Acorn International, Inc.
Form 20-F
April 24, 2009
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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

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008

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 ordinary shares, par value $0.01 per share	**New York Stock Exchange**

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: 88,209,368

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

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

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

US GAAP x International Financial Reporting Standards as issued by the International Accounting Standards Board ¨ Other ¨

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

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 x No

Indicate by check mark which financial statement item the registrant has elected to follow: ¨ Item 17 x Item 18

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ACORN INTERNATIONAL, INC.

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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, 2006, 2007 and 2008, and audited consolidated balance sheet data as of December 31, 2007 and 2008.

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;

- 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;
- expected synergies resulting from our acquisition of Yiyang Yukang Communication Equipment Co., Ltd.; 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, 2006, 2007 and 2008, and the selected consolidated balance sheet data as of December 31, 2007 and 2008, have been derived from our consolidated financial statements, 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 combined statements of operations data for the years ended December 31, 2004 and 2005, and our consolidated combined balance sheet data as of December 31, 2004, 2005 and 2006, have been derived from our consolidated combined financial statements, which have been audited by Deloitte Touche Tohmatsu CPA, Ltd., and are not included in this annual report. The selected consolidated combined financial data should be read in conjunction with those consolidated combined financial statements and related notes and Item 5. Operating and Financial Review and Prospects in this annual report. Our consolidated combined financial statements are prepared and presented in accordance with U.S. GAAP.

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	For the years ended December 31, 2004	2005	2006	2007	2008
	(in thousands, except share and per share data)				
Condensed Consolidated Combined Statements of Operations Data					
Revenues:					
Direct sales, net	$ 52,038	$ 76,828	$ 107,411	$ 184,292	$ 171,619
Distribution sales, net	43,022	93,512	89,087	77,805	79,033
Total revenues, net	95,060	170,340	196,498	262,097	250,652
Cost of revenues:					
Direct sales	16,826	26,646	32,013	85,895	83,414
Distribution sales	19,279	43,566	41,260	38,004	37,714
Total cost of revenues	36,105	70,212	73,273	123,899	121,129
Gross profit	58,955	100,128	123,225	138,198	129,523
Operating income (expenses):					
Advertising expenses	(27,903)	(55,564)	(76,549)	(75,981)	(74,371)
Other selling and marketing expenses[1]	(7,697)	(13,734)	(21,023)	(31,673)	(42,216)
General and administrative expenses[1]	(6,126)	(12,340)	(27,115)	(28,455)	(31,674)
Impairment of goodwill and intangible assets					(8,668)
Other operating income, net	498	1,553	3,105	5,783	6,281
Total operating expenses	(41,228)	(80,085)	(121,582)	(130,327)	(150,648)
Income (loss) from operations	17,727	20,043	1,643	7,871	(21,125)
Total other income (expenses)	(50)	(9,485)	2,167	16,513	(69)
Total income tax expenses (benefits)	571	770	(696)	(1,330)	768
Minority interest	(2,614)	(1,756)	(561)	(7,062)	(3,629)
Net income (loss)[2][3]	14,492	8,032	3,945	18,652	(25,591)
Deemed dividend on Series A convertible redeemable preferred shares		(162)	(162)	(54)	
Income (loss) attributable to holders of ordinary shares	$ 14,492	$ 7,870	$ 3,783	$ 18,598	$ (25,591)
Income (loss) per ordinary share basic	$ 0.31	$ 0.13	$ 0.05	$ 0.20	$ (0.29)
Income (loss) per ordinary share diluted	$ 0.31	$ 0.12	$ 0.05	$ 0.19	$ (0.29)
Weighted average shares used in calculating basic income per ordinary share	46,809,668	45,814,725	48,979,394	77,738,701	86,856,467
Weighted average shares used in calculating diluted income per ordinary share	46,809,668	48,645,299	53,607,999	84,472,947	86,856,467
Dividends declared per ordinary share	$ 0.17	$ 0.02	$	$	$

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	As of December 31, 2004	2005	2006 (in thousands)	2007	2008
Condensed Consolidated Combined Balance Sheet Data					
Cash and cash equivalents	$ 16,645	$ 35,386	$ 40,744	$ 148,743	$ 147,649
Prepaid advertising expenses	4,903	20,090	25,384	23,151	16,757
Total assets	39,862	100,372	118,699	287,776	304,185
Deferred revenue			4,193	13,352	12,798
Total liabilities	13,971	12,569	15,183	35,160	74,860
Total liabilities, mezzanine equity and shareholders equity	$ 39,862	$ 100,372	$ 118,699	$ 287,776	$ 304,185

	For the years ended December 31, 2006	2007 (in thousands, except percentages)	2008
Selected Operating Data			
Number of inbound calls generated through direct sales platforms[4]	4,560	6,900	7,320
Conversion rate for inbound calls to product purchase orders[4]	19.2%	16.8%	23.2%
Total TV direct sales program minutes	761	890	596

(1) Includes share-based compensation of:

	For the years ended December 31, 2004	2005	2006 (in thousands)	2007	2008
Other selling and marketing expenses	$	$ (168)	$ (741)	$ (423)	$ (292)
General and administrative expenses	$	$ (2,168)	$ (7,932)	$ (6,096)	$ (2,997)

(2) Includes:

	For the years ended December 31, 2004	2005	2006 (in thousands)	2007	2008
Share-based compensation	$	$ (2,336)	$ (8,673)	$ (6,519)	$ (3,289)
Expensed offering costs			(3,166)		
Change in fair value in warrant liability		(10,059)			
Goodwill and intangible assets impairment losses					(8,668)
Available-for-sale securities impairment losses					(3,275)

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 .

(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 arrangement with China Unicom.

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Exchange Rate Information

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 RMB6.8225 to US$1.00, the noon buying rate in effect as of December 31, 2008. The noon buying rate in effect as of April 17, 2009 was RMB6.8325 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(1)	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				
January	6.8392	6.8360	6.8403	6.8225
February	6.8395	6.8363	6.8470	6.8241
March	6.8329	6.8360	6.8438	6.8240
April (through April 17, 2009)	6.8325	6.8337	6.8361	6.8316

(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 business and operations may be adversely affected by the recent global economic crisis.

The recent global economic crisis is adversely affecting the economy in the United States and many other parts of the world, including China, where our primary business operations are located. The Chinese economy has recently experienced a slowing of its growth rate, and the slow-down has been exacerbated by the recent global crisis in the financial services and credit markets, which has resulted in significant volatility and dislocation in the global capital markets. It is uncertain how long the global economic crisis will continue and how much of an impact it will have on the global economy in general, or the Chinese economy in particular, and whether slowing economic growth in China could result in our customers reducing their spending. We have recently experienced a decline in our revenues as a result of the slow-down in the Chinese economy, particularly with respect to revenues generated from our high-end products and products with high unit prices. We expect this situation will continue for the foreseeable future, and demand for some of our products and services, particularly our high-end products and products with high unit prices may continue to decline. 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.

Our limited operating history and the early stage of development of our industry makes it difficult to evaluate our business and future prospects.

We commenced operations in 1998 and began selling our products and services through our integrated multiple sales platforms on a larger scale in 2000. Our business model continues to evolve in conjunction with the evolution of China s TV direct sales industry (including the TV home shopping industry) and market conditions. For example, 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. However, we expect to return to our historic emphasis on growing our proprietary branded products, such as Ozing and Babaka, while continuing to develop joint sales and marketing services arrangements as sources of complementary revenue streams. Accordingly, our current business has a limited operating history from which you can evaluate our viability and sustainability. In addition, we have experienced significant growth in recent periods. From 2006 to 2008, our net revenues and gross profit grew at compound annual growth rates, or CAGRs, of 12.9% and 2.5%, respectively, which rates may not be sustained. In particular, we have recorded a net loss of $25.6 million in 2008, which was primarily due to the effects of the global economic crisis, intensifying industry competition, natural disasters in China and the conclusion of the 2008 Beijing Olympics.

Moreover, the TV 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. For example, 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 March 31, 2009, we have established relationships with 13 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.

You should consider our future prospects in light of risks and uncertainties experienced by early stage companies in evolving industries in China, including an evolving regulatory environment and emerging consumer preferences. These circumstances may make it difficult for you to evaluate our business and future prospects.

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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.

Product and service-related factors:

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 and our nationwide distribution network and their average selling prices;
- the portion of any subscription or service revenue deferred or recognized in any period;
- 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 devices, 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. In addition, following our acquisition of Yiyang Yukang, we expect to sell our cell phone products through our distribution network in addition to our direct sales platforms, which may benefit from longer public holidays, such as the Chinese New Year or the National Day holidays;
- 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; and

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

Other factors:

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;

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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.

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 79.1% and 70.7% of our gross revenues in 2007 and 2008, respectively. In 2008, our cell phone products line was our best-selling product, and accounted for approximately 22.4% of our gross revenues in that year. Sales of our electronic learning device product line, which has consistently been one of our five best-selling products and had been the best-selling product prior to 2007, accounted for approximately 19.1% and 18.7% of our gross revenues in 2007 and 2008, respectively. 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.

Only approximately 9.3% of our TV direct sales customers purchased products or services through our direct sales platform more than once in 2008. 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 2008, our sales of cell phone products declined to approximately $56.3 million from $105.6 million in 2007, and the decline was partially offset by the increase in sales of our cosmetics, GPS products and Meijin electronic dictionary products,

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which increased approximately $16.5 million, $14.1 million and $8.2 million, respectively, in 2008 compared to 2007, primarily as a result of increase in sales of certain branded cosmetic products that were not part of our product mix in 2007, increased media spending on our E-roda GPS product, and sales of our Meijin electronic dictionary which was not part of our product mix until the second quarter of 2007. 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.

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 devices. 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 2008.

In addition, we have recent experience with certain individuals attempting to steal our clients personal information, including phone numbers. We have also received some recent complaints reporting that certain individuals are impersonating our staff and delivering counterfeit products or products with inferior quality to our

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customers. Although the total number of cases and the total amount involved in this malicious behavior are immaterial, such events could materially adversely affect our reputation among our customers and potential customers. We believe that we have taken necessary steps to prevent similar events from recurring, but there can be no assurance that we will be able to effectively prevent the recurrence of such events.

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. Substantially all of our direct sales, which accounted for 54.7%, 70.3% and 68.5% of our total net revenues in 2006, 2007 and 2008, 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. The Temporary Regulation on Advertising on Television or Radio issued by the State Administration of Radio, Film and Television, or SARFT, on September 15, 2003 and effective as of January 1, 2005 requires that the total airtime allocated to advertising on TV not exceed twenty percent of the total broadcasting hours on a daily basis and not exceed fifteen percent of the broadcasting hours between 19:00 and 21:00. 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. 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 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 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.

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 2008, we selectively lowered 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 intend to seek to maximize media efficiency by continuing our more flexible media buying plan and a more targeted airtime allocation scheme with channels that offer higher media returns, but there can be no assurance that we will be able to manage our media time efficiently or effectively.

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, 2008, we had signed contracts to purchase $63.7 million of TV advertising time for direct sales programs for 2009. 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. 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 and marketing services 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.

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. Our marketing services arrangements generate marketing services revenues. We expect that these arrangements will continue to constitute a substantial part of our business in the future, although we expect to return to our historic emphasis on growing our proprietary branded products while continuing to develop joint sales and marketing services arrangements as sources of complementary revenue streams. 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 and marketing services 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 or marketing services arrangements terminates, our business, results of operations, financial condition and prospects could be adversely affected.

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. In 2006, 2007 and 2008, 45.3%, 29.7% and 31.5%, respectively, of our net revenues were generated through our approximately 80 distributors. Our largest distributor accounted for approximately 3.2%, 5.7% and 1.8% of our gross revenues in 2006, 2007 and 2008. 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.

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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 among our five best-performing distributors in 2006 and 2007, and one was among our five best-performing distributors in 2008, with aggregate revenue contribution of approximately 4.3%, 2.7% and 1.7% of our gross revenues in 2006, 2007 and 2008, 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.

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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 2006, 2007 and 2008, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 26.9%, 25.4% and 14.7% of our distribution gross revenues, respectively, or 12.9%, 7.5% and 4.6% of our total gross revenues, respectively. Certain of these distributors have been among our top distributors in 2006, 2007 and 2008. In addition, one distributor in 2006 and part of 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. 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 desired synergy of our acquisition of Yiyang Yukang.

On December 24, 2008, we completed our acquisition of Yiyang Yukang Communication Equipment Co., Ltd., or 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 extensive nationwide distribution network to facilitate sales of our featured cell phone products. We believe the acquisition will provide us a strong pipeline of mid-to-high end, differentiated and branded cell phone products, as well as strengthen our distribution capability in China. There can be no assurance that our desired synergy as a result of the acquisition will be carried out 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. 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.

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 device 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. In these arrangements, we have typically received at least majority control and exclusive rights to distribute a product through the joint venture in exchange for our agreement to market and sell the product through our multiple sales platforms, a minority equity stake and cash consideration. 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

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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 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 1,937 employees as of December 31, 2008. In particular, we added approximately 177 employees following our acquisition of Yiyang Yukang in December 2008. 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, Kevin Guohui Hu, our vice president responsible for media purchasing, planning and management and Gordon Xiaogang Wang, our vice president and our chief financial officer. 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 3.3% to 7.6% in 2006, 1.3% to 7.8% in 2007, and 2.2% to 10.0% in 2008, 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

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experienced employees in our call centers or other critical areas could seriously disrupt our business and operations and negatively affect our financial performance.

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 in particular dependent on China Express Mail Service Corporation, or EMS, to make our product deliveries and from time to time we have been required to write off certain accounts receivable from EMS.

