the U.S. dollar. Under the new policy, the Renminbi will be permitted to fluctuate within a band against a basket of certain foreign currencies. This change in policy resulted initially in an approximately 2.0% appreciation in the value of the Renminbi against the U.S. dollar. There remains significant international pressure on the PRC government to adopt a substantial liberalization of its currency policy, which could result in a further and more significant appreciation in the value of the Renminbi against the U.S. dollar.

**Regulation of Foreign Exchange in Certain Onshore and Offshore Transactions**

In January and April 2005, the PRC State Administration of Foreign Exchange, or SAFE, issued two rules that require PRC residents to register with, and receive approvals from, SAFE in connection with their offshore investment activities. SAFE has announced that the purpose of these regulations is to achieve the proper balance of foreign exchange and the standardization of the cross-border flow of funds.



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On October 21, 2005, SAFE issued the Notice on Issues Relating to the Administration of Foreign Exchange in Fund-raising and Reverse Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 75, which became effective as of November 1, 2005. Notice 75 replaced the two rules issued by SAFE in January and April 2005 mentioned above. According to Notice 75:

prior to establishing or assuming control of an offshore company for the purpose of financing that offshore company with assets or equity interests in an onshore enterprise in the PRC, each PRC resident, whether a natural or legal person, must complete the overseas investment foreign exchange registration procedures with the relevant local SAFE branch;

an amendment to the registration with the local SAFE branch is required to be filed by any PRC resident that directly or indirectly holds interests in that offshore company upon either (1) the injection of equity interests or assets of an onshore enterprise to the offshore company, or (2) the completion of any overseas fund raising by such offshore company; and

an amendment to the registration with the local SAFE branch is also required to be filed by such PRC resident when there is any material change involving a change in the capital of the offshore company, such as (1) an increase or decrease in its capital, (2) a transfer or swap of shares, (3) a merger or division, (4) a long-term equity or debt investment, or (5) the creation of any security interests over the relevant assets located in China.

Moreover, Notice 75 applies retroactively. As a result, PRC residents who have established or acquired control of offshore companies that have made onshore investments in the PRC in the past are required to complete the relevant overseas investment foreign exchange registration procedures by March 31, 2006. Under the relevant rules, failure to comply with the registration procedures set forth in Notice 75 may result in restrictions being imposed on the foreign exchange activities of the relevant onshore company, including the payment of dividends and other distributions to its offshore parent or affiliate and the capital inflow from the offshore entity, and may also subject relevant PRC residents to penalties under PRC foreign exchange administration regulations. Moreover, PRC residents who are beneficial holders of our shares are required to register with SAFE in connection with their investment in us.

As a result of the uncertainties relating to Notice 75, we cannot predict how these regulations will affect our business operations or strategies. For example, our present or future PRC subsidiaries' ability to conduct foreign exchange activities, such as remittance of dividends and foreign-currency-denominated borrowings, may be subject to compliance with such SAFE registration requirements by relevant PRC residents, over whom we have no control. In addition, we cannot assure you that any such PRC residents will be able to complete the necessary approval and registration procedures required by the SAFE regulations. We require all shareholders in Acorn International who are PRC residents to comply with any SAFE registration requirements and we understand that the relevant shareholders have registered their offshore investment in us with Shanghai SAFE, but we have no control over either our shareholders or the outcome of such registration procedures. Such uncertainties may restrict our ability to implement our acquisition strategy and adversely affect our business and prospects.

***Dividend Distributions***

Pursuant to the Foreign Currency Administration Rules promulgated in 1996 and amended in 1997, and various regulations issued by SAFE and other relevant PRC government authorities, the PRC government imposes controls on the convertibility of RMB into foreign currencies and, in certain cases, the remittance of currency out of China.

The principal regulations governing the distribution of dividends paid by wholly foreign-owned enterprises and Sino-foreign joint equity enterprise enterprises include:

the Wholly Foreign-Owned Enterprise Law (1986), as amended in 2000;

the Wholly Foreign-Owned Enterprise Law Implementing Rules (1990), as amended in 2001;



the Sino-foreign Joint Equity Enterprise Law (1979), as amended in 2001;

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the Sino-foreign Joint Equity Enterprise Law Implementing Rules (1983), as amended in 2001; and

Company Law of the PRC (2005).

Under these regulations, foreign-invested enterprises in China may pay dividends only out of their accumulated profits, if any, determined in accordance with PRC accounting standards and regulations. In addition, a foreign-invested enterprise in China is required to set aside at least a certain percentage of its after-tax profit based on PRC accounting standards each year to its general reserves. These reserves are not distributable as cash dividends. The board of directors of a foreign-invested enterprise has the discretion to allocate a portion of its after-tax profits to employee welfare and bonus funds. These funds, however, may not be distributed to equity owners except in the event of liquidation.

**E. Taxation**

*The following is a summary of the material Cayman Islands and U.S. federal income tax consequences relevant to an investment in our ADSs and ordinary shares. The summary is not intended to be, nor should it be construed as, legal or tax advice to any particular prospective purchaser. The summary is based on laws and relevant interpretations thereof in effect as of the date of this annual report, all of which are subject to change or different interpretations, possibly with retroactive effect. The summary does not address United States state or local tax laws, or tax laws of jurisdictions other than the Cayman Islands and the United States. To the extent that the discussion relates to matters of Cayman Islands tax law, it represents the opinion of Conyers, Dill and Pearman, special Cayman Islands counsel to us. You should consult your own tax advisors with respect to the consequences of acquisition, ownership and disposition of our ADSs and ordinary shares.*

**Cayman Islands Taxation**

The Cayman Islands currently levies no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty or withholding tax applicable to us or to any holder of our ADSs and ordinary shares. There are no other taxes likely to be material to us levied by the Government of the Cayman Islands except for stamp duties, which may be applicable on instruments executed in, or after execution brought within the jurisdiction of the Cayman Islands. No stamp duty is payable in the Cayman Islands on transfers of shares of Cayman Islands companies, except those which hold interests in land in the Cayman Islands. The Cayman Islands is not party to any double tax treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

Pursuant to Section 6 of the Tax Concessions Law (1999 Revision) of the Cayman Islands, we have obtained an undertaking from the Governor-in-Council:

- (1) that no law which is enacted in the Cayman Islands imposing any tax to be levied on profits or income or gains or appreciation shall apply to us or our operations; and
- (2) that the aforesaid tax or any tax in the nature of estate duty or inheritance tax shall not be payable on our shares, debentures or other obligations.

The undertaking for us is for a period of twenty years from January 10, 2006.

**U.S. Federal Income Taxation**

This discussion describes certain material U.S. federal income tax consequences to U.S. Holders (as defined below) relating to the purchase, ownership and disposition of our ADSs and ordinary shares. This discussion does not address any aspect of U.S. federal gift or estate tax, or the state, local or non-U.S. tax consequences of an investment in our ADSs and ordinary shares. This discussion does not apply to U.S. Holders who are a member of a class of holders subject to special rules, such as:

dealers in securities or currencies;

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traders in securities who elect to use a mark-to-market method of accounting for securities holdings;

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banks or other financial institutions;

insurance companies;

tax-exempt organizations;

partnerships and other entities treated as partnerships or other pass through entities for U.S. federal income tax purposes or persons holding ADSs and ordinary shares through any such entities;

regulated investments companies or real estate investment trusts;

persons that hold ADSs and ordinary shares as part of a hedge, straddle, constructive sale, conversion transaction or other integrated investment;

persons whose functional currency for tax purposes is not the U.S. dollar;

persons liable for alternative minimum tax; or

persons who own ADSs or ordinary shares and who actually or constructively own 10% or more of the total combined voting power of all classes of our shares entitled to vote.

This discussion is based on the U.S. Internal Revenue Code of 1986, as amended, which we refer to in this discussion as the Code, its legislative history, existing and proposed regulations promulgated thereunder, published rulings and court decisions, all as of the date hereof. These laws are subject to change, possibly on a retroactive basis. In addition, this discussion relies on our assumptions regarding the value of our ADSs and ordinary shares and the nature of our business over time.

**Prospective purchasers and U.S. Holders of our ADSs and ordinary shares are urged to consult their own tax advisor concerning the particular U.S. federal income tax consequences to them relating to the purchase, ownership and disposition of our ADSs and ordinary shares, as well as the consequences to them arising under the laws of any other taxing jurisdiction.**

For purposes of the U.S. federal income tax discussion below, you are a U.S. Holder if you beneficially own our ADSs or ordinary shares as capital assets for U.S. federal income tax purposes and are:

a citizen or resident of the United States for U.S. federal income tax purposes;

a corporation, or other entity taxable as a corporation, that was created or organized in or under the laws of the United States or any state thereof or the District of Columbia;

an estate the income of which is subject to U.S. federal income tax regardless of its source; or

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a trust if (a) a court within the United States is able to exercise primary supervision over its administration and one or more U.S. persons have the authority to control all substantial decisions of the trust, or (b) the trust has a valid election in effect to be treated as a U.S. person.

For U.S. federal income tax purposes, income earned through a non-U.S. or U.S. partnership or other flow-through entity is attributed to its owners. Accordingly, if a partnership or other flow-through entity holds ADSs or ordinary shares, the tax treatment of the holder will generally depend on the status of the partner or other owner and the activities of the partnership or other flow-through entity.

### *Dividends on ADSs and Ordinary Shares*

We do not anticipate paying dividends on our ADSs and ordinary shares in the foreseeable future. See Item 8.A, Financial Information Consolidated statements and other financial information Dividend policy .

Financial Information Consolidated statements and other financial information Subject to the Passive Foreign Investment Company discussion below, if we do make distributions and you are a U.S. Holder, the

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gross amount of any distributions with respect to your ADSs and ordinary shares (including the amount of any taxes withheld therefrom) will generally be includible in your gross income on the day you actually or constructively receive such income as dividend income if the distributions are made from our current or accumulated earnings and profits, calculated according to U.S. federal income tax principles. However, if you are a non-corporate U.S. Holder, including an individual, and have held your ADSs and ordinary shares for a sufficient period of time, dividend distributions on our ADSs and ordinary shares will generally constitute qualified dividend income taxed at a preferential rate (generally 15% for dividend distributions before January 1, 2011) as long as our ADSs or ordinary shares continue to be readily tradable on the New York Stock Exchange. You should consult your own tax advisor as to the rate of tax that will apply to you with respect to dividend distributions, if any, you receive from us.

Subject to the *Passive Foreign Investment Company* discussion below, to the extent, if any, that the amount of any distribution by us on ADSs and ordinary shares exceeds our current and accumulated earnings and profits as determined under U.S. federal income tax principles, it will be treated first as a tax-free return of the U.S. Holder's adjusted tax basis in the ADSs and ordinary shares and thereafter as capital gain. However, we do not intend to calculate our earnings and profits according to U.S. federal income tax principles. Accordingly, distributions on our ADSs and ordinary shares, if any, will generally be reported to you as dividend distributions for U.S. tax purposes. Corporations will not be entitled to claim a dividends-received deduction with respect to distributions made by us. Dividends generally will constitute foreign source passive income for purposes of the U.S. foreign tax credit rules.

***Sales and Other Dispositions of ADSs or Ordinary Shares***

Subject to the *Passive Foreign Investment Company* discussion below, when you sell or otherwise dispose of ADSs or ordinary shares, you will generally recognize capital gain or loss in an amount equal to the difference between the amount realized on the sale or other disposition and your adjusted tax basis in the ADSs or ordinary shares. Your adjusted tax basis will generally equal the amount you paid for the ADSs or ordinary shares. Any gain or loss you recognize will be long-term capital gain or loss if your holding period in our ADSs or ordinary shares is more than one year at the time of disposition. If you are a non-corporate U.S. Holder, including an individual, any such long-term capital gain will be taxed at preferential rates (generally 15% for capital gain recognized before January 1, 2011). Your ability to deduct capital losses will be subject to various limitations.

***Passive Foreign Investment Company***

In general, we will be classified as a passive foreign investment company ( PFIC ) in any taxable year if either: (a) the average quarterly value of our gross assets that produce passive income or are held for the production of passive income is at least 50% of the average quarterly value of our total gross assets or (b) 75% or more of our gross income for the taxable year is passive income (such as certain dividends, interest or royalties). For purposes of the above tests, we will be treated as owning our proportionate share of the assets and earning our proportionate share of the income of any other corporation in which we own, directly or indirectly, at least 25% (by value) of the stock. For purposes of the first test: (a) any cash and cash invested in short-term, interest bearing, debt instruments, or bank deposits that are readily convertible into cash will generally count as producing passive income or held for the production of passive income, and (b) the total value of our assets is calculated based on our market capitalization.

We believe we were classified as a PFIC for U.S. federal income tax purposes in the taxable year ended December 31, 2009. Although we intend to conduct our business activities in a manner to reduce the risk of our classification as a PFIC in the future, we currently hold, and expect to continue to hold, a substantial amount of cash and other passive assets, and, because the value of our assets is likely to be determined in large part by reference to the market prices of our ADSs and ordinary shares, which are likely to fluctuate, there can no assurance that we will not continue to be classified as a PFIC for 2010 or any future taxable year.

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If we were a PFIC for any taxable year during which you held our ADSs or ordinary shares, certain adverse U.S. federal income tax rules would apply. You would generally be subject to additional taxes and interest charges on certain excess distributions we make and on any gain realized on the disposition or deemed disposition of your ADSs or ordinary shares, regardless of whether we continue to be a PFIC in the year in which you receive an excess distribution or dispose of or are deemed to dispose of your ADSs or ordinary shares. Distributions in respect of your ADSs or ordinary shares during a taxable year would generally constitute excess distributions if, in the aggregate, they exceed 125% of the average amount of distributions with respect to your ADSs or ordinary shares over the three preceding taxable years or, if shorter, the portion of your holding period before such taxable year.

To compute the tax on excess distributions or any gain, (a) the excess distribution or the gain would be allocated ratably to each day in your holding period, (b) the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which we were a PFIC would be taxed as ordinary income in the current year, (c) the amount allocated to other taxable years would be taxable at the highest applicable marginal rate in effect for that year, and (d) an interest charge at the rate for underpayment of taxes for any period described under (c) above would be imposed with respect to any portion of the excess distribution or gain that is allocated to such period.

If we were a PFIC in any taxable year during which you held our ADSs or ordinary shares, under certain attribution rules, you will be deemed to own your proportionate share of lower-tier PFICs, and will be subject to U.S. federal income tax on (a) a distribution on the shares of a lower-tier PFIC and (b) a disposition of shares of a lower-tier PFIC, both as if you directly held the shares of such lower-tier PFIC. In addition, no distribution that you receive from us would qualify for taxation at the preferential rate discussed in the Dividends on ADSs and ordinary shares section above.

You would generally be able to avoid the excess distribution rules described above by making a timely so-called mark-to-market election with respect to your ADSs or ordinary shares provided our ADSs or ordinary shares are marketable. Our ADSs or ordinary shares will be marketable as long as they remain regularly traded on a national securities exchange, such as the New York Stock Exchange. If you made a mark-to-market election in a timely fashion, you would generally recognize as ordinary income or ordinary loss the difference between the fair market value of your ADSs or ordinary shares on the first day of any taxable year and their value on the last day of that taxable year. Any ordinary income resulting from this election would generally be taxed at ordinary income rates and would not be eligible for the reduced rate of tax applicable to qualified dividend income. Any ordinary losses would be limited to the extent of the net amount of previously included income as a result of the mark-to-market election, if any. Your basis in the ADSs or ordinary shares would be adjusted to reflect any such income or loss. You should consult your own tax advisor regarding potential advantages and disadvantages to you of making a mark-to-market election with respect to your ADSs or ordinary shares. The mark-to-market election will not be available for any lower tier PFIC that is deemed owned pursuant to the attribution rules discussed above.

Alternatively, you can make a qualified electing fund or QEF election to include annually your pro rata share of our earnings and net capital gains currently in income each year, regardless of whether or not dividend distributions are actually distributed. This means you could have a tax liability for the earnings or gain without a corresponding receipt of cash. Your basis in your ADSs or ordinary shares will be increased to reflect the amount of the taxed but undistributed income. Distributions of income that had previously been taxed will result in a corresponding reduction of basis in the ADSs or ordinary shares and will not be taxed again as a distribution to you. To make a QEF election you will need to have an annual information statement from the PFIC setting forth the earnings and capital gains for the taxable year.

Since we believe we were classified as a PFIC for the 2009 taxable year, we may arrange to provide a PFIC annual information statement (including information for lower tier PFICs) to U.S. Holders upon their request.

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This 2009 statement we are preparing indicates that the combined pro rata share (on a per ADS, per day basis) of earnings and net capital gains of the Company as a PFIC and its lower-tier PFICs is \$0.000024 and nil, respectively. We may post this 2009 statement on our corporate website in the Investor Relations section. Information contained on our website does not constitute a part of this annual report. If not posted on our corporate website, you would have to contact the Company to make a request. If you decide to make a QEF election, it must be made on or before the due date for filing your U.S. federal income tax return (including extensions) for the 2009 taxable year or the first year to which the QEF election will apply.

**You are urged to consult your own tax advisor concerning the making of such a QEF election and in particular with regard to the application of the excess distribution rules to you on any gain realized on the disposition or deemed disposition of your ADSs or ordinary shares, regardless of whether we continue to be a PFIC in the year in which you receive an excess distribution or dispose of or are deemed to dispose of your ADSs or ordinary shares should you not make the QEF election with respect to the 2009 taxable year.**

If we were a PFIC for any taxable year during which you held our ADSs or ordinary shares, you must file IRS Form 8621 for each taxable year in which you recognize any gain on the sale or other disposition of your ADS or ordinary shares, receive deemed or actual distributions from us, or make certain elections (including a QEF and mark-to-market election) with respect to your ADSs or ordinary shares. In addition, recently enacted legislation imposes an annual filing requirement for U.S. persons owning shares of a PFIC. Under recently issued IRS guidance, this new filing requirement will apply for taxable years beginning on or after March 18, 2010, and therefore should not apply to a calendar year shareholder until 2011. You should consult your own tax advisor as to the application of any information reporting requirements to you resulting from our status as a PFIC. We cannot ensure you that we will provide you with all of the information you would need make or maintain any PFIC related elections (including the QEF election described above for the 2009 taxable year) for any taxable year.

### ***U.S. Information Reporting and Backup Withholding Rules***

In general, dividend payments with respect to the ADSs and ordinary shares and the proceeds received on the sale or other disposition of ADSs and ordinary shares may be subject to information reporting to the IRS and to backup withholding (currently imposed at a rate of 28%). Backup withholding will not apply, however, if you (a) are a corporation or come within certain other exempt categories and, when required, can demonstrate that fact or (b) provide a taxpayer identification number, certify as to no loss of exemption from backup withholding and otherwise comply with the applicable backup withholding rules. To establish your status as an exempt person, you will generally be required to provide certification on IRS Form W-9. Any amounts withheld from payments to you under the backup withholding rules that exceed your U.S. federal income tax liability will be allowed as a refund or a credit against your U.S. federal income tax liability, provided that you timely furnish the required information to the IRS.

PROSPECTIVE PURCHASERS OF OUR ADSS AND ORDINARY SHARES SHOULD CONSULT THEIR OWN TAX ADVISOR REGARDING THE APPLICATION OF THE U.S. FEDERAL INCOME TAX LAWS TO THEIR PARTICULAR SITUATIONS AS WELL AS ANY OTHER TAX CONSEQUENCES RESULTING FROM PURCHASING, HOLDING OR DISPOSING OF OUR ADSS AND ORDINARY SHARES, INCLUDING THE APPLICABILITY AND EFFECT OF THE TAX LAWS OF ANY STATE, LOCAL OR NON-US JURISDICTION AND INCLUDING ESTATE, GIFT AND INHERITANCE LAWS.

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

Not applicable.

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

Not applicable.



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

We previously filed with the Securities and Exchange Commission our registration statement on Form F-1, as amended.

We have filed this annual report on Form 20-F with the Securities and Exchange Commission under the Exchange Act. Statements made in this annual report as to the contents of any document referred to are not necessarily complete. With respect to each such document filed as an exhibit to this annual report, reference is made to the exhibit for a more complete description of the matter involved, and each such statement shall be deemed qualified in its entirety by such reference.

We are subject to the informational requirements of the Exchange Act and file reports and other information with the Securities and Exchange Commission. Reports and other information which the Company filed with the Securities and Exchange Commission, including this annual report on Form 20-F, may be inspected and copied at the public reference room of the Securities and Exchange Commission at 100 F Street N.E. Washington D.C. 20549.

You can also obtain copies of this annual report on Form 20-F by mail from the Public Reference Section of the Securities and Exchange Commission, 100 F Street, N.E., Washington D.C. 20549, at prescribed rates. Additionally, copies of this material may be obtained from the Securities and Exchange Commission's Internet site at <http://www.sec.gov>. The Commission's telephone number is 1-800-SEC-0330.

### **I. Subsidiaries Information**

Not applicable.

