

ROSETTA STONE INC  
Form 10-Q  
November 05, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2014  
Commission file number: 1-34283  
Rosetta Stone Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State of incorporation)

1919 North Lynn St., 7th Fl.  
Arlington, Virginia  
(Address of principal executive offices)

043837082  
(I.R.S. Employer  
Identification No.)

22209  
(Zip Code)

800-788-0822  
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of stock, as of the latest practicable date. As of October 31, 2014, there were 21,326,653 shares of the registrant's Common Stock, \$.00005 par value, outstanding.

ROSETTA STONE INC.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## ROSETTA STONE INC.

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

|   | September 30,<br>2014<br>(unaudited) | December 31,<br>2013 |
|---|--------------------------------------|----------------------|
| Assets  |                                      |                      |
| Current assets:   |                                      |                      |
| Cash and cash equivalents   | \$49,361                             | \$98,825             |
| Restricted cash   | 131                                  | 12,424               |
| Accounts receivable (net of allowance for doubtful accounts of \$1,452 and \$1,000, respectively)   | 61,222                               | 60,342               |
| Inventory, net  | 6,490                                | 6,639                |
| Deferred sales commissions  | 9,821                                | 6,079                |
| Prepaid expenses and other current assets   | 6,221                                | 6,215                |
| Income tax receivable   | 735                                  | 197                  |
| Total current assets  | 133,981                              | 190,721              |
| Deferred sales commissions  | 4,212                                | 1,809                |
| Property and equipment, net   | 25,116                               | 17,766               |
| Goodwill  | 77,272                               | 50,059               |
| Intangible assets, net  | 36,287                               | 29,006               |
| Other assets  | 598                                  | 1,415                |
| Total assets  | \$277,466                            | \$290,776            |
| Liabilities and stockholders' equity  |                                      |                      |
| Current liabilities:  |                                      |                      |
| Accounts payable  | \$12,088                             | \$10,326             |
| Accrued compensation  | 18,338                               | 16,380               |
| Obligations under capital lease   | 620                                  | 256                  |
| Other current liabilities   | 36,506                               | 41,936               |
| Deferred revenue  | 84,230                               | 67,173               |
| Total current liabilities   | 151,782                              | 136,071              |
| Deferred revenue  | 26,631                               | 11,684               |
| Deferred income taxes   | 10,169                               | 9,022                |
| Obligations under capital lease   | 3,400                                | 217                  |
| Other long-term liabilities   | 1,391                                | 2,539                |
| Total liabilities   | 193,373                              | 159,533              |
| Commitments and contingencies (Note 14)   |                                      |                      |
| Stockholders' equity:   |                                      |                      |
| Preferred stock, \$0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively  | —                                    | —                    |
| Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 22,819 and 22,588 shares issued and 21,819 and 21,588 shares outstanding at September 30, 2014 and December 31, 2013, respectively | 2                                    | 2                    |
| Additional paid-in capital  | 177,238                              | 171,123              |
| Accumulated loss  | (81,462)                             | (29,292)             |

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|   |           |           |   |
|---|-----------|-----------|---|
| Accumulated other comprehensive income (loss)   | (250      | ) 845     |   |
| Treasury stock, at cost, 1,000 shares at September 30, 2014 and 1,000 shares at December 31, 2013 | (11,435   | ) (11,435 | ) |
| Total stockholders' equity  | 84,093    | 131,243   |   |
| Total liabilities and stockholders' equity  | \$277,466 | \$290,776 |   |

See accompanying notes to consolidated financial statements

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ROSETTA STONE INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except per share amounts)  
(Unaudited)