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 62.9% and 34.1% of our direct sales gross revenues in 2006, respectively, 76.1% and 19.1% of our direct sales gross revenues in 2007, respectively, and 59.3% and 29.8% of our direct sales gross revenues in 2008, 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 77%, 75% and 75% were successful in 2006, 2007 and 2008, 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 50 days to remit to us the COD payments received from our customers. Of our total accounts receivable balance as of December 31, 2006, 2007 and 2008, $7.8 million or 66.3%, $8.3 million or 35.9%, and $9.0 million or 32.5%, respectively, was 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 2006, 2007 and 2008 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, China SevenStar and Smile TV (Chi Ma Ao);

- 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;

- 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 devices which

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compete with electronic learning devices from BBK, e100, 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 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; and

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.

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 oxygen generating products, which may be sold in department stores, pharmacies and general merchandise stores.

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 2006, 2007 and 2008, approximately 54.7%, 70.3% and 68.5% 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.

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

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the trademark law in China to protect our product brands. We currently maintain approximately 117 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 121 trademarks in China, including trademarks for two of our best-selling product lines in 2008. 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 2008, our GPS products, and our engine lubricant 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 June and December 2007, NavInfo Co., Ltd., or NavInfo, filed three suits in the People s Court of Haidian District against Shanghai HJX Digital Technology Co., Ltd., or Shanghai HJX, Beijing Acorn Trade Co., Ltd. and Shanghai Acorn Network Technology Development Co., Ltd., all of which are our subsidiaries or our affiliates, and Shenzhen Careland Information System Co., Ltd., or Careland, alleging that the digital maps incorporated in our GPS products and provided by Careland infringed on NavInfo s copyrighted digital map. The court ruled in favor of NavInfo in the suits and awarded NavInfo total compensation of RMB1,000,000 (approximately $147,000). Careland has indemnified us for the loss we suffer in connection with the suits.

In October 2007, Beijing Ren ai Education Research Institute, or Beijing Ren ai, filed a suit in Henan Puyang Intermediate People s Court against Shanghai HJX and Henan Puyang Hualong Commercial Building Co., Ltd., or Hualong Building, alleging that the English programs we provide to the users of our electronic learning devices infringe upon the copyright of Beijing Ren ai. Beijing Ren ai claimed damages of RMB500,000 (approximately $73,000). This legal proceeding is still pending and we are vigorously contesting Beijing Ren ai s claim.

In November 2007, Beijing Ren ai filed a suit in Anhui Hefei Intermediate People s Court against Shanghai HJX, Hefei Huitong Science and Trade Co., Ltd. and Hefei Xinhua Bookstore Co., Ltd. making a similar allegation and claiming RMB500,000 (approximately $73,000) in compensation. On May 4, 2008, the Anhui Hefei Intermediate People s Court ruled that Shanghai HJX and Hefei Huitong Science and Trade Co., Ltd.

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should cease infringement of the copyright of Beijing Ren ai and ordered Shanghai HJX to pay RMB50,000 (approximately $7,000) in damages. We have made the damages payment as of December 31, 2008.

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 devices 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.

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. The legal proceeding is currently pending and at this stage we are unable to predict or assess with any degree of certainty either the outcome of this litigation or the overall financial performance an unfavorable judgment would have on us. We are vigorously contesting Liaoning TV s claim.

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

The re-institution or institution of litigation against us may have a negative effect on the business operations of our oxygen generating device and negatively affect our overall financial performance.

On April 19, 2006, Beijing Huashi Industrial Company brought a lawsuit against us in Beijing Xicheng District People s Court, alleging that transfers of trademarks, as well as fixed and moveable assets in connection with our acquisition of our oxygen generating devices business from its subsidiary in 2000, violated PRC laws that require a valuation and approval of transferred state-owned assets to be undertaken, and such transfers should, as a consequence, be voided. We were informed that the plaintiff had revoked its claim. However, it is still possible that the same or a similar lawsuit may be filed against us in the future. If this happens, our management s attention may be distracted and the outcome of the litigation may have a negative effect on our oxygen generating device business operations and negatively affect our overall financial performance.

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

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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 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 one-third of the products we sell in terms of cost of revenues in 2008, 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 devices product line, from outside suppliers in China. Our largest supplier in 2006, which supplies PDA cell phones, accounted for approximately 14.9% of our total cost of revenues in 2006. Our largest supplier in 2007, which supplies Gionee branded cell phones, accounted for approximately 14.9% of our total cost of revenues in 2007. Our largest supplier in 2008, which supplies Konka branded cell phones, accounted for approximately 11.2% of our total cost of revenues in 2008. We typically purchase all production materials, including critical components such as flash memory, chipsets and LCD display screens for our electronic learning devices, 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;

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- 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 2008, we had two cell phone suppliers each accounting for more than 6% of our cost of revenues in these periods. 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 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 acquisitions and investments in equity securities.

We have made minority investments in the equity securities of a number of companies, including Kela (Hong Kong) Jewelry Investment Limited. Under U.S. generally accepted accounting principles that we are

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subject to, if there is a decline in the fair value of the shares we hold in this company, 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 cannot assure you that we will not need to incur additional expenses related to the impairment of such investments, or other investments, in the future. Any such impairment expense 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.

Effective January 1, 2002, we adopted SFAS No. 142, which requires us, among other things, to conduct annual reviews of goodwill, and SFAS No. 144, which requires us to test intangible assets for impairment whenever events or changes in circumstances indicate that their carrying amount 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 related useful lives of those assets, we have to make assumptions regarding their fair value, our 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 $8.7 million as a result of our valuation in 2008 of goodwill and acquired intangible assets mainly attributable to our acquisition of the 49% equity interest of Shanghai HJX in 2005. It is possible that future reviews will result in further write-downs of goodwill and other intangible assets.

We have recorded a US$3.3 million non-cash impairment charge to net income, and may be required to record additional significant charges to earnings from the declines in fair value of our available-for-sale debt securities if such declines become other-than-temporary.

Our investment policy and strategy attempt primarily to preserve capital and meet our liquidity requirements. Our short-term and long-term debt securities are classified as available-for-sale securities and are reported at fair value with net unrealized losses recognized as accumulated other comprehensive income in stockholders equity unless there is a decline in fair value below cost that we consider is other-than-temporary, in which case the amount of the decline would be recognized as a loss and reflected in our income statement. In 2008, we recognized a $3.3 million non-cash impairment charge to net income related to our long-term investments in certain index-linked structure note. We review our short-term and long-term investments to determine whether any differences between cost and fair value are other-than-temporary impairment in accordance with FASB Staff Position SFAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments and SEC Staff Accounting Bulletin Topic 5M, The Meaning of Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities. We review short-term and long-term investments for impairment whenever events or changes in circumstances indicate that the carrying value of such investments may no longer be recoverable. The losses incurred on these short-term and long-term investments are primarily related to the changes in the general global market conditions. If factors arise that would require us to account for additional declines as other-than-temporary or if we are required to sell our debt securities before the recovery, we may need to 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. Under the current SEC regulations, we will be required to include a management report on internal controls over financial reporting in our Form 20-F annual report for the year ended December 31, 2008, and we will be required to

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include an auditor s report on internal controls over financial reporting for the year ending December 31, 2009. Failure to achieve and maintain an effective internal control environment, regardless of whether we are required to maintain such controls, could also cause investors to lose confidence in our reported financial information, which could have a material adverse effect on our stock price. Although we are not aware of anything that would materially impact our ability to maintain effective internal controls, we have not obtained an independent audit of our internal controls, and, as a result, we are not aware of any deficiencies which would result from such an audit. Further, at such time as we are required to comply with the internal controls requirements of Sarbanes-Oxley, we may incur significant expenses in having our internal controls audited and in implementing any changes which are required.

Risks Related to Our Industry

Our businesses and growth prospects are dependent upon the expected growth in China s consumer retail markets, including, in particular, the TV direct sales market. Any future slowdown or decline in China s consumer retail markets, including the TV direct sales market, 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, particularly the TV direct sales market. 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, including particularly China s TV direct sales industry, 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 2006, 2007 and 2008, we derived 54.7%, 70.3% and 68.5%, 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

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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 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, advertisings 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 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 device 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. Separately we sell a software program that tracks market performance of specified stocks listed on China s domestic stock exchanges and provides technical analysis to aid investment decisions. Due to the nature of this program, consumers could allege that our packaging or TV direct sales programs and other direct sales advertising contain misleading or false recommendations or fail to adequately warn consumers of the risks related to their use of the software in tracking and subsequently trading securities. Damages, including potential trading losses, sought by consumers could be substantial. 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.

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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. Consequently, until the new rules are adopted, 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. It is unclear when the new rules governing those direct sales activities will be issued. 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 deems that the sales of our stock tracking software program constitute the provision of securities investment advisory services, our sales of that product may be discontinued.

In January 2006, we began full-scale marketing of our technical analysis software program for individual investors as one of our featured products. This software program can also track market performance of specified stocks listed on China s domestic stock exchanges to aid individual investors in making investment decisions. In late May 2006, we received a written notice from the Shanghai branch of the China Securities Regulatory Commission, or the CSRC, demanding that we temporarily withdraw the media advertisement of this software program pending its investigation. The written notice also stated (i) that the CSRC branches in other cities have received complaints claiming that we, through direct TV marketing, were selling a software program that provides online trading recommendations and investment forecasts to investors, and (ii) that we may have violated PRC regulations because we do not have a license for provision of securities investment advisory services.

Securities regulations in China require entities that provide securities investment advisory services to the public to obtain a securities investment advisory business license from the CSRC. However, the definition of securities investment advisory services is subject to interpretation by the CSRC. We have no intention of providing securities investment advisory services and do not believe that our sale of this software program constitutes the provision of securities investment advisory services covered by the relevant regulations as our software program is designed to provide technical analysis. Nevertheless, we have been advised by our special PRC counsel that was engaged specifically to advise us regarding this matter that there is only a small likelihood that the CSRC Shanghai branch will deem our sale of software programs as the provision of securities investment advisory services. Beginning in May 2006, we discontinued most TV advertisements for this software program. As of the present date, we have not been informed of any fines or other penalties by the CSRC or its Shanghai branch.

If the CSRC Shanghai branch or the CSRC at any time in the future takes the view that we have been engaging in the business of providing securities investment advisory services, we may be required to discontinue selling the software program and the CSRC may confiscate all our revenues generated from the sale of such software program and impose a fine against us up to an amount equivalent to the revenues from these sales.

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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 Oct. 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 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

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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;
- imposing conditions or requirements with which we, Acorn Information or our affiliated entities may be unable to comply;
- requiring us or Acorn Information or our affiliated entities to restructure the relevant ownership structure or operations; or
- restricting or prohibiting our use of the proceeds of this offering to finance our business and operations in China.

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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 17 PRC subsidiaries and two Chinese affiliated entities. We 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 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 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. 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

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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.

Under the New EIT Law, an enterprise established outside of China with de facto management bodies within China is considered a resident enterprise , meaning that it can be treated in a manner similar to a Chinese enterprise for enterprise income tax purposes. The implementing rules of the New EIT Law define de facto management as substantial and overall management and control over the production and operations, personnel, accounting, and properties of the enterprise. Currently no official interpretation or application of this new resident enterprise classification is available, and therefore it is unclear how tax authorities will determine tax residency based on the facts of each case.

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 implementing 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 income tax 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

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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 levied through withholding at the source. Any enterprise or individual who has the obligation to pay the relevant proceeds to non-resident enterprise shall be the obligor of tax withholding. Such obligor shall 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 may be subject to audit or challenge by the PRC tax authorities; a finding that Acorn Information or our consolidated affiliated entities 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. We could face material and adverse tax consequences if the PRC tax authorities determine that the contractual arrangements among Acorn Information, each of our consolidated affiliated entities and their shareholders do not represent arm s-length prices and adjust any of their income in the form of a transfer pricing adjustment. A transfer pricing adjustment could, among other things, result in, for PRC tax purposes, a reduction of expense deductions recorded by Acorn Information or our consolidated affiliated entities or an increase in taxable income, all of which could in turn increase our tax liabilities. In addition, the PRC tax authorities may impose late payment fees and other penalties on Acorn Information or consolidated affiliated entities for under-paid taxes.

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 17 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.

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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 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.

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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, 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 SAFE in October 2005 and requires registration with the local SAFE in connection with direct or indirect offshore investment by PRC residents. On May 29, 2007, Notice 106, which serves as the implementing rules of Notice 75, was promulgated by SAFE. These two notices apply not only to our shareholders who are PRC residents but also to our prior and future offshore acquisitions.

These two notices retroactively require 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 and Notice 106. 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.

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Upon the completion of our acquisition of Yiyang Yukang in December 2008, shareholders of the company 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.

Any future outbreak of 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. During May and June of 2003, many businesses in China were closed by the PRC government to prevent transmission of SARS. The World Health Organization has announced that there is a high likelihood of an outbreak of avian flu, with the potential to be as disruptive if not more disruptive than SARS. Any recurrence of the SARS outbreak, an avian flu outbreak, or development of a similar health hazard in China, may deter people from congregating in public places, with severely disruptive effects on consumer spending. In addition, health or other government regulation may require temporary closure of our offices and operations. Lastly, such outbreak may cause the sickness or death of our key management and employees. Any of such occurrences would adversely affect our business and results of operations.

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 2009 we believe we were classified as a PFIC for the 2008 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 2009 will not be determinable until after the close of the taxable year ending December 31, 2009. 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 2009 and any future taxable year. Based on a determination made in 2009 with respect to the 2008 taxable year, we believe we were classified as a PFIC for the 2008 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 2008 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 depositary may make these rights available to holders of our ADSs if it is lawful and reasonably practicable to do so. However, the depositary 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 depositary 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 expenses. Holders of our ADSs receive these distributions in proportion to the number of our ordinary shares

their ADSs represent. However, the depositary is not responsible if it is unlawful or impractical to make a distribution available to any holders of ADSs. For example, it would be unlawful to make a distribution to a holder of ADSs if it consists of securities that require registration under the Securities Act but that are not properly registered or distributed pursuant to an applicable exemption from registration. The depositary is not responsible for making a distribution available to any holders of ADSs if any government approval or registration is required for such distribution. We have no obligation to take any other action to permit the distribution of our ADSs, ordinary shares, rights or anything else to holders of our ADSs. This means that 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 depositary receipts, are transferable on the books of the depositary. However, the depositary may close its books at any time or from time to time when it deems expedient in connection with the performance of its duties. The depositary may close its books for a number of reasons, including in connection with corporate events such as a rights offering, during which time the depositary needs to maintain an exact number of ADS holders on its books for a specified period. The depositary may also close its books in emergencies, and on weekends and public holidays. The depositary may refuse to deliver, transfer or register transfers of our ADSs generally when our books or the books of the depositary are closed, or at any time if we or the depositary thinks it is necessary or advisable to do so in connection with the performance of its duty under the deposit agreement, including due to any requirement of law or any government or governmental body, or under any provision of the deposit agreement.