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

### **A. Quantitative and Qualitative Disclosures about Market Risk**

#### ***Foreign Exchange Risk***

The conversion of Renminbi is highly regulated. In addition, the value of the Renminbi against the U.S. dollar and other currencies may fluctuate and is affected by, among other things, changes in China's political and economic conditions. The conversion of Renminbi into foreign currencies, including U.S. dollars, has been based on rates set by the PBOC. On July 21, 2005, the PRC government changed its policy of pegging the value of the Renminbi to the U.S. dollar. Under the new policy, the Renminbi will be permitted to fluctuate within a band against a basket of certain foreign currencies. There remains significant international pressure on the PRC government to adopt a substantial liberalization of its currency policy, which could result in a further and more significant appreciation in the value of the Renminbi against the U.S. dollar.

We use the U.S. dollar as the reporting and functional currency for our financial statements. Since we conduct our operations through our PRC subsidiaries and affiliated companies, the functional currency of our PRC subsidiaries and affiliated entities is Renminbi. Substantially all our revenue and related expenses, including cost of revenues and advertising expenses, are denominated and paid in Renminbi. Transactions in other currencies are recorded in Renminbi at the rates of exchange prevailing when the transactions occur. Monetary assets and liabilities denominated in other currencies are remeasured into Renminbi at rates of exchange in effect at the balance sheet dates. Exchange gains and losses are recorded in our statements of operations as a component of current period earnings.

Fluctuations in exchange rates, primarily those involving the U.S. dollar, may affect our costs and operating margins, as well as our net income reported in U.S. dollars. For example, to the extent that we need to convert U.S. dollars into Renminbi for our operations, appreciation of the Renminbi against the U.S. dollar would have

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an adverse effect on the Renminbi amount we receive from the conversion. Conversely, if we decide to convert our Renminbi into U.S. dollars for the purpose of making payments for dividends on our ordinary shares or ADSs, or for other business purposes, appreciation of the U.S. dollar against the Renminbi would have a negative effect on the U.S. dollar amounts available to us. We have not used any forward contracts or currency borrowings to hedge our exposure to foreign currency exchange risk.

***Interest Rate Risk***

As of December 31, 2009, we had no outstanding borrowings. If we borrow money in future periods, we may be exposed to interest rate risk. We do not have any derivative financial instruments and believe our exposure to interest rate risk and other relevant market risks is not material.

***Inflation***

Inflation in China has not materially impacted our results of operations in recent years. According to the National Bureau of Statistics of China, the change of consumer price index in China was 4.8%, 5.9% and -0.7% in 2007, 2008 and 2009, respectively.

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

**D. American Depositary Shares**

***Fees Payable by ADS Holders***

Citibank, N.A., the depository of our ADS program, collects its fees for delivery and surrender of ADSs directly from investors depositing shares or surrendering ADSs for the purpose of withdrawal or from intermediaries acting for them. Depository fees payable in connection with distributions of cash or securities to ADS holders and the depository service fee are charged by the depository to the holders of record of ADSs as of the applicable ADS record date. In the case of cash distributions, the depository fees are generally deducted from the cash being distributed. In the case of distributions other than cash (e.g., stock dividends, rights, etc.), the depository charges the applicable fee to the ADS record date holders concurrent with the distribution. In the case of ADSs registered in the name of the investor (whether certificated or in DRS), the depository sends invoices to the applicable record date ADS holders. In the case of ADSs held in brokerage and custodian accounts (via DTC), the depository generally collects its fees through the settlement systems provided by DTC (whose nominee is the registered holder of the ADSs held in DTC) from the brokers and custodians holding ADSs in their DTC accounts.

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

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**Persons depositing or withdrawing shares must pay:**

Up to \$5.00 per 100 ADSs (or fraction thereof).

\$1.50 per certificate presented for transfer.

Taxes and other governmental charges the depository or the custodian has to pay on any ADS or ordinary share.

Registration or transfer fees.

Expenses of the depository.

Any charges incurred by the depository in connection with compliance with exchange control regulations and other regulatory requirements applicable to the shares, deposited securities, ADSs and ADRs.

Any charges incurred by the depository for servicing or delivering the ordinary shares on deposit.

***Fees Payable by the Depository to Us***

From January 1, 2009 to March 31, 2010, we received from the depository a reimbursement of \$185,267 for certain expenses related to the maintenance of the ADR program, including our annual stock exchange listing fees and our expenses incurred in connection with investor relations programs, as well as a sponsorship of \$13,971 for our advertising and promotional activities.

**For:**

Issuance of ADSs.

Cancellation of ADSs.

Distribution of cash dividends or other cash distributions.

Distribution of ADSs pursuant to share dividends or other free share distributions or exercise of rights.

Depository Service Fee

Distribution of securities other than ADSs or rights to purchase additional ADSs.

Transfer of ADRs.

As necessary.

Transfer and registration of ordinary shares on the share register to or from the name of the custodian or depository in connection with the deposit or withdraw of ordinary shares.

Cable, telex, fax transmissions and delivery expenses.

Converting foreign currency to U.S. dollars

As necessary.

As necessary.

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**PART II**

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

None.

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

**Material Modifications to the Rights of Security Holders**

The rights of securities holders have not been materially modified.

**ITEM 15T. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures.*

We evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2009. Based on that evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective and designed to ensure that the information required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules, regulations and forms and to ensure that information required to be disclosed by us in the reports we file or submit is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

*Management's Report on Internal Control over Financial Reporting.*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act for our company. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements in accordance with generally accepted accounting principles and includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of a company's assets, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with generally accepted accounting principles, and that a company's receipts and expenditures are being made only in accordance with authorizations of a company's management and directors and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a company's assets that could have a material effect on the consolidated financial statements. Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation, our management concluded that our internal control over financial reporting was effective as of December 31, 2009.

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

This annual report does not include an attestation report of the company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management's report in this annual report.

**Table of Contents***Changes in Internal Control over Financial Reporting*

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

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

Our audit committee consists of Denny Lee, Hongbing Lv and Joe Zhixiong Zhou. Denny Lee is the chairman of our audit committee and meets the criteria of an audit committee financial expert. Each member of our audit committee satisfies the independence requirements of the corporate governance rules of New York Stock Exchange and meets the criteria for independence set forth in Section 10A(m)(3) of the Exchange Act.

**ITEM 16B. CODE OF ETHICS**

Our board of directors has adopted a code of ethics, which is applicable to our senior executive and financial officers. In addition, our board of directors has adopted a code of conduct, which is applicable to all of our directors, officers and employees. Our code of ethics and our code of conduct are publicly available on our website at <http://www.chinadrvtv.com>, and each is filed as an exhibit to our registration statement on Form F-1 (No. 333-141860).

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

The following table sets forth the aggregate fees by specified category in connection with certain professional services rendered by Deloitte Touche Tohmatsu CPA Ltd., our principal external auditors, for the periods indicated. We did not pay any other fees to our auditors during the periods indicated below.

|                               | 2008       | 2009       |
|-------------------------------|------------|------------|
| Audit fees <sup>(1)</sup>     | \$ 800,000 | \$ 800,000 |
| Tax fees <sup>(2)</sup>       | 62,000     | 46,000     |
| All other fees <sup>(3)</sup> | 91,000     |            |

(1) Audit fees means the aggregate fees billed for professional services rendered by our principal auditors for the assurance and related services. The audit fee for 2008 and 2009 mainly represents audit and review of financial statements.

(2) Tax fees includes fees billed for tax consultations.

(3) All other fees represents fees billed for services rendered in connection with our acquisition due-diligence in 2008.

The policy of our audit committee or our board of directors is to pre-approve all auditing services and permitted non-audit services to be performed for us by our independent auditor, including the fees and terms thereof (subject to the de minimis exceptions for non-audit services described in Section 10A(i)(1)(B) of the Exchange Act which are approved by the audit committee or our board of directors prior to the completion of the audit).

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

None.

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

The table below details our purchases of our own equity securities pursuant to our share repurchase program, previously adopted and announced publicly. Our repurchase program lapsed on May 31, 2009. As of December 31, 2009, we had repurchased an aggregate of 3,272,013 ADSs, representing 9,816,039 ordinary shares, on the open market for total cash consideration of \$25.5 million.

| Period                  | Total number of ADSs purchased | Average share price paid per ADS | Total purchase price paid |
|-------------------------|--------------------------------|----------------------------------|---------------------------|
| 12/06/2007 - 12/31/2007 | 683,000 ADSs                   | \$ 9.97                          | \$ 6,833,124              |
| 01/01/2008 - 12/31/2008 | 1,949,747 ADSs                 | \$ 8.37                          | 16,378,724                |
| 01/01/2009 - 12/31/2009 | 639,266 ADSs                   | \$ 3.55                          | 2,288,136                 |
|                         | 3,272,013 ADSs                 |                                  | \$ 25,499,984             |

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

Not applicable.

**ITEM 16G. CORPORATE GOVERNANCE**

As a foreign private issuer with shares listed on the NYSE, we are subject to corporate governance requirements imposed by the NYSE. Under Section 303A of the NYSE's Listed Company Manual, NYSE listed non-US companies may, in general, follow their home country corporate governance practices in lieu of some of the NYSE corporate governance requirements. We are committed to a high standard of corporate governance. As such, we endeavor to comply with most of the NYSE corporate governance practices. However, the following are the ways in which our current corporate governance practices differ from NYSE corporate governance requirements since the laws of Cayman Islands do not require such compliance:

The majority of our board of directors is not comprised of independent directors.

Our corporate governance and nominating committee of our board of directors is not comprised entirely of independent directors.

Our compensation committee of our board of directors is not comprised entirely of independent directors.

We may in the future determine to voluntarily comply with one or more of the foregoing provisions as required by NYSE's Listed Company Manual.

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**PART III**

**ITEM 17. FINANCIAL STATEMENTS**

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

**ITEM 18. FINANCIAL STATEMENTS**

Our consolidated financial statements are included at the end of this annual report.

**ITEM 19. EXHIBITS**

**EXHIBITS INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 1.1*                      | Amended and Restated Memorandum and Articles of Association of Acorn International, Inc.   |
| 2.1*                      | Specimen American Depositary Receipt   |
| 2.2*                      | Specimen Certificate for Ordinary Shares   |
| 2.3**                     | Form of Deposit Agreement among Acorn International, Inc., Citibank, N.A., and holders and beneficial owners of American Depositary Shares issued thereunder   |
| 4.1*                      | 2006 Equity Incentive Plan   |
| 4.2*                      | Forms of option grant agreements and form of SARs Award Agreement  |
| 4.3*                      | Form of Indemnification Agreement with the directors of Acorn International, Inc.  |
| 4.4*                      | Form of Employment Agreement of Acorn International, Inc. and Employment Agreement of James Yujun Hu   |
| 4.5*                      | Investors Rights Agreement among Acorn International, Inc., SB Asia Investment Fund II L.P., and the several ordinary shareholders therein as of March 31, 2006  |
| 4.6*                      | Asset Purchase Agreement between Acorn Information Technology (Shanghai) Co., Ltd. and Tianjin BABAKA Technology Development Co., Ltd. dated June 1, 2005  |
| 4.7*                      | Equity Transfer Agreement between Shanghai Acorn HJX Digital Technology Co., Ltd. and Acorn Information Technology (Shanghai) Co., Ltd. dated June 30, 2005  |
| 4.8*                      | Equity Transfer Agreement between Shanghai Acorn HJX Digital Technology Co., Ltd. and Acorn International Electronic Technology (Shanghai) Co., Ltd. dated June 30, 2005   |
| 4.9*                      | Patent Application Right Transfer Agreement between Acorn Information Technology (Shanghai) Co., Ltd. and Tianjin BABAKA Technology Development Co., Ltd. dated August 1, 2005   |
| 4.10*                     | Joint Venture Contract between Acorn Information Technology (Shanghai) Co., Ltd. and Shanghai Yimeng Digital Technology Co., Ltd. dated December 9, 2005   |
| 4.11*                     | 2005 Service Fee Pricing Agreement under the Exclusive Technical Service Agreement between Acorn Information Technology (Shanghai) Co., Ltd. and Shanghai Acorn Network Technology Development Co., Ltd. dated December 31, 2005 |
| 4.12*                     | 2005 Service Fee Pricing Agreement under the Exclusive Technical Service Agreement between Acorn Information Technology (Shanghai) Co., Ltd. and Beijing Acorn Trade Co., Ltd. dated December 31, 2005                           |

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| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 4.13*                 | 2005 Service Fee Pricing Agreement under the Exclusive Technical Service Agreement between Acorn Information Technology (Shanghai) Co., Ltd. and Shanghai Acorn Advertising Broadcasting Co., Ltd. dated December 31, 2005   |
| 4.14*                 | Joint Venture Contract between China DRTV, Inc. and Shanghai Jia Guan Hang Automobile Maintenance Products Co., Ltd. dated February 28, 2006   |
| 4.15*                 | Loan Agreement by and among Acorn Information Technology (Shanghai) Co., Ltd., Don Dongjie Yang and David Chenghong He dated March 20, 2006  |
| 4.16*                 | Form of Operation and Management by and among Acorn Information Technology (Shanghai) Co., Ltd., Shanghai Acorn Advertising Broadcasting Co. Ltd./Beijing Acorn Trade Co., Ltd./Shanghai Acorn Network Development Technology Co., Ltd., Don Dongjie Yang and David Chenghong He |
| 4.17*                 | Form of Equity Pledge Agreement among Acorn Information Technology (Shanghai) Co., Ltd., Don Dongjie Yang and David Chenghong He   |
| 4.18*                 | Form of Exclusive Technical Service Agreement between Shanghai Acorn Advertising Broadcasting Co., Ltd./Beijing Acorn Trade Co., Ltd./Shanghai Acorn Network Development Technology Co., Ltd. and Acorn Information Technology (Shanghai) Co., Ltd.                              |
| 4.19*                 | Form of Exclusive Purchase Agreement among Acorn Information Technology (Shanghai) Co., Ltd., Don Dongjie Yang, David Chenghong He and Shanghai Acorn Advertising Broadcasting Co., Ltd./ Beijing Acorn Trade Co., Ltd./Shanghai Acorn Network Development Technology Co., Ltd.  |
| 4.20*                 | Form of Power of Attorney issued by Don Dongjie Yang and David Chenghong He in favor of designees of Acorn Information Technology (Shanghai) Co., Ltd.   |
| 4.21*                 | Agreement among Don Dongjie Yang, David Chenghong He, Acorn Information Technology (Shanghai) Co., Ltd. and Acorn International Electronic Technology (Shanghai) Co., Ltd. dated March 20, 2006  |
| 4.22*                 | Agreement among Don Dongjie Yang, David Chenghong He, Acorn Information Technology (Shanghai) Co., Ltd. and Shanghai HJX Digital Technology Co., Ltd. dated March 20, 2006   |
| 4.23*                 | Agreement between China Express Mail Service Corporation and Shanghai Acorn Network Technology Development Co., Ltd. dated March 24, 2006  |
| 4.24*                 | Joint Venture Contract between China DRTV, Inc. and Zhuhai Sunrana Cosmetics Products Co., Ltd. dated May 10, 2006   |
| 4.25*                 | Voting Agreement among James Yujun Hu, The 2004 Trust for Robert W. Roche s Descendants and Acorn Composite Corporation dated July 6, 2006   |
| 4.26*                 | Voting Agreement between SB Asia Investment Fund II L.P. and James Yujun Hu dated March 30, 2007   |
| 4.27*                 | Strategic Cooperation Agreement dated January 24, 2007 between Unicom Huasheng Telecommunication Technology Co., Ltd. and Shanghai Acorn Advertising Broadcasting Co., Ltd. and the Supplementary Agreement dated March 12, 2007   |
| 4.28*                 | Subscription Agreement dated April 17, 2007 by and among Acorn International, Inc., Alibaba.com Corporation, Merrill Lynch, Pierce, Fenner & Smith Incorporated and Deutsche Bank Securities Inc.  |
| 8.1                   | List of subsidiaries   |
| 11.1*                 | Code of Business Conduct and Ethics of Acorn International, Inc.   |
| 12.1                  | CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |



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| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 12.2                  | CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 13.1                  | CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 13.2                  | CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 23.1                  | Consent of Commerce & Finance   |
| 23.2                  | Consent of Deloitte Touche Tohmatsu CPA Ltd.                                |

- \* Previously filed as an exhibit to the Registration Statement on F-1 registration (File No. 333-141860), as amended, initially filed with the Securities and Exchange Commission on April 3, 2007.
- \*\* Incorporated by reference to the Registration Statement on Form F-6 (File No. 333-142177), which was filed with the Securities and Exchange Commission with respect to American depository shares representing ordinary shares on April 17, 2007. Confidential treatment has been requested with respect to certain portions of this exhibit. A complete copy of the agreement, including the redacted portions, has been filed separately with the Commission.

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**SIGNATURE**

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

*ACORN INTERNATIONAL, INC.*

**Name:** /s/ DAVID CHENGHONG HE  
**Title:** David Chenghong He  
Chief Financial Officer

Date: May 6, 2010

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**ACORN INTERNATIONAL, INC.**

**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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| <u>Consolidated Statements of Changes in Equity and Comprehensive Income (Loss) for the Years ended December 31, 2007, 2008 and 2009</u> | F-6  |
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

TO THE BOARD OF DIRECTORS AND SHAREHOLDERS OF

ACORN INTERNATIONAL, INC.

We have audited the accompanying consolidated balance sheets of Acorn International, Inc. and its subsidiaries and variable interest entities (collectively, the Group) as of December 31, 2008 and 2009, and the related consolidated statements of operations, changes in equity and comprehensive income (loss) and cash flows for each of the three years in the period ended December 31, 2009 and related financial statement schedule. These financial statements and related financial statement schedule are the responsibility of the Group's management. Our responsibility is to express an opinion on these financial statements and related financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Group is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Acorn International, Inc. and its subsidiaries and variable interest entities as of December 31, 2008 and 2009 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects, the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, on January 1, 2009, the Group adopted FASB Accounting Standards Codification 810-10-65, Consolidation Overall Transition and Open Effective Date Information (previously Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51).

/s/ Deloitte Touche Tohmatsu CPA Ltd.

Shanghai, China

May 6, 2010

**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED BALANCE SHEETS****(In US dollars, except share data)**

|  | <b>December 31,</b>   |                       |
|--|-----------------------|-----------------------|
|  | <b>2008</b>           | <b>2009</b>           |
|  | <b>(As adjusted)</b>  |                       |
| <b>Assets</b>  |                       |                       |
| Current assets:  |                       |                       |
| Cash and cash equivalents  | \$ 147,648,774        | \$ 142,952,944        |
| Restricted cash  | 1,425,102             | 2,394,213             |
| Short-term investments   | 19,745,444            | 18,572,790            |
| Accounts receivable, net of allowance for doubtful accounts of \$3,524,673 and \$1,597,556 as of December 31, 2008 and 2009, respectively  | 27,708,460            | 17,030,857            |
| Notes receivable   | 150,607               | 2,242,641             |
| Inventory  | 29,521,680            | 26,180,629            |
| Prepaid advertising expenses   | 16,756,954            | 9,968,493             |
| Other prepaid expenses and current assets, net of allowance for doubtful accounts of \$1,109,547 and \$11,643 as of December 31, 2008 and 2009, respectively                                 | 13,362,528            | 7,794,537             |
| Deferred tax assets, net   | 3,355,151             | 2,320,535             |
| <b>Total current assets</b>  | <b>259,674,700</b>    | <b>229,457,639</b>    |
| Prepaid land use right   |                       | 7,349,957             |
| Property and equipment, net  | 15,641,434            | 14,818,404            |
| Acquired intangible assets, net  | 21,313,949            | 3,181,596             |
| Long-term investments  | 5,275,000             | 8,020,069             |
| Investments in affiliates  | 1,159,134             | 8,881,830             |
| Other long-term assets   | 1,121,100             | 1,673,755             |
| <b>Total assets</b>  | <b>\$ 304,185,317</b> | <b>\$ 273,383,250</b> |
| <b>Liabilities and equity</b>  |                       |                       |
| Current liabilities:   |                       |                       |
| Accounts payable   | \$ 20,734,493         | \$ 15,528,580         |
| Accrued expenses and other current liabilities   | 19,652,820            | 14,838,142            |
| Notes payable  | 3,657,859             | 3,253,005             |
| Income taxes payable   | 3,327,869             | 3,422,261             |
| Dividend payable   |                       | 29,322,782            |
| Deferred revenue   | 12,797,716            |                       |
| <b>Total current liabilities</b>   | <b>60,170,757</b>     | <b>66,364,770</b>     |
| Deferred tax liability   | 3,581,569             | 889,625               |
| Business combination liability   | 11,107,375            | 1,103,015             |
| <b>Total liabilities</b>   | <b>74,859,701</b>     | <b>68,357,410</b>     |
| Commitments and contingencies (Note 22)  |                       |                       |
| Equity:  |                       |                       |
| Acorn International, Inc. shareholders' equity:  |                       |                       |
| Ordinary shares (\$0.01 par value; 100,000,000 shares authorized, 93,543,506 and 93,544,748 shares issued and 88,209,368 and 88,856,915 shares outstanding as of December 31, 2008 and 2009, | 935,435               | 935,447               |

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|   |                       |                       |
|---|-----------------------|-----------------------|
| respectively)   |                       |                       |
| Additional paid-in capital  | 205,651,072           | 178,176,225           |
| Retained earnings   | 9,737,468             | 18,573,296            |
| Accumulated other comprehensive income  | 15,113,507            | 17,562,561            |
| Treasury stock, at cost (5,334,138 and 4,687,833 shares as of December 31, 2008 and 2009, respectively) | (15,676,206)          | (11,612,546)          |
| <b>Total Acorn International, Inc. shareholders' equity</b>   | <b>215,761,276</b>    | <b>203,634,983</b>    |
| Noncontrolling interests  | 13,564,340            | 1,390,857             |
| <b>Total equity</b>   | <b>229,325,616</b>    | <b>205,025,840</b>    |
| <b>Total liabilities and equity</b>   | <b>\$ 304,185,317</b> | <b>\$ 273,383,250</b> |