|  | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |              |
|--|-------------------------------------|-------------|------------------------------------|--------------|
|  | 2014                                | 2013        | 2014                               | 2013         |
| Revenue:                                   |                                     |             |                                    |              |
| Product                                    | \$ 32,392                           | \$ 34,038   | \$ 92,888                          | \$ 107,087   |
| Subscription and service                   | 32,123                              | 26,834      | 89,707                             | 79,847       |
| Total revenue                              | 64,515                              | 60,872      | 182,595                            | 186,934      |
| Cost of revenue:                           |                                     |             |                                    |              |
| Cost of product revenue                    | 7,916                               | 7,325       | 23,010                             | 21,263       |
| Cost of subscription and service revenue   | 5,071                               | 3,419       | 14,109                             | 9,969        |
| Total cost of revenue                      | 12,987                              | 10,744      | 37,119                             | 31,232       |
| Gross profit                               | 51,528                              | 50,128      | 145,476                            | 155,702      |
| Operating expenses:                        |                                     |             |                                    |              |
| Sales and marketing                        | 43,771                              | 34,844      | 120,700                            | 104,904      |
| Research and development                   | 8,689                               | 8,797       | 25,830                             | 25,248       |
| General and administrative                 | 14,748                              | 13,987      | 44,805                             | 40,209       |
| Goodwill impairment                        | —                                   | —           | 2,199                              | —            |
| Lease abandonment and termination          | (53                                 | ) 7         | 3,635                              | 835          |
| Total operating expenses                   | 67,155                              | 57,635      | 197,169                            | 171,196      |
| Loss from operations                       | (15,627                             | ) (7,507    | ) (51,693                          | ) (15,494    |
| Other income and (expense):                |                                     |             |                                    |              |
| Interest income                            | 3                                   | 21          | 13                                 | 105          |
| Interest expense                           | (46                                 | ) (9        | ) (153                             | ) (54        |
| Other income and (expense)                 | (752                                | ) (305      | ) (772                             | ) 105        |
| Total other income (expense)               | (795                                | ) (293      | ) (912                             | ) 156        |
| Loss before income taxes                   | (16,422                             | ) (7,800    | ) (52,605                          | ) (15,338    |
| Income tax (benefit)                       | (244                                | ) (3,631    | ) (435                             | ) (3,052     |
| Net loss                                   | \$ (16,178                          | ) \$ (4,169 | ) \$ (52,170                       | ) \$ (12,286 |
| Loss per share:                            |                                     |             |                                    |              |
| Basic                                      | \$ (0.76                            | ) \$ (0.19  | ) \$ (2.46                         | ) \$ (0.57   |
| Diluted                                    | \$ (0.76                            | ) \$ (0.19  | ) \$ (2.46                         | ) \$ (0.57   |
| Common shares and equivalents outstanding: |                                     |             |                                    |              |
| Basic weighted average shares              | 21,305                              | 21,827      | 21,228                             | 21,587       |
| Diluted weighted average shares            | 21,305                              | 21,827      | 21,228                             | 21,587       |

See accompanying notes to consolidated financial statements

ROSETTA STONE INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS  
(in thousands)  
(Unaudited)

|  | Three Months Ended |             | Nine Months Ended |              |
|--|--------------------|-------------|-------------------|--------------|
|  | September 30,      |             | September 30,     |              |
|  | 2014               | 2013        | 2014              | 2013         |
| Net loss                                 | \$ (16,178         | ) \$ (4,169 | ) \$ (52,170      | ) \$ (12,286 |
| Other comprehensive income, net of tax:  |                    |             |                   |              |
| Foreign currency translation gain (loss) | (994               | ) 373       | (1,095            | ) 12         |
| Other comprehensive income (loss)        | (994               | ) 373       | (1,095            | ) 12         |
| Comprehensive loss                       | \$ (17,172         | ) \$ (3,796 | ) \$ (53,265      | ) \$ (12,274 |

See accompanying notes to consolidated financial statements

ROSETTA STONE INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(Unaudited)

|   | Nine Months Ended<br>September 30, |               |
|---|------------------------------------|---------------|
|   | 2014                               | 2013          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                            |                                    |               |
| Net loss  | \$(52,170                          | ) \$(12,286 ) |
| Adjustments to reconcile net loss to cash used in operating activities: |                                    |               |
| Stock-based compensation expense  | 5,468                              | 6,229         |
| Loss on foreign currency transactions                                   | 756                                | —             |
| Bad debt expense  | 2,023                              | 682           |
| Depreciation and amortization   | 10,229                             | 7,005         |
| Deferred income tax (benefit)   | (1,116                             | ) (4,527 )    |
| Loss on disposal of equipment   | 181                                | 246           |
| Loss on goodwill impairment   | 2,199                              | —             |
| Net change in:  |                                    |               |
| Restricted cash   | (21                                | ) (9 )        |
| Accounts receivable   | 93                                 | 5,672         |
| Inventory   | 648                                | (506 )        |
| Deferred sales commissions  | (5,989                             | ) (2,072 )    |
| Prepaid expenses and other current assets                               | 240                                | (1,051 )      |
| Income tax receivable   | (431                               | ) 391         |
| Other assets  | 973                                | (132 )        |
| Accounts payable  | 885                                | 961           |
| Accrued compensation  | (776                               | ) (4,180 )    |
| Other current liabilities   | (6,302                             | ) (8,092 )    |
| Other long term liabilities   | 537                                | 329           |
| Deferred revenue  | 30,517                             | 7,606         |
| Net cash used in operating activities                                   | (12,056                            | ) (3,734 )    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                            |                                    |               |
| Purchases of property and equipment                                     | (7,227                             | ) (6,415 )    |
| Decrease in restricted cash for Vivity acquisition                      | 12,314                             | —             |
| Acquisitions, net of cash acquired                                      | (41,687                            | ) (25,675 )   |
| Net cash used in investing activities                                   | (36,600                            | ) (32,090 )   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                            |                                    |               |
| Proceeds from the exercise of stock options                             | 646                                | 2,379         |
| Repurchase of shares from exercised stock options                       | —                                  | (1,040 )      |
| Proceeds from equity offering, net of issuance costs                    | —                                  | (228 )        |
| Payments under capital lease obligations                                | (480                               | ) (213 )      |
| Net cash provided by financing activities                               | 166                                | 898           |
| Decrease in cash and cash equivalents                                   | (48,490                            | ) (34,926 )   |
| Effect of exchange rate changes in cash and cash equivalents            | (974                               | ) (160 )      |
| Net decrease in cash and cash equivalents                               | (49,464                            | ) (35,086 )   |
| Cash and cash equivalents—beginning of period                           | 98,825                             | 148,190       |
| Cash and cash equivalents—end of period                                 | \$49,361                           | \$113,104     |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>                               |                                    |               |
| Cash paid during the periods for:                                       |                                    |               |