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.chinadrtv.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 TV air time purchased, 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. However, we expect to return to our historic emphasis on growing our proprietary branded products, such as Ozing and Babaka, while continuing to develop joint sales and marketing services arrangements as sources of complementary revenue streams.

Using our integrated TV direct sales and nationwide distribution network platforms, we have developed several leading proprietary brands, including Ozing electronic learning devices, Babaka posture correction products and Meijin electronic dictionaries. In addition, we have expanded into other forms of direct selling, such as catalogs, Internet sales, outbound calls and third-party bank channel 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, 23 national satellite TV channels, six international satellite channels operating in China and 12 local channels. Sales generated through our TV direct sales platform accounted for substantially all of our direct sales net revenues, which in turn comprised 54.7%, 70.3% and 68.5% of our net revenues in 2006, 2007 and 2008, respectively. We also purchase TV advertising time for brand promotion advertising to enhance brand awareness of our proprietary products and services.

We have two call centers in Shanghai and Beijing 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, 2008, we had 804 sales representatives and 120 customer service representatives. In 2006, 2007 and 2008, our sales representatives collectively processed an average of approximately 12,400, 18,800 and 20,000 incoming calls per day generated from our TV and other direct sales platforms, respectively. 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, during the fourth quarter of 2008, we entered into an agreement with the Management Committee of the Wuxi Xishan economic development zone to establish a new call center for our outbound call operations in Wuxi. The new call center is approximately 500 square meters and commenced operation on March 8, 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

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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 2006, 2007 and 2008, sales generated through our nationwide distribution network accounted for 45.3%, 29.7% and 31.5% 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. In 2006, we also began to 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 2008 included cell phones, electronic learning devices, electronic dictionaries, collectibles, stock tracking software, health and wellness products, consumer electronic products, and cosmetics. In addition, we offer over 700 products via our catalogs and the Internet.

On December 24, 2008, we completed our acquisition of Yiyang Yukang Communication Equipment Co., Ltd., or 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 extensive nationwide distribution network to facilitate sales of our featured cell phone products. We believe the acquisition will provide us a strong pipeline of mid-to-high end, differentiated and branded cell phone products, as well as strengthen our distribution capability in China.

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 RMB50 million (approximately $7.3 million). We plan to use the land to build a warehouse or a call center, and to establish a factory for manufacturing our proprietary branded products as part of our strategy to develop infrastructure for building a future home shopping business in the next three to five years.

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 catalog sales, third-party bank channel sales, Internet sales, outbound call 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.

Direct Sales Platforms

TV Direct Sales Platform

Our TV direct sales platform is our primary sales platform and accounted for substantially all of our direct sales net revenues, which in turn accounted for 54.7%, 70.3% and 68.5% of our net revenues in 2006, 2007 and 2008, respectively. We generally focus our TV direct sales marketing efforts on approximately four or five 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 46 channels, including five CCTV channels, 23 national satellite TV channels, six international satellite TV channels operating in China and 12 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 four years. We purchase advertising time from the TV stations directly or through their advertising agencies. In 2006, 2007 and 2008, we produced and broadcasted over 760,000, 890,000 and 590,000 minutes of TV direct sales programs, respectively, corresponding to over 244, 285 and 189 hours per week, respectively. 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.

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, using TV brand promotion advertising to enhance brand awareness for our Ozing branded electronic learning devices 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 2008, we broadcasted TV brand promotion advertising on six 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 a more targeted airtime allocation scheme with channels that offer higher media returns, but those can be no assurance that we will be able to manage our media time efficiently or effectively.

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. For example, in April 2006, we entered into an arrangement with a cell phone manufacturer to be the exclusive TV direct sales platform through which it markets some of its PDA cell phones. In addition to generating TV direct sales revenues for us, as additional consideration for the sales support provided by our TV direct sales platform, the manufacturer agreed to pay to us an amount based on the number of units sold by it through its own distribution network (reflected as a reduction to our cost of direct sales revenues). We have subsequently entered into joint sales arrangements with other cell phone manufacturers, including a joint sales arrangement with Gionee entered into in 2007. Our arrangement with Gionee provides that we are the TV direct sales platform through which Gionee markets featured cell phones and pursuant to which Gionee shares a certain percentage of our advertising costs for their featured cell phone products. During 2008, our cell phone products and cosmetic products were the two major categories of products subject to joint sales arrangements. 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 significant revenue contributions from our marketing service arrangements in 2008. As described above, we expect to return to our historic emphasis on growing our proprietary branded products, 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 catalog sales, third-party bank channel sales, Internet sales and our outbound call sales. We also market and directly sell through print media and radio.

Catalogs. In February 2005, we began marketing our products through print catalogs. We currently offer over 270 products via our catalogs, of which approximately 26 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 2008. Our catalog sales are increasingly important to our direct sales platform, and revenue contributed by our catalog sales in 2008 accounted for approximately 2.9% of our revenue from direct sales.

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 March 31, 2009, we have established relationships with 13 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 2008 accounted for approximately 7.9% of our revenue from direct sales.

Internet. We began marketing our products through the Internet in December 2006. We currently offer over 700 products via our website, of which approximately 51 are our branded products and the remainder are third- party products.

Outbound Calls. We began our outbound call direct sales in the fourth quarter of 2004. As of December 31, 2008, our 323 specialized outbound call center sales representatives utilize our customer database, which contains information relating to approximately six million previous customers, to target calls at customer subgroups identified by us as likely purchasers of particular products or services. During the fourth quarter of 2008, we entered into an agreement with the Management Committee of the Wuxi Xishan economic development zone to establish a new call center for our outbound call operations in Wuxi. The new call center has commenced operation on March 8, 2009.

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

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membership points based on the type of product or service purchased with point values ranging from 500 to 2,000 points per product or service, 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. 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 2006, 2007 and 2008, sales generated through our nationwide distribution network accounted for 45.3%, 29.7% and 31.5% of our net revenue, respectively. We typically provide our distributors with the exclusive right to distribute selected products and services in their respective territories. In 2006, 2007 and 2008, sales generated by our top five distributors accounted for 10.6%, 7.0% and 7.7% of our gross revenues, respectively. In addition, we believe our acquisition of Yiyang Yukang will strengthen our distribution capability in China by providing us with an extensive nationwide distribution network to facilitate sales of our cell phone products.

In most cases, 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 devices 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 monthly and annual sales volume target for our selected featured products and services and, in the case of electronic learning device 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. In addition, we typically require our distributors 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, they 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.

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Several of our distributors, including two of which were among our top five distributors in 2006 and 2007 and one of which was among our top five distributors in 2008, 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 2006, 2007 and 2008, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 26.9%, 25.4% and 14.7% of our distribution gross revenues, respectively, or 12.9%, 7.5% and 4.6% of our total gross revenues, respectively. Certain of these distributors have been among our top distributors in 2006, 2007 and 2008. In addition, one distributor in 2006 and part of 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. 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 .

Our Products and Services

We offer over 700 products and services through our multiple sales platforms, approximately 8.6% 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 catalogs, third-party bank channel sales, outbound calls or the Internet. Our recently featured product categories include cell phones, electronic learning devices, health and wellness products, cosmetics products, consumer electronics products, stock tracking software, collectibles products, and electronic dictionary 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.

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Recent Featured Product Categories

We generally focus on marketing and selling four or five 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 2008, we featured products in the following categories and under the following proprietary and third-party brands:

Cell Phone Products featuring the Amoi, 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 14.1%, 40.1% and 22.4% of our gross revenues in 2006, 2007 and 2008, 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 Amoi, Gionee, K-touch, Lenovo, Nokia and Konka branded cell phones. In September 2006, we entered into a marketing services arrangement with China Unicom to develop a multi-phase TV direct sales marketing plan to promote China Unicom s CDMA services and CDMA cell phones and in November 2007, we entered into a joint services 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. The retail prices for the cell phone products that we market ranged from RMB588 to RMB4,960 per unit in 2007 and from RMB599 to RMB7,410 (or approximately $88 to $1,086) per unit in 2008.

Electronic Learning Devices featuring the Ozing brand name accounted for 31.7%, 19.1% and 18.7% of our gross revenues in 2006, 2007 and 2008, 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 device, targeted at middle and high school students, in December 2003. The retail prices for our Ozing products ranged from RMB698 to RMB1,298 per unit in 2006, RMB798 to RMB1,499 per unit in 2007 and RMB599 to RMB1,499 (or approximately $88 to $220) per unit in 2008. In the fourth quarter of 2008, we lowered the selling prices of certain models of our Ozing branded products as part of our strategy to stimulate sales, which effectively increased the sales volume of our electronic learning devices.

Health and Wellness Products featuring the Babaka, Zehom and Youngleda brand names accounted for 23.6%, 9.8% and 14.3% of our gross revenues in 2006, 2007 and 2008, 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 RMB288 to RMB2,080 per unit in 2006, RMB128 to RMB1,980 per unit in 2007 and RMB86 to RMB3,495 (or approximately $13 to $512) per unit in 2008.

Cosmetics Products featuring the Aoya, Cobor, Dr Cell and CMM brand names. We began marketing and selling our cosmetics products in the third quarter of 2007. Cosmetic products accounted for 9.4% of our gross revenues in 2008. The retail prices for our cosmetics products ranged from RMB48 to RMB1288 per unit in 2007 and RMB79 to RMB1,980 (or approximately $12 to $290) per unit in 2008.

Consumer Electronics Products featuring the Net E-cam, Aptek Net E-cam (both of which we stopped featuring in 2007) and Soloky brand names, accounting for 6.9%, 0.5% and 1.9% of our gross revenues in 2006, 2007 and 2008, respectively. The retail prices for our consumer electronics products ranged from RMB1,280 to RMB3,980 per unit in 2006, RMB860 to RMB1,980 per unit in 2007 and RMB899 to RMB2,280 (or approximately $132 to $334) per unit in 2008.

In 2005, we featured digital video products under the Net E-cam and Aptek E-cam brands. We began marketing and selling new consumer electronics products with more advanced applications under our

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Soloky brand in August 2005 and stopped featuring the Net E-cam and Aptek Net E-cam brands in 2007. Our featured Soloky product is a digital video device that includes a digital camera and MP3 and MP4 capabilities and is a lower cost alternative to many of our competitors offerings with similar capabilities.

Stock Tracking Software featuring the Cao Pan Shou, or CPS brand name, which we introduced in 2006 and which accounted for 2.4%, 6.4% and 7.1% of our total gross revenues in 2006, 2007 and 2008, respectively, with a retail price of RMB3,380 (or approximately $495) per unit. In October 2008, we introduced an upgraded product, Level II, with a retail price of RMB4,800 (or approximately $704) per unit.

Collectibles Products featuring 2008 Olympics stamps and coins, animal stamp collections, world coin collections and other Olympic related collectibles, which we introduced in 2006 and which accounted for 4.0%, 7.3% and 6.4% of our total gross revenues in 2006, 2007 and 2008, respectively. The retail prices for our collectibles ranged from RMB350 to RMB58,000 (or approximately $51 to $8,501) per unit in 2008. There has been a significant decrease in demand for our collectibles products following the end of the 2008 Olympics.

Electronic Dictionary Products featuring the Meijin brand name, which we introduced in July 2007, accounted for 2.3% and 5.7% of our total gross revenues in 2007 and 2008, respectively. The retail prices for our electronic dictionary products ranged from RMB498 to RMB1,298 per unit in 2007 and RMB598 to RMB898 (or approximately $88 to $132) per unit in 2008.

GPS Products featuring the E-roda brand name, which we introduced in 2006, accounted for 5.0%, 2.6% and 6.8% of our total gross revenues in 2006, 2007 and 2008, respectively. The retail prices for our GPS products ranged from RMB1,578 to RMB2,378 (or approximately $231 to $349) per unit in 2008.

Our five best-selling products and product lines in 2006, 2007 and 2008 are set forth below:

Product	Brand	Revenues	2006 percentage	Rank	Revenues	2007 percentage	Rank	Revenues	2008 percentage	Rank
					(in thousands, except percentages and ranks)					
Cell phone	Amoi, Gionee, K-touch, Lenovo, Nokia & Konka	$ 26,050	13.2%	2	$ 105,563	40.1%	1	$ 56,262	22.4%	1
Electronic learning device	Ozing	62,464	31.7%	1	50,151	19.1%	2	46,939	18.7%	2
Posture correction product	Babaka	15,723	8.0%	4	16,175	6.1%	5	28,598	11.4%	3
Neck massager*	Zehom	24,354	12.3%	3						
Cosmetic products	Aoya, Cobor, Dr Cell and CMM brand names							23,726	9.4%	4
Consumer electronics	Soloky, Aptek Net E-cam & Net E-cam	13,642	6.9%	5						
Stock tracking software	CPS				16,819	6.4%	4	17,953	7.1%	5
Collectibles					19,332	7.3%	3			
Total top five		**$ 142,233**	**72.1%**		**$ 208,040**	**79.1%**		**$ 173,478**	**69.1%**	
Other products and marketing services revenues		$ 54,978	27.9%		$ 55,105	20.9%		$ 77,682	30.9%	
Total gross revenues		$ 197,211	100%		$ 263,145	100%		$ 251,160	100%	
Total sales tax		$ (713)			$ (1,048)			$ (508)		
Total revenues, net		$ 196,498			$ 262,097			$ 250,652		

* The figure contains revenue generated from sales of our sleeping aid products in 2006.