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In US dollars, except share data)**

|   | For the years ended December 31, |                       |                |
|---|----------------------------------|-----------------------|----------------|
|   | 2007<br>(As adjusted)            | 2008<br>(As adjusted) | 2009           |
| <b>Revenues:</b>  |                                  |                       |                |
| Direct sales, net   | \$ 181,319,805                   | \$ 166,947,475        | \$ 160,357,948 |
| Distribution sales, net                                       | 66,717,204                       | 67,189,946            | 127,227,672    |
| Total revenues, net   | 248,037,009                      | 234,137,421           | 287,585,620    |
| <b>Cost of revenues:</b>                                      |                                  |                       |                |
| Direct sales  | 85,982,152                       | 83,300,736            | 67,530,966     |
| Distribution sales  | 37,366,039                       | 37,326,214            | 83,096,932     |
| Total cost of revenues  | 123,348,191                      | 120,626,950           | 150,627,898    |
| Gross profit  | 124,688,818                      | 113,510,471           | 136,957,722    |
| <b>Operating (expenses) income</b>                            |                                  |                       |                |
| Advertising expenses  | (74,965,646)                     | (73,381,193)          | (61,048,515)   |
| Other selling and marketing expenses                          | (29,250,583)                     | (38,317,161)          | (42,955,923)   |
| General and administrative expenses                           | (26,100,091)                     | (27,746,833)          | (31,195,949)   |
| Impairment of goodwill and intangible assets                  |                                  | (8,667,961)           | (15,247,873)   |
| Other operating income, net                                   | 3,144,324                        | 5,039,075             | 6,004,481      |
| Total operating (expenses) income                             | (127,171,996)                    | (143,074,073)         | (144,443,779)  |
| Loss from operations  | (2,483,178)                      | (29,563,602)          | (7,486,057)    |
| Other income (expenses)                                       | 13,710,909                       | (667,297)             | 1,651,386      |
| Income (loss) before income taxes and discontinued operations | 11,227,731                       | (30,230,899)          | (5,834,671)    |
| <b>Income tax (expenses) benefits:</b>                        |                                  |                       |                |
| Current   | (1,453,133)                      | (127,933)             | (1,280,089)    |
| Deferred  | 1,466,082                        | 122,965               | 3,819,354      |
| Total income tax (expenses) benefits                          | 12,949                           | (4,968)               | 2,539,265      |
| Income (loss) from continuing operations                      | 11,240,680                       | (30,235,867)          | (3,295,406)    |
| <b>Discontinued operations (Note 4):</b>                      |                                  |                       |                |
| Income from discontinued operations                           | 13,156,605                       | 9,036,863             | 841,559        |
| Gain on disposition of discontinued operations                |                                  |                       | 16,366,355     |
| Income tax (expenses) benefits                                | 1,317,054                        | (763,234)             | (1,845,225)    |
| Total income from discontinued operations                     | 14,473,659                       | 8,273,629             | 15,362,689     |

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|   |               |                 |               |
|---|---------------|-----------------|---------------|
| Net income (loss)   | 25,714,339    | (21,962,238)    | 12,067,283    |
| Net income attributable to noncontrolling interests                                     | (7,062,433)   | (3,629,131)     | (184,019)     |
| Net income (loss) attributable to Acorn International, Inc.                             | 18,651,906    | (25,591,369)    | 11,883,264    |
| Deemed dividend on Series A convertible redeemable preferred shares                     | (53,800)      |                 |               |
| Net income (loss) attributable to holders of ordinary shares                            | \$ 18,598,106 | \$ (25,591,369) | \$ 11,883,264 |
| Income (loss) per ordinary share:   |               |                 |               |
| Continuing operations   | \$ 0.11       | \$ (0.34)       | \$ (0.04)     |
| Discontinued operations   | 0.09          | 0.05            | 0.17          |
| Basic   | \$ 0.20       | \$ (0.29)       | \$ 0.13       |
| Continuing operations   | \$ 0.10       | \$ (0.34)       | \$ (0.04)     |
| Discontinued operations   | 0.09          | 0.05            | 0.17          |
| Diluted   | \$ 0.19       | \$ (0.29)       | \$ 0.13       |
| Weighted average number of shares used in calculating income (loss) per ordinary share: |               |                 |               |
| Basic   | 77,738,701    | 86,856,467      | 88,174,675    |
| Diluted   | 84,472,947    | 86,856,467      | 88,174,675    |

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**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)****(In US dollars, except share data)**

|  | <b>For the years ended December 31,</b> |                      |                |
|--|---|----------------------|----------------|
|  | <b>2007</b>                             | <b>2008</b>          | <b>2009</b>    |
|  | <b>(As adjusted)</b>                    | <b>(As adjusted)</b> |                |
| Net income (loss) attributable to Acorn International, Inc.: |   |                      |                |
| Income (loss) from continuing operations, net of tax         | \$ 11,270,342                           | \$ (29,810,919)      | \$ (2,999,844) |
| Income from discontinued operations, net of tax              | 7,381,564                               | 4,219,550            | 14,883,108     |
|  | \$ 18,651,906                           | \$ (25,591,369)      | \$ 11,883,264  |
| Includes share-based compensation related to:                |   |                      |                |
| Other selling and marketing expenses                         | \$ 423,490                              | \$ 292,135           | \$ 94,453      |
| General and administrative expenses                          | 6,095,588                               | 2,997,097            | 1,751,432      |
|  | \$ 6,519,078                            | \$ 3,289,232         | \$ 1,845,885   |

The accompanying notes are an integral part of these consolidated financial statements.

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**ACORN INTERNATIONAL, INC.**

**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (LOSS)**

(In US dollars, except share data)

|   | Ordinary shares |            | Additional paid-in capital | Acorn International, Inc. shareholders equity |                   |  | Treasury stock, at cost |        | Total         | Noncontrolling interests | Total equity  | Comprehensive income (loss) |
|---|-----------------|------------|----------------------------|---|-------------------|--|-------------------------|--------|---------------|--------------------------|---------------|-----------------------------|
|   | Shares          | Amount     |                            | Subscription receivable                       | Retained earnings | Accumulated other comprehensive income | Shares                  | Amount |               |                          |               |                             |
| Balance at January 1, 2007  | 48,979,394      | \$ 489,794 | \$ 35,902,165              | \$ (9,289,478)                                | \$ 21,084,593     | \$ 3,029,752                           |                         | \$     | \$ 51,216,826 | \$ 1,437,796             | \$ 52,654,622 |                             |
| Issuance of ordinary shares in public offering                      | 23,565,000      | 235,650    | 112,994,175                |   |                   |  |                         |        | 113,229,825   |                          | 113,229,825   |                             |
| Cost of initial offering  |                 |            | (4,344,262)                |   |                   |  |                         |        | (4,344,262)   |                          | (4,344,262)   |                             |
| Conversion of A-1 convertible preferred shares into ordinary shares | 17,709,815      | 177,098    | 31,872,401                 |   |                   |  |                         |        | 32,049,499    |                          | 32,049,499    |                             |
| Issuance of A-1 convertible preferred shares into ordinary shares   | 2,882,155       | 28,822     | 18,836,902                 |   |                   |  |                         |        | 18,865,724    |                          | 18,865,724    |                             |
| Redemption of convertible preferred stock                           |                 |            |                            | 9,289,478                                     |                   |  |                         |        | 9,289,478     |                          | 9,289,478     |                             |
| Share repurchase and stock option                                   | 119,076         | 1,190      | 121,152                    |   |                   |  |                         |        | 122,342       |                          | 122,342       |                             |
| Acquisition of ordinary shares based on asset acquisition           |                 |            | 6,519,078                  |   |                   |  |                         |        | (2,049,000)   | (6,833,124)              | (6,833,124)   |                             |
| Share repurchase  |                 |            |                            |   | 18,651,906        |  |                         |        | 6,519,078     |                          | 6,519,078     |                             |
| Share repurchase  |                 |            |                            |   |                   |  |                         |        | 18,651,906    | 7,062,433                | 25,714,339    | \$ 25,714,339               |
| Share repurchase  |                 |            |                            |   |                   |  |                         |        |               | 430,000                  | 430,000       |                             |
| Share repurchase  |                 |            |                            |   | (53,800)          |  |                         |        | (53,800)      |                          | (53,800)      |                             |

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|                                |            |            |                |    |               |              |             |                |                |              |                |          |  |  |
|--------------------------------|------------|------------|----------------|----|---------------|--------------|-------------|----------------|----------------|--------------|----------------|----------|--|--|
| zed losses                     |            |            |                |    |               |              |             |                |                |              |                |          |  |  |
| le-for-sale<br>es              |            |            |                |    |               |              |             |                |                |              |                |          |  |  |
| n currency<br>ion<br>ments     |            |            |                |    |               |              |             |                |                |              |                |          |  |  |
| e at<br>ber 31,<br>s adjusted) | 93,255,440 | \$ 932,554 | \$ 201,901,611 | \$ | \$ 39,682,699 | \$ 7,690,985 | (2,049,000) | \$ (6,833,124) | \$ 243,374,725 | \$ 9,241,277 | \$ 252,616,002 | \$ 30,68 |  |  |

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**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (LOSS) (Continued)**

(In US dollars, except share data)

|   | Ordinary shares |            | Additional<br>paid-in<br>capital | Acorn International, Inc. shareholders' equity |                      |   | Treasury stock, at cost |                 | Total          | Noncontrolling<br>interests | Total equity   | Compre<br>income |
|---|-----------------|------------|----------------------------------|--|----------------------|---|-------------------------|-----------------|----------------|-----------------------------|----------------|------------------|
|   | Shares          | Amount     |                                  | Subscription<br>receivable                     | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Shares                  | Amount          |                |                             |                |                  |
| Balance at<br>December 31,<br>2015 (as adjusted)                                  | 93,543,506      | \$ 935,435 | \$ 205,651,072                   | \$   | \$ 9,737,468         | \$ 15,113,507                                   | (5,334,138)             | \$ (15,676,206) | \$ 215,761,276 | \$ 13,564,340               | \$ 229,325,616 | \$ (13,842,000)  |
| Issuance of stock   | 1,242           | 12         | 2,050                            |  |                      |   |                         |                 | 2,062          |                             | 2,062          |                  |
| Repurchase of<br>common shares  |                 |            |                                  |  |                      |   | (1,917,798)             | (2,288,136)     | (2,288,136)    |                             | (2,288,136)    |                  |
| Issuance of<br>restricted stock<br>in connection with<br>acquisition of<br>Yukang |                 |            |                                  |  | (3,047,436)          |   | 2,564,103               | 6,351,796       | 3,304,360      |                             | 3,304,360      |                  |
| Issuance of<br>restricted stock   |                 |            | 1,845,885                        |  |                      |   |                         |                 | 1,845,885      |                             | 1,845,885      |                  |
| Payment of<br>dividend  |                 |            | (29,322,782)                     |  |                      |   |                         |                 | (29,322,782)   |                             | (29,322,782)   |                  |
| Net income  |                 |            |                                  |  | 11,883,264           |   |                         |                 | 11,883,264     | 184,019                     | 12,067,283     | \$ 12,067,283    |

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**ACORN INTERNATIONAL, INC.**

**CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (LOSS) (Continued)**

(In US dollars, except share data)

|   | Ordinary shares |            | Acorn International, Inc. shareholders' equity |                         |                   |  | Treasury stock, at cost |                 | Total          | Noncontrolling interests | Total equity   | Comprehensive income (loss) |
|---|-----------------|------------|--|-------------------------|-------------------|--|-------------------------|-----------------|----------------|--------------------------|----------------|-----------------------------|
|   | Shares          | Amount     | Additional paid-in capital                     | Subscription receivable | Retained earnings | Accumulated other comprehensive income | Shares                  | Amount          |                |                          |                |                             |
| Noncontrolling interests upon formation of a subsidiary                   |                 |            |  |                         |                   |  |                         |                 |                | 758,720                  | 758,720        |                             |
| Noncontrolling interests recognized upon consolidation of Shanghai Jimeng |                 |            |  |                         |                   |  |                         |                 |                | (13,139,887)             | (13,139,887)   |                             |
| Unrealized losses on available-for-sale securities                        |                 |            |  |                         |                   | 2,312,564                              |                         |                 | 2,312,564      | 19,965                   | 2,332,529      | 2,332,529                   |
| Foreign currency translation adjustments                                  |                 |            |  |                         |                   | 136,490                                |                         |                 | 136,490        | 3,700                    | 140,190        | 140,190                     |
| Balance at December 31, 2009  | 93,544,748      | \$ 935,447 | \$ 178,176,225                                 | \$                      | \$ 18,573,296     | \$ 17,562,561                          | (4,687,833)             | \$ (11,612,546) | \$ 203,634,983 | \$ 1,390,857             | \$ 205,025,840 | \$ 14,540,000               |

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In US dollars, except share data)**

|  | <b>For the years ended December 31,</b> |                      |               |
|--|---|----------------------|---------------|
|  | <b>2007</b>                             | <b>2008</b>          | <b>2009</b>   |
|  | <b>(As adjusted)</b>                    | <b>(As adjusted)</b> |               |
| <b>Operating activities:</b>   |   |                      |               |
| Net income (loss)  | \$ 25,714,339                           | \$ (21,962,238)      | \$ 12,067,283 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |   |                      |               |
| Gain on disposition of discontinued operations, net of taxes                             |   |                      | (14,386,301)  |
| Goodwill and intangible assets impairment losses   |   | 8,667,961            | 15,247,873    |
| Share-based compensation   | 6,519,078                               | 3,289,232            | 1,845,885     |
| Equity in loss of affiliates   |   | 40,939               | 416,337       |
| Loss on change in fair value of derivative assets  |   | 3,275,000            | 1,306,256     |
| Allowance for doubtful receivables   | 1,517,638                               | 2,607,753            | (3,024,575)   |
| Depreciation and amortization  | 1,928,016                               | 2,355,726            | 5,561,533     |
| Loss on disposal of equipment  | 60,137                                  | 20,510               | 64,463        |
| Deferred income tax benefits   | (2,783,136)                             | (380,698)            | (4,625,879)   |
| Realized gain from sales of trading securities   | (9,255,911)                             | (2,177,486)          | (1,275,164)   |
| Unrealized (gain) loss on trading securities   | (1,449,241)                             | 1,554,429            | (302,484)     |
| Accrued interests on available-for-sale securities                                       | (225,556)                               | 190,001              | (735,455)     |
| Changes in operating assets and liabilities:   |   |                      |               |
| Purchase of trading securities   | (44,565,920)                            | (11,554,176)         | (45,906,632)  |
| Proceeds from sales of trading securities  | 41,757,384                              | 20,648,615           | 36,112,589    |
| Accounts receivable  | (12,432,611)                            | 5,887,247            | 11,785,575    |
| Notes receivable   | (1,348,977)                             | 1,544,011            | (2,092,034)   |
| Inventory  | (8,568,071)                             | (5,754,799)          | 3,118,315     |
| Prepaid advertising expenses   | 2,232,734                               | 6,481,182            | 6,449,501     |
| Other prepaid expenses and current assets  | 1,693,590                               | (4,507,136)          | 18,469,172    |
| Purchase of prepaid land use right   |   |                      | (7,489,280)   |
| Accounts payable   | 4,488,152                               | 4,775,729            | (6,178,250)   |
| Accrued expenses and other current liabilities   | 5,054,694                               | 3,687,492            | (3,442,827)   |
| Notes payable  | 997,180                                 | 2,660,679            | (404,854)     |
| Income taxes payable   | (20,684)                                | 63,631               | (806,305)     |
| Deferred revenue   | 9,159,076                               | (554,655)            | 6,029,869     |
| Net cash provided by operating activities  | \$ 20,471,911                           | \$ 20,858,949        | \$ 27,804,611 |
| <b>Investing activities:</b>   |   |                      |               |
| Purchase of available-for-sale securities  | (20,000,000)                            |                      | (1,355,325)   |
| Redemption of available-for-sale securities by the issuer                                |   |                      | 10,000,000    |
| Purchase of property and equipment   | (9,248,137)                             | (2,902,844)          | (3,079,508)   |
| Proceeds from disposal of equipment  | 124,008                                 | 56,299               | 24,773        |
| Purchase of acquired intangible assets   | (208,129)                               | (623,716)            | (514,814)     |
| Purchase of other long-term assets   |   | (175,072)            | (891,379)     |
| Acquisition of Yiyang Yukang, net of cash acquired                                       |   | (6,971,274)          |               |
| Disposal of Shanghai Yimeng, net of cash disposed  |   |                      | (23,571,819)  |
| Investments in affiliates  |   | (1,200,073)          | (3,939,801)   |
| Increase in restricted cash  | (224,430)                               | (750,842)            | (969,111)     |

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|                                       |                 |                 |                 |
|---------------------------------------|-----------------|-----------------|-----------------|
| Net cash used in investing activities | \$ (29,556,688) | \$ (12,567,522) | \$ (24,296,984) |
|---------------------------------------|-----------------|-----------------|-----------------|

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**Table of Contents****ACORN INTERNATIONAL, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

(In US dollars, except share data)

|   | For the years ended December 31, |                       |                 |
|---|----------------------------------|-----------------------|-----------------|
|   | 2007<br>(As adjusted)            | 2008<br>(As adjusted) | 2009            |
| <b>Financing activities:</b>  |                                  |                       |                 |
| Capital contribution from noncontrolling interests                          | 430,000                          |                       | 758,720         |
| Proceeds from initial public offering (net of issuance cost of \$4,344,262) | 108,885,563                      |                       |                 |
| Collection of subscription receivable                                       | 9,289,478                        |                       |                 |
| Proceeds from exercise of stock options                                     | 122,342                          | 463,110               | 2,062           |
| Repurchase of ordinary shares   | (6,833,124)                      | (16,378,724)          | (2,288,136)     |
| Yiyang Yukang first earn-out payment  |                                  |                       | (6,700,000)     |
| Net cash provided by (used in) financing activities                         | \$ 111,894,259                   | \$ (15,915,614)       | \$ (8,227,354)  |
| Effect of exchange rate changes   | \$ 5,189,272                     | \$ 6,529,802          | \$ 23,897       |
| Net increase (decrease) in cash and cash equivalents                        | \$ 107,998,754                   | \$ (1,094,385)        | \$ (4,695,830)  |
| Cash and cash equivalents at the beginning of the year                      | 40,744,405                       | 148,743,159           | 147,648,774     |
| Cash and cash equivalents at the end of the year                            | \$ 148,743,159                   | \$ 147,648,774        | \$ 142,952,944  |
| <b>Supplemental disclosure of cash flow information:</b>                    |                                  |                       |                 |
| Income taxes paid   | \$ 1,658,178                     | \$ 1,879,118          | \$ 2,567,446    |
| Interest paid   | \$ 320                           | \$                    | \$              |
| Acquisition of Yiyang Yukang:   |                                  |                       |                 |
| Cash consideration  |                                  | \$ 6,700,000          | \$ 6,700,000    |
| Fair value of ordinary shares issued  |                                  | 3,181,780             | 3,304,360       |
| Direct expenses related to the acquisition                                  |                                  | 657,757               |                 |
| Business combination liability  |                                  | 11,107,375            | (10,004,360)    |
| Assets acquired (including intangible asset of \$17,632,341)                |                                  | \$ 21,646,912         | \$              |
| Purchase consideration settled in cash                                      |                                  | \$ (7,357,757)        | \$ (6,700,000)  |
| Add: cash and cash equivalents acquired                                     |                                  | 386,483               |                 |
| Cash outflow on the acquisition   |                                  | \$ (6,971,274)        | \$ (6,700,000)  |
| Disposition of Shanghai Yimeng:   |                                  |                       |                 |
| Total cash received   |                                  |                       | \$ 10,477,081   |
| Less: cash and cash equivalents disposed                                    |                                  |                       | (34,048,900)    |
| Cash outflow on the disposition   |                                  |                       | \$ (23,571,819) |

The accompanying notes are an integral part of these consolidated financial statements.





**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****1. Organization and principal activities**

Acorn International, Inc. ( Acorn International ) was incorporated in Cayman Islands on December 20, 2005. China DRTV, Inc. ( China DRTV ) was incorporated in the British Virgin Islands ( BVI ) on March 4, 2004.

Acorn International and its subsidiaries and variable interest entities ( VIEs ) (collectively, the Group ) is an integrated multi-platform marketing company in China which develops, promotes and sells consumer products and services. The Group s two primary sales platforms are vertically integrated direct sales and a nationwide distribution network. Direct sales platforms include TV direct sales, third-party bank channel sales, catalogs sales, internet sales and direct sales through print media and radio. Direct sales are not only combined with the nationwide distribution network to market and sell the Group s products and services to consumers, but also used to promote and sell third-party branded products and services to consumers pursuant to joint sales arrangements and marketing services arrangements.