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|   |          |          |
|---|----------|----------|
| Interest  | \$ 153   | \$ 10    |
| Income taxes  | \$ 1,276 | \$ 2,745 |
| Noncash financing and investing activities:                 |          |          |
| Accrued purchase price of business acquisition              | \$—      | \$ 3,375 |
| Accrued liability for purchase of property and equipment    | \$ 378   | \$ 1,147 |
| Equipment acquired under capital lease                      | \$—      | \$ 586   |
| See accompanying notes to consolidated financial statements |          |          |



ROSETTA STONE INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

1. NATURE OF OPERATIONS

Rosetta Stone Inc. and its subsidiaries ("Rosetta Stone," or the "Company") develop, market and support a suite of language, literacy and brain fitness solutions consisting of software products, online services, audio practice tools and mobile applications under the Rosetta Stone, Livemocha, Lexia, Fit Brains and Tell Me More brand names. In January 2014, Rosetta Stone acquired Vivity Labs Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") (see Footnote 3, Business Combinations). The Company's software products are sold on a direct basis and through select retailers. The Company provides its software applications to customers through the sale of packaged software and online subscriptions, domestically and in certain international markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Rosetta Stone Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain numbers in the prior period consolidated financial statements have been reclassified to conform to the current period presentation which primarily relate to the discrete presentation of deferred sales commissions.

Basis of Presentation

The accompanying consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and applicable rules and regulations of the SEC regarding interim financial reporting. Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. Accordingly, these interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K filed with the SEC on March 3, 2014. The September 30, 2014 consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes, required by GAAP.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the Company's statement of financial position at September 30, 2014 and December 31, 2013, the Company's results of operations for the three and nine months ended September 30, 2014 and 2013 and its cash flows for the nine months ended September 30, 2014 and 2013 have been made. The results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the year ending December 31, 2014. All references to September 30, 2014 or to the three and nine months ended September 30, 2014 and 2013 in the notes to the consolidated financial statements are unaudited.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires that management make certain estimates and assumptions. Significant estimates and assumptions have been made regarding the allowance for doubtful accounts, estimated sales returns, stock-based compensation, fair value of intangibles and goodwill, inventory reserve, disclosure of contingent assets and liabilities, disclosure of contingent litigation, and allowance for valuation of deferred tax assets. Actual results may differ from these estimates.

Revenue Recognition

The Company's primary sources of revenue are online subscriptions, software and bundles of software and online subscriptions. The Company also generates revenue from the sale of audio practice products and training and implementation services. Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenues are recorded net of discounts.

The Company identifies the units of accounting contained within our sales arrangements in accordance with Accounting Standards Codification ("ASC") 605-25 Revenue Recognition - Multiple Element Arrangements ("ASC 605-25"). In doing so, the Company evaluates a variety of factors including whether the undelivered element(s) have value to the customer on a stand-alone basis or if the undelivered element(s) could be sold by another vendor on a stand-alone basis.

For multiple element arrangements that contain software products and related services, the Company allocates the total arrangement consideration to all deliverables based on vendor-specific objective evidence of fair value, or vendor-specific objective evidence ("VSOE"), in accordance with ASC subtopic 985-605-25 Software: Revenue Recognition-Multiple-Element Arrangements ("ASC 985-605-25"). The Company generates a substantial portion of its consumer revenue from Rosetta Stone Version 4 TOTALe which is a multiple element arrangement that includes perpetual software bundled with the subscription and conversational coaching components of the Company's TOTALe online service. The Company has identified two deliverables generally contained in Rosetta Stone Version 4 TOTALe software arrangements. The first deliverable is the perpetual software, which is delivered at the time of sale, and the second deliverable is the subscription service, which is considered a software-related element. Because the Company only sells the Version 4 TOTALe software on a stand-alone basis in its homeschool version, the Company does not have a sufficient concentration of stand-alone sales of the Version 4 TOTALe software to establish VSOE of fair value for this element. Accordingly, the Company allocates the arrangement consideration using the residual method based on the existence of VSOE of the undelivered element, the subscription service. The Company determines VSOE of fair value of the subscription service by reference to the range of stand-alone renewal sales of the three-month subscription service. The Company reviews these stand-alone sales on a quarterly basis. VSOE of fair value is established if at least 80% of the stand-alone sales are within a range of plus or minus 15% of a midpoint of the range of prices, consistent with generally accepted industry practice.