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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 20 branded product lines, including 12 proprietary branded product lines and eight third-party branded product lines, many of which began as a single product and became one of our five best-selling products in later periods. In 2008, we introduced 16 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, which turned out to be a very successful product. 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 evaluation. 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 2008, we test-marketed over 120 new or upgraded products over our TV direct sales platform, of which 16 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. We have also recently leveraged our success in developing leading brands to engage in marketing services arrangements with large companies such as China Unicom whereby we promote their branded products and services through our TV direct sales platform and in joint service arrangements by which we receive, in addition to TV direct sales revenues for TV direct sales of third-party branded products and services, additional consideration for sales support provided by our TV direct sales platform based on the number of units sold by the third party through its own distribution network. We also monitor consumer product and service infomercials broadcast outside China and participate in trade shows to identify new products and services.

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. In recent periods, one of our most successful product sources has been our existing portfolio of branded products. 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.

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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.

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 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, 2008, we had 804 dedicated sales representatives. In 2006, 2007 and 2008, our call centers processed an average of approximately 12,400, 18,800 and 20,000 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.

During the fourth quarter of 2008, we entered into an agreement with the Management Committee of the Wuxi Xishan economic development zone to establish a new call center for our outbound call operations in Wuxi. The new call center is approximately 500 square meters and commenced operation on March 8, 2009.

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Order Fulfillment

The majority of products sold by us through our direct sales platforms, including TV direct sales, catalog and Internet direct 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 2006, 2007 and 2008, of the total attempted product deliveries by EMS and local delivery companies on a cash-on-delivery, or COD, basis, approximately 77%, 75% and 75% 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 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 2006, 2007 and 2008, approximately 98.7%, 99.5% and 93.1% of our direct sales were settled on a COD basis by our customers. Alternative payment methods 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 50 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, 2006, 2007 and 2008, $7.8 million, or 66.3%, $8.3 million, or 35.8%, and $9.0 million, or 32.5%, respectively, was due from EMS.

In 2006, 2007 and 2008, approximately 62.9%, 76.1% and 59.3% of our direct sales gross revenues resulted from products delivered by EMS, respectively, and approximately 34.1 %, 19.1%, and 29.8% of our direct sales gross revenues resulted from products delivered by local delivery companies, respectively.

We recently expanded our payment options to include payments through credit cards on a zero interest and zero fee installment payment basis. As of March 31, 2009, we have established relationships with 13 established domestic banks through which we directly market products through specialized catalogs to credit card holders of these banks.

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 and Shanghai call centers are currently staffed with approximately 120 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.

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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 2006, 2007 and 2008. 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 2006, 2007 and 2008.

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 last-mile 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 devices and posture correction product lines. After the completion of our acquisition of Yiyang Yukang, we further expanded our manufacturing operations 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. Five of our 17 PRC operating subsidiaries engaged in manufacturing operations enjoy the preferential tax benefits afforded to foreign-invested manufacturing enterprises. Accordingly, these entities are entitled to a two-year exemption from enterprise income tax beginning from the year when they first generate profits and a 50% enterprise income tax reduction for the following three years. Three of these five PRC operating subsidiaries became profitable beginning in 2005. However, entities not generating profits before 2008 are required to commence the tax holiday term beginning January 1, 2008 under the New EIT Law. See Item 3.D, Key Information Risk Factors Risks Relating to China The discontinuation of any of the preferential tax treatments and government subsidies available to us in the PRC could materially and adversely affect our results of operations and financial condition .

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 device and electronic dictionary products, for which we maintained an average of two weeks of inventory in 2008, 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 device 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.

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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 seven majority-owned subsidiaries, which are primarily engaged in developing and/or selling our stock tracking software program, electronic dictionaries, and engine lubricant products. 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 device-related subsidiary in which we acquired rights to the electronic learning devices 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 .

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 an initial consideration of $6.7 million in cash and 2,564,103 of our ordinary shares at a fair value of $3.2 million in aggregate, based on the average market price of our ordinary shares over a specified period before and after the date of agreement. In addition, we structured a performance based payment with respect to the consideration for the acquisition as described below. 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 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 extensive nationwide distribution network to facilitate sales of our featured cell phone products. We believe the acquisition will provide us a strong pipeline of mid-to-high end, differentiated and branded cell phone products, as well as strengthen our distribution capability in China. However, we have limited experience in managing and operating a cell phone manufacturer and, therefore, we maintain only low level supervision over the daily operation of Yiyang Yukang. We will rely heavily upon Yiyang Yukang s core management in operating the company. We structured a performance based payment with respect to the consideration for the acquisition pursuant to which we will be obligated to pay up to three earn-out payments equal to a maximum aggregate amount of $37.1 million in a combination of cash and ordinary shares, contingent on Yiyang Yukang meeting certain earnings targets in 2008, 2009 and 2010 for each earn-out payment.

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;

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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 devices which compete with electronic learning devices under the BBK, e100, 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; and

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.

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.

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.

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.

Seasonality

Certain of our products are subject to seasonality, such as our electronic learning devices 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. In addition, following our acquisition of Yiyang Yukang, we expect to sell our cell phone products through our distribution network in addition to our direct sales platforms, which may benefit from longer public holidays, such as the Chinese New Year or the National Day holidays. 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 117 trademark registrations and are in the process of applying for registrations or transfer for approximately 121 trademarks in China. We own five 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.

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 June and December 2007, NavInfo Co., Ltd., or NavInfo, filed three suits in the People s Court of Haidian District against Shanghai HJX Digital Technology Co., Ltd., or Shanghai HJX, Beijing Acorn Trade Co., Ltd. and Shanghai Acorn Network Technology Development Co., Ltd., all of which are our subsidiaries or our affiliates, and Shenzhen Careland Information System Co., Ltd., or Careland, alleging that the digital maps incorporated in our GPS products and provided by Careland infringed on NavInfo s copyrighted digital map. The court ruled in favor of NavInfo in the suits and awarded NavInfo total compensation of RMB1,000,000 (approximately $147,000). Careland has indemnified us for the loss we suffer in connection with the suits.

In October 2007, Beijing Ren ai Education Research Institute, or Beijing Ren ai, filed a suit in Henan Puyang Intermediate People s Court against Shanghai HJX and Henan Puyang Hualong Commercial Building Co., Ltd., or Hualong Building, alleging that the English programs we provide to the users of our electronic learning devices infringe upon the copyright of Beijing Ren ai. Beijing Ren ai claimed damages of RMB500,000 (approximately $73,000). This legal proceeding is still pending and we are vigorously contesting Beijing Ren ai s claim.

In November 2007, Beijing Ren ai filed a suit in Anhui Hefei Intermediate People s Court against Shanghai HJX, Hefei Huitong Science and Trade Co., Ltd. and Hefei Xinhua Bookstore Co., Ltd. making a similar allegation and claiming RMB500,000 (approximately $73,000) in compensation. On May 4, 2008, the Anhui Hefei Intermediate People s Court ruled that Shanghai HJX and Hefei Huitong Science and Trade Co., Ltd. should cease infringement of the copyright of Beijing Ren ai and ordered Shanghai HJX to pay RMB50,000 (approximately $7,000) in damages. We have made the damages payment as of December 31, 2008.

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

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the users of our electronic learning devices 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;

- 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 SAFD and the Ministry of Industry and Information Technology, or MIIT.

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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.

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 Sept. 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

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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 Oct. 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.

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

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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 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. A Medical Device Registration Certificate has also been issued for our Youngleda oxygen generating devices with a valid term of four years from February 15, 2006. Another of our subsidiaries, Acorn International Electronic (Shanghai) Co., Ltd. holds a valid Medical Device Manufacturing Enterprise License that expires on August 2, 2010 and a Medial Device Registration Certificate for sleeping aid products with a valid term of four years from December 27, 2005. In addition, Shanghai HJX holds a Medical Device Operation Enterprise license which expires on January 3, 2010. Separately, our two direct sale affiliated entities, Shanghai Network and Beijing Acorn, hold valid Medial Device Operation Enterprise Licenses, which expire on January 3, 2010 and July 3, 2010, respectively. On November 24, 2006, Zhuhai Acorn Electronic Technology Co., Ltd. obtained a Medical Device Manufacturing Enterprise License expiring on November 24, 2011.

Regulation of Internet Content Providers

We currently operate 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, 2005 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

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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 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 home shopping programs is typically considered to be advertising time. Current regulations require that total airtime allocated to advertising on a TV channel not exceed 20% of the total broadcasting hours on a daily basis and not exceed 15% of the broadcasting hours between 19:00 and 21:00. The total airtime of a TV shopping program is limited to 15 minutes per hour except on special shopping channels.

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 recently 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. 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 .

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

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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 .

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.

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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

- 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.

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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.

On May 29, 2007, SAFE issued a Notice on Issuing Implementing Rules and Procedures of Notice on Issues Relating to the Administration of Foreign Exchange in Financing and Round-trip Investment Activities of Domestic Residents Conducted via Offshore Special Purpose Companies, or Notice 106. As the implementing rules of Notice 75, Notice 106 clarified the application of Notice 75 to some extent.

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 and Notice 106. 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 and Notice 106, 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, Bright Rainbow Investments Limited and Emoney Investments Limited. On December 13, 2007, we formed

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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 July 2008, we established Shanghai Chuangying Xianke Information Technology Co., Ltd. and Guangzhou Yiteng Information Technology Co., Ltd., respectively, under Shenghai Yimeng to further expand our distribution network. In August 2008, we acquired Shanghai Yitong Investment Consulting Co., Ltd., which holds a securities investment consulting license issued by CSRC, through Shanghai Yimeng. 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.

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 .

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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[(1)]:

(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 .

(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.

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, and Zhuhai Acorn Electronic Technology Co., Ltd. manufacture and distribute through our nationwide distribution network most of our electronic learning devices, posture correction products and oxygen generating devices, 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 Information or its designee an exclusive option to purchase at any time if and when permitted under

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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 13,736 square meters of office and call center spaces in Beijing and Shanghai. Our leases are typically for a term from one to five years. In the fourth quarter of 2007, we entered into multiple office building purchase agreements as part of the planned relocation of our headquarters from Yishan Road, Shanghai to a new, larger facility on Tianlin Road, Shanghai, in order to accommodate our growing number of employees and expanding operations. The total purchase price was RMB51.5 million (or approximately $7.5 million). The relocation took place in January 2009. During the fourth quarter of 2008, we entered into an agreement with the Management Committee of the Wuxi Xishan economic development zone to establish a new call center for our outbound call operations in Wuxi. The new call center is approximately 500 square meters and commenced operation on March 8, 2009. Our four central warehousing hubs cover approximately 5,639 square meters and are subject to varying lease terms. We typically enjoy a priority right to renew our leases for our warehouses. We also utilize at no cost to us four local delivery companies warehouses located in Beijing, Hebei, Liaoning, Shanghai and Zhejiang.

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 devices product line. As of December 31, 2008, our production capacity was 5,000 units per day for our electronic learning devices, 8,000 units per day for our posture correction products, and an aggregate of 15,000 units per day for our oxygen generating devices. In 2008, the manufacturing facilities producing our electronic learning devices products operated at or near capacity. In 2008, the daily utilization rate for the manufacturing facilities producing our posture correction products and oxygen generating devices ranged from 50% to 80% and 30% to 90%, 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 RMB50 million (approximately $7.3 million). We plan to use the land to build a warehouse or a call center, and to establish a factory for manufacturing our proprietary branded products as part of our strategy to develop infrastructure for building a future home shopping business in the next three to five years.

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. Our two primary operating segments 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 TV air time purchased. 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. In addition to our TV direct sales platform and our nationwide distribution network, we have expanded into other direct sales platforms, such as catalogs, Internet sales, outbound calls and third-party bank channel sales.

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 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 and Shanghai. As of December 31, 2008, our call centers were staffed by 804 sales representatives and 120 customer service personnel. Our call centers operate 24 hours per day. In 2006, 2007 and 2008, our call centers processed on average approximately 12,400, 18,800 and 20,000 incoming calls per day generated from our TV and other direct sales platforms, respectively. During the fourth quarter of 2008, we entered into an agreement with the Management Committee of the Wuxi Xishan economic development zone to establish a new call center for our outbound call operations in Wuxi. The new call center is approximately 500 square meters and commenced operation on March 8, 2009.

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. We acquired Yiyang Yukang for an initial consideration of $6.7 million in cash and 2,564,103 of our ordinary shares at a fair value of $3.2 million in aggregate, based on the average market price of our ordinary shares over a specified period before and after the date of agreement. We used ordinary shares repurchased through our repurchase plan for the acquisition. Our total expenses related to the acquisition were $0.7 million. We structured a performance based payment with respect to the consideration for the acquisition pursuant to which we will be obligated to pay up to three earn-out payments equal to a maximum aggregate amount of $37.1 million in a combination of cash and ordinary shares, contingent on Yiyang Yukang meeting certain earnings targets in 2008, 2009 and 2010 for each earn-out payment.

Our net revenues, which include direct sales net revenues and distribution net revenues, were $196.5 million, $262.1 million and $250.7 million in 2006, 2007 and 2008, 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, grew from $107.4 million in 2006 to $184.3 million in 2007, but declined to $171.6 million in 2008. Distribution net revenues, which are derived from sales of products and services to our distributors, declined from $89.1 million in 2006 to $77.8 million in 2007, but grew to $79.0 million in 2008.