As of December 31, 2009, the subsidiaries and VIEs of Acorn International were as follows:

| <b>Name of subsidiaries and variable interest entities</b>                            | <b>Percentage of ownership</b> | <b>Date of incorporation</b> | <b>Place of incorporation</b> |
|---|--------------------------------|------------------------------|-------------------------------|
| China DRTV, Inc. ( China DRTV )   | 100%                           | March 4, 2004                | BVI                           |
| Smooth Profit Limited ( Smooth Profit )   | 100%                           | September 18, 2007           | BVI                           |
| MK AND T Communications Limited ( MK AND T )  | 100%                           | October 27, 1998             | Hong Kong                     |
| Emony Investments Limited ( Emony )   | 100%                           | October 26, 2007             | Hong Kong                     |
| Bright Rainbow Investments Limited ( Bright Rainbow )                                 | 100%                           | October 29, 2007             | Hong Kong                     |
| Acorn Hong Kong Holdings Limited ( Acorn Hong Kong )                                  | 51%                            | September 10, 2009           | Hong Kong                     |
| U King Communication Equipment (Hong Kong) Limited ( U King Hong Kong )               | 100%                           | November 30, 2009            | Hong Kong                     |
| Shanghai Acorn Advertising Broadcasting Co., Ltd. ( Shanghai Advertising )            | 100%                           | August 19, 2004              | PRC                           |
| Shanghai HJX Digital Technology Co., Ltd. ( Shanghai HJX )                            | 100%                           | August 23, 2004              | PRC                           |
| Acorn International Electronic Technology (Shanghai) Co., Ltd. ( Acorn Electronic )   | 100%                           | August 23, 2004              | PRC                           |
| Shanghai An-Nai-Chi Automobile Maintenance Products Co., Ltd. ( Shanghai An-Nai-Chi ) | 51%                            | August 23, 2004              | PRC                           |
| Acorn Information Technology (Shanghai) Co., Ltd. ( Acorn Information )               | 100%                           | August 27, 2004              | PRC                           |
| Beijing Acorn Youngleda Oxygen Generating Co., Ltd. ( Beijing Youngleda )             | 100%                           | October 20, 2004             | PRC                           |
| Yiyang Yukang Communication Equipment Co., Ltd. ( Yiyang Yukang )                     | 100%                           | November 29, 2005            | PRC                           |
| Zhuhai Sunrana Bio-tech Co., Ltd. ( Zhuhai Sunrana )                                  | 51%                            | June 16, 2006                | PRC                           |
| Shanghai Acorn Enterprise Management Consulting Co., Ltd. ( Acorn Consulting )        | 100%                           | September 26, 2006           | PRC                           |
| Zhuhai Acorn Electronic Technology Co., Ltd. ( Zhuhai Acorn )                         | 100%                           | November 8, 2006             | PRC                           |
| Beijing HJZX Software Technology Development Co., Ltd. ( Beijing HJZX )               | 100%                           | January 22, 2007             | PRC                           |
| Zhongshan Meijin Digital Technology Co., Ltd. ( Zhongshan Meijin )                    | 75%                            | February 13, 2007            | PRC                           |
| Acorn Trade (Shanghai) Co., Ltd. ( Acorn Trade )                                      | 100%                           | December 14, 2007            | PRC                           |
| Shanghai Acorn HJX Software Technology Development Co., Ltd. ( HJX Software )         | 100%                           | May 12, 2009                 | PRC                           |
| Beijing Acorn Trade Co., Ltd. ( Beijing Acorn )                                       | 100%                           | March 19, 1998               | PRC                           |
| Shanghai Acorn Network Technology Development Co., Ltd. ( Shanghai Network )          | 100%                           | November 2, 2004             | PRC                           |



**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****1. Organization and principal activities (Continued)**

People's Republic of China ( PRC ) laws and regulations restrict foreign ownership entities engaged in direct sales in China. To comply with PRC laws and regulations, Acorn International conducts its direct sales through two VIEs (Beijing Acorn and Shanghai Network) which hold direct sales licenses. The two VIEs are owned 100% by two PRC nationals: Yang Dongjie (or Don Dongjie Yang), Acorn International's president, and He Chenghong (or David Chenghong He), Acorn International's executive officer. Acorn International has entered into various agreements with the two VIEs, including the use of trademarks of Acorn International and exclusive service agreement, entitling Acorn International to receive service fees based on the services provided. In addition, Acorn International has been assigned all voting rights by the owners of the two VIEs through an agreement valid indefinitely, which cannot be amended or terminated except by written consent of all parties. Finally, Acorn International has the option to acquire all the equity interests of the two VIEs once the PRC laws permit.

Through the above arrangements, Acorn International holds all the variable interests of the two VIEs through which it absorbs the majority of the economic risks and rewards of the VIEs and has been determined to be most closely associated with the two VIEs. Therefore, Acorn International is the primary beneficiary of the two VIEs. Accordingly, the financial statements of Beijing Acorn and Shanghai Network have been consolidated with Acorn International as its subsidiaries since they were established.

The following balance sheet amounts of the Group's two VIEs were included in the Group's consolidated balance sheets as of December 31, 2008 and 2009:

|                   | <b>December 31,</b> |               |
|-------------------|---------------------|---------------|
|                   | <b>2008</b>         | <b>2009</b>   |
| Total assets      | \$ 27,867,651       | \$ 34,171,811 |
| Total liabilities | \$ 31,172,867       | \$ 29,284,198 |

In June 2009, the Group sold 33% equity interests in Shanghai Yimeng Software Technology Co., Ltd. ( Shanghai Yimeng ), previously a subsidiary engaged in development and marketing of CPS stock tracking software. Upon completion of the disposal, the Group owned 18% of equity interests in Shanghai Yimeng and ceased to consolidate Shanghai Yimeng as a subsidiary (refer to Note 4 for details of the discontinuance of the stock tracking software business).

**2. Summary of principal accounting policies****(a) Basis of presentation**

The consolidated financial statements of the Group have been prepared in accordance with the accounting principles generally accepted in the United States of America ( US GAAP ).

**(b) Basis of consolidation**

The consolidated financial statements include the financial statements of the Group, its majority-owned subsidiaries and VIEs. All intercompany transactions and balances are eliminated upon consolidation.

**(c) Use of estimates**

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The preparation of financial statements in conformity with US GAAP requires the Group to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

*(c) Use of estimates (Continued)*

and liabilities at the date of the financial statements, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant accounting estimates reflected in the Group's financial statements include allowance for doubtful accounts, inventory valuation, assumptions related to the valuation of available-for-sale debt securities and embedded derivative, useful lives and impairment of long-lived assets and goodwill, assumptions used in purchase price allocation, assumptions related to the valuation of share-based compensation and related forfeiture rates, assumptions used in determining the fair value of retained noncontrolling investment upon deconsolidation of a former subsidiary, and valuation allowance on deferred tax assets and provision for uncertain tax positions.

*(d) Fair value of financial instruments*

On January 1, 2008, the Group adopted the provisions of Accounting Standards Codification (ASC) 820-10, Fair Value Measurements and Disclosures Overall (previously Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements), for financial assets and financial liabilities. As permitted by an amendment to ASC 820-10 that the Financial Accounting Standards Board (FASB) issued in February 2008 (previously FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157), the Group elected to defer the adoption of ASC 820-10 for the Group's nonfinancial assets and nonfinancial liabilities until January 1, 2009, except those that are recognized or disclosed at fair value in the consolidated financial statements on a recurring basis. The guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (also referred to as an exit price) and expands disclosure requirements about assets and liabilities measured at fair value. The guidance establishes a hierarchy for inputs used in measuring fair value that gives the highest priority to observable inputs and the lowest priority to unobservable inputs as follows:

Level 1 Observable unadjusted quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than quoted prices in active markets for identical assets or liabilities, for which all significant inputs are observable, either directly or indirectly.

Level 3 Unobservable inputs to the valuation methodology that are significant to the measurement of fair value of assets or liabilities.

When available, the Group measures the fair value of financial instruments based on quoted market prices in active markets, valuation techniques that use observable market-based inputs or unobservable inputs that are corroborated by market data. The Group uses valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. Assets and liabilities measured at fair value are classified in the categories of Level 1, Level 2, and Level 3 based on the lowest level input that is significant to the fair value measurement in its entirety. Pricing information the Group obtains from third parties is internally validated for reasonableness prior to use in the consolidated financial statements. When observable market prices are not readily available, the Group generally estimates the fair value using valuation techniques that rely on alternate market data or inputs that are generally less readily observable from objective sources and are estimated based on pertinent information available at the time of the applicable reporting periods. In certain cases, fair values are not subject to precise quantification or verification and may fluctuate as economic and market factors vary and the Group's evaluation of those factors changes. Although the Group uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any

estimation technique. In these cases, a

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(d) Fair value of financial instruments (Continued)***

minor change in an assumption could result in a significant change in its estimate of fair value, thereby increasing or decreasing the amounts of the Group's consolidated assets, liabilities, equity and net income or loss.

The Group's financial instruments consist of cash and cash equivalents, restricted cash, short-term investments, accounts receivable, notes receivable, long-term investments, accounts payable and notes payable. For cash and cash equivalents, restricted cash, accounts receivable, notes receivable, accounts payable and notes payable, the carrying amounts of these financial instruments as of December 31, 2008 and 2009 were considered representative of their fair values due to their short terms to maturity.

***(e) Cash and cash equivalents***

Cash and cash equivalents consist of cash on hand and highly liquid investments which are unrestricted as to withdrawal or use, and which have original maturities of three months or less when purchased.

***(f) Restricted cash***

Under the notes payable and third-party bank channel sales arrangements with the banks, the Group is required to maintain certain cash balances in the banks based on the amounts of notes payable granted or certain fixed amounts. These balances related to the notes payable and third-party bank channel sales arrangements were reflected as restricted cash in the balance sheet and amounted to \$1,278,788 and \$2,394,213 as of December 31, 2008 and 2009, respectively.

The restricted cash also included \$146,314 and nil as of December 31, 2008 and 2009, respectively, which represented the cash frozen by the court in regard to a pending lawsuit.

***(g) Short-term and long-term investments***

The Group's short-term investments consist of trading securities and available-for-sale securities.

The Group's long-term investments consist of available-for-sale securities and an embedded derivative instrument.

Securities that the Group buys and holds principally for the purpose of selling them in the near term are classified as trading securities. Trading securities are recorded at fair value, with unrealized gains and losses recognized in the consolidated statements of operations.

Securities that the Group has the positive intention and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.

Securities not classified as either trading securities or held-to-maturity securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses recorded as a component of accumulated other comprehensive income or loss in equity. Realized gains or losses are recognized in the consolidated statements of operations during the period in which the gains or losses are realized. If the Group





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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(g) Short-term and long-term investments (Continued)***

determines that a decline in the fair value of the individual available-for-sale security is other-than-temporary, the cost basis of the security is written down to the fair value as a new cost basis and the amount of the write-down is accounted for as a realized loss. The new cost basis will not be changed for subsequent recoveries in fair value. The Group reviews several factors to determine whether a loss is other-than-temporary. These factors include, but are not limited to, the: (1) nature of the investment; (2) cause and duration of the impairment; (3) extent to which fair value is less than cost; (4) financial conditions and near term prospects of the issuers; and (5) the Group's ability to hold the security for a period of time sufficient to allow for any anticipated recovery of its amortized cost or fair value.

On April 1, 2009, the Group adopted an amendment to ASC 320-10, *Investments in Debt and Equity Securities - Overall* (previously FASB Staff Position FAS 115-2 and 124-2), regarding the other-than-temporary impairment model for debt securities. The amended guidance requires an entity to recognize other-than-temporary impairment in earnings if an investor has the intent to sell the debt security or if it is more-likely-than-not that the investor will be required to sell the debt security before recovery of its amortized cost basis. Additionally, an entity must evaluate expected cash flows to be received and determine if credit-related losses on debt securities exist, which are considered to be other-than-temporary impairment recognized in earnings (refer to Note 5 for the impact of the adoption of ASC 320-10 on the Group's consolidated financial statements).

Available-for-sale securities not expected to be realized in cash or sold in the next normal operating cycle of the business are classified as long-term investments.

***(h) Derivative instruments***

The Group holds investment in securities that meet the definition of a derivative instrument, including investment in share options of a Japanese public company. In addition, one of the Group's long-term investments contains an embedded derivative instrument that is linked to an equity index and an interest rate index. The embedded derivative is bifurcated from the host contract for separate accounting.

Derivative instruments are recognized as assets or liabilities and measured at fair value initially and at the end of each reporting period. Changes in fair value of the derivatives are recorded in the consolidated statements of operations. The Group's derivative instruments do not qualify for hedge accounting.

The balances of the share options of the Japanese public company are presented in other long-term assets in the consolidated balance sheets. The balances of the embedded derivative and the host security are combined in one line and presented in long-term investments in the consolidated balance sheets.

***(i) Inventory***

The cost of inventory comprises all costs of purchase, costs of conversion, and other costs incurred to bring inventory to its present location and condition. The cost of inventory is calculated using the weighted-average method.

Inventory is stated at the lower of cost or market value. Adjustments are recorded to write down the cost of obsolete and excess inventory to the estimated market value based on historical and forecast demand.

***(j) Prepaid land use right***

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In January 2009, the Group obtained a 50-year land use right of a piece of land in Qingpu district of Shanghai for an aggregate cash consideration of \$7,489,280. The land use right is valued at cost less accumulated amortization. Amortization is computed using the straight-line method over its useful lives of 50 years.

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****2. Summary of principal accounting policies (Continued)*****(k) Property and equipment, net***

Property and equipment are carried at cost less accumulated depreciation and amortization. Depreciation and amortization is calculated on a straight-line method over the following estimated useful lives:

|                                | <b>Estimated useful lives</b>  |
|--------------------------------|--|
| Buildings                      | 20 years   |
| Leasehold improvements         | Lesser of the term of the lease or the<br>estimated useful lives of the assets |
| Machinery                      | 10 years   |
| Computers and office equipment | 3-5 years  |
| Vehicles                       | 5 years  |

***(l) Acquired intangible assets, net***

Acquired intangible assets, which consist primarily of distribution networks, trademarks, securities investment advisory service license, patents and assembled and trained workforce, are valued at cost less accumulated amortization. Amortization is computed using the straight-line method over their expected useful lives of 3 to 15 years.

***(m) Impairment of long-lived assets***

The Group evaluates its long-lived assets and finite-lived intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. When these events occur, the Group measures impairment by comparing the carrying amount of the assets to the future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the future undiscounted cash flow is less than the carrying amount of the assets, the Group would recognize an impairment loss equal to the excess of the carrying amount over the fair value of the assets.

***(n) Investment in affiliates***

The affiliated companies in which the Group has non-significant influence are accounted for using cost method of accounting. Dividends received that are distributed from the net accumulated earnings of the investee are recognized in the Group's consolidated statements of operations. Dividends received in excess of earnings are recorded as reductions of cost of the investment. A series of operating losses of the investee or other factors may indicate that a decrease in value of the investment has occurred which is other-than-temporary and should accordingly be recognized.

The affiliated companies in which the Group has significant influence are accounted for using equity method of accounting. The share of earnings or losses of the investee are recognized in the Group's consolidated statements of operations and adjusts the carrying amount of the investment. Dividends received reduce the carrying amount of the investment. A series of operating losses of the investee or other factors may

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indicate that a decrease in value of the investment has occurred which is other-than-temporary and should accordingly be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method of accounting.

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****2. Summary of principal accounting policies (Continued)****(o) Goodwill**

The Group performs a two-step goodwill impairment test on an annual basis. The first step compares the fair value of each reporting unit to its carrying amount, including goodwill. If the fair value of each reporting unit exceeds its carrying amount, goodwill is not considered to be impaired and the second step will not be required. If the carrying amount of a reporting unit exceeds its fair value, the second step compares the implied fair value of goodwill to the carrying value of a reporting unit's goodwill. The fair value of each reporting unit is estimated using the expected present value of future cash flows. The implied fair value of goodwill is determined in a manner similar to accounting for a business combination with the allocation of the assessed fair value determined in the first step to the assets and liabilities of the reporting unit. The excess of the fair value of the reporting unit over the amounts assigned to the assets and liabilities is the implied fair value of goodwill. This allocation process is only performed for purposes of evaluating goodwill impairment and does not result in an entry to adjust the value of any assets or liabilities. An impairment loss is recognized for any excess in the carrying value of goodwill over the implied fair value of goodwill. Goodwill is reviewed at least annually for impairment, or earlier if there is an indication of impairment.

In 2007, the Group performed an annual goodwill impairment test on April 30. In 2008, the Group changed the annual goodwill impairment testing day to October 1, so in 2008 the Group performed the goodwill impairment test on both April 30 and October 1. This change is considered preferable because it allows the Group to use more current financial information and matches the Group's business plan timing. This change in the method of applying accounting principle does not delay, accelerate or avoid an impairment charge or affect the Group's financial statements.

In 2008, the Group determined that an indication of potential goodwill impairment existed due to the sustained decrease in the Group's market capitalization below book value along with the consideration of certain 2009 budgeting activities that indicated lower operating results than previously forecasted. After the goodwill impairment test, the Group recognized \$7,571,865 goodwill impairment loss in 2008.

The carrying amount of goodwill allocated by segment for the years ended December 31, 2008 and 2009 were as follows:

|  | Direct sales | Distribution sales | Total        |
|--|--------------|--------------------|--------------|
| Balance at January 1, 2008                 | \$ 1,481,777 | \$ 6,090,088       | \$ 7,571,865 |
| Impairment loss recognized during the year | (1,481,777)  | (6,090,088)        | (7,571,865)  |
| Balance at December 31, 2008               | \$           | \$                 | \$           |
| Impairment loss recognized during the year |              |                    |              |
| Balance at December 31, 2009               | \$           | \$                 | \$           |

The changes in the gross amount and accumulated impairment losses of goodwill for the year ended December 31, 2008 were as follows:

| Gross amount | Accumulated impairment loss | Net amount |
|--------------|-----------------------------|------------|
|--------------|-----------------------------|------------|

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|                              |              |                |              |
|------------------------------|--------------|----------------|--------------|
| Balance at January 1, 2008   | \$7,571,865  | \$             | \$ 7,571,865 |
| Impairment loss recognized   |              | (7,571,865)    | (7,571,865)  |
| Balance at December 31, 2008 | \$ 7,571,865 | \$ (7,571,865) | \$           |

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(p) Revenue recognition***

**Direct sales, net**

The Group's direct sales net revenues primarily represent product sales through the Group's TV direct sales and other direct sales platforms, such as third-party bank channel sales, outbound calls, catalogue sales, internet sales, and direct sales through print media and radio. Revenues from sales of products are recognized once the products are delivered to and accepted by the customers.

Under marketing services arrangements, the Group provides a TV direct sales marketing plan, the related TV advertising time and call center support to third parties for a fixed fee. Marketing services revenues are recognized ratably over the contractual period of the arrangements. The related costs, including TV advertising expenses, are classified as cost of direct sales net revenues.

Under joint sales arrangements, the Group generates direct sales net revenues from the sales of products and also receives payments from the joint sales partners based on sales of the featured products through the joint sales partners' own distribution channels. These payments are classified as a reduction to cost of direct sales net revenues via a reduction in the purchase price of the products purchased by the Group from the joint sales partners.

The Group conducted promotional activities of direct sales primarily through the use of cash coupon discounts and the membership-based loyalty program which includes membership points. All such costs are netted against revenues at the time the revenue is recorded. The Group uses historical trend experience to accrue for cash coupon discounts and membership points.

The Group relies on China Express Mail Service Corporation (EMS) and local delivery companies to provide the Group data as to their successful deliveries for the Group's direct sales products. EMS and local delivery companies regularly report product delivery information. Direct sales net revenues for 2007, 2008 and 2009 reflected actual delivery information received from EMS and local delivery companies to ensure the Group did not recognize revenues on unsuccessful deliveries. For unsuccessful deliveries, EMS and local delivery companies are required to return the undelivered products to the Group. It generally takes two to three weeks for EMS to return the undelivered products to the Group whereas it generally takes seven days for local delivery companies to do so.

**Distribution sales, net**

The Group's distribution sales net revenues represent product sales to the distributors comprising the Group's nationwide distribution networks. The distributor agreements do not provide discounts, chargeback, price protection or stock rotation rights. However, there were certain distributor agreements that provided performance-based cash rebates which were netted against revenues at the time the revenue was recorded. Accordingly, the Group records the revenues when products are delivered to and accepted by the distributors as there are no future remaining obligations.

**Software revenue recognition**

The Group generated revenues from annual subscription fees from subscribers for the Group's stock tracking software which includes access to the Group's initial software CD containing data analysis tools and services. Upon receipt of the upfront cash payments from the subscriber, the Group provides an access code to





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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(p) Revenue recognition (Continued)***

the subscriber and activates the subscriber's account when the subscriber first logs on. This commences the one-year subscription period and the full payment is deferred and recognized ratably over the one-year subscription period. After the initial subscription period, the subscribers can register for an additional one year renewal. The pricing of the initial subscription fee and renewal fee is same regardless of whether it is sold by the Group directly or through the Group's distribution network. Because the data services are essential to the functionality of the software analysis tools, the Group recognizes revenue ratably over the one-year subscription period. In June 2009, the Group discontinued its stock tracking software business and included a gain from disposition and its results prior to the disposition in income from discontinued operations in the consolidated statements of operations (refer to Note 4 for details of the discontinuance of the stock tracking software business).