For non-software multiple element arrangements the Company allocates revenue to all deliverables based on their relative selling prices. The Company's non-software multiple element arrangements primarily occur as sales to its Global Enterprise & Education customers. These arrangements can include subscription-based services, audio practice materials and training or any combination thereof. The Company does not have a sufficient concentration of stand-alone sales of the various deliverables noted above to its Global Enterprise & Education customers, and therefore cannot establish VSOE of fair value of each deliverable. Third party evidence of fair value does not exist for the subscription, audio practice and training services due to the lack of interchangeable language products and services within the market. Accordingly, the Company determines the selling price of the subscription, audio practice and training services deliverables included in its non-software multiple element arrangements using the best estimated selling price. The Company determines the best estimated selling price based on its internally published price list which includes suggested sales prices for each deliverable based on the type of client and volume purchased. This price list is derived from past experience and from the expectation of obtaining a reasonable margin based on what each deliverable costs the Company.

In the US, the Company offers consumers who purchase packaged software and audio practice products directly from the Company a 30-day, unconditional, full money-back refund. The Company also permits some of our retailers and distributors to return packaged products, subject to certain limitations. The Company establishes revenue reserves for packaged product returns at the time of sale based on historical experience, estimated channel inventory levels, the timing of new product introductions and other factors.

The Company distributes its products and services both directly to the end customer and indirectly through resellers. Our resellers earn commissions generally calculated as a fixed percentage of the gross sale to the end customer. The Company evaluates each of its reseller relationships in accordance with ASC 605-45 Revenue Recognition - Principal Agent Considerations ("ASC 605-45") to determine whether the revenue recognized from indirect sales should be the

gross amount of the contract with the end customer or reduced for the reseller commission. In making this determination the Company evaluates a variety of factors including whether it is the primary obligor to the end customer. Revenue is recorded net of taxes.

Revenue for online service subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met. Rosetta Stone Version 4 TOTALe bundles, which include an online service subscription including conversational coaching and packaged software, allow customers to begin their online services at any point during a registration window, which is up to six months from the date of purchase from us or an authorized reseller. Online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

expiry. Revenue from non-refundable upfront fees that are not related to products already delivered or services already performed is deferred and recognized over the term of the related arrangement because the period over which a customer is expected to benefit from the service that is included within our subscription arrangements does not extend beyond the contractual period. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

Software products include sales to end user customers and resellers. In many cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products and audio practice products is recognized as the products are shipped and title passes and risks of loss have been transferred. For many product sales, these criteria are met at the time the product is shipped. For some sales to resellers and certain other sales, the Company defers revenue until the customer receives the product because the Company legally retains a portion of the risk of loss on these sales during transit. In other cases where packaged software products are sold to resellers on a consignment basis, revenue is recognized for these consignment transactions once the end user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with ASC 985-605-50 Revenue Recognition: Customer Payments and Incentives ("ASC 605-50"), cash sales incentives to resellers are accounted for as a reduction of revenue, unless a specific identified benefit is identified and the fair value is reasonably determinable. Price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue at the time of sale.

The Company offers customers the ability to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than 12 months, a successful collection history has been established and these fees are fixed and determinable, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met. Packaged software is provided to customers who purchase directly from our company with a limited right of return. The Company allows its retailers to return unsold products, subject to some limitations. In accordance with ASC subtopic 985-605-15, Software: Revenue Recognition: Products ("ASC 985-605-15"), product revenue is reduced for estimated returns, which are based on historical return rates.

In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, via telephone support at no additional cost for up to six months from the time of purchase. As the fee for technical support is included in the initial licensing fee, the technical support and services are generally provided within one year, the estimated cost of providing such support is deemed insignificant and no unspecified upgrades/enhancements are offered, technical support revenues are recognized together with the software product and license revenue. Costs associated with the technical support are accrued at the time of sale. Sales commissions from non-cancellable Software as a Service ("SaaS") contracts are deferred and amortized in proportion to the revenue recognized from the related contract.

**Income Taxes**

The Company accounts for income taxes in accordance with ASC topic 740, Income Taxes ("ASC 740"), which provides for an asset and liability approach to accounting for income taxes. Deferred tax assets and liabilities represent the future tax consequences of the differences between the financial statement carrying amounts of assets and liabilities versus the tax basis of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted.