Our net revenues and operating income in any period are largely driven by our direct sales and distribution platforms and product and service mix, advertising expenses, and events occurring in the period. In 2008, our total net revenues declined to $250.7 million, down 4.4% from $262.1 million in 2007. Of our total net revenues in 2008, our direct sales net revenues declined to $171.6 million, down 6.9% from $184.3 million in 2007, and our distribution net revenues increased to $79.0 million, up 1.6% from $77.8 million in 2007. The overall decline in net revenues was driven primarily by declines in overall sales due to several factors, including the effects of the global economic crisis which weakened the purchasing power of our customers, intensified industry competition in the TV direct sales industry in China and the conclusion of the 2008 Beijing Olympics. Our net revenues were also adversely affected by natural disasters in China, including the snow storms that swept through most provinces in China in early 2008 and the major earthquake that struck Wenchuan in the Sichuan province in May 2008, which disrupted our television advertising time and adversely affected the logistics and delivery of our products and the willingness for our customers to accept the products sold. In 2008, sales of our cell phones, primarily through our TV direct sales platform, continued to be our top product line in terms of percentage of total net revenues. However, sales of our cell phones declined to approximately $56.3 million in 2008, compared to $105.6 million in 2007, primarily due to a decrease in the average sales 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. This decline in sales of cell phones was partially offset by the increase in sales of our cosmetics, GPS products and Meijin electronic dictionary products, which increased approximately $16.5 million, $14.1 million and $8.2 million, respectively, in 2008 compared to 2007. The increase in sales of our cosmetics products was primarily due to a significant increase in sales of certain branded cosmetic products that were not part of our product mix in 2007. The increase in sales of our GPS products was primarily due to the increased media spending on our E-roda GPS product. The increase in sales of our Meijin electronic dictionary was primarily due to continued customer demand of this product which was not part of our product mix until the second quarter of 2007.

In addition to the factors described above, our net revenues and operating income in 2008 continued to be adversely impacted by PRC regulatory changes (still in effect) prohibiting TV and radio direct sales programs of certain products, including our branded neck massager product. These products were two of our best-selling and highest margin products in the first half of 2006. Gross revenues from sales of our neck massager product line dropped from $18.9 million in the first half of 2006 to $5.5 million in the second half of 2006, and dropped further in 2007 and 2008. In July 2006, several articles appeared in the Chinese media questioning the price and quality of our products, particularly our electronic learning devices. The negative media coverage led to a decline in sales volume and revenues for this product and several of our other products. We are not aware of any such negative publicity of our electronic learning device in 2008, but the total gross revenues from sales of our electronic learning devices decreased to $47.0 million in 2008, down 6.4% from $50.2 million in 2007. We believe the decrease was due to a decrease in unit sale prices compared to 2007, and not negative media coverage.

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We had operating losses of $21.1 million in 2008 compared to operating income of $7.9 million in 2007. This loss was driven largely by the decrease in net revenues described above and increases in certain operating expenses, including an increase in selling and marketing expenses from $31.7 million in 2007 to $42.2 million in 2008, an increase in general and administrative expenses from $28.5 million in 2007 to $31.7 million in 2008, and an impairment loss of $8.7 million for goodwill and intangible assets in the third quarter of 2008. This loss was partially offset by a slight decrease in advertising expenses from $76.0 million in 2007 to $74.4 million in 2008. The increase in selling and marketing expenses was primarily due to increased business development and promotion expenses to our distributors, higher delivery and packaging costs associated with the Beijing Olympics and an increase in the mailing of catalogs associated with third-party bank channel sales. The increase in general and administrative expenses was primarily due to the increase in research and development expenses, depreciation and amortization expenses of fixed assets and intangible assets, consulting fees and bad debt provisions. The loss for impairment of goodwill and intangible assets was due to our evaluation of our long-lived assets as a result of our net loss position and changes in circumstances that indicate that the carrying amount of such assets may not be recoverable.

Our product and service revenues are driven significantly by our spending on advertising, particularly our TV direct sales programs. Our total advertising expenses decreased slightly from $76.5 million in 2006 to $76.0 million in 2007 and to $74.4 million in 2008. The largest component of our total advertising expenses, constituting over 80% of total advertising expenses in each of 2006, 2007 and 2008, is purchased TV advertising time. Purchased TV advertising expenses increased by 4.3% from $69.0 million in 2006 to $72.0 million in 2007 and decreased by 1.0 % to 71.3 million in 2008. The slight decrease of total advertising expenses in 2008 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. The increase in purchased TV advertising expenses in 2007 reflects our decision in 2007 to increase spending levels on both TV direct sales programs and TV brand promotion advertising. Since 2007, however, we have changed our strategy to focus more of our advertising spending on our TV direct sales platform and to reduce the amount of purchased TV advertising time devoted to broadcasting solely brand promotion advertising.

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 63 in 2007 to 46 in 2008. In 2008, we broadcast brand promotion advertising on six TV channels, including three channels on which we did not broadcast TV direct sales programs.

As of December 31, 2008, our commitments to purchase TV advertising time in 2009 were approximately $63.7 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 2008, approximately 10.1% of our purchased TV advertising time was preempted by these TV stations due to special events such as the 2008 Beijing Olympics in August 2008, which significantly affected our sales performance in the third quarter. 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 arrangement with China Unicom), or as advertising expenses (which may be reduced by shared advertising costs under joint sales arrangements, such as our arrangement with Gionee pursuant to which Gionee shares a certain percentage of our advertising costs for their featured cell phone products). In 2008, the reduction in cost of direct sales revenues and advertising expenses were $1.1 million and $3.2 million, respectively, due to our accounting for joint sales and marketing services arrangements.

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In addition to our TV brand promotion advertising, we also promote brands through print and other media, primarily newspaper advertising. 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.

The number of inbound calls generated through our direct sales platforms received by our call centers has continued to increase, with inbound calls in 2006, 2007 and 2008 totaling approximately 4.5 million, 6.9 million, and 7.3 million, respectively. The conversion rate for inbound calls, which is the percentage of inbound calls that result in product or service purchase orders, was 19.2%, 16.8%, and 23.2% in 2006, 2007 and 2008, respectively. In calculating our conversion rate and inbound calls, we exclude calls generated under our marketing services arrangements, such as our 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 agrees to pay us an amount based on the number of units sold by it through its own distribution network. 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 2008, our cell phone products and cosmetics products were the two major categories of products subject to joint sales arrangements. Under a marketing services arrangement, we provide a marketing plan, related TV advertising time and call center support to our customers for a fixed fee. We have included the fixed fee we received pursuant to this marketing services agreement in direct sales net revenues. We did not recognize significant revenue contributions from our marketing services arrangements in 2008. We expect to return to our historic emphasis on growing our proprietary branded products while continuing to develop joint sales and marketing services arrangements as sources of complementary revenue streams.

The recent global economic crisis is adversely affecting the economy in the United States and many other parts of the world, including China, where our primary business operations are located, and the Chinese economy has recently experienced a slowing of its growth rate. 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 collectible products or high-end 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 turnover and profit.

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 utilize our product and service development and marketing strengths, our national TV media presence and our media management expertise to offer selected products throughout China through our integrated sales platforms. We expect continued growth in our cosmetics products, and are making further improvements in our third-party bank channel sales business and credit card payment system 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

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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

	For the years ended December 31,					
	2006		2007		2008	
	Amount	% of total revenue, net	Amount	% of total revenue, net	Amount	% of total revenue, net
	(in U.S. dollars, except percentage)					
Revenues:						
Direct sales, net	$ 107,410,669	54.7	$ 184,291,903	70.3	$ 171,618,902	68.5
Distribution sales, net	89,087,622	45.3	77,804,769	29.7	79,032,628	31.5
Total revenues, net	196,498,291	100.0	262,096,672	100.0	250,651,530	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 catalog sales, third-party bank channel sales, Internet sales and sales realized through our outbound calls. To date, substantially all of our direct sales net revenues have been generated from our TV direct sales platform. As we continue to develop other direct sales platforms, we expect our third-party bank channel sales, catalog sales and outbound calls sales to increase their contribution to our revenue. Our marketing services revenues, which we started generating in 2006 as part of our direct sales net revenues, totaled $6.7 million, $16.0 million and $3.2 million in 2006, 2007 and 2008, 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. The percentage of our total net revenues generated through our nationwide distribution network was 45.3% in 2006, 29.7% in 2007 and 31.5% in 2008.

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 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 $0.7 million in 2006, $1.0 million in 2007 and $0.5 million in 2008. 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 2006, 2007 and 2008 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 2006, 2007 and 2008, the aggregate sales generated by distributors owned in whole or in part by our employees accounted for approximately 26.9%, 25.4% and 14.7% of our distribution gross revenues or 12.9%, 7.5% and 4.6% of our total gross revenues, respectively. Certain of these distributors were among our top distributors in 2006, 2007 and 2008.

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We generally focus on marketing and selling four or five 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:

(1) cell phone products featuring the Amoi, Gionee, K-touch, Lenovo, Nokia and Konka brand names and China Unicom s CDMA service and CDMA cell phones from China Unicom s partners. We began introducing cell phones in April 2006, which are sold by us only through our TV direct sales platform and accounted for 14.1%, 40.1% and 22.4% of our total gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB2,980 to RMB7,580 per unit in 2006, ranging from RMB588 to RMB4,960 per unit in 2007 and ranging from RMB599 to RMB7,140 (US$88 to US$1,047) per unit in 2008;

(2) electronic learning devices featuring our proprietary Ozing brand, which accounted for 31.7%, 19.1% and 18.7% of our total gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB698 to RMB1,298 per unit in 2006, RMB798 to RMB1499 per unit in 2007 and RMB599 to RMB1,499 (US$88 to US$220) per unit in 2008;

(3) health and wellness products, including our posture correction product, neck massager product and oxygen generating product lines, featuring our proprietary Babaka, Zehom and Youngleda brand names, which accounted for 23.6%, 9.8% and 14.3% of our total gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB288 to RMB1,980 per unit in 2006, RMB128 to RMB1,980 per unit in 2007 and RMB86 to RMB3,495 (US$13 to US$512) per unit in 2008;

(4) cosmetics products featuring the Aoya, Cobor, Dr. Cell and CMM brand names, introduced in 2007, which accounted for 2.7% of our total gross revenues in late 2007 and 9.4% of our total gross revenues in 2008, with retail prices ranging from RMB48 to RMB1,288 per unit in 2007 and RMB79 to RMB1,980 (US$12 to US$290) per unit in 2008;

(5) consumer electronics products featuring Soloky brand name, which accounted for 6.9%, 0.5% and 1.9% of our total gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB1,280 to RMB3,980 per unit in 2006, RMB860 to RMB1,980 per unit in 2007 and RMB899 to RMB2,280 (US$132 to US$334) per unit in 2008.

(6) stock tracking software featuring the Cao Pan Shou, or CPS brand name, which accounted for 2.4%, 6.4% and 7.1% of our total gross revenues in 2006, 2007 and 2008, with a retail price of RMB3,380 (or approximately $495) per unit in 2008. In October 2008, we introduced an upgraded product, Level II, with a retail price of RMB4,800 (or approximately $704) per unit;

(7) collectibles products featuring 2008 Olympics stamps and coins, animal stamp collections, world coin collections and other Olympic related collectibles, which accounted for 4.0%, 7.3% and 6.4% of our total gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB350 to RMB58,000 (US$51 to US$8,501) in 2008; and

(8) electronic dictionary products featuring the Meijin brand name, which we introduced in July 2007, accounted for 2.3% and 5.7% of our gross revenues in 2007 and 2008, respectively, with retail prices ranging from RMB498 to RMB1,298 per unit in 2007 and prices ranging from RMB598 to RMB898 (US$88 to US$132) per unit in 2008;

(9) GPS products featuring the E-roda brand name, which we introduced in 2006, accounted for 5.0%, 2.6% and 6.8% of our gross revenues in 2006, 2007 and 2008, respectively, with retail prices ranging from RMB598 to RMB898 (US$88 to US$132) per unit in 2008;

Our three best-selling product lines accounted for an aggregate of 57.2%, 66.5% and 52.5% of our total gross revenues in 2006, 2007 and 2008, respectively.

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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 700 products and services through our multiple sales platforms, approximately 8.6% of which are sold primarily through our TV direct sales programs, nationwide distribution network or both, with the remaining sold through our third-party bank channel sales, catalogs and the internet. In addition to the eight product lines we presently feature, we sell other products and services, including auto care, beauty and household products, primarily through our catalogs, third-party bank channel, outbound calls 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, 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 seek to diversify our product and service offerings by adding products and services that offer recurring revenue opportunities. For example, in January 2006 we began full-scale marketing of our CPS stock tracking software, a software program that tracks market performance of specified stocks listed on China s domestic stock exchanges and provides technical analysis to aid investment decisions. The use of this product requires the payment of an annual subscription fee at the beginning of the subscription period. The initial subscription fee was RMB3,380 (approximately $495) for the old product and RMB4,800 (approximately $704) for the upgraded product in 2008. For stock tracking software sold through our distributors, we offer our distributors a discount on the subscription fee and annual renewal fee. The pricing of the initial subscription fee and renewal fee is the same regardless of whether it is sold by us or through our distribution network. Revenues from both initial and renewal fees are deferred and recognized ratably over the twelve-month subscription period. In 2008, we recognized $18.0 million in related subscription revenue, or 7.1% as a percentage of total net revenues in 2008, and our deferred revenue balance was $12.8 million as of December 31, 2008.

In late May 2006, the Shanghai branch of the China Securities Regulatory Commission, or CSRC, sent us a notice requiring we suspend advertisements of our stock tracking software program as it believed we did not have the required permit to provide securities investment advisory services. Although we do not believe that our sale of this software program involves the provision of securities investment advisory services, beginning in May 2006, we discontinued most TV advertisements for this program.

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. Consequently, we were unable to, and until the new rules are adopted we will be unable to, broadcast TV- and radio-based direct sales programs for some of our products, primarily our neck massager. Our net revenues from sales of our neck massager product declined from $24.4 million in 2006 to $3.9 million in 2007 and $2.4 million in 2008, respectively. These products were two of our high margin products and, during the six months ended June 30, 2006, our neck massager was our second best-selling product in terms of gross revenues and our best-selling product in terms of direct sales gross revenues. It is unclear when the new rules governing those direct sales activities will be issued. 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 circular have been, and we expect

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will continue to be, adversely impacted as a result of this prohibition. In 2007, distribution sales of our neck massager products decreased by 75.0% to $2.7 million from $10.8 million in 2006, largely due to a lack of TV direct sales program marketing support. In 2008, distribution sales of our neck massager products further decreased by 60.1% to $1.1 million from $2.7 million in 2007. 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 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 devices. 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 devices and other products or services. In September 2007, an article in the Chinese media reported that the advertisement of our CPS product was declared to be false advertising by the State Administration for Industry and Commerce Shanghai Branch, which had a material adverse effect on the sales of our CPS product in 2007. To our knowledge, we are not aware of any such negative publicity in relation to our products or services in 2008.