The Group estimates the amount of sales returns and cost of product warranty replacements based on the products' historical trend of sales returns and current economic trends including market acceptance of new and existing products. In 2007, 2008 and 2009, the sales returns and warranty replacements were insignificant.

The Group presented revenues net of sales taxes incurred. The sales taxes amounted to \$825,022, \$209,469 and \$195,923 for the years ended December 31, 2007, 2008 and 2009, respectively. Before subtracting sales taxes, gross direct sales were \$182,138,800, \$167,156,706 and \$160,553,758 and gross distribution sales were \$66,723,231, \$67,190,184 and \$127,227,785 for the years ended December 31, 2007, 2008 and 2009, respectively.

***(q) Advertising expenses***

The Group records cash advances to the advertising companies as prepaid advertising expenses in the consolidated balance sheets. The Group then expenses the prepaid advertising expenses as the advertisement is shown.

***(r) Shipping and handling costs***

The Group records costs incurred for shipping and handling as part of other selling and marketing expenses in the consolidated statements of operations. Shipping and handling costs were \$7,216,096, \$9,992,238 and \$12,431,793 for the years ended December 31, 2007, 2008 and 2009, respectively.

***(s) Operating leases***

Leases where substantially all the rewards and risks of ownership of assets remain with the leasing company are accounted for as operating leases. Payments made under operating leases are charged to the consolidated statements of operations on a straight-line basis over the lease periods.

***(t) Government subsidies***

The Group receives unrestricted government subsidies from local governmental agencies for certain taxes paid by the Group which include value-added, business and income taxes. The Group records unrestricted government subsidies as other operating income in the consolidated statements of operations.

The government subsidies in 2007, 2008 and 2009 were \$1,789,900, \$3,669,893 and \$5,094,301, respectively.



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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(u) Income taxes***

Current income taxes are provided for in accordance with the relevant statutory tax laws and regulations.

Deferred income taxes are recognized for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Net operating losses are carried forward and credited by applying enacted statutory tax rates applicable to future years. Deferred tax assets are reduced by a valuation allowance when, in the opinion of the Group, it is more-likely-than-not that some portion or all of the deferred tax assets will not be realized. The components of the deferred tax assets and liabilities are individually classified as current and non-current based on the characteristics of the underlying assets and liabilities, or the expected timing of their use when they do not relate to a specific asset or liability.

The Group recognizes the impact of an uncertain income tax position at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant tax authority. The Group classifies interests and penalties related to income tax matters in income tax expense.

***(v) Foreign currency translation***

The functional currency and reporting currency of Acorn International, China DRTV, Smooth Profit, MK AND T, Emoney, Bright Rainbow, Acorn Hong Kong and U King Hong Kong are the United States dollar ( US dollar ). Monetary assets and liabilities denominated in currencies other than the US dollar are translated into the US dollar at the rates of exchange ruling at the balance sheet date. Transactions in currencies other than the US dollar during the year are converted into US dollar at the applicable rates of exchange prevailing on the first day of the month in which the transactions occurred. Transaction gains and losses are recognized in the consolidated statements of operations.

The financial records of the Group's PRC subsidiaries and VIEs are denominated in its local currency, the Renminbi ( RMB ), which is the functional currency. Assets and liabilities are translated at the exchange rates at the balance sheet date. Equity accounts are translated at historical exchange rates. Revenues, expenses, gains and losses are translated using the average rate for the period. Translation adjustments are reported as cumulative translation adjustments and are shown as a separated component of accumulated other comprehensive income in the consolidated statements of changes in equity and comprehensive income (loss).

The aggregated gains through foreign currency transactions in 2007 and 2008 were \$486,471, \$542,423 and losses through foreign currency transactions in 2009 were \$1,925.

The RMB is not a freely convertible currency. The PRC State Administration for Foreign Exchange, under the authority of the People's Bank of China, controls the conversion of RMB into foreign currencies. The value of the RMB is subject to changes in central government policies and to international economic and political developments affecting supply and demand in China's foreign exchange trading system market. The Group's aggregate amount of cash and cash equivalents and restricted cash denominated in RMB amounted to RMB589,841,731 and RMB605,716,689 as of December 31, 2008 and 2009, respectively.

***(w) Comprehensive income (loss)***

Comprehensive income (loss) includes all changes in equity except those resulting from investments by owners and distributions to owners and is comprised of net income (loss), unrealized gains and losses on available-for-sale securities and foreign currency translation adjustments. Comprehensive income (loss) is reported in the consolidated statements of changes in equity and comprehensive income (loss).



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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(x) Concentration of credit risk***

Financial instruments that potentially expose the Group to concentration of credit risk consist primarily of cash and cash equivalents, restricted cash, available-for-sale securities, derivative instruments, accounts receivable and notes receivable. All of the Group's cash and cash equivalents and restricted cash are held with financial institutions that the Group believes to be high credit quality. The Group's available-for-sale securities and derivative instruments are issued by financial institutions and a Japanese public company listed on the JASDAQ with high credit ratings. The Group conducts credit evaluations of customers and generally does not require collateral or other security from its customers. The Group establishes an allowance for doubtful accounts primarily based on the age of the receivables and factors surrounding the credit risk of specific customers.

The Group mainly engaged EMS to deliver products to customers and to collect cash from the customers for direct sales gross revenues through direct sales platforms. As of December 31, 2008 and 2009, accounts receivables from EMS were \$9,010,888 and \$2,173,542, respectively. These amounts represented 32.52% and 12.76% of the total accounts receivables as of December 31, 2008 and 2009, respectively.

***(y) Share-based compensation***

Share-based compensation cost is measured at grant date, based on the fair value of the award, and recognized in expense over the requisite service period. The Group has made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards to vest.

***(z) Income (loss) per share***

The Group has determined that its Series A convertible redeemable preferred shares and Series A-1 convertible redeemable preferred shares are participating securities as the preferred shares participate in undistributed earnings on the same basis as the ordinary shares. Accordingly, the Group has used the two-class method of computing income per share under which income per share is computed for ordinary and preferred shares according to participation rights in undistributed earnings. Under this method, net income applicable to holders of ordinary shares is allocated on a pro rata basis to the ordinary and preferred shares to the extent that each class may share in income for the period had been distributed. Diluted income per share is computed using the more dilutive of (a) the two-class method or (b) the if-converted method. For the period from January 1, 2007 to the Group's initial public offering (IPO) on May 3, 2007, the application of the two-class method was more dilutive than the if-converted method. The preferred shares have been converted into ordinary shares upon the completion of the IPO, the two-class method of computing income per share ceased to apply on the conversion date.

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****2. Summary of principal accounting policies (Continued)****(z) Income (loss) per share (Continued)**

The computation of basic and diluted income (loss) per ordinary share from continuing operations and discontinued operations for the years ended December 31, 2007, 2008 and 2009 was as follows:

|   | <b>For the years ended December 31,</b> |                        |                       |
|---|---|------------------------|-----------------------|
|   | <b>2007</b>                             | <b>2008</b>            | <b>2009</b>           |
| <b>Numerator:</b>   |   |                        |                       |
| Net income (loss) attributable to Acorn International, Inc. from continuing operations                                    | \$ 11,270,342                           | \$ (29,810,919)        | \$ (2,999,844)        |
| Deemed dividend on Series A convertible redeemable preferred shares   | (48,729)                                |                        |                       |
| Income allocated to Series A and Series A-1 convertible redeemable preferred shares for participating rights to dividends | (2,492,040)                             |                        |                       |
| <b>Income (loss) attributable to holders of ordinary shares from continuing operations basic and diluted</b>              | <b>\$ 8,729,573</b>                     | <b>\$ (29,810,919)</b> | <b>\$ (2,999,844)</b> |
| Net income attributable to Acorn International, Inc. from discontinued operations   | \$ 7,381,564                            | \$ 4,219,550           | \$ 14,883,108         |
| Deemed dividend on Series A convertible redeemable preferred shares   | (5,071)                                 |                        |                       |
| Income allocated to Series A and Series A-1 convertible redeemable preferred shares for participating rights to dividends | (260,079)                               |                        |                       |
| <b>Income attributable to holders of ordinary shares from discontinued operations basic and diluted</b>                   | <b>\$ 7,116,414</b>                     | <b>\$ 4,219,550</b>    | <b>\$ 14,883,108</b>  |
| <b>Denominator:</b>   |   |                        |                       |
| Weighted average ordinary shares outstanding basic  | 77,738,701                              | 86,856,467             | 88,174,675            |
| Stock options and stock appreciation rights   | 6,734,246                               |                        |                       |
| <b>Weighted average ordinary shares outstanding diluted</b>   | <b>84,472,947</b>                       | <b>86,856,467</b>      | <b>88,174,675</b>     |
| <b>Income (loss) per ordinary share:</b>  |   |                        |                       |
| continuing operations   | \$ 0.11                                 | \$ (0.34)              | \$ (0.04)             |
| discontinued operations   | 0.09                                    | 0.05                   | 0.17                  |
| <b>Basic</b>  | <b>\$ 0.20</b>                          | <b>\$ (0.29)</b>       | <b>\$ 0.13</b>        |
| continuing operations   | \$ 0.10                                 | \$ (0.34)              | \$ (0.04)             |
| discontinued operations   | 0.09                                    | 0.05                   | 0.17                  |
| <b>Diluted</b>  | <b>\$ 0.19</b>                          | <b>\$ (0.29)</b>       | <b>\$ 0.13</b>        |

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The Group had 1,824,646, 16,020,975 and 15,709,569 weighted average stock options and stock appreciation rights ( SAR ) outstanding in 2007, 2008 and 2009, respectively, which could have potentially diluted income per share in the future, but were excluded in the computation of diluted income (loss) per share in those periods, as their exercise prices were above the average market share prices in 2007, and the Group had net loss attributable to holders of ordinary shares from continuing operations in 2008 and 2009.

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(aa) Noncontrolling interest***

On January 1, 2009, the Group adopted ASC 810-10-65, *Consolidations Overall Transition and Open Effective Date Information* (previously SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51 ). A noncontrolling interest in a subsidiary or VIE of the Group represents the portion of the equity (net assets) in the subsidiary or VIE not directly or indirectly attributable to the Group. This pronouncement requires noncontrolling interests to be presented as a separate component of equity in the consolidated balance sheet and modifies the presentation by requiring earnings and other comprehensive income to be attributed to controlling and noncontrolling interests. The presentation regarding noncontrolling interests was retrospectively applied for all the periods presented.

As a result of the adoption of this accounting standard, the Group retrospectively (1) reclassified \$9,241,277 and \$13,564,340 of minority interests to noncontrolling interests, a component of equity as of December 31, 2007 and 2008, respectively, and (2) presented \$7,062,433 and \$3,629,131 of minority interests, previously deducted from net income (loss) for the years ended December 31, 2007 and 2008, respectively, as an adjustment to net income (loss) to arrive at net income (loss) attributable to Acorn International, Inc. in the consolidated statements of operations.

For the year ended December 31, 2009, the Group derecognized \$13.1 million noncontrolling interests in Shanghai Yimeng in its consolidated statement of changes in equity and comprehensive income (loss). Prior to the deconsolidation of Shanghai Yimeng in June 2009, Shanghai Yimeng declared cash dividends of \$30.0 million pro rata to its existing shareholders, of which the noncontrolling interest holders were entitled to receive \$14.7 million. The cash dividends were recorded to reduce the balance of noncontrolling interests when the dividends were declared. The negative carrying amount of the noncontrolling interests in Shanghai Yimeng of \$1.6 million was derecognized upon deconsolidation.

***(bb) Recently issued accounting pronouncements***

In June 2009, the FASB issued amendments to ASC 860-10, *Transfers and Servicing Overall* (previously SFAS No. 166, *Accounting for Transfers of Financial Assets* ). The amendments limit the circumstances in which a financial asset, or a portion of a financial asset, should be derecognized when the transferor has not transferred the entire original financial asset to an entity that is not consolidated with the transferor in the financial statements being presented, and/or when the transferor has continuing involvement with the transferred financial asset. The new guidance in ASC 860-10 is effective for financial asset transfers occurring after the beginning of an entity's first fiscal year that begins after November 15, 2009, or January 1, 2010 for companies reporting earnings on a calendar-year basis. The adoption of this new guidance is not expected to have a material impact on the Group's financial position, results of operations or cash flows.

In June 2009, the FASB issued amendments to ASC 810-10, *Consolidation Overall* (previously SFAS 167, *Amendments to FASB Interpretation No. 46(R)* ). This accounting standard eliminates exceptions of the previously issued pronouncement to consolidating qualifying special purpose entities, contains new criteria for determining the primary beneficiary, and increases the frequency of required reassessments to determine whether a company is the primary beneficiary of a variable interest entity. This accounting standard also contains a new requirement that any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a variable interest entity, a company's power over a variable interest entity, or a company's obligation to absorb losses or its right to receive benefits of an entity must be disregarded in applying the provisions of the previously issued pronouncement. This accounting standard will be effective for the Group's

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**2. Summary of principal accounting policies (Continued)**

***(bb) Recently issued accounting pronouncements (Continued)***

fiscal year beginning January 1, 2010. The adoption of this new guidance is not expected to have a material impact on the Group's financial position, results of operations or cash flows.

In August 2009, the FASB issued Accounting Standards Update (ASU) 2009-05, Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value. ASU 2009-05 amends ASC 820-10, Fair Value Measurements and Disclosures Overall, for the fair value measurement of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure the fair value using (1) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities or similar liabilities when traded as assets or (2) another valuation technique that is consistent with the principles of Topic 820. It also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability and that both a quoted price in an active market for the identical liability at measurement date and that the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. The provisions of ASU 2009-05 are effective for the first reporting period (including interim periods) beginning after January 1, 2010. Early application is permitted. The adoption of this new guidance is not expected to have a material impact on the Group's financial position, results of operations or cash flows.

In October 2009, the FASB issued ASU 2009-13, Revenue Recognition (Topic 605) Multiple-Deliverable Revenue Arrangements (previously EITF 08-1, Revenue Arrangements with Multiple Deliverables). This ASU addresses the accounting for multiple-deliverable arrangements to enable vendors to account for products or services (deliverables) separately rather than as a combined unit. Specifically, this guidance amends the criteria for separating consideration in multiple-deliverable arrangements. This guidance establishes a selling price hierarchy for determining the selling price of a deliverable, which is based on: (a) vendor-specific objective evidence; (b) third-party evidence; or (c) estimates. This guidance also eliminates the residual method of allocation and requires that arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. In addition, this guidance significantly expands required disclosures related to a vendor's multiple-deliverable revenue arrangements. This accounting standard will be effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is permitted. The Group is currently evaluating the impact of adoption on its consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends ASC 820 (formerly SFAS 157) to add new requirements for disclosures about (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in Level 3 fair value measurements, and (4) the transfers between Levels 1, 2, and 3. The guidance in ASU 2010-06 is effective for the first reporting period beginning after December 15, 2009, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. In the period of initial adoption, entities will not be required to provide the amended disclosures for any previous periods presented for comparative purposes. However, those disclosures are required for periods ending after initial adoption. Early adoption is permitted. The Group is currently evaluating the impact of adoption on its consolidated financial statements.

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****3. Acquisition**

On December 24, 2008, the Group completed its acquisition of 100% equity interests of Yiyang Yukang, a cell phone producer and distributor in the PRC, pursuant to the terms of the definitive agreement entered into on December 18, 2008. Under the agreement, the Group acquired Yiyang Yukang for an initial purchase price of \$6,700,000 in cash and 2,564,103 of its ordinary shares at a fair value of \$3,181,780 in aggregate, based on average market price of the Group's ordinary shares for a reasonable period before and after the date of the agreement. The Group shall additionally pay up to three earn-out payments equivalent to the maximum amount of \$37.1 million in a combination of cash and ordinary shares, contingent on Yiyang Yukang meeting certain earnings targets in 2008 to 2010. The ordinary shares repurchased through the Group's share repurchase program were used for the acquisition. The Group's total expenses related to the acquisition were \$657,757. A business combination liability resulted from the acquisition and amounted to \$11,107,375 as of December 31, 2008.

In 2009, Yiyang Yukang met the first earn-out payment earnings target for the year 2008 and the first quarter of 2009. The Group paid out \$6,700,000 in cash and 2,564,103 of its ordinary shares at a fair value of \$3,304,360 in aggregate, based on average market price of the Group's ordinary shares for a reasonable period before and after the date of the agreement. In addition, Yiyang Yukang did not meet the second earn-out payment earnings target for the year 2009 and the Group did not need to pay the second earn-out payment. The maximum amount of the third earn-out payment is \$14.7 million, contingent on Yiyang Yukang meeting earnings target for the year 2010. The business combination liability after the first earn-out payment amounted to \$1,103,015 as of December 31, 2009.

The Group believes that the acquisition will provide it a strong pipeline of mid-to-high end, differentiated and branded cell phone products as well as strengthening its distribution capability in the PRC.

The following table represented the purchase price payments as of December 31, 2009:

|   |                      |
|---|----------------------|
| Initial cash consideration  | \$ 6,700,000         |
| Cash consideration as a result of first contingent consideration resolved                   | 6,700,000            |
| Fair value of initial ordinary shares issued  | 3,181,780            |
| Fair value of ordinary shares issued as a result of first contingent consideration resolved | 3,304,360            |
| Direct expenses related to the acquisition  | 657,757              |
| Business combination liability  | 1,103,015            |
| <b>Total</b>  | <b>\$ 21,646,912</b> |

The assets acquired and liabilities assumed in the acquisition were as follows:

|   |               | <b>Amortization<br/>Period</b> |
|---|---------------|--------------------------------|
| Tangible assets   | \$ 22,298,973 |                                |
| Liabilities incurred                                    | (14,702,833)  |                                |
| Intangible asset - distribution network                 | 17,632,341    | 8 years                        |
| Deferred tax liability on intangible asset amortization | (3,581,569)   | 8 years                        |

Total

\$ 21,646,912

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****3. Acquisition (Continued)**

The transaction was accounted using the purchase method of accounting, and accordingly, the acquired assets were recorded at their estimated fair values on the acquisition date. When the contingency is resolved and the third earn-out payment becomes issuable, the excess of the fair value of the third earn-out payment over the business combination liability will be recorded to goodwill as additional purchase price. If the business combination liability exceeds the fair value of the third earn-out payment, the excess will be allocated as a pro rata reduction to the amounts assigned to certain acquired assets.

The valuation of the distribution network was based on the excess earnings method, a method within the income approach whereby the value of an intangible asset was captured by discounting to present value the earnings generated by the asset that remains after a deduction for a return on other contributory assets. These assets normally include working capital, fixed assets and other intangible assets. After a fair return on tangible and other intangible assets is subtracted, the remaining excess cash flow (or net cash flow) is attributed to the intangible asset being valued. The excess-earnings approach explicitly recognizes that the current value of an investment is premised upon the expected receipt of future economic benefits. In the valuation of an intangible asset, an indication of value is developed by discounting excess cash flows attributed to the asset to present value at a rate that reflects the current return requirements of the market.

**4. Disposal of stock tracking software business**

In June 2009, in order to focus on the Group's core competency and enhance operating efficiency, the Group sold 33% of its equity interests in Shanghai Yimeng, a company engaged in development and marketing CPS stock tracking software. Shanghai Yimeng was established in December 2005 with 51% of its equity interests held by the Group and 49% by Shanghai Yimeng Digital Technology Co., Ltd., a third party. The Group sold the 33% equity interests to a shareholder of Shanghai Yimeng Digital Technology Co., Ltd. for a total cash consideration of \$10.5 million. The gain on deconsolidation of \$16.4 million was calculated as the difference between: a) the aggregate of (1) the cash consideration received of \$10.5 million, (2) the fair value of the retained 18% equity interests of \$4.2 million, (3) the 49% noncontrolling interests with a negative carrying amount of \$1.6 million, and b) Shanghai Yimeng's net assets with a negative carrying amount of \$3.3 million. The resulting gain on disposition of \$16.4 million was included in income from discontinued operations for the year ended December 31, 2009. The income tax expenses on the gain of disposition was \$2.0 million. There were no remaining assets or liabilities associated with discontinued operations in the consolidated balance sheet as of December 31, 2009.