**Deferred Tax Valuation Allowance**

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2014. When measuring the need for a valuation allowance on a jurisdiction by jurisdiction basis, the Company assesses both positive and negative evidence regarding whether these deferred tax assets are realizable. In determining deferred tax assets and valuation allowances, the Company is required to make judgments and estimates related to projections of profitability, the timing and extent of the utilization of temporary differences, net operating loss carryforwards, tax credits, applicable tax rates,

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

transfer pricing methodologies and tax planning strategies. The valuation allowance is reviewed quarterly and is maintained until sufficient positive evidence exists to support a reversal. Because evidence such as the Company's operating results during the most recent three-year period is afforded more weight than forecasted results for future periods, the Company's cumulative loss in certain jurisdictions represents significant negative evidence in the determination of whether deferred tax assets are more likely than not to be utilized in certain jurisdictions. This determination resulted in the need for a valuation allowance on the deferred tax assets of certain jurisdictions. The Company will release this valuation allowance when it is determined that it is more likely than not that its deferred tax assets will be realized. Any future release of valuation allowance may be recorded as a tax benefit increasing net income.

**Fair Value of Financial Instruments**

The Company values its assets and liabilities using the methods of fair value as described in ASC 820, Fair Value Measurements and Disclosures, ("ASC 820"). ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. The three levels of fair value hierarchy are described below:

Level 1: Quoted prices for identical instruments in active markets.

Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3: Significant inputs to the valuation model are unobservable.

The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents, restricted cash, accounts receivable, accounts payable and other accrued expenses approximate fair value due to relatively short periods to maturity.

**Business Combinations**

The Company recognizes all of the assets acquired, liabilities assumed and contractual contingencies from the acquired company as well as contingent consideration at fair value on the acquisition date. The excess of the total purchase price over the fair value of the assets and liabilities acquired is recognized as goodwill. Acquisition-related costs are recognized separately from the acquisition and expensed as incurred. Generally, restructuring costs incurred in periods subsequent to the acquisition date are expensed when incurred. Subsequent changes to the purchase price (i.e., working capital adjustments) or other fair value adjustments determined during the measurement period are recorded as adjustments to goodwill.

**Stock-Based Compensation**

The Company accounts for its stock-based compensation in accordance ASC topic 718, Compensation—Stock Compensation ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date and recognized as expense in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the nine months ended September 30, 2014 and 2013, the fair value of options granted was calculated using the following assumptions:

|                                 | Nine Months Ended<br>September 30, |             |
|---------------------------------|------------------------------------|-------------|
|                                 | 2014                               | 2013        |
| Expected stock price volatility | 63.7%-65.0%                        | 64.4%-68.0% |
| Expected term of options        | 6 years                            | 6 years     |
| Expected dividend yield         | —                                  | —           |
| Risk-free interest rate         | 1.46%-1.80%                        | 0.75%-1.65% |

The Company reviews a group of comparable industry-related companies and its own data to estimate its expected volatility over the most recent period commensurate with the estimated expected term of the awards. In addition to analyzing our own and peer group data, the Company also considers the contractual option term and vesting period when determining

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

the expected option life and forfeiture rate. The Company estimates the expected term of options using a combination of peer company information and the simplified method for estimating the expected term described in ASC 718-10-S99. For the risk-free interest rate, the Company uses a US Treasury Bond rate consistent with the estimated expected term of the option award.

The Company's restricted stock and restricted stock unit grants are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant.

The following table presents stock-based compensation expense included in the related financial statement line items (dollars in thousands):

|                            | Three Months Ended |         | Nine Months Ended |         |
|----------------------------|--------------------|---------|-------------------|---------|
|                            | September 30,      |         | September 30,     |         |
|                            | 2014               | 2013    | 2014              | 2013    |
| Cost of revenue            | \$45               | \$86    | \$63              | \$108   |
| Sales and marketing        | 632                | 669     | 1,573             | 1,067   |
| Research and development   | 437                | 348     | 869               | 971     |
| General and administrative | 995                | 1,422   | 2,963             | 4,083   |
| Total                      | \$2,109            | \$2,525 | \$5,468           | \$6,229 |

## Foreign Currency Translation and Transactions

The functional currency of the Company's foreign subsidiaries is their local currency. Accordingly, assets and liabilities of the foreign subsidiaries are translated into US dollars at exchange rates in effect on the balance sheet date. Income and expense items are translated at average rates for the period. Translation adjustments are recorded as a component of other comprehensive income (loss) in stockholders' equity.

Cash flows of consolidated foreign subsidiaries, whose functional currency is their local currency, are translated to US dollars using average exchange rates for the period. The Company reports the effect of exchange rate changes on cash balances held in foreign currencies as a separate item in the reconciliation of the changes in cash and cash equivalents during the period. The following table presents the effect of exchange rate changes on total comprehensive loss (dollars in thousands):

|  | Three Months Ended |           | Nine Months Ended |            |
|--|--------------------|-----------|-------------------|------------|
|  | September 30,      |           | September 30,     |            |
|  | 2014               | 2013      | 2014              | 2013       |
| Net loss                                 | \$(16,178)         | \$(4,169) | \$(52,170)        | \$(12,286) |
| Foreign currency translation gain (loss) | (994)              | 373       | (1,095)           | 12         |
| Total comprehensive loss                 | \$(17,172)         | \$(3,796) | \$(53,265)        | \$(12,274) |

## Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three and nine months ended September 30, 2014 was \$20.3 million and \$50.4 million, respectively, and for the three and nine months ended September 30, 2013 was \$15.9 million and \$43.4 million, respectively.