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 and brand promotion advertising and the portion of our TV direct sales programs dedicated to joint sales and marketing services arrangements;

- the mix of products and services marketed through our TV direct sales programs and our nationwide distribution network and their average selling prices;

- the portion of any subscription or service revenue deferred or recognized in any period;

- new product and 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 devices, posture correction products and to a lesser extent, electronic dictionary products, which, with respect to the latter, are typically higher around the first and third fiscal quarters which correspond with the end and beginning of school semesters in China. In addition, following our acquisition of Yiyang Yukang, we expect to sell our cell phone products through our distribution network in addition to our direct sales platforms, which may benefit from longer public holidays, such as the Chinese New Year or the National Day holidays;

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

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

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- 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;
- 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.

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 March 31, 2009, we have established relationships with 13 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 instalment basis. During such process, the banks would conduct credit investigations to ensure the credit card holders ability to pay. Third-party bank channel sales is of growing importance to our direct sales platform, and revenues contributed by our third-party bank channel sales in 2008 accounted for approximately 7.9% 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.

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 collectible 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.

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In 2008, we received $1.1 million in payments from our joint sales partners based on sales of featured products or services through their own distribution channels, which reduced our cost of direct sales revenues. In addition, we received $17.8 million in payments based on advertising costs shared by our joint sales arrangements, which reduced our advertising expenses.

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.

If we defer revenues in a period, our operating margins will be initially adversely impacted as we recognize the cost of revenues in full in the period, and will be favorably impacted in later periods as we recognize deferred revenue without the offsetting cost of revenues.

Operating Income (Expenses)

Our operating income (expenses) 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 channels on which we run almost exclusively TV direct sales programs accounted for $53.3 million, or 77.2%, $67.3 million, or 93.5%, and $59.2 million, or 79.5%, of total expenses incurred in purchasing TV advertising time in 2006, 2007 and 2008, respectively. TV advertising time dedicated to TV direct sales programs increased from over 760,000 minutes in 2006, to over 890,000 minutes in 2007, and decreased to approximately 590,000 minutes in 2008. The decrease in 2008 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. TV brand promotion advertising expenses accounted for $15.7 million, or 22.8%, $4.7 million, or 6.2%, and $12.2 million, or 16.4%, of our total expenses incurred in purchasing TV advertising time in 2006, 2007 and 2008, respectively. The increase in 2008 reflects our TV brand promotion advertisements for our electronic learning devices and posture correction products broadcasted in the first quarter of the year. The decrease in 2007 reflects our decision in 2007 to change our strategy to focus more of our advertising spending on our TV direct sales platforms and to reduce the amount of purchased TV advertising time devoted to broadcasting solely brand promotion advertising. In 2008, we engaged in brand promotion advertising primarily to support electronic learning devices and posture correction products. In 2007, we engaged in brand promotion advertising primarily to support our electronic learning devices, neck massager and posture correction product lines. In 2006, TV brand promotion advertising primarily supported our oxygen generating devices, neck massager, posture correction, electronic learning devices and stock tracking software 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

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advertising cost are recorded as a reduction to our TV advertising expense. 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 2006, 2007 and 2008 included an aggregate of $6.3 million, or 8.3%, $3.1 million, or 4.1%, and $2.6 million, or 3.5%, respectively, which primarily was used to support our neck massager and oxygen generating devices product lines.

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 2006, 2007 and 2008 included $1.0 million, or 1.3%, $0.5 million, or 0.7%, and $0.1 million, or 0.2% of these distributor reimbursements, respectively, primarily related to our oxygen generating devices, neck massager, posture correction, electronic learning devices and stock tracking software product lines.

During 2006, 2007 and 2008, our TV brand promotion advertisements were broadcasted on eighteen, eight and six channels, respectively, including CCTV 1, which has the largest national viewership in China and is our primary TV channel for brand promotion advertising.

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, 2006, 2007 and 2008, we had a prepaid advertising balance of $25.4 million, $23.2 million and $16.8 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 increases in advertising expenses related to the direct sales business primarily reflect the purchase of more expensive broadcast time slots and an increase in price per minute. Our average per minute advertising cost for TV direct sales programs in 2006, 2007 and 2008 was approximately $70, $75 and $99, 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 2008, our top five TV channels in terms of amount of TV direct sales program advertising expenditures accounted for approximately 39.5% of our total TV direct sales program advertising expenditures and approximately 35.9% of our total TV direct sales program advertising minutes. In contrast, in 2008, our top five TV channels by total TV direct sales program advertising minutes accounted for approximately 42.3% of our total TV direct sales program advertising minutes and 27.9% of our total TV direct sales program advertising expenditures.

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 will be included in other selling and marketing expenses starting from 2009. See note 3 to our consolidated financial statements.

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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 62.9% and 34.1% of our direct sales gross revenues in 2006, 76.1% and 19.1% of our direct sales gross revenues in 2007, and 59.3% and 29.8% of our direct sales gross revenues in 2008, respectively. We are responsible for the delivery and handling fee regardless whether the delivery is successful.

In 2008, the increase in other selling expenses primarily reflects the increase in business development fees, costs related to product delivery, costs related to packing of our products and salaries and benefits of our employees, the increased delivery charges by EMS and local delivery companies and our increased product mix, respectively.

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 $27.1 million in 2006, $28.5 million in 2007 and $31.7 million in 2008, which increases primarily reflect higher salaries and benefits.

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.

The total amount of EMS-related accounts receivable written off in 2006, 2007 and 2008 was approximately $0.3 million in each year.

Impairment of Goodwill and Intangible Assets

Impairment losses of goodwill and intangible assets for the full year 2008 totaled $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 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.

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, Emoney Investments Limited and MK AND T Communications 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.

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In 2006 and 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 2006, 2007 and 2008, 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 2006 and 2007 and 18% CIT in 2008 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 2006 and 2007 as qualified foreign-invested manufacturing enterprises.

Acorn Information and Shanghai Yimeng registered in Pudong New District, Shanghai of the PRC, are subject to 15% CIT in 2006 and 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 2006 and 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 applicable CIT rate is 18%.

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 and 18% CIT in 2008.

The Group s remaining PRC subsidiaries are subject to the statutory rate of 33% in 2006 and 2007 in accordance with the PRC Corporate Income Tax Laws, and 25% in 2008 in accordance with the New EIT Law.

Shanghai Advertising, as a recognized new service company, is entitled to CIT exemption in 2006.

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. Shanghai Yimeng, as a recognized software company, is eligible for the Tax Holiday from 2006.

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

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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 and 2008. Beijing HJZX is not qualified as high and new technology company from 2009 and will not be subject to the high and new technology company s preferential tax treatment from 2009.

Shanghai Network, as a recognized new trading company, is entitled to CIT exemption in 2006 and 2007.

Effective on January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of SFAS No. 109 , or FIN 48. Based on our FIN 48 analysis, 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. The adoption of FIN 48 did not have any impact on our total liabilities or shareholders equity. As of December 31, 2007 and 2008, we had unrecognized tax benefits of approximately nil and $3.1 million respectively.

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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 2006, 2007 and 2008:

	For the years ended December 31,					
	2006		2007		2008	
	Amount	% of total revenues, net	Amount	% of total revenues, net	Amount	% of total revenues, net
	(in thousands, except percentages)					
Revenues:						
Direct sales, net	$ 107,411	54.7 %	$ 184,292	70.3 %	$ 171,619	68.5%
Distribution sales, net	89,087	45.3	77,805	29.7	79,033	31.5
Total revenues, net	196,498	100.0	262,097	100.0	250,652	100
Cost of revenues:						
Direct sales	32,013	(16.3)	85,895	(32.8)	83,414	(33.3)
Distribution sales	41,260	(21.0)	38,004	(14.5)	37,714	(15.0)
Total cost of revenues	73,273	(37.3)	123,899	(47.3)	121,129	(48.3)
Gross profit	123,225	62.7	138,198	52.7	129,523	51.7
Operating income (expenses):						
Advertising expenses	(76,549)	(39.0)	(75,981)	(29.0)	(74,371)	(29.7)
Other selling and marketing expenses[(1)]	(21,023)	(10.7)	(31,673)	(12.1)	(42,216)	(16.8)
General and administrative expenses[(1)]	(27,115)	(13.8)	(28,455)	(10.9)	(31,674)	(12.6)
Impairment of goodwill and intangible assets					(8,668)	(3.5)
Other operating income, net	3,105	1.6	5,783	2.2	6,281	2.5
Total operating expenses	(121,582)	(61.9)	(130,327)	(49.8)	(150,648)	(60.1)
Income (loss) from operations	1,643	0.8	7,871	2.9	(21,125)	(8.4)
Interest expenses	(14)		(0.3)			
Other income (expenses), net	2,181	1.1	16,514	6.3	(69)	
Income tax benefits (expenses)	696	0.4	1,330	0.5	(768)	(0.3)
Minority interest	(561)	(0.3)	(7,062)	(2.7)	(3,629)	(1.4)
Net income (loss)	3,945	2.0	18,652	7.1	(25,591)	(10.2)
Deemed dividend on Series A convertible redeemable preferred shares	(162)	(0.1)	(54)			
Income (loss) attributable to holders of ordinary shares	$ 3,783	1.9%	$ 18,598	7.1%	$ (25,591)	(10.2)

(1) Includes share-based compensation of:

Other selling and marketing expenses	$ (741)	(0.4)%	$ (423)	(0.2)%	$ (292)	(0.1)%

General and administrative expenses	$	(7,932)	(4.0)%	$	(6,096)	(2.3)%	$	(2,997)	(1.2)%

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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	Revenues	2006 percentage	Rank	Revenues	2007 percentage	Rank	Revenues	2008 percentage	Rank
		(in thousands, except percentages and ranks)								
Cell phone	Amoi, Gionee, K-touch, Lenovo, Nokia & Konka	$ 26,050	13.2%	2	$ 105,563	40.1%	1	$ 56,262	22.4%	1
Electronic learning device	Ozing	62,464	31.7%	1	50,151	19.1%	2	46,939	18.7%	2
Posture correction product	Babaka							28,598	11.4%	3
Neck massager*	Zehom	24,354	12.3%	3						
Collectibles					19,332	7.3%	3			
Total top three		**$ 112,868**	**57.2%**		**$ 175,046**	**66.5%**		**$ 131,799**	**52.5%**	
Other products and marketing services revenues		$ 84,343	42.8%		$ 88,099	33.5%		$ 119,361	47.5%	
Total gross revenues		$ 197,211	100%		$ 263,145	100%		$ 251,160	100%	
Total sales tax		$ (713)			$ (1,048)			$ (508)		
Total revenues, net		$ 196,498			$ 262,097			$ 250,652		

* The figure contains revenue generated from sales of our sleeping aid products in 2006.

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 device 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.

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	Revenues	2006 percentage	Rank	Revenues	2007 percentage	Rank	Revenues	2008 percentage	Rank
		(in thousands, except percentages and ranks)								
Direct Sales:										
Cell phone	Amoi, Gionee, K-touch, Lenovo, Nokia & Konka	$ 26,050	24.1%	1	$ 104,675	56.5%	1	$ 56,202	32.7%	1
Posture correction product	Babaka				9,403	5.1%	3	19,225	11.2%	3
Neck massager*	Zehom	13,579	12.6%	3						
Cosmetics products	Aoya, Cobor, Dr Cell and CMM brand names							23, 399	13.6%	2
Consumer electronics	Soloky, Aptek Net E-cam & Net E-cam	11,959	11.1%	2						
Collectibles					19, 235	10.4%	2			
Direct Sales-total top three		**$ 51,588**	**47.7%**		**$ 133,313**	**72.0%**		**$ 98,826**	**57.5%**	
Other products and marketing services revenues		$ 56,455	52.3%		$ 51,845	28.0%		$ 73,116	42.5%	

Total gross revenues	$ 108,043	100%	$ 185,158	100%	$ 171,942	100%
Total sales tax	$ (632)		$ (866)		$ (323)	
Total revenues, net	$ 107,411		$ 184,292		$ 171,619	

* The figure contains revenue generated from sales of our sleeping aid products in 2006.