Accordingly, the discontinued operations were retrospectively reflected for all the years presented in the consolidated statements of operations. The following shows summarized operating results reported as discontinued operations for the years ended December 31, 2007, 2008 and 2009:

|   | For the years ended December 31, |               |               |
|---|----------------------------------|---------------|---------------|
|   | 2007                             | 2008          | 2009          |
| Net revenues  | \$ 14,260,446                    | \$ 16,530,024 | \$ 7,447,940  |
| Income from discontinued operations before income taxes | \$ 13,156,605                    | \$ 9,036,863  | \$ 17,207,914 |
| Income tax (expenses) benefits                          | 1,317,054                        | (763,234)     | (1,845,225)   |
| Income from discontinued operations                     | \$ 14,473,659                    | \$ 8,273,629  | \$ 15,362,689 |



**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****5. Short-term and long-term investments***Trading securities*

The Group's trading securities were marketable equity shares. The cost and fair value of the trading securities as of December 31, 2008 and 2009 were as follows:

|                    | December 31, |               |               |               |
|--------------------|--------------|---------------|---------------|---------------|
|                    | 2008         |               | 2009          |               |
|                    | Cost         | Fair value    | Cost          | Fair value    |
| Trading securities | \$ 9,104,901 | \$ 10,088,054 | \$ 17,254,651 | \$ 18,572,790 |

Investment gain (loss) of trading securities for the years ended December 31, 2007, 2008 and 2009 consisted of the following and was included in the other income (expenses) in the consolidated statements of operations:

|  | For the years ended December 31, |            |              |
|--|----------------------------------|------------|--------------|
|  | 2007                             | 2008       | 2009         |
| Realized gain from sales of trading securities | \$ 7,817,094                     | \$ 426,004 | \$ 1,210,816 |
| Unrealized holding gain (loss)                 | 111,612                          | (155,445)  | 333,137      |
| Total investment gain                          | \$ 7,928,706                     | \$ 270,559 | \$ 1,543,953 |

*Available-for-sale securities*

The Group's available-for-sale securities represent investments in 950,000 shares of the ordinary shares of a Japanese company listed on JASDAQ securities exchange, which was acquired in November 2009 (refer to Note 6 for the terms of the investment in equity shares of the Japanese company), and two index-linked notes ( Note A and Note B ), each with a principal of USD10,000,000.

In June 2007, the Group purchased Note A from a bank. Note A has a contractual variable interest rate ranging from 0%-8% (increased to 9% and 10% in years 6-10 and 11-15, respectively), computed based on the number of days in which the 6-month USD-LIBOR rate is within a stated range. Interests are paid at fixed intervals on a quarterly basis. Interests received on Note A for the years ended December 31, 2007, 2008 and 2009 were \$435,556, \$800,000 and \$164,445, respectively, which was included in the other income in the consolidated statements of operations. The issuer has an option to call the note before or at maturity for an amount equal to principal plus any unpaid interests. Note A matures on June 14, 2022. On March 14, 2009, Note A was called by the issuer for an amount equal to principal plus all unpaid interests. The Group received the total redemption value on March 16, 2009 with no realized gain or loss recognized in 2009.

In August 2007, the Group purchased Note B from a bank. Note B has a contractual variable interest rate ranging from 0%-12%, computed based on the number of days in which both the Nikkei 225 index and the 3-month USD-LIBOR-BBA are above or within the stated ranges, respectively. Interests are paid at fixed intervals on a quarterly basis. Interests received on Note B for the years ended December 31, 2007, 2008 and 2009 were \$490,000, \$31,740 and nil, respectively, which was included in the other income in the consolidated statements of operations. The issuer has an option to call the note before or at maturity for an amount equal to principal plus any unpaid interests. Note B matures on

August 3, 2019.

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****5. Short-term and long-term investments (Continued)***Available-for-sale securities (Continued)*

Note B contains an embedded derivative instrument that is linked to an equity index and an interest rate index. The embedded derivative is bifurcated from the debt host for separate accounting and is measured at fair value initially and at the end of each reporting period (refer to Note 6). The debt host is accounted for as an available-for-sale security. The initial fair values of the embedded derivative and the debt host were \$5,287,940 and \$4,712,060, respectively.

Upon adoption of ASC 320-10, Investments in Debt and Equity Securities Overall (previously FASB Staff Position FAS 115-2 and 124-2) effective on April 1, 2009, the Group determined that credit-related losses with respect to the Note B debt host were insignificant and did not recognize credit-related losses in earnings or make any adjustments to the cumulative net unrealized loss of \$80,058 included in accumulated other comprehensive income in the consolidated balance sheet.

The cost and fair value of the available-for-sale securities as of December 31, 2009 were as follows:

|                                       | Cost         | Unrealized gain | Accrued interest | Estimated fair value |
|---------------------------------------|--------------|-----------------|------------------|----------------------|
| Note B debt host                      | \$ 4,712,060 | \$ 463,620      | \$ 771,010       | \$ 5,946,690         |
| Equity shares of the Japanese company | 1,355,325    | 40,744          |                  | 1,396,069            |
|                                       | \$ 6,067,385 | \$ 504,364      | \$ 771,010       | \$ 7,342,759         |

The cost and fair value of the available-for-sale securities as of December 31, 2008 were as follows:

|                  | Cost          | Unrealized loss | Accrued interest | Estimated fair value |
|------------------|---------------|-----------------|------------------|----------------------|
| Note A           | \$ 10,000,000 | \$ (378,165)    | \$ 35,555        | \$ 9,657,390         |
| Note B debt host | 4,712,060     | (1,450,000)     |                  | 3,262,060            |
|                  | \$ 14,712,060 | \$ (1,828,165)  | \$ 35,555        | \$ 12,919,450        |

The short-term investments as of December 31, 2008 and 2009 were as follows:

|                    | December 31,  |               |
|--------------------|---------------|---------------|
|                    | 2008          | 2009          |
| Trading securities | \$ 10,088,054 | \$ 18,572,790 |
| Note A             | 9,657,390     |               |

\$ 19,745,444    \$ 18,572,790

The long-term investments as of December 31, 2008 and 2009 were as follows:

|                                       | <b>December 31,</b> |              |
|---------------------------------------|---------------------|--------------|
|                                       | <b>2008</b>         | <b>2009</b>  |
| Note B debt host                      | \$ 3,262,060        | \$ 5,946,690 |
| Note B embedded derivative            | 2,012,940           | 677,310      |
| Equity shares of the Japanese company |                     | 1,396,069    |
|                                       | \$ 5,275,000        | \$ 8,020,069 |

In 2009, the Group re-evaluated its investment in Note B and bifurcated the embedded derivative contained in the debt host security. In 2007 and 2008 this adjustment is immaterial. The Group believes the current presentation and bifurcation of the embedded derivative more accurately reflects the hybrid instrument.

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****6. Derivative instruments**

In September 2009, the Group and two third parties formed Acorn Hong Kong for the purpose of establishing business alliance relationship with and invest in a Japanese company listed on JASDAQ securities exchange. The Group and the other two parties each held 51.0%, 19.5% and 29.5% equity interests in Acorn Hong Kong, respectively. As the Group held controlling interests in Acorn Hong Kong, the Group consolidated Acorn Hong Kong since its inception. In November 2009, Acorn Hong Kong purchased 950,000 ordinary shares and 450 options each to subscribe for 1,000 ordinary shares of the Japanese company for cash consideration of \$1,541,142. Acorn Hong Kong held less than 20% of the equity interests of the Japanese company and does not have the ability to exercise significant influence in the operations of the Japanese company. The Group recorded the investment in 950,000 ordinary shares as an available-for-sale security (refer to Note 5). The 450 options are fully vested, non-forfeitable, and exercisable in three years. The Group recorded \$185,818 for the original estimated fair value of the share options in other long-term assets. The share options are considered a derivative instrument and are therefore marked to market at the end of each reporting period based on the market price of the underlying ordinary shares. The share options were valued at \$215,192 as of December 31, 2009. Accordingly, the Group recorded a gain of \$29,374 due to changes in the fair value of the derivative as an increase in other long-term assets and other income in 2009 (refer to Note 7 for disclosure of the method and assumptions used in determining the fair value of the share options).

The Group's investment in Note B contains an embedded derivative instrument that is linked to an equity index and an interest rate index. The embedded derivative has been bifurcated and accounted for at fair value with changes in the fair value recorded in the consolidated statements of operations. On the date when Note B was issued, the Group recorded \$5,287,940 initial estimated fair value of the embedded derivative in long-term investments on the consolidated balance sheet. The embedded derivative was valued at \$2,012,940 and \$677,310 as of December 31, 2008 and 2009. In 2008 and 2009, the Group recorded losses due to changes in the fair value of the embedded derivative of \$3,275,000 and \$1,335,630, respectively, which were included in the other expenses in the consolidated statements of operations (refer to Note 7 for disclosure of the method and assumptions used in determining the fair value of the embedded derivative).

**7. Fair value measurement**

The Group did not have any liabilities measured at fair value on a recurring or non-recurring basis for the years ended December 31, 2008 and 2009.

***Assets measured at fair value on a recurring basis***

As of December 31, 2009, the Group's assets measured at fair value on a recurring basis subsequent to initial recognition were as follows:

|                                       | Quoted<br>prices<br>in active<br>markets for<br>identical assets<br>(Level 1) | Fair value measurements using                             |  | Total         |
|---------------------------------------|---|---|--|---------------|
|                                       |   | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |               |
| Trading securities                    | \$ 18,572,790   | \$  | \$   | \$ 18,572,790 |
| Note B                                |   |   | 6,624,000  | 6,624,000     |
| Equity shares of the Japanese company | 1,396,069   |   |  | 1,396,069     |
| Share options of the Japanese company |   | 215,192   |  | 215,192       |

\$ 19,968,859    \$ 215,192    \$ 6,624,000    \$ 26,808,051

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****7. Fair value measurement (Continued)***Assets measured at fair value on a recurring basis (Continued)*

As of December 31, 2008, the Group's assets measured at fair value on a recurring basis subsequent to initial recognition were as follows:

|   | Quoted<br>prices<br>in active<br>markets for<br>identical assets<br>(Level 1) | Fair value measurements using                             |  | Total                       |
|---|---|---|--|-----------------------------|
|   |   | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |                             |
| Trading securities<br>Note A and Note B | \$ 10,088,054   | \$  | \$ 14,932,390                                      | \$ 10,088,054<br>14,932,390 |
|   | \$ 10,088,054   | \$  | \$ 14,932,390                                      | \$ 25,020,444               |

Investments in trading securities consist of marketable equity shares measured using the closing stock prices from the exchange market as of the measurement date; as such, they are classified as Level 1 instruments.

The equity shares of the Japanese company measured using the closing stock prices from the exchange market as of the measurement date; as such, they are classified as Level 1 instruments.

The fair value of the share options requires the observable inputs directly or indirectly obtained from active markets, including the Japanese company's stock price, volatility, interest rate, dividends, marketability and expected return requirements. The Group used the Black-Scholes-Merton option-pricing model to determine the fair value of the share options. As such, the derivative asset is classified as a Level 2 instrument.

Note A and Note B (including the embedded derivative) are index-linked notes measured using a discounted cash flow projection on principal and interest based on assumptions supported by, derived or implied from quoted market prices or rates, adjusted for the specific features of these instruments. They are classified as Level 3 instruments. Determining the appropriate fair value model and calculating the fair value of these instruments require the input of significant estimates and assumptions, some of which are unobservable. The significant estimates and assumptions include comparable bonds issued by the same issuer, risk-free interest rates, global banking industry bond yield curve, data on the indices, volatilities and dividend yield.

The fair value estimates presented above were based on pertinent information available to the Group as of December 31, 2008 and 2009. Although the Group is not aware of any factors that would significantly affect its fair value estimates, such amounts have not been comprehensively revalued for purposes of financial statements since December 31, 2008 and 2009, respectively, and current estimates of fair value may differ significantly from the amounts presented.



**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****7. Fair value measurement (Continued)***Assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3 inputs)*

A summary of changes in Level 3 instruments for the years ended December 31, 2008 and 2009 was as follows:

|  | <b>For the years ended December 31,</b> |               |
|--|---|---------------|
|  | <b>2008</b>                             | <b>2009</b>   |
| Balance at beginning of the year   | \$ 18,669,240                           | \$ 14,932,390 |
| Redemption of Note A   |   | (10,000,000)  |
| Loss on change in fair value of embedded derivative                          | (3,275,000)                             | (1,335,630)   |
| Unrealized gains (losses) included in accumulated other comprehensive income | (271,849)                               | 2,291,785     |
| Accrued interest   | (190,001)                               | 735,455       |
| Balance at end of the year   | \$ 14,932,390                           | \$ 6,624,000  |

Net unrealized gain (loss) included in net income (loss) related to assets and liabilities still held as of December 31, 2008 and 2009 consisted of loss on change in fair value of embedded derivative of \$3,275,000 and \$1,335,630 that were reported in other expenses in the consolidated statements of operations in 2008 and 2009, respectively.

*Assets measured at fair value on a non-recurring basis*

The following table presents the Group's assets measured at fair value on a non-recurring basis for the year ended December 31, 2009:

|   | <b>Year ended<br/>December 31,<br/>2009</b> | <b>Fair value measurements using</b>  |  |  | <b>Total gains<br/>(losses)</b> |
|---|---|---|--|--|---------------------------------|
|   |   | <b>Quoted<br/>prices<br/>in<br/>active<br/>markets<br/>for<br/>identical<br/>assets<br/>(Level 1)</b> | <b>Significant<br/>other<br/>observable<br/>inputs<br/>(Level 2)</b> | <b>Significant<br/>unobservable<br/>inputs<br/>(Level 3)</b> |                                 |
| Acquired intangibles - distribution network | \$ 180,428                                  | \$  | \$   | \$ 180,428   | \$ (15,247,873)                 |
| Investment in an affiliate                  | 4,196,707                                   |   |  | 4,196,707  | 4,794,083                       |
|   |   |   |  |  | \$ (10,453,790)                 |

In 2009, as a result of reduced expectations of future cash flows from certain identified intangible assets, the Group determined that the Yiyang Yukang distribution network with a carrying amount of \$15,428,301 was not recoverable and consequently recorded an impairment charge of \$15,247,873 for the year ended December 31, 2009. The Group applied the income approach multi-period excess earning method to estimate the fair value of the distribution network. Calculating the fair value of the distribution network requires the input of significant estimates and

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assumptions, some of which are unobservable. The significant estimates and assumptions include business assumptions, weighted average cost of capital, terminal growth rate, discount rate, return on contributory asset, attrition rate and tax amortization benefit.

Upon deconsolidation of Shanghai Yimeng in June 2009, the Group retained 18% equity interests in Shanghai Yimeng with a negative carrying amount of \$597,376 and accounted for the retained investment using the cost method of accounting. The 18% equity interests investment was recorded at the fair value of \$4,196,707 on the date the Group deconsolidated Shanghai Yimeng. The Group applied the income approach in measuring the equity value of Shanghai Yimeng using significant estimates and assumptions, some of which are unobservable. The significant estimates and assumptions include business assumptions, weighted average cost of capital and terminal growth rate.

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****8. Accounts receivable**

An analysis of allowance for doubtful accounts for the years ended December 31, 2007, 2008 and 2009 was as follows:

|                                  | 2007         | December 31,<br>2008 | 2009         |
|----------------------------------|--------------|----------------------|--------------|
| Balance at beginning of the year | \$ 508,829   | \$ 1,580,214         | \$ 3,524,673 |
| Charged to expenses              | 1,395,920    | 2,423,722            | 121,960      |
| Charges taken against allowance  | (324,535)    | (479,263)            | (2,049,077)  |
| Balance at end of the year       | \$ 1,580,214 | \$ 3,524,673         | \$ 1,597,556 |

**9. Inventory**

Inventory consisted of the following:

|                                      | December 31,<br>2008 | 2009          |
|--------------------------------------|----------------------|---------------|
| Raw materials and work in progress   | \$ 14,236,630        | \$ 11,131,629 |
| Finished goods and merchandise goods | 15,285,050           | 15,049,000    |
|                                      | \$ 29,521,680        | \$ 26,180,629 |

**10. Other prepaid expenses and current assets**

Other prepaid expenses and current assets consisted of the following:

|                        | December 31,<br>2008 | 2009         |
|------------------------|----------------------|--------------|
| Advances to suppliers  | \$ 2,036,232         | \$ 2,712,740 |
| Prepaid income tax     | 1,149,688            | 246,071      |
| Other prepaid expenses | 10,176,608           | 4,835,726    |
|                        | \$ 13,362,528        | \$ 7,794,537 |

The Group made allowance for doubtful accounts in the aggregate amount of \$446,253 and \$663,294 in 2007 and 2008, respectively. The Group reversed the allowance for doubtful accounts in the aggregate amount of \$1,097,904 in 2009.



**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****11. Property and equipment, net**

Property and equipment, net consisted of the following:

|   | December 31,  |               |
|---|---------------|---------------|
|   | 2008          | 2009          |
| Buildings                                       | \$ 10,378,406 | \$ 10,399,957 |
| Leasehold improvements                          | 1,434,811     | 1,134,018     |
| Machinery                                       | 199,621       | 370,010       |
| Computers and office equipment                  | 7,398,446     | 6,518,785     |
| Vehicles  | 1,443,119     | 1,428,366     |
|   | \$ 20,854,403 | \$ 19,851,136 |
| Less: accumulated depreciation and amortization | (5,212,969)   | (6,477,832)   |
|   | \$ 15,641,434 | \$ 13,373,304 |
| Construction in progress                        |               | 1,445,100     |
|   | \$ 15,641,434 | \$ 14,818,404 |

The construction in progress was a new factory building on the land in Qingpu district of Shanghai.

Depreciation and amortization expenses for property and equipment were \$1,249,659, \$1,326,081 and \$2,092,583 for the years ended December 31, 2007, 2008 and 2009, respectively.

**12. Acquired intangible assets, net**

Acquired intangible assets, net consisted of the following:

|  | December 31,  |              |
|--|---------------|--------------|
|  | 2008          | 2009         |
| Distribution networks                          | \$ 19,962,190 | \$ 4,714,317 |
| Trademarks                                     | 2,447,064     | 2,962,303    |
| Assembled and trained workforce                | 232,928       |              |
| Patents  | 311,210       | 178,232      |
| Securities investment advisory service license | 365,786       |              |
|  | \$ 23,319,178 | \$ 7,854,852 |
| Less: accumulated amortization                 | (2,005,229)   | (4,673,256)  |

\$ 21,313,949      \$ 3,181,596

In 2008, as a result of reduced expectations of future cash flows from certain identified intangible assets, the Group determined that the HJX distribution network was not recoverable and consequently recorded an intangible asset impairment charge of \$1,096,096 for the HJX distribution network.

In 2009, as a result of reduced expectations of future cash flows from certain identified intangible assets, the Group determined that the Yiyang Yukang distribution network was not recoverable and consequently recorded an intangible asset impairment charge of \$15,247,873 for the Yiyang Yukang distribution network (refer to Note 7 for fair value measurements relating to the impairment charge).

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The Group recorded amortization expenses of \$533,311, \$602,790 and \$2,992,679 for the years ended December 31, 2007, 2008 and 2009, respectively. The amortization expenses of the above intangible assets will be approximately \$475,764, \$462,262, \$358,131, \$344,941 and \$331,770 for the years 2010, 2011, 2012, 2013 and 2014, respectively.

**13. Investments in affiliates***Investments accounted for under the equity method of accounting*

In July 2008, the Group invested 30% equity interests in Kela (Hong Kong) Jewelry Investment Limited ( Kela ) for cash of \$1,200,000. In October 2009, the Group increased its investment in Kela from 30% to 35%. As the Group has the ability to exercise significant influence over Kela, the Group accounts for this investment using the equity method of accounting. The Group's equity in losses of Kela in 2008 and 2009 were \$40,939 and \$12,351, respectively, and were recognized in other expenses in the consolidated statements of operations.

In June 2009, the Group invested 26% equity interests in KYOBI Cosmetics (Hong Kong) Co., Limited ( KYOBI ) for cash of RMB8 million USD equivalents. As the Group has the ability to exercise significant influence over KYOBI, the Group accounts for this investment using the equity method of accounting. The Group's equity in losses of KYOBI in 2009 was \$403,986 and was recognized in other expenses in the consolidated statements of operations.

*Investment accounted for under the cost method of accounting*

In June 2009, the Group sold 33% equity interests in Shanghai Yimeng, a company which previously was a 51% equity-owned consolidated subsidiary of the Group. After the sale, the Group retained 18% equity interests in Shanghai Yimeng and does not have the ability to exercise significant influence over Shanghai Yimeng's operational and financial policies and activities. The Group accounts for the retained 18% equity interests investment using the cost method of accounting. The retained 18% equity interests investment was recorded at the fair value of \$4.2 million on the date the Group deconsolidated Shanghai Yimeng (refer to Note 4 for details of deconsolidation of Shanghai Yimeng).

**14. Accrued expenses and other current liabilities**

Accrued expenses and other current liabilities consisted of the following:

|                                      | <b>December 31,</b> |               |
|--------------------------------------|---------------------|---------------|
|                                      | <b>2008</b>         | <b>2009</b>   |
| Other taxes payable                  | \$ 4,086,616        | \$ 2,906,553  |
| Accrued employee payroll and welfare | 3,522,526           | 2,897,918     |
| Other payable                        | 5,029,413           | 5,357,401     |
| Accrued expenses                     | 2,081,090           | 2,480,212     |
| Advances from customers              | 4,933,175           | 1,196,058     |
|                                      | \$ 19,652,820       | \$ 14,838,142 |

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Other taxes payable mainly consist of value-added tax payable and sales taxes payable. The Group's PRC subsidiaries are subject to value-added tax at a rate of 17% on product purchases and sales amount. Value-added tax payable on sales is computed net of value-added tax paid on purchases. The Group's PRC subsidiaries are also subject to business tax at a rate of 5% on sales related to service rendered.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**15. Dividend payable**

On December 18, 2009, the board of directors of Acorn International approved and declared a one-time special cash dividend of \$0.33 per ordinary share on its outstanding shares to shareholders of record as of the close of trading on December 31, 2009 directly from the share premium account of Acorn International. The total dividend payable as of December 31, 2009 was \$29,322,782. The balance of additional paid-in capital was reduced for the full amount of this special dividend as of December 31, 2009.