## Recently Issued Accounting Standards

In August 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40) ("ASU 2014-15"). ASU 2014-15 addresses management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management's evaluation should be based on relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued. ASU 2014-15 will be effective for the first interim period within annual reporting periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect to early adopt this guidance and does

not believe that the adoption of this guidance will have a material impact on our financial statements and disclosures.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In June 2014, the FASB issued ASU No. 2014-12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period ("ASU 2014-12"). ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. ASU 2014-12 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted. The Company does not expect to early adopt this guidance and does not believe that the adoption of this guidance will have a material impact on our financial statements and disclosures.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which replaces the current revenue accounting guidance. ASU 2014-09 is effective for annual periods beginning after December 15, 2016. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model to 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract and 5) recognize revenue when (or as) the entity satisfies a performance obligation. Entities may chose from two adoption methods, with certain practical expedients. The Company is in the process of evaluating the impact of the new guidance on our financial statements and disclosures and our adoption method.

In April 2014, the FASB issued ASU No. 2014-08 Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of Equity ("ASU 2014-08"), which amends the definition of a discontinued operation and requires entities to provide additional disclosures about discontinued operations as well as disposal transactions that do not meet the discontinued operations criteria. The new guidance changes the definition of a discontinued operation and requires discontinued operations treatment for disposals of a component or group of components that represents a strategic shift that has or will have a major impact on an entity's operations or financial results. ASU 2014-08 is effective prospectively for all disposals (except disposals classified as held for sale before the adoption date) or components initially classified as held for sale in periods beginning on or after December 15, 2014; earlier adoption is permitted. The adoption of this guidance affects prospective presentation of disposals and therefore, is not expected to have a material impact on the Company's consolidated financial condition, results of operations or cash flows.

In July 2013, the FASB issued ASU No. 2013-11, Income Taxes (Topic 740): Presentation of Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists ("ASU 2013-11"), which requires that an unrecognized tax benefit be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except for a situation in which some or all of such net operating loss carryforward, a similar loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable tax jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The Company adopted this guidance beginning in fiscal year 2014, and the adoption of such guidance did not have a material impact on the presentation of the Company's reported results of operations or financial position.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BUSINESS COMBINATIONS

Livemocha, Inc.

On April 1, 2013, the Company completed its acquisition of Livemocha, Inc. (the “Livemocha Merger”). Livemocha, Inc. is one of the world’s largest online language-learning communities with over 16 million registered members. The acquisition of Livemocha, Inc.’s technology platform has accelerated the Company’s transition to cloud-based learning solutions and reinforced its leadership position in the competitive language-learning industry. The aggregate amount of consideration paid by the Company was \$8.4 million in cash.

The acquisition of Livemocha, Inc. resulted in goodwill of approximately \$5.2 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Livemocha Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Livemocha Merger were \$0.4 million during the year ended December 31, 2013. The results of operations for Livemocha, Inc. have been included in the consolidated results of operations since April 1, 2013.

The Company allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Livemocha Merger. The table below summarizes the estimates of fair value of the Livemocha, Inc. assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date.

The Company finalized its allocation of the purchase price for Livemocha, Inc. as of March 31, 2014. The purchase price was allocated as follows (in thousands):

|                                       |         |   |
|---------------------------------------|---------|---|
| Cash                                  | \$ 191  |   |
| Accounts receivable                   | 227     |   |
| Other current assets                  | 93      |   |
| Fixed assets                          | 35      |   |
| Accounts payable and accrued expenses | (956    | ) |
| Deferred revenue                      | (743    | ) |
| Net deferred tax liability            | (1,161  | ) |
| Net tangible assets acquired          | (2,314  | ) |
| Goodwill                              | 5,185   |   |
| Amortizable intangible assets         | 5,500   |   |
| Purchase price                        | \$8,371 |   |

The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|                          | Useful Lives | Value   |
|--------------------------|--------------|---------|
| Online community         | 3 years      | \$1,800 |
| Enterprise relationships | 5 years      | 100     |
| Technology platform      | 5 years      | 3,400   |
| Tradenname               | 2 years      | 200     |
| Total assets             |              | \$5,500 |

In connection with the Livemocha Merger, the Company recorded deferred tax liabilities related to definite-lived intangible assets that were acquired. As a result of this deferred tax liability balance, the Company reduced its deferred

tax asset valuation allowance by \$1.2 million. Such reduction was recognized as an income tax benefit in the consolidated statements of operations for the year ended December 31, 2013.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BUSINESS COMBINATIONS (Continued)

Lexia Learning Systems, Inc.