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Product	Brand	2006 Revenues	2006 percentage	2006 Rank	2007 Revenues	2007 percentage	2007 Rank	2008 Revenues	2008 percentage	2008 Rank
					(in thousands, except percentages and ranks)					
Distribution Sales:										
Electronic learning device	Ozing	$ 53,541	60.0%	1	$ 43,175	55.4%	1	$ 35,727	45.1%	1
Posture correction product	Babaka	11,768	13.2%	2	6,722	8.6%	3			
Neck massager	Zehom	10,775	12.1%	3						
Electronic dictionary products	Meijin							13,897	17.5%	2
Stock tracking software	CPS				11,211	14.4%	2	12,009	15.2%	3
Distribution sales-total top three		**$ 76,084**	**85.3%**		**$ 61,108**	**78.4%**		**$ 61,633**	**77.8%**	
Other products and marketing services revenues		$ 13,084	14.7%		$ 16,879	21.6%		$ 17,585	22.2%	
Total gross revenues		$ 89,168	100%		$ 77,987	100%		$ 79,218	100%	
Total sales tax		$ (81)			$ (182)			$ (185)		
Total revenues, net		$ 89,087			$ 77,805			$ 79,033		

Comparison of Years Ended December 31, 2006, December 31, 2007 and December 31, 2008

Revenues

Our total net revenues increased from $196.5 million in 2006 to $262.1 million in 2007, and decreased to $250.7 million in 2008, or a 33.4% increase and a 4.4% decrease, respectively. The net decrease of $11.4 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 sales 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 $11.4 million in total net revenues in 2008 was partially offset by increases of $16.5 million, $14.1 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. Despite a decrease in sales of cell phones of $49.3 million from $105.6 million in 2007 to $56.3 million in 2008, our cell phone products line continued to be our top product line in 2008. Our other top product lines in 2008 were our Ozing electronic learning device, which we lowered the selling prices of certain models in the fourth quarter of 2008 as part of our strategy to stimulate sales and generated $46.9 million in revenues, and our Babaka posture correction product, which generated $28.6 million in revenues. The net increase of $65.6 million in total net revenues in 2007 primarily reflects a $101.2 million increase in sales of cell phones, collectibles and our stock tracking software program, with sales of these products collectively generating $141.7 million in gross revenues and cell phones emerging as our top product line in 2007. The $101.2 million increase was partially offset by decreases of $12.4 million, $12.3 million and $20.4 million in sales of our consumer electronics, Ozing electronic learning device, and Zehom neck massager products, respectively, reflecting a significant decline in revenues from our electronic leaving device product which was our top product line in 2006. Included in total net revenues in 2006, 2007 and 2008 were approximately $6.7 million, $16.0 million and $3.2 million in marketing services revenues, respectively, which are mainly generated from our marketing services arrangement with China Unicom. In addition, in 2006, 2007 and 2008, we recognized $4.7 million, $16.8 million and $18.0 million in subscription revenue related to our stock tracking software, respectively, and our deferred revenue balance was $4.2 million, $13.4 million and $12.8 million as of December 31, 2006, 2007 and 2008, respectively.

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Direct sales net revenues increased from $107.4 million in 2006 to $184.3 million in 2007, and decreased to $171.6 million in 2008, or a 71.6% increase and a 6.9% decrease, respectively. The net decrease of $12.7 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. As described above, the decrease in sales of cell phones was primarily due to intensified competition, and a decrease in the average sales 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 $12.7 million in direct sales net revenues in 2008 was partially offset by increases of $16.4 million, $14.4 million and $0.1 million in sales of our cosmetics, GPS products and Meijin electronic dictionary products, respectively, reflecting an increase of 236.0%, 192.7% 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 E-roda satellite navigation system product, and sales of our Meijin electronic dictionary which was not part of product mix until the second quarter of 2007. From a product mix perspective, our top three direct sales products in 2008 were cell phones, cosmetics and posture correction products, which accounted for $98.8 million, or 57.5%, of our direct sales net revenues in 2008. In 2008, direct sales net revenues also benefited from an increase in the number of inbound calls to our call centers from 6.9 million in 2007 to 7.3 million in 2008, and an increase in our conversion rate from 16.8% in 2007 to 23.2% in 2008. The net increase of $76.9 million in direct sales net revenues in 2007 primarily reflects a significant increase in sales of cell phones of $78.6 million from $26.1 million in 2006 to $104.7 million in 2007, partially offset by decreases in sales of our GPS products and electronic learning devices from $12.0 million and $8.9 million in 2006 to $1.2 million and $7.0 million in 2007, respectively. These decreases reflect an approximate 52.4% and 20.1% decrease in unit sales of our consumer electronics products in 2006 and 2007, respectively, and an approximate 11.5% and 27.3% decrease in unit sales of our electronic learning devices in 2006 and 2007, respectively. From a product mix perspective, our top three direct sales products in 2007 were cell phones, collectibles and our Babaka posture correction product, which accounted for $133.3 million, or 72.0%, of our direct sales net revenues in 2007. In 2007, direct sales net revenues also benefited from an increase in the number of inbound calls to our call centers from 4.5 million in 2006 to 6.9 million in 2007, partially offset by a decrease in our conversion rate from 19.2% in 2006 to 16.8% in 2007. Also included in direct sales net revenues in 2006, 2007 and 2008 were approximately $6.7 million, $16.0 million and $3.2 million in marketing services revenues, respectively, which are mainly generated from our marketing services arrangement with China Unicom, with the increase in 2007 primarily due to a new project based marketing arrangement with China Unicom with a significant majority recognized in the first half of the year.

Distribution sales net revenues decreased from $89.1 million in 2006 to $77.8 million in 2007, and increased to $79.0 million in 2008, or a 12.7% decrease and a 1.6% increase, respectively. The net increase of $1.2 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 $1.2 million in distribution sales net revenues in 2008 was partially offset by a decrease in sales of the Ozing electronic learning device of $7.5 million from $43.2 million in 2007 to $35.7 million in 2008. From a product mix perspective, our top three distribution sales products in 2008 were our Ozing electronic learning device, Meijin electronic dictionary products and stock tracking software, which accounted for $61.6 million, or 77.8% of our distribution sales net revenues in 2008. The net decrease of $4.4 million in distribution sales net revenues in 2007 was primarily due to a $12.3 million, or 19.7%, decrease (based on a 34.0% decline in unit sales) in sales of our electronic learning devices compared to 2006. The decrease in unit sales of our electronic learning devices was primarily due to increasing industry competition and continued higher costs for flash memory in 2007 that began in 2006. Distribution sales net revenues in 2007 were also negatively affected by higher discounts in the third quarter of 2007 offered to our distributors of our electronic learning device products as part of an incentive plan to stimulate sales of the product line in the period. The net decrease of $4.4 million in distribution sales net revenues in 2007 was partially offset by a $9.6 million, or 614.0%, increase in distribution sales of our CPS stock tracking software. From a product mix perspective, our top three distribution sales products in 2007 were our Ozing, electronic learning device, CPS stock tracking software and Babaka posture correction product, which accounted for $61.1 million, or 78.4% of our distribution sales net revenues in 2007.

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 increased from $73.3 million in 2006 to $123.9 million in 2007 and decreased to $121.1 million in 2008. As a percentage of total net revenues, total cost of revenues was 37.3%, 47.3% and 48.3% in 2006, 2007 and 2008, respectively. The overall decrease in cost of revenues in 2008 was primarily driven by the lower volume of sales of our cell phone products that generally have higher product costs. The overall increase in cost of revenues in 2007 was primarily driven by the increases in volume of sales of our cell phone products, which have higher per unit cost of revenues compared to many of our other products sold during these periods.

Direct sales cost of revenues increased from $32.0 million in 2006 to $85.9 million in 2007 and decreased to $83.4 million in 2008, or a 168.4% increase and a 2.9% decrease, respectively. The overall decrease in 2008 reflects lower sales volume of our cell phone products that generally have higher product costs. The overall increase in 2007 primarily reflects increases in the volume of sales of our cell phone products, which generally have higher product costs. Offsetting the increase in direct sales cost of revenues in 2007 was a significant decrease in unit sales of our electronic learning devices product line and sales of our consumer electronics product line.

Distribution cost of revenues increased from $41.3 million in 2006 to $38.0 million in 2007 and decreased to $37.7 million in 2008 or a 7.9% decline and a 0.8% decrease, respectively. The decrease in 2008 primarily reflected our decision in the fourth quarter 2007 to terminate our prior distribution incentive plan, which offered distributors higher discounts. Such measure improved the gross margins of our Ozing electronic learning devices and Meijin electronic dictionary in 2008. The decrease in 2007 primarily reflected the decrease in unit sales of our neck massager product line sold during such period. Partially offsetting the decrease in 2007 was an increase in the unit costs of our electronic learning devices due to the higher costs of flash memory until about September 2007.

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,					
	2006		2007		2008	
	Gross Profit	Gross Margin	Gross Profit	Gross Margin	Gross Profit	Gross Margin
	(in U.S. dollars)					
Direct sales, net	$ 75,397,498	70.2%	$ 98,396,972	53.4%	$ 88,204,777	51.4%
Distribution sales, net	47,827,436	53.7%	39,800,604	51.2%	41,318,182	52.3%
Total	$ 123,224,934	62.7%	$ 138,197,576	52.7%	$ 129,522,959	51.7%

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.

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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 increased from $123.2 million in 2006 to $138.2 million in 2007 and decreased to $129.5 million in 2008, or a 12.2% increase and a 6.3% decrease, respectively. The $8.7 million decrease in total gross profits in 2008 reflects a $10.2 million decrease in direct sales gross profits, partially offset by a $1.5 million increase in distribution sales gross profits. Our three best-selling product lines in 2008, our cell phones, electronic learning devices and posture correction product lines, collectively accounted for approximately 48.2% of our gross profit for the same period. The $15.0 million increase in total gross profits in 2007 reflects a $23.0 million increase in direct sales gross profits, partially offset by a $8.0 million decrease in distribution gross profits. Our three best-selling product lines in 2007, our cell phones, electronic learning devices and collectibles product lines, collectively accounted for approximately 61.0% of our gross profit for the same period. Our overall gross margin decreased from 62.7% in 2006 to 52.7% in 2007 and 51.7% in 2008. 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 gross margin decrease in 2007 was primarily due to the change in our product mix during the period, reflecting a substantial contribution to total revenues from sales of lower margin cell phone products offset by favorable impact of $3.7 million in payments received under our joint sales arrangements in 2007.

The $10.2 million, or 10.4% decrease in gross profits from direct sales in 2008 reflects a decrease in our sales of our cell phone product lines. The $23.0 million, or 30.5% increase, in gross profits from direct sales in 2007 reflects the additional gross profits contributed by newly featured products in the period and marketing services revenues and other payments reducing cost of direct sales revenues generated from our joint sales arrangements in each period.

Gross margin on direct sales decreased from 70.2% in 2006 to 53.4% in 2007 and to 51.4% in 2008. 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 decrease in gross margin on direct sales in 2007 was primarily due to significant increase in unit sales during 2007 of our lower margin cell phone products, offset by favorable impact of our higher margin stock tracking software.

The $1.5 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. The $8.0 million decrease in gross profits from distribution sales in 2007 primarily reflects decreased sales of electronic learning device and our neck massager products line, with declines offset by the favorable impact of our stock tracking software. In 2006, 2007 and 2008, our electronic learning devices product line accounted for 55.6%, 48.0% and 38.9% and our posture correction product line accounted for 16.7%, 9.0% and 12.9%, respectively, of our total gross profits from distribution sales for the period.

Gross margin on distribution sales decreased slightly from 53.7% in 2006 to 51.2% in 2007 and increased slightly to 52.3% in 2008, due primarily to margin compression of our electronic learning devices due to lowered average selling price in the fourth quarter of 2008, higher discounts given to distributors during the third quarter of 2007 and higher unit costs due to continued higher costs of flash memory until September 2007, offset by the favorable impact of sales of our higher-margin stock tracking software.

Operating Income (Expense)

Our total operating income (expense) increased from $(121.6) million in 2006 to $(130.3) million in 2007 and to $(150.6) million in 2008. Total operating expense, as a percentage of total net revenue, decreased from 61.9% in 2006 to 49.8% in 2007 and increased to 60.1% in 2008. Of the total increase in 2008, $10.5 million was attributable to an increase in other selling and marketing expenses; $3.2 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 $0.5 million increase in other operating income, net. Of the total increase in 2007, $10.7 million was attributable to increase in other selling and marketing expenses and $1.3 million reflected an increase in general and administrative expenses. These increases were partially offset by a $0.6 million decrease in advertising expenses and $2.7 million increase in other operating income, net.

Advertising Expenses

Our advertising expenses decreased slightly from $76.5 million in 2006 to $76.0 million in 2007 and to $74.4 million in 2008. As a percentage of total net revenues, advertising expenses decreased from 39.0% in 2006 to 29.0% in 2007 and increased slightly to 29.7% in 2008. The overall decrease in advertising expenses in 2008 reflects primarily 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. The overall decrease in advertising expenses in 2007 primarily reflects a decrease in brand advertising in our distribution business and an increase in direct sales advertising costs shared by joint sales partners of $15.6 million, partially offset by an increase in advertising costs for the direct sales business.

Advertising expenses related to purchased TV advertising time increased from $69.0 million in 2006 to $72.0 million in 2007 and decreased lightly to $71.3 million in 2008, or 4.3% growth and 1.0% decrease, respectively. The decrease in purchased TV advertising expenses in 2008 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. The increase in purchased TV advertising expenses in 2007 reflects our change in 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. Due to regulations affecting our neck massager product, however, brand promotion TV advertising expenses in 2007 decreased by $11.1 million, or 70.3%, to $4.7 million from $15.7 million in 2006. Offsetting the increase in TV advertising expenses in 2006 and 2007 was a $0.6 million or 8.7%, and $3.1 million or 50.8%, decrease in non-TV brand promotion advertising (primarily newspaper advertising), respectively, which expenditures were primarily in support of distribution sales of our oxygen generating devices product line and our neck massager product line. Also offsetting the overall increases in advertising expenses was a decrease in advertising-related reimbursements paid to our distributors from $1.0 million in 2006 to $0.5 million in 2007 and to $0.1 million in 2008. These distributor reimbursements related primarily to our oxygen generating devices, neck massager and posture correction product lines, electronic learning devices product lines, and stock tracking software product lines.

Other Selling and Marketing Expenses

Our other selling and marketing expenses increased from $21.0 million in 2006 to $31.7 million in 2007 and to $42.2 million in 2008, or 51.0% growth and 33.3% growth, respectively. As a percentage of total net revenues, other selling and marketing expenses increased from 10.7% in 2006 to 12.1% in 2007 and to 16.8% in 2008. These increases are primarily attributable to the growth of direct sales and reflect increasing expenditures in advertising production, deliveries, and salaries and commissions for our call center personnel. Of the total increase in 2008, approximately $3.6 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. Of the total increase in 2007,

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approximately $2.1 million related to increased advertisement production expenses, $2.6 million was attributable to increases in delivery costs, and $4.1 million was attributable to increased salaries and benefits primarily due to the growth of our call center operations.