**16. Share-based compensation**

In 2005, the Group adopted the 2005 Equity Incentive Plan and the 2005 Equity Incentive Plan B (collectively, the 2005 Option Plan ) which allows the Group to offer a variety of incentive awards to employees, officers, directors or individual consultants or advisors who render services to the Group. In 2005, 9,415,366 ordinary shares were authorized under the 2005 Option Plan. In May 2006, the Group adopted the 2006 Equity Incentive Plan (the 2006 Option Plan ) and authorized the issuance of 24,133,000 ordinary shares. Under the 2005 and 2006 Option Plans, the options and SARs are generally granted with an exercise price equal to the fair market value of the underlying shares, as determined by the Group's board of directors at the date of grant and expire after ten years and six years, respectively, with vesting occurring 25% upon grant and the remaining 75% vesting ratably over three years. Certain options and SARs granted vest immediately upon grant, and certain options and SARs granted vest upon the satisfaction of certain performance targets. The proceeds from the exercise of the SARs by the grantee will be equity settled by delivery of equivalent fair value of ordinary shares of the Group.

The Group recorded compensation expense of \$6,519,078, \$3,289,232 and \$1,845,885 for the years ended December 31, 2007, 2008 and 2009, respectively. In connection with the acquisition of Yiyang Yukang, the Group granted 900,000 performance-based options in 2009 under the 2006 Option Plan. These options will vest in three equal tranches of 300,000 options each upon Yiyang Yukang meeting certain earnings targets in 2008 to 2010. The Group excluded the last tranche of 300,000 options outstanding as of December 31, 2009 from compensation expense, as the Group does not expect that Yiyang Yukang 2010 earnings target will be met.

Prior to the Group's IPO in May 2007, the derived fair value of the ordinary shares underlying the options and SARs was determined based on a retrospective third-party valuation using generally accepted valuation methodologies, including a weighted average equity value derived by using a combination of the discounted cash flow method, a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate and the guideline companies method, which incorporates certain assumptions including the market performance of comparable listed companies as well as the financial results and growth trends of the Group, to derive the total equity value of the Group. The valuation model allocated the equity value between the ordinary shares and the preferred shares and determined the fair value of ordinary shares based on the option-pricing method under the enterprise value allocation method. Under this method, the ordinary shares have value only if the funds available for distribution to shareholders exceed the value of the liquidation preference at the time of a liquidity event (for example, merger or sale). The ordinary shares are considered to be a call option with claim on the enterprise at an exercise price equal to the remaining value immediately after the preferred shares are liquidated. Subsequent to the Group's IPO in May 2007, the fair value of the underlying ordinary shares is based on quoted market prices.

Except for the options granted in 2009, the fair value of each option/SAR granted was estimated on the date of grant using the Black-Scholes-Merton option-pricing formula. The risk-free interest rate for periods within the contractual life of the option/SAR is based on the yield of Chinese International Bond. The expected life of options/SARs granted represents the period of time that the options/SARs are expected to be outstanding and is

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****16. Share-based compensation (Continued)**

based on historical data related to option/SAR exercises and employee terminations. Expected volatilities are based on the average volatility of comparable companies with the time period commensurate with the expected time period.

|                                  | 2007                                     |                                       |
|----------------------------------|--|---------------------------------------|
|                                  | SARs without<br>performance<br>condition | SARs with<br>performance<br>condition |
| Average risk-free interest rate  | 5.09%                                    | 5.03%                                 |
| Average expected option/SAR life | 3.58 years                               | 3.58 years                            |
| Average expected volatility rate | 36.00%                                   | 36.00%                                |
| Average dividend yield           | 0%                                       | 0%                                    |

The fair value of each option granted in 2009 was estimated on the date of grant using the binomial option-pricing formula. The risk-free interest rate for periods within the contractual life of the option is based on the yield of ten-year USD China Government BFV Curve with similar time maturity of the option valued as of grant date. The Group uses historical data to estimate option exercise and employee termination within the pricing formula. The contractual life of the option is ten years. Expected volatilities are based on the weighted average historical volatility of the Group and the comparable companies with the time period commensurate with the expected time period.

|                                  | 2009     |
|----------------------------------|----------|
| Average risk-free interest rate  | 4.48%    |
| Contractual life of the option   | 10 years |
| Average expected volatility rate | 72.98%   |
| Average dividend yield           | 0%       |

A summary of the options and SARs activities for the year ended December 31, 2009 and the information regarding the options and SARs outstanding as of December 31, 2009 were as follows:

|  | Number of<br>options/<br>SARs | Weighted average<br>exercise price | Weighted<br>average<br>remaining<br>contract<br>terms | Aggregate<br>intrinsic<br>value |
|--|-------------------------------|------------------------------------|---|---------------------------------|
| Options/SARs outstanding at January 1, 2009                  | 15,538,759                    | \$ 2.68                            |   |                                 |
| Granted  | 900,000                       | \$ 2.00                            |   |                                 |
| Forfeited  | (311,736)                     | \$ 2.06                            |   |                                 |
| Exercised  | (1,242)                       | \$ 1.66                            |   |                                 |
| Options/SARs outstanding at December 31, 2009                | 16,125,781                    | \$ 2.65                            | 4.35 years  | \$                              |
| Options/SARs vested or expected to vest at December 31, 2009 | 15,825,781                    | \$ 2.66                            | 4.25 years  | \$                              |



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|  |            |    |      |            |    |
|--|------------|----|------|------------|----|
| Options/SAR exercisable at December 31, 2009 | 15,758,250 | \$ | 2.66 | 4.26 years | \$ |
|--|------------|----|------|------------|----|

The weighted-average fair value of options and SARs granted in 2007, 2008 and 2009 was \$1.51, nil and \$1.05, respectively. The total fair value of options and SARs vested in 2007, 2008 and 2009 was \$5,852,492, \$5,134,790 and \$1,873,984, respectively. The aggregate intrinsic value of options and SARs exercised in 2007, 2008 and 2009 was \$643,532, \$186,881 and \$298, respectively.

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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**16. Share-based compensation (Continued)**

As of December 31, 2009, there was \$101,859 in total unrecognized compensation expense related to unvested share-based compensation arrangements granted under the 2005 and 2006 Option Plans, which is expected to be recognized over a weighted-average period of 0.25 years.

**17. Taxation**

Acorn International is incorporated in the Cayman Islands and is not subject to tax in this jurisdiction.

China DRTV and Smooth Profit are incorporated in the British Virgin Islands and are not subject to tax in this jurisdiction.

The Group's Hong Kong subsidiaries, MK AND T, Emoney, Bright Rainbow, Acorn Hong Kong and U King Hong Kong, are subject to Hong Kong statutory income tax on their Hong Kong sourced income.

In 2007, the Group's PRC subsidiaries are subject to Corporate Income Tax ( CIT ) on the taxable income in accordance with the Enterprise Income Tax Law and the Income Tax Law of the PRC concerning Foreign Investment Enterprise and Foreign Enterprises (collectively PRC Corporate Income Tax Laws ), respectively.

On March 16, 2007, the PRC government promulgated Law of the People's Republic of China on Enterprise Income Tax ( New EIT Law ), which is effective from January 1, 2008. Under the New EIT Law, domestically-owned enterprises and foreign-invested enterprises are subject to a uniform tax rate of 25%. While the New EIT Law equalizes the tax rates for domestically-owned and foreign-invested companies, preferential tax treatment would continue to be given to companies in certain encouraged sectors and to enterprises classified as high and new technology companies, whether domestically-owned or foreign-invested enterprises. The New EIT Law also provides a five-year transition period starting from its effective date for those enterprises which were established before the promulgation date of the New EIT Tax Law and which were entitled to a preferential tax treatment such as a reduced tax rate or a tax holiday. The tax rate of such enterprises will transition to the uniform tax rate of 25% within a five-year transition period and the tax holiday, which has been enjoyed by such enterprises before the effective date of the New EIT Law, may continue to be enjoyed until the end of the holiday.

Shanghai Advertising registered in Pudong New District, Shanghai of the PRC, is subject to 15% CIT in 2007, 18% CIT in 2008 and 20% CIT in 2009 pursuant to the local tax preferential arrangement.

Shanghai HJX, Acorn Electronic, Shanghai An-Nai-Chi, Beijing Youngleda and Zhuhai Acorn registered in the Old Districts of the PRC, are subject to 27% CIT in 2007 as qualified foreign-invested manufacturing enterprises.

Acorn Information registered in Pudong New District, Shanghai of the PRC, are subject to 15% CIT in 2007 pursuant to the local tax preferential arrangement.

Zhuhai Sunrana registered in Zhuhai Specific Economic Zone of the PRC, is subjected to 15% CIT in 2007 pursuant to the local tax preferential arrangement. Starting from January 1, 2008, Zhuhai Sunrana is subject to the preferential five-year transition period tax rates under the New EIT Law and 2008 and 2009 applicable CIT rates are 18% and 20%, respectively.

Beijing HJZX, as a recognized high and new technology HJ company and registered in Zhongguancun technology zone in Beijing of the PRC, is subject to 15% CIT in 2007.



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**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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**17. Taxation (Continued)**

The Group's remaining PRC subsidiaries are subject to the statutory rate of 33% in 2007 in accordance with the PRC Corporate Income Tax Laws, and 25% in 2008 and 2009 in accordance with the New EIT Law.

Shanghai HJX, Acorn Electronic, Shanghai An-Nai-Chi, Beijing Youngleda, Yiyang Yukang and Zhuhai Acorn, as foreign-invested manufacturing enterprises which are scheduled to operate for at least ten years, are entitled to a two-year exemption and three-year 50% reduction starting from the first profit making year after absorbing all prior years' tax losses, which can be carried forward for five years (the Tax Holiday). Under the New EIT Law, enterprises not generating profits before 2008 are required to commence the Tax Holiday beginning January 1, 2008.

Acorn Information, as a recognized software company, is eligible for the Tax Holiday from 2005.

Acorn Consulting, as a recognized new service company, is entitled to CIT exemption in 2007.

Beijing HJZX, as a recognized high and new technology company and registered in Zhongguancun technology zone in Beijing of the PRC, is entitled to CIT exemption in 2007.

Shanghai Network, as a recognized new trading company, is entitled to CIT exemption in 2007.

Tax that would otherwise have been payable without tax holidays amounted to \$22,185,570, \$908,069 and \$992,459 in 2007, 2008 and 2009, respectively (representing a (reduction) increase in basic income (loss) per ordinary share from continuing operations of \$(0.29), \$0.01 and \$0.01 and diluted income (loss) from continuing operations per ordinary share of \$(0.26), \$0.01 and \$0.01 in 2007, 2008 and 2009, respectively).

Under the New EIT Law and implementation regulations issued by the PRC State Council, income tax at the rate of 10% is applicable to interest and dividends payable to investors that are non-resident enterprises, which do not have an establishment or place of business in the PRC, or which have such establishment or place of business but the relevant income is not effectively connected with the establishment or place of business, to the extent such interest or dividends have their sources within the PRC. Undistributed earnings of the Group's PRC subsidiaries of \$105,084,071 as of December 31, 2009 are considered to be indefinitely reinvested and, accordingly, no provision for PRC dividend withholding tax has been provided thereon. Upon distribution of these earnings in the form of dividends or otherwise in the future, the Group would be subject to PRC withholding tax at 10% or a lower treaty rate.

Under applicable accounting principles, a deferred tax liability should be recorded for taxable temporary differences attributable to the excess of financial reporting basis over tax basis in a domestic subsidiary. However, recognition is not required in situations where the tax law provides a means by which the reported amount of that investment can be recovered tax-free and the enterprise expects that it will ultimately use that means. The Group has not recorded any such deferred tax liability attributable to the undistributed earnings of its financial interests in VIEs because these entities do not have any unremitted earnings to be distributed.

Effective on January 1, 2007, the Group adopted the provisions of ASC 740-10, Income Taxes Overall (previously FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of SFAS No. 109). Based on its analysis under ASC 740-10, the Group made its assessment of the level of authority for each tax position (including the potential application of interests and penalties) based on the technical merits, and has measured the unrecognized benefits associated with the tax positions. As of



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December 31, 2008 and 2009, the Group had unrecognized tax benefits of approximately \$3.1 million and \$3.1 million, respectively. The unrecognized tax benefits would impact the effective income tax if recognized. A reconciliation of the beginning and ending amount of unrecognized tax benefits for the years ended December 31, 2008 and 2009 was as follows:

|  | For the years ended December 31, |                      |                      |
|--|----------------------------------|----------------------|----------------------|
|  | 2007<br>(in million)             | 2008<br>(in million) | 2009<br>(in million) |
| Unrecognized tax benefits at beginning of the year | \$                               | \$                   | \$ 3.1               |
| Gross increases tax positions in prior years       |                                  |                      |                      |
| Gross decreases tax positions in prior years       |                                  |                      |                      |
| Gross increases tax positions in current year      |                                  |                      |                      |
| Settlements in current year                        |                                  |                      |                      |
| Increases related to acquired business             |                                  | 3.1                  |                      |
| Lapsing of statutes of limitations                 |                                  |                      |                      |
| Unrecognized tax benefits at end of the year       | \$                               | \$ 3.1               | \$ 3.1               |

As of December 31, 2008 and 2009, the amount of interests and penalties related to uncertain tax positions was immaterial. The Group does not anticipate any significant increases or decreases to its liabilities for unrecognized tax benefits within the next twelve months.

According to the PRC Tax Administration and Collection Law, the statute of limitations is three years if the underpayment of income taxes is due to computational errors made by the taxpayer. The statute of limitations will be extended to five years under special circumstances, which are not clearly defined, but an underpayment of income tax liability exceeding RMB100,000 (approximately \$15,000) is specifically listed as a special circumstance. In the case of a transfer pricing related adjustment, the statute of limitations is ten years. There is no statute of limitations in the case of tax evasion. The Group's PRC subsidiaries are therefore subject to examination by the PRC tax authorities from 2005 through 2009 on non-transfer pricing matters, and from 2000 through 2009 on transfer pricing matters.

Reconciliation between the effective income tax rate and the PRC statutory income tax rate was as follows:

|  | For the years ended December 31, |       |       |
|--|----------------------------------|-------|-------|
|  | 2007                             | 2008  | 2009  |
| PRC statutory tax rate   | 33%                              | 25%   | 25%   |
| Tax effect of advertising expenses that are not deductible in determining taxable profit | 148%                             | (4)%  | 19%   |
| Tax effect of other expenses that are not deductible in determining taxable profit       | 21%                              | (1)%  | (22)% |
| Effect of differences between PRC statutory tax rate and foreign effective tax rates     | 10%                              | (15)% | (29)% |
| Effect of tax holidays granted to PRC subsidiaries                                       | (212)%                           | 4%    | 17%   |
| Effect of deferred tax assets valuation allowance  |                                  | (9)%  | 34%   |

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\$ (226,418) \$ 1,430,910

As of December 31, 2009, the Group had tax losses carrying forward of \$5,294,371. The tax losses will expire in 2010-2014 if they are not used.

The Group considers positive and negative evidence to determine whether some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, the Group believes it is more-likely-than-not that the Group will realize the benefits of these deductible differences, net of the existing valuation allowances as of December 31, 2009. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carry forward periods are reduced.

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Other income (expenses) consisted of the following:

|                                     | For the years ended December 31, |                |              |
|-------------------------------------|----------------------------------|----------------|--------------|
|                                     | 2007                             | 2008           | 2009         |
| Investment gain (loss)              | \$ 8,854,262                     | \$ (2,172,701) | \$ 402,142   |
| Equity in loss in equity investment |                                  | (40,939)       | (416,337)    |
| Interest income                     | 4,141,579                        | 2,090,698      | 1,506,751    |
| Interest expenses                   | (320)                            |                |              |
| Others                              | 715,388                          | (544,355)      | 158,830      |
|                                     | \$ 13,710,909                    | \$ (667,297)   | \$ 1,651,386 |

**19. Convertible redeemable preferred shares**

In January 2005, the Group issued 17,709,815 Series A convertible redeemable preferred shares to SB Asia Investment Fund II L.P. ( SAIF ) for consideration of US\$1.98 per share for total proceeds of US\$32,479,902, net of issuance costs of \$2,520,098. In conjunction with the issuance of Series A preferred shares, the Group also issued a detachable warrant to SAIF for no additional consideration. As per the warrant agreement, SAIF could purchase an aggregate of 2,882,155 Series A-1 convertible redeemable preferred shares at a per share exercise price of US\$2.78. The warrant was exercised in full on December 28, 2005 for total proceeds of US\$8,000,000. The proceeds received in the Series A convertible redeemable preferred shares offerings were first allocated between the convertible instrument and the warrants on a residual fair value basis. The accretion to the redemption value was reflected as a reduction to net income to arrive at net income available to ordinary shareholders in the consolidated statements of operations and amounted to \$53,800, nil and nil for the years ended December 31, 2007, 2008 and 2009, respectively. The Group determined that there was no embedded beneficial conversion feature attributable to the Series A convertible redeemable preferred shares.

Upon the completion of the Group's IPO in May 2007, Series A convertible redeemable preferred shares and Series A-1 convertible redeemable preferred shares were converted into ordinary shares on a one-to-one basis.

**20. Share repurchase program**

In December 2007, the Group adopted a share repurchase program enabling it to repurchase up to an aggregate of \$30,000,000 of its ADSs, each representing its three ordinary shares. As of December 31, 2007, the Group had repurchased an aggregate of 683,000 ADSs, representing 2,049,000 ordinary shares, on the open market for total cash consideration of \$6,833,124. The share repurchase program continued until April 2008 and was extended by the board of directors in 2008 and run through May 31, 2009. As of December 31, 2008, the Group had repurchased an aggregate of 2,632,747 ADSs, representing 7,898,241 ordinary shares, on the open market for total cash consideration of \$23,211,848. As of December 31, 2009, the Group had repurchased an aggregate of 3,272,013 ADSs, representing 9,816,039 ordinary shares, on the open market for total cash consideration of \$25,499,984.

In December 2008, the Group issued 2,564,103 of its ordinary shares repurchased through the share repurchase program for the acquisition of Yiyang Yukang. The total repurchase costs of the shares issued in December 2008 for the acquisition of Yiyang Yukang is \$7,535,642. In June 2009, the Group issued 2,564,103 of its ordinary shares repurchased through the share repurchase program for the acquisition of Yiyang

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Yukang. The total repurchase costs of the shares issued in June 2009 for the acquisition of Yiyang Yukang is \$6,351,796.

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**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****21. Mainland China contribution plan and profit appropriation**

Employees of the Group in the PRC are entitled to retirement benefits calculated with reference to their salaries basis upon retirement and their length of service in accordance with a PRC government-managed retirement plan. The PRC government is directly responsible for the payments of the benefits to these retired employees. The Group is required to make contributions to the government-managed retirement plan based on certain percentages of the employees' monthly salaries. The amounts contributed by the Group were \$1,122,387, \$1,248,862 and \$1,237,011 for the years ended December 31, 2007, 2008 and 2009, respectively.

In addition, the Group is required by law to contribute medical, unemployment, housing and other statutory benefits based on certain percentages of the employees' monthly salaries. The PRC government is directly responsible for the payments of the benefits to these employees. The amounts contributed by the Group were \$1,076,278, \$1,224,088 and \$1,225,763 for the years ended December 31, 2007, 2008 and 2009, respectively.

In accordance with relevant PRC Company Law and regulations and the Group's Articles of Association, the Group's PRC subsidiaries were required to appropriate 10% of their respective profit after taxation reported in their statutory financial statements prepared under the PRC GAAP to the statutory surplus reserve. The Group has statutory reserve balance of \$6,146,485 and \$4,369,781 as of December 31, 2008 and 2009, respectively. The appropriation of statutory surplus reserve will cease upon the balance of the statutory surplus reserve reaching 50% of the companies' registered capital. The statutory surplus reserves may be used to make up losses or for conversion into the shareholders' equity.

**22. Commitments and contingencies****(A) Leases commitments**

The Group leases certain office premises and buildings under non-cancelable leases. Rental expenses under operating leases for 2007, 2008 and 2009 were \$1,848,233, \$2,639,904 and \$3,260,183, respectively.

As of December 31, 2009, future minimum lease payments under non-cancelable operating leases agreements were as follows:

|                     |              |
|---------------------|--------------|
| 2010                | \$ 1,969,552 |
| 2011                | 956,943      |
| 2012                | 359,370      |
| 2013                | 109,016      |
| 2014 and thereafter | 51,323       |
|                     | \$ 3,446,204 |

**(B) Advertising commitments**

As of December 31, 2009, the commitments for the advertising contracts signed by the Group were as follows:

2010

\$ 52,859,954

Of the total commitments, \$9,771,139 were prepaid as of December 31, 2009.

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**22. Commitments and contingencies (Continued)**

***(C) Legal matters***

The Group is a party to legal matters and claims that are normal in the course of its operations. While the Group believes that the ultimate outcome of these matters will not have a material adverse effect on its financial position, results of operations and cash flows, the outcome of these matters is not determinable with certainty and negative outcomes may adversely affect the Group.