On August 1, 2013, the Company completed its acquisition of Lexia Learning Systems, Inc. (the “Lexia Merger”). Lexia is one of the most trusted and established companies in the literacy technology market. The transaction marked the Company’s first extension beyond language learning and takes the Company deeper into the Education Technology industry. The aggregate amount of consideration paid by the Company was \$21.1 million in cash, net of working capital and deferred revenue adjustments, including a holdback of \$3.4 million with 50% of such holdback paid within 30 days of the Company filing its Form 10-K for the year ended December 31, 2013 and 50% of such holdback to be paid on the 18 month anniversary of the acquisition. The Company paid \$1.7 million of the holdback in April of 2014.

The acquisition of Lexia resulted in goodwill of approximately \$9.9 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Lexia Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Lexia Merger were \$0.1 million during the year ended December 31, 2013. The results of operations for Lexia have been included in the consolidated results of operations since August 1, 2013.

The Company allocated the purchase price based on current estimates of the fair value of assets acquired and liabilities assumed in connection with the Lexia Merger. The table below summarizes the estimates of fair value of the Lexia assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date.

The Company finalized its allocation of the purchase price for Lexia as of June 30, 2014. The purchase price was allocated as follows (in thousands):

|                                       |          |   |
|---------------------------------------|----------|---|
| Cash                                  | \$263    |   |
| Accounts receivable                   | 2,404    |   |
| Other current assets                  | 105      |   |
| Fixed assets                          | 255      |   |
| Accounts payable and accrued expenses | (899     | ) |
| Deferred revenue                      | (1,223   | ) |
| Net deferred tax liability            | (4,210   | ) |
| Net tangible assets acquired          | (3,305   | ) |
| Goodwill                              | 9,938    |   |
| Amortizable intangible assets         | 14,500   |   |
| Purchase price                        | \$21,133 |   |

The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|                          | Useful Lives | Value    |
|--------------------------|--------------|----------|
| Enterprise relationships | 10 years     | \$9,400  |
| Technology platform      | 7 years      | 4,100    |
| Tradenname               | 5 years      | 1,000    |
| Total assets             |              | \$14,500 |



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BUSINESS COMBINATIONS (Continued)

## Vivity Labs Inc.

On January 2, 2014, the Company completed its acquisition of Vivity Labs Inc. (the "Vivity Labs Merger" and "Vivity"). Vivity's principal business activity is the development of brain fitness games aimed at improving the user's cognitive function through activity, awareness and motivation through its flagship product, Fit Brains. The applications are designed for use on mobile, web and social platforms. Vivity's emphasis on mobile solutions is especially compatible with Rosetta Stone's focus on cloud-based technology to enable on-the-go learning. The aggregate amount of consideration paid by the Company was \$12.2 million in cash.

The acquisition of Vivity Labs Inc. resulted in goodwill of approximately \$9.4 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Vivity Labs Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Vivity Labs Merger were \$57 thousand and \$51 thousand during the nine months ended September 30, 2014 and December 31, 2013, respectively. The results of operations for Vivity Labs have been included in the consolidated results of operations since January 2, 2014.

The Company has preliminarily allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Vivity Labs Merger. The table below summarizes the estimates of fair value of the Vivity Labs assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date. Any changes to the initial estimates of the fair value of the assets and liabilities will be recorded as adjustments to those assets and liabilities and residual amounts will be allocated to goodwill. In the second quarter of 2014 we revised the preliminary value of the acquired technology platform which resulted in a \$0.4 million increase to this acquired intangible asset and corresponding decrease to goodwill, with an immaterial impact to amortization expense. The Company has substantially completed the purchase price allocation for this acquisition. However, if additional information is obtained about these assets and liabilities within the measurement period (not to exceed one year from the date of acquisition), including finalization of asset appraisals, the Company will refine its estimates of fair value to allocate the purchase price more accurately. Any such revisions are not expected to be significant.

The preliminary purchase price is allocated as follows (in thousands):

|                                       |           |   |
|---------------------------------------|-----------|---|
| Cash                                  | \$ 14     |   |
| Accounts receivable                   | 427       |   |
| Other current assets                  | 5         |   |
| Accounts payable and accrued expenses | (307      | ) |
| Net deferred tax liability            | (919      | ) |
| Net tangible assets acquired          | (780      | ) |
| Goodwill                              | 9,353     |   |
| Amortizable intangible assets         | 3,577     |   |
| Preliminary purchase price            | \$ 12,150 |   |

The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|  | Preliminary<br>Estimated<br>Useful Lives | Preliminary<br>Estimated Value<br>January 2, 2014 |
|--|--|---|
|--|--|---|