General and Administrative Expenses

Our general and administrative expenses increased from $27.1 million in 2006 to $28.5 million in 2007 and to $31.7 million in 2008, or 5.2% growth and 11.3% growth, respectively. As a percentage of total net revenues, general and administrative expenses decreased from 13.8% in 2006 to 10.9% in 2007, but increased to 12.6% in 2008. Of the total $3.2 million increase in 2008, $2.2 million was attributable to increased research and consulting fees, $1.5 million was attributable to agency and management service fees, $1.1 million was attributable to an increased bad debt provision, $0.8 million was attributable to increased depreciation and amortization and $0.7 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. Of the total $1.4 million increase in 2007, $2.2 million was attributable to increased salaries and benefits primarily due to the overall increase in our headcount, offset by a decrease of $1.8 million, or 23.2%, in share-based compensation expenses. Of the total $14.8 million in 2006, $5.8 million was attributable to share-based compensation charges, $3.2 million was attributable to offering related costs expensed in 2006, $2.4 million was attributable to increased salaries and benefits primarily due to the overall increase in our headcount and a company-wide salary increase.

Impairment of Goodwill and Intangible Assets

Impairment losses of goodwill and intangible assets for the full year 2008 totaled $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 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, $5.8 million and $6.3 million in 2006, 2007 and 2008, 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 could materially and adversely affect our results of operations and financial condition . Other operating income, net also includes miscellaneous commission income.

Income (Loss) from Operations

Income from operations increased from $1.6 million in 2006 to $7.9 million in 2007, and to a loss of $21.1 million in 2008. As a percentage of total net revenues, income from operations increased from 0.8% in 2006 to 3.0% in 2007 and decreased to (8.4)% in 2008. In 2008, we recognized impairment losses of goodwill and intangible assets in an aggregate amount of $8.7 million compared to nil in 2007 and 2006, and we recognized $3.3 million in share-based compensation charges compared to $6.5 million in 2007 and $8.7 million in 2006.

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The loss also reflects a 33.3% increase in other selling and marketing expenses with a 4.4% decrease in total net revenues and 6.3% decrease in gross profits. The increase as a percentage of total net revenues for 2007 also reflects a 0.7% decrease in advertising costs with a 33.4% increase in total net revenues and 12.2% increase in gross profits.

Other Income (Expenses), Net

Other income (expenses), net was $2.2 million, $16.5 million and $(-0.1) million in 2006, 2007 and 2008, respectively. In 2006, 2007 and 2008, other income (expenses) included $0.8 million, $4.2 million and 2.4 million in interest income, respectively. Other income (expenses) in 2008 included an investment loss of $1.9 million, and in 2007 included an investment gain of $11.6 million, compared to an investment gain of $0.9 million in 2006.

In the third quarter of 2008, we evaluated our available-for-sale securities investments for impairment. We determine the fair value of our investment in an index-linked structure 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 these instruments. Based on our evaluation of the factors including the cause and duration of the impairment, the extent to which fair value is below cost and the near-term prospects of the issuers, we believe that the impairment is other-than-temporary as of September 30, 2008 and we recorded a $3.3 million impairment charge on our investment during the third quarter of 2008 to write down our investment to its fair value. Changes in management estimates to the unobservable inputs in our valuation models would change the valuation of the investment.

Income Taxes

We had a net tax benefit of $0.7 million in 2006, a net tax benefit of $1.3 million in 2007 and a net tax expense of $0.8 million in 2008. Because of various special tax rates and incentives in China, our taxes have been relatively low. Our effective income tax rate for 2006, 2007 and 2008 was (18)%, (5)% and (4)%, respectively.

Minority Interest

Minority interests consist of the 49% or less outside ownership interests in our majority-owned subsidiaries. In 2006, 2007 and 2008, the minority interests totaled $0.6 million, $7.1 million and $3.6 million, respectively, primarily reflecting net income generated by Shanghai Yimeng, our subsidiary in charge of our stock tracking software. We may form other majority-owned subsidiaries in the future to secure managerial expertise, acquire complementary and additional distribution networks, or secure product or service distribution rights.

Net Income (Loss)

As a result of the foregoing, net income increased from $3.9 million in 2006 to $18.7 million in 2007 and decreased to a $25.6 million net loss in 2008. As a percentage of total net revenues, net income was 2.0%, 7.1% and (10.2)% in 2006, 2007 and 2008, respectively.

B. Liquidity and Capital Resources

	For the years ended December 31,		
	2006	2007	2008
		(in thousands)	
Cash and cash equivalents	$ 40,744.4	$ 148,743.2	$ 147,648.8
Net cash provided by operating activities	$ 1,363.6	$ 20,471.9	$ 20,858.9
Net cash provided by (used in) investing activities	$ 1,952.0	$ (29,556.7)	$ (12,567.5)
Net cash provided by (used in) financing activities	$ 81.4	$ 111,894.3	$ (15,915.6)

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Operating Activities

As of December 31, 2008, we had $168.8 million in cash, cash equivalents, restricted cash and short-term investments. Net cash provided by operating activities increased from $1.4 million in 2006 to $20.5 million in 2007 and to $20.9 million in 2008. These amounts were adjusted for non-cash items such as minority interest, share-based compensation, goodwill and intangible assets impairment losses, available-for-sales securities impairment losses and 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 2008 was primarily attributable to proceeds from sales of trading securities. The increase in 2007 was primarily attributable to increases in minority interest, proceeds from sales of trading securities and deferred revenue.

Minority interest was $0.6 million, $7.1 million and $3.6 million in 2006, 2007 and 2008, respectively. The change in minority interest in 2008 reflects the performance of our majority-owned subsidiary in selling our stock tracking software products.

Share-based compensation, a non-cash expense, totaled $8.7 million in 2006 following our adoption of SFAS No. 123-R, $6.5 million in 2007 and $3.3 million in 2008.

Impairment losses of goodwill and intangible assets for the full year 2008 totaled $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. As a result of the evaluation, 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. In addition, in the third quarter of 2008, we evaluated our available-for-sale securities investments for impairment. As a result of the evaluation, we recorded a $3.3 million impairment charge on our investment in one of our two structure notes during the third quarter of 2008 to write down our investment to its fair value.

Our inventory balances increased from $7.8 million at December 31, 2006 to $16.4 million at December 31, 2007 and to $29.5 million at December 31, 2008. The increase in inventory in 2008 was primarily due to our acquisition of Yiyang Yukang and the related consolidation of Yiyang Yukang s balance sheet at December 31, 2008. Our accounts receivables increased from $11.7 million at December 31, 2006 to $23.1 million at December 31, 2007 and to $27.7 million at December 31, 2008. The increase in accounts receivables in 2008 was primarily due to our acquisition of Yiyang Yukang and the related consolidation of Yiyang Yukang s balance sheet at December 31, 2008. Prepaid advertising expenses decreased from $25.4 million at December 31, 2006 to $23.2 million at December 31, 2007 and decreased to $16.8 million at December 31, 2008. Other prepaid expenses and current assets decreased from $10.4 million at December 31, 2006 to $8.1 million at December 31, 2007 and increased to $13.4 million at December 31, 2008. In 2006, 2007 and 2008, we also had an aggregate increase (decrease) of approximately $(0.1) million, $9.5 million and $8.5 million, respectively, in our accounts payable and accrued expenses and other current liabilities over 2006 and 2007, with those increases (decreases) providing cash and utilizing cash, respectively.

As of December 31, 2008, we held approximately $10.1 million in trading securities, which were predominantly initial public A shares of Chinese companies, with a small portion consisting of secondary equities of large cap companies in China. Net cash used in trading securities was $2.0 million and $2.8 million in 2006 and 2007, respectively, and net proceeds from trading securities were $9.1 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 available-for-sale securities. Net cash used in investing activities was $(2.0) million, $29.6 million and $12.6 million in 2006, 2007 and 2008, respectively. Net cash used in

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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 available-for-sale securities for $20.0 million. Net cash used in investing activities in 2006 reflects expenditures of $1.7 million in connection with the expansion of our call center. In 2007, we purchased two structure notes for $10.0 million each, which we mark-to-market.

Financing Activities

Financing activities include proceeds from short-term and long-term bank loans, dividend payments, and issuance of capital and stock redemptions. For 2008, we used $16.4 million to repurchase 1,949,747 of our outstanding ADS. For 2007, we used $6.8 million to repurchase 683,000 of our outstanding ADS, 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. For 2006, our financing activities were primarily receipt of a $0.4 million subscription receivable and a net repayment of $0.3 million in borrowings.

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 $1.7 million, $9.2 million and $2.9 million in 2006, 2007 and 2008, 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 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 approximately RMB50 million (approximately $7.3 million). We plan to use the land to build a warehouse or a call center, and to establish a factory for manufacturing our proprietary branded products as part of our strategy to develop infrastructure for building a future home shopping business in the next three to five years. 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

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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.

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 required period, which is generally the period from the date of grant to the date when the share compensation is no longer contingent upon additional service, or the vesting period. We determine fair value of our share options as of the grant date using the Black-Scholes-Merton (BSM) option pricing model. Under this model, we make a number of assumptions regarding 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 of the underlying shares. 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. Our compensation charges may change based on changes to our actual forfeitures.

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. Of the total attempted product deliveries in 2006, 2007 and 2008, approximately 23%, 25% and 25%, respectively were unsuccessful due to customers refusal to accept a product upon delivery or failure to successfully locate the delivery address. Generally, the higher a product s sales price and the longer the amount of time between ordering and delivery, the more likely a customer may refuse product delivery. 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 for 2006, 2007 and 2008 have been 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. Our marketing services arrangements are predominately marketing in nature and are expected to generate limited or no TV direct product sales revenues.

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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, there were certain distributor agreements that provided performance-based cash rebates which were net against revenue at the time revenue was recorded.

We generate revenue from annual subscription fees from subscribers for our stock tracking software, which includes 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 provide an access code to the subscriber and will activate the subscriber s account when the subscriber first logs on. This will commence the one-year subscription period and the full payment will be deferred and recognized ratably over the one-year subscription period. After the initial subscription period, users can subscribe for additional one-year renewal periods. The pricing of the initial subscription fee and renewal fee is the same regardless of whether it is sold by us or through our distribution network. Because the data services are essential to the functionality of the software analysis tools, we recognize revenue ratably over the one-year subscription period. For 2008, we recognized $18.0 million in relation to subscription revenue and at December 31, 2008 our deferred revenue balance was $13.0 million.

Goodwill Valuation

We account for goodwill and indefinite-lived intangibles in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, or SFAS 142. SFAS No. 142 states that goodwill and indefinite-lived intangible assets are not amortized, but are instead reviewed for impairment annually (or more frequently if impairment indicators arise). We conduct our annual impairment testing to determine if we will be able to recover all or a portion of the carrying value of goodwill and indefinite-lived intangibles.

The application of the impairment test requires judgment, including the identification of reporting units, assignments of assets and liabilities to reporting units and the determination of the fair value of each reporting unit. Further, the impairment test involves the use of accounting estimates and assumptions related to future operating results. The significant assumptions regarding our future operating performance are revenue growth rates, discount rates and a terminal multiple. Consistent with the requirements of SFAS No. 142, the fair values of our reporting units are generally based on discounted cash flow projections that are believed to be reasonable under current and forecasted circumstances, the results of which form the basis for making judgments about carrying values of the reported net assets of our reporting units.

In 2006 and 2007, we performed an annual goodwill impairment test on April 30. In 2008, however, we changed the annual goodwill impairment testing day to October 1, and therefore in 2008 we performed the goodwill impairment test on both April 30 and October 1. We considered this change to be preferable because it allows us to use more current financial information and matches our business plan timing. This change in the method of applying accounting principle does not delay, accelerate or avoid an impairment charge or affect our financial statements. During the goodwill impairment test conducted in 2008, we recognized $7.6 million goodwill impairment loss for 2008.

We will continue to closely monitor the 2009 results and projections for our reporting units and the economic conditions of the product end-markets. Any significant change in market conditions and estimates or judgments could give rise to impairment in the period that the change becomes known.

Income taxes

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 loss carry forwards and credits, by applying enacted statutory tax rates applicable to future years.

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We record a valuation allowance to reduce our deferred tax assets to the amount that we believe is more likely than not to be realized. When we determine that we would not be able to realize all or part of our deferred tax assets in the future, an adjustment to the valuation allowance would be charged to income in the period such change occurred.

Other Intangible Assets

Prior to performing the goodwill impairment testing process for a reporting unit under SFAS 142, if there is reason to believe that other non-goodwill related intangible assets may be impaired, these other intangible assets must first be tested for impairment under SFAS No. 142 or SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, or SFAS No. 144. Assets governed by SFAS No. 144 require a recoverability test for impairment whereby the gross undiscounted cash flows are determined specific to the asset. For non-goodwill related indefinite-lived assets, a fair value determination is made. If the carrying value of the asset exceeds the fair value, then impairment occurs. The carrying values of these assets are impaired as necessary to provide the appropriate carrying value for the goodwill impairment calculation.

These impairment tests also involve the use of accounting estimates and assumptions believed to be reasonable, the results of which form the basis for our conclusions. Significant changes to these estimates and assumptions could adversely impact our conclusion to these impairment tests.

Impairment of Long-lived Assets

We evaluate our long-lived assets and definite life 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 long-lived assets and definite life intangibles 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.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, restricted cash, accounts receivable, notes receivable, accounts payable and notes payable approximate their fair values due to the short-term maturity of these instruments. Fair value of investment in equity securities without readily determined fair value was determined based on the discounted cash flow model, using unobservable inputs mainly including assumptions about expected future cash flows based on information supplied by the investee, degree of liquidity in the current credit markets and discounted rate.

Financial Instruments Measured at Fair Value

A number of our financial instruments are carried at fair value with changes in fair value recognized in earnings or accumulated comprehensive income each period. 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.

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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 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 and 5 to the consolidated financial statements.

C. Research and Development

We spent $0.1 million, $0.1 million and $1.1 million in research and development in 2006, 2007 and 2008, respectively. The increase in research and development expenses in 2008 was primarily due to the development of Level II, our upgraded stock tracking software.

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, 2006 to December 31, 2008 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 reco