In March 2009, the Group received a complaint from Advertising Broadcasting Center of Liaoning TV Station ( Liaoning TV ), which filed a suit against Shanghai Acorn Advertising Broadcasting Co., Ltd. ( Shanghai Advertising ), claiming that Shanghai Advertising breached its advertisement broadcasting contract with Liaoning TV by not fully performing its payment obligation under the contract and asserted damages of approximately RMB19.0 million (approximately \$2.8 million). Liaoning TV further applied for provisional seizure of Shanghai Advertising's bank account in the same amount of its claim. In June 2009, the people's court ruled in favor of Liaoning TV and awarded Liaoning TV an aggregate payment of RMB10.9 million (approximately \$1.6 million). In July 2009, the Group appealed to the people's court at higher level, which affirmed the judgment in September 2009. In November 2009, the Group paid Liaoning TV RMB10.9 million (approximately \$1.6 million), but the Group has applied for retrial of this case.

**23. Segment and geographic information**

The Group engages primarily in direct sales, including TV direct sales, third-party bank channel sales, catalogs sales, internet sales and direct sales through print media and radio, and distribution sales through its national distribution network in the PRC.

The Group's chief operating decision maker has been identified as the Chief Executive Officer ( CEO ), who reviews consolidated results when making decisions about allocating resources and assessing performance of the Group. The Group uses the management approach to determine operating segments. The management approach considers the internal organization and reporting used by the Group's chief operating decision makers for making decisions, allocating resources and assessing performance. Based on this assessment, the Group has determined that it has two operating and reporting segments, which are direct sales, net and distribution sales, net.

The Group's chief operating decision maker evaluates segment performance based on revenues, cost of revenues and gross profit. Accordingly, all expenses are considered corporate level activities and are not allocated to segments. Therefore, it is not practical to show profit or loss by reportable segments. Also, the Group's chief decision maker does not assign assets to these segments. Consequently, it is not practical to show assets by reportable segments.

**Table of Contents****ACORN INTERNATIONAL, INC.****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009****(In US dollars, except share data, unless otherwise stated)****23. Segment and geographic information (Continued)**

The Group's revenues are all generated from external customers in the PRC. The revenues by each group of similar products and services are as follows:

| <b>Product</b>                            | <b>For the years ended December 31,</b> |                       |                       |
|---|---|-----------------------|-----------------------|
|   | <b>2007</b>                             | <b>2008</b>           | <b>2009</b>           |
| Electronic learning device and dictionary | \$ 56,199,326                           | \$ 61,175,108         | \$ 105,223,419        |
| Beauty and health products                | 32,899,378                              | 59,666,463            | 74,974,358            |
| Cell phones                               | 105,562,888                             | 56,242,401            | 61,276,510            |
| Consumer electronics                      | 7,949,819                               | 22,008,208            | 9,666,139             |
| Collectible products                      | 19,332,223                              | 16,141,592            | 9,515,504             |
| Subscription service revenues             | 2,586,550                               | 1,160,290             | 223,207               |
| Marketing service revenues                | 16,035,935                              | 3,168,617             |                       |
| Other products                            | 8,295,912                               | 14,784,211            | 26,902,406            |
| <b>Total gross revenues</b>               | <b>\$ 248,862,031</b>                   | <b>\$ 234,346,890</b> | <b>\$ 287,781,543</b> |
| Less: sales taxes                         | (825,022)                               | (209,469)             | (195,923)             |
| <b>Total revenues, net</b>                | <b>\$ 248,037,009</b>                   | <b>\$ 234,137,421</b> | <b>\$ 287,585,620</b> |

The gross profit by segments is as follows:

|                    | <b>For the years ended December 31,</b> |                       |                       |
|--------------------|---|-----------------------|-----------------------|
|                    | <b>2007</b>                             | <b>2008</b>           | <b>2009</b>           |
| Direct sales       | \$ 95,337,653                           | \$ 83,646,739         | \$ 92,826,982         |
| Distribution sales | 29,351,165                              | 29,863,732            | 44,130,740            |
| <b>Total</b>       | <b>\$ 124,688,818</b>                   | <b>\$ 113,510,471</b> | <b>\$ 136,957,722</b> |

**Geographic information**

The Group operates in the PRC and all of the Group's long-lived assets are located in the PRC.

In 2007, 2008 and 2009, no customer accounted for 10% or more of the Group's net revenues.

**24. Related party transactions****Transactions with employees**

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The Group's customers include distributors who are owned by certain employees of the Group. Details of the transactions for the years ended December 31, 2007, 2008 and 2009 were as follows:

|                     | For the years ended December 31, |               |               |
|---------------------|----------------------------------|---------------|---------------|
|                     | 2007                             | 2008          | 2009          |
| Sales               | \$ 18,947,783                    | \$ 11,523,922 | \$ 16,202,838 |
| Accounts receivable | 802,859                          | 730,897       | 1,011,897     |

These sales represented 7.6%, 4.9% and 5.6% of the total gross revenues in 2007, 2008 and 2009, respectively. The sales with the single entity owned by a family member of the Group's CEO were \$859,436, nil and nil for the years ended December 31, 2007, 2008 and 2009, respectively.

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**ACORN INTERNATIONAL, INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**FOR THE YEARS ENDED DECEMBER 31, 2007, 2008 AND 2009**

**(In US dollars, except share data, unless otherwise stated)**

**25. Restricted net assets**

Relevant PRC laws and regulations permit payments of dividends by the Group's PRC subsidiaries only out of their retained earnings, if any, as determined in accordance with PRC accounting standards and regulations. As a result of these PRC laws and regulations, the Group's PRC subsidiaries are restricted in their abilities to transfer a portion of their net assets either in the form of dividends, loans or advances, which restricted portion amounted to \$35,432,956 as of December 31, 2009. This amount is made up of the registered equity of the Group's PRC subsidiaries and the statutory reserves disclosed in Note 21. In addition, as a result of the Group's restructuring effective January 1, 2005, retained earnings of \$20,336,734 related to the pre-restructuring companies was unavailable for distribution as a normal dividend to Acorn International in accordance with relevant PRC laws and regulations.

**26. Subsequent events**

In January 2010, the Group paid out the special dividend of \$29,322,782 to its shareholders.

In January 2010, Shanghai An-Nai-Chi, a previously consolidated subsidiary of the Group, received a cash injection of \$1.5 million from a third party. The Group's equity interests in Shanghai An-Nai-Chi therefore decreased from 51.00% to 33.15% so that the Group no longer had controlling interests in Shanghai An-Nai-Chi. Upon the completion of the capital injection, the Group ceased to consolidate Shanghai An-Nai-Chi and accounts for the retained investment using the equity method of accounting.

In February 2010, Emoney, a previously consolidated subsidiary of the Group, was deregistered and the Group ceased to consolidate Emoney upon the completion of this deregistration.

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**Table of Contents****ADDITIONAL INFORMATION FINANCIAL STATEMENT SCHEDULE I****ACORN INTERNATIONAL, INC.**

These financial statements have been prepared in conformity with accounting principles generally accepted in the United States.

**FINANCIAL INFORMATION OF PARENT COMPANY****BALANCE SHEETS**

(In US dollars, except share data)

|  | December 31,          |                       |
|--|-----------------------|-----------------------|
|  | 2008                  | 2009                  |
| <b>Assets</b>  |                       |                       |
| Current assets:  |                       |                       |
| Cash and cash equivalents  | \$ 57,037,995         | \$ 48,188,467         |
| Short-term investments   | 9,657,390             |                       |
| Other current assets   | 171,710               | 118,212               |
| Amounts due from subsidiaries  | 8,918,791             | 9,963,344             |
| <b>Total current assets</b>  | <b>75,785,886</b>     | <b>58,270,023</b>     |
| Investments in subsidiaries  | 113,001,522           | 148,120,697           |
| Amounts due from a subsidiary  | 1,200,000             |                       |
| Long-term investments  | 5,275,000             | 6,624,000             |
| <b>Total assets</b>  | <b>\$ 195,262,408</b> | <b>\$ 213,014,720</b> |
| <b>Liabilities and equity</b>  |                       |                       |
| Current liabilities:   |                       |                       |
| Other current liabilities  | \$ 880,470            | \$ 1,436,293          |
| Dividend payable   |                       | 29,322,782            |
| <b>Total current liabilities</b>   | <b>880,470</b>        | <b>30,759,075</b>     |
| Equity:  |                       |                       |
| Ordinary shares (\$0.01 par value; 100,000,000 shares authorized, 93,543,506 and 93,544,748 shares issued and 88,209,368 and 88,856,915 shares outstanding as of December 31, 2008 and 2009, respectively) | 935,435               | 935,447               |
| Additional paid-in capital   | 203,113,548           | 175,638,701           |
| Retained deficit   | (9,104,346)           | (268,518)             |
| Accumulated other comprehensive income   | 15,113,507            | 17,562,561            |
| Treasury stock, at cost (5,334,138 and 4,687,833 shares as of December 31, 2008 and 2009, respectively)  | (15,676,206)          | (11,612,546)          |
| <b>Total equity</b>  | <b>194,381,938</b>    | <b>182,255,645</b>    |
| <b>Total liabilities and equity</b>  | <b>\$ 195,262,408</b> | <b>\$ 213,014,720</b> |

**Table of Contents****FINANCIAL INFORMATION OF PARENT COMPANY****STATEMENTS OF OPERATIONS****(In US dollars)**

|   | <b>For the years ended December 31,</b> |                 |               |
|---|---|-----------------|---------------|
|   | <b>2007</b>                             | <b>2008</b>     | <b>2009</b>   |
| Operating expenses:   |   |                 |               |
| Other selling and marketing expenses                                | \$ 1,246,555                            | \$ 1,361,489    | \$ 1,176,988  |
| General and administrative expenses                                 | 7,084,014                               | 5,005,417       | 3,647,183     |
| Total operating expenses  | 8,330,569                               | 6,366,906       | 4,824,171     |
| Loss from operations  | (8,330,569)                             | (6,366,906)     | (4,824,171)   |
| Equity in earnings (losses) of subsidiaries                         | 22,122,152                              | (18,116,119)    | 17,051,897    |
| Other income (expenses)   | 4,860,323                               | (1,108,344)     | (344,462)     |
| Income (loss) before income taxes                                   | 18,651,906                              | (25,591,369)    | 11,883,264    |
| Income taxes  |   |                 |               |
| Net income (loss) attributable to Acorn International, Inc.         | 18,651,906                              | (25,591,369)    | 11,883,264    |
| Deemed dividend on Series A convertible redeemable preferred shares | (53,800)                                |                 |               |
| Net income (loss) attributable to holders ordinary shares           | \$ 18,598,106                           | \$ (25,591,369) | \$ 11,883,264 |

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**Table of Contents****FINANCIAL INFORMATION OF PARENT COMPANY****STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (LOSS)**

(In US dollars, except share data)

|   | Ordinary shares |            | Additional<br>Paid-in<br>capital | Subscription<br>receivable | Retained<br>earnings<br>(deficit) | Accumulated<br>other<br>comprehensive<br>income | Treasury stock,<br>at cost |             | Total equity  | Comprehensive<br>income (loss) |
|---|-----------------|------------|----------------------------------|----------------------------|-----------------------------------|---|----------------------------|-------------|---------------|--------------------------------|
|   | Shares          | Amount     |                                  |                            |                                   |   | Shares                     | Amount      |               |                                |
| Balance at<br>January 1, 2007   | 48,979,394      | \$ 489,794 | \$ 33,364,641                    | \$ (9,289,478)             | \$ 2,242,779                      | \$ 3,029,752                                    |                            | \$          | \$ 29,837,488 |                                |
| Issuance of<br>ordinary shares in<br>initial public<br>offering   | 23,565,000      | 235,650    | 112,994,175                      |                            |                                   |   |                            |             | 113,229,825   |                                |
| Cost of initial<br>public offering  |                 |            | (4,344,262)                      |                            |                                   |   |                            |             | (4,344,262)   |                                |
| Conversion of<br>Series A<br>convertible<br>redeemable<br>preferred shares to<br>ordinary shares<br>upon the<br>completion of<br>initial public<br>offering   | 17,709,815      | 177,098    | 31,872,401                       |                            |                                   |   |                            |             | 32,049,499    |                                |
| Conversion of<br>Series A-1<br>convertible<br>redeemable<br>preferred shares to<br>ordinary shares<br>upon the<br>completion of<br>initial public<br>offering | 2,882,155       | 28,822     | 18,836,902                       |                            |                                   |   |                            |             | 18,865,724    |                                |
| Collection of<br>subscription<br>receivable   |                 |            |                                  | 9,289,478                  |                                   |   |                            |             | 9,289,478     |                                |
| Exercise of stock<br>options and stock<br>appreciate rights   | 119,076         | 1,190      | 121,152                          |                            |                                   |   |                            |             | 122,342       |                                |
| Repurchase of<br>ordinary shares  |                 |            |                                  |                            |                                   |   | (2,049,000)                | (6,833,124) | (6,833,124)   |                                |
| Share-based<br>compensation<br>expenses   |                 |            | 6,519,078                        |                            |                                   |   |                            |             | 6,519,078     |                                |
| Net income  |                 |            |                                  |                            | 18,651,906                        |   |                            |             | 18,651,906    | \$ 18,651,906                  |
| Deemed dividend<br>on Series A<br>convertible<br>redeemable<br>preferred shares   |                 |            |                                  |                            | (53,800)                          |   |                            |             | (53,800)      |                                |
| Unrealized losses<br>on<br>available-for-sales<br>securities  |                 |            |                                  |                            |                                   | (1,556,316)                                     |                            |             | (1,556,316)   | (1,556,316)                    |
| Foreign currency<br>translation<br>adjustments  |                 |            |                                  |                            |                                   | 6,217,549                                       |                            |             | 6,217,549     | 6,217,549                      |

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|  |            |            |                |    |                |               |             |                 |                |                 |
|--|------------|------------|----------------|----|----------------|---------------|-------------|-----------------|----------------|-----------------|
| Balance at<br>December 31,<br>2007   | 93,255,440 | \$ 932,554 | \$ 199,364,087 | \$ | \$ 20,840,885  | \$ 7,690,985  | (2,049,000) | \$ (6,833,124)  | \$ 221,995,387 | \$ 23,313,139   |
| Exercise of stock<br>options   | 288,066    | 2,881      | 460,229        |    |                |               |             |                 | 463,110        |                 |
| Repurchase of<br>ordinary shares   |            |            |                |    |                |               | (5,849,241) | (16,378,724)    | (16,378,724)   |                 |
| Issuance of<br>repurchased shares<br>in connection with<br>the acquisition of<br>Yiyang Yukang |            |            |                |    | (4,353,862)    | 2,564,103     | 7,535,642   |                 | 3,181,780      |                 |
| Share-based<br>compensation<br>expenses  |            |            | 3,289,232      |    |                |               |             |                 | 3,289,232      |                 |
| Net loss   |            |            |                |    | (25,591,369)   |               |             |                 | (25,591,369)   | \$ (25,591,369) |
| Unrealized losses<br>on<br>available-for-sales<br>securities                                   |            |            |                |    |                | (271,849)     |             |                 | (271,849)      | (271,849)       |
| Foreign currency<br>translation<br>adjustments   |            |            |                |    |                | 7,694,371     |             |                 | 7,694,371      | 7,694,371       |
| Balance at<br>December 31,<br>2008   | 93,543,506 | \$ 935,435 | \$ 203,113,548 | \$ | \$ (9,104,346) | \$ 15,113,507 | (5,334,138) | \$ (15,676,206) | \$ 194,381,938 | \$ (18,168,847) |

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## FINANCIAL INFORMATION OF PARENT COMPANY

## STATEMENTS OF CHANGES IN EQUITY AND COMPREHENSIVE INCOME (LOSS) (Continued)

(In US dollars, except share data)

|  | Ordinary shares |            | Additional<br>Paid-in<br>capital | Subscription<br>receivable | Retained<br>earnings<br>(deficit) | Accumulated<br>other<br>comprehensive<br>income | Treasury stock,<br>at cost |                 | Total equity   | Comprehensive<br>income<br>(loss) |
|--|-----------------|------------|----------------------------------|----------------------------|-----------------------------------|---|----------------------------|-----------------|----------------|-----------------------------------|
|  | Shares          | Amount     |                                  |                            |                                   |   | Shares                     | Amount          |                |                                   |
| Exercise of stock options  | 1,242           | 12         | 2,050                            |                            |                                   |   |                            |                 | 2,062          |                                   |
| Repurchase of ordinary shares  |                 |            |                                  |                            |                                   |   | (1,917,798)                | (2,288,136)     | (2,288,136)    |                                   |
| Issuance of repurchased shares in connection with the acquisition of Yiyang Yukang |                 |            |                                  |                            | (3,047,436)                       |   | 2,564,103                  | 6,351,796       | 3,304,360      |                                   |
| Share-based compensation expenses  |                 |            | 1,845,885                        |                            |                                   |   |                            |                 | 1,845,885      |                                   |
| Appropriate special dividend   |                 |            | (29,322,782)                     |                            |                                   |   |                            |                 | (29,322,782)   |                                   |
| Net income   |                 |            |                                  |                            | 11,883,264                        |   |                            |                 | 11,883,264     | \$ 11,883,264                     |
| Unrealized losses on available-for-sales securities                                |                 |            |                                  |                            |                                   | 2,312,564                                       |                            |                 | 2,312,564      | 2,312,564                         |
| Foreign currency translation adjustments   |                 |            |                                  |                            |                                   | 136,490   |                            |                 | 136,490        | 136,490                           |
| Balance at December 31, 2009   | 93,544,748      | \$ 935,447 | \$ 175,638,701                   | \$                         | \$ (268,518)                      | \$ 17,562,561                                   | (4,687,833)                | \$ (11,612,546) | \$ 182,255,645 | \$ 14,332,318                     |

**Table of Contents****FINANCIAL INFORMATION OF PARENT COMPANY****STATEMENTS OF CASH FLOWS**

(In US dollars)

|   | For the years ended December 31, |                 |                |
|---|----------------------------------|-----------------|----------------|
|   | 2007                             | 2008            | 2009           |
| <b>Operating activities:</b>  |                                  |                 |                |
| Net income (loss) attributable to holders of ordinary shares                  | \$ 18,598,106                    | \$ (25,591,369) | \$ 11,883,264  |
| Deemed dividend on Series A convertible redeemable preferred shares           | 53,800                           |                 |                |
| Net income (loss) attributable to Acorn International, Inc.                   | 18,651,906                       | (25,591,369)    | 11,883,264     |
| Share-based compensation  | 6,519,078                        | 3,289,232       | 1,845,885      |
| Equity in (earnings) losses of subsidiaries                                   | (22,122,152)                     | 18,116,119      | (17,051,897)   |
| Loss on change in fair value of derivative asset                              |                                  | 3,275,000       | 1,335,630      |
| Accrued interests on available-for-sale securities                            | (225,556)                        | 190,001         | (735,455)      |
| Changes in operating assets and liabilities:                                  |                                  |                 |                |
| Other current assets  | (823,821)                        | 652,111         | 53,498         |
| Amounts due from subsidiaries   | 199,761                          | (109,596)       | (1,044,553)    |
| Other current liabilities   | 505,637                          | (481,121)       | 555,823        |
| Net cash provided by (used in) operating activities                           | \$ 2,704,853                     | \$ (659,623)    | \$ (3,157,805) |
| <b>Investing activities:</b>  |                                  |                 |                |
| Purchase of available-for-sale securities                                     | (20,000,000)                     |                 |                |
| Redemption of available-for-sale securities by the issuer                     |                                  |                 | 10,000,000     |
| Investments in subsidiaries   | (10,290,000)                     | (20,357,757)    | (7,905,649)    |
| Amounts due from a subsidiary   |                                  | (1,200,000)     | 1,200,000      |
| Net cash used in investing activities   | \$ (30,290,000)                  | \$ (21,557,757) | \$ 3,294,351   |
| <b>Financing activities:</b>  |                                  |                 |                |
| Proceeds from initial public offering (net of issuance cost of US\$4,344,262) | 108,885,563                      |                 |                |
| Collection of subscription receivable   | 9,289,478                        |                 |                |
| Proceeds from exercise of stock options                                       | 122,342                          | 463,110         | 2,062          |
| Repurchase of ordinary shares   | (6,833,124)                      | (16,378,724)    | (2,288,136)    |
| Yiyang Yukang first earn-out payment  |                                  |                 | (6,700,000)    |
| Net cash provided by (used in) financing activities                           | \$ 111,464,259                   | \$ (15,915,614) | \$ (8,986,074) |
| Net increase (decrease) in cash and cash equivalents                          | \$ 83,879,112                    | \$ (38,132,994) | \$ (8,849,528) |
| Cash and cash equivalents at the beginning of the year                        | 11,291,877                       | 95,170,989      | 57,037,995     |
| Cash and cash equivalents at the end of the year                              | \$ 95,170,989                    | \$ 57,037,995   | \$ 48,188,467  |

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**FINANCIAL INFORMATION OF PARENT COMPANY  
FOR THE YEARS ENDED DECEMBER 31, 2007, 2008, AND 2009**

**Note to Schedule I**

Schedule I has been provided pursuant to the requirements of Rule 12-04(a) and 5-04(c) of Regulation S-X, which require condensed financial information as to the financial position, changes in financial position and results of operations of a parent company as of the same dates and for the same periods for which audited consolidated financial statements have been presented when the restricted net assets of consolidated subsidiaries exceed 25 percent of consolidated net assets as of the end of the most recently completed fiscal year.

Certain balances in the prior year were reclassified to conform to current year presentation.

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