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|                        |         |         |
|------------------------|---------|---------|
| Tradename              | 3 years | \$188   |
| Technology platform    | 5 years | 2,448   |
| Customer relationships | 3 years | 941     |
| Total assets           |         | \$3,577 |

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BUSINESS COMBINATIONS (Continued)

## Tell Me More S.A.

On January 9, 2014, the Company completed its acquisition of Tell Me More S.A., (the "Tell Me More Merger" and "Tell Me More") a company organized under the laws of France. Tell Me More provides on-line language learning subscriptions and learning services primarily to corporate and educational organizations. Tell Me More offers a robust suite of SaaS-based language learning products and services that provide intermediate, advanced and business language solutions in nine languages. The Tell Me More Merger strengthens the Company's growing Enterprise & Education business and expands its global footprint. The aggregate amount of consideration paid by the Company was €22.1 million (\$30.2 million), including assumed net debt.

The Tell Me More Merger resulted in goodwill of approximately \$21.4 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Tell Me More Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Merger were \$1.0 million and \$0.5 million during the nine months ended September 30, 2014 and the year ended December 31, 2013, respectively. The results of operations for Tell Me More S.A. have been included in the consolidated results of operations since January 9, 2014.

The Company has preliminarily allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Tell Me More Merger. The table below summarizes the estimates of fair value of the Tell Me More S.A. assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date. Any changes to the initial estimates of the fair value of the assets and liabilities will be recorded as adjustments to those assets and liabilities and residual amounts will be allocated to goodwill. The Company has substantially completed the purchase price allocations for this acquisition. However, if additional information is obtained about these assets and liabilities within the measurement period (not to exceed one year from the date of acquisition), including finalization of asset appraisals, the Company will refine its estimates of fair value to allocate the purchase price more accurately. Any such revisions are not expected to be significant.

The preliminary purchase price is allocated as follows (in thousands):

|                                |          |   |
|--------------------------------|----------|---|
| Cash                           | \$2,323  |   |
| Accounts receivable            | 3,106    |   |
| Inventory                      | 526      |   |
| Prepaid expenses               | 227      |   |
| Fixed assets                   | 5,594    |   |
| Other non current assets       | 130      |   |
| Accounts payable               | (732     | ) |
| Accrued compensation           | (2,863   | ) |
| Deferred revenue               | (2,190   | ) |
| Other current liabilities      | (1,126   | ) |
| Obligation under capital lease | (3,958   | ) |
| Net deferred tax liability     | (1,392   | ) |
| Net tangible assets acquired   | (355     | ) |
| Goodwill                       | 21,436   |   |
| Amortizable intangible assets  | 9,105    |   |
| Preliminary purchase price     | \$30,186 |   |



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BUSINESS COMBINATIONS (Continued)

The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|                        | Preliminary<br>Estimated<br>Useful Lives | Preliminary<br>Estimated Value<br>January 9, 2014 |
|------------------------|--|---|
| Customer relationships | 5 years                                  | \$4,348   |
| Technology platform    | 5 years                                  | 4,144   |
| Tradenname             | 1 year                                   | 613   |
| Total assets           |  | \$9,105   |

## Pro Forma Adjusted Summary

The results of Livemocha, Lexia, Vivity and Tell Me More's operations have been included in the consolidated financial statements subsequent to their respective acquisition dates.

The following schedule presents unaudited consolidated pro forma results of operations data as if the Vivity Labs and Tell Me More Mergers had occurred on January 1, 2013 and the Livemocha and Lexia Mergers had occurred on January 1, 2012 (collectively "the Mergers"). This information does not purport to be indicative of the actual results that would have occurred if the Mergers had actually been completed on the date indicated, nor is it necessarily indicative of the future operating results or the financial position of the combined company (in thousands, except per share amounts):

|                        | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |             |
|------------------------|-------------------------------------|------------|------------------------------------|-------------|
|                        | 2014                                | 2013       | 2014                               | 2013        |
| Revenue                | \$66,900                            | \$72,211   | \$194,004                          | \$218,766   |
| Net loss               | \$(13,664 )                         | \$(7,195 ) | \$(40,325 )                        | \$(21,772 ) |
| Basic loss per share   | \$(0.64 )                           | \$(0.33 )  | \$(1.90 )                          | \$(1.01 )   |
| Diluted loss per share | \$(0.64 )                           | \$(0.33 )  | \$(1.90 )                          | \$(1.01 )   |

The operations of Livemocha and Tell Me More have been integrated into the overall operations of the Company. The results of Livemocha and Tell Me More are reported within the results of the Company's operating segments and are not recorded on a stand-alone basis. Therefore, it is impracticable to report revenue and earnings from Livemocha and Tell Me More for the nine months ended September 30, 2014. Revenue and net loss from Lexia were \$6.2 million and \$6.3 million for the nine months ended September 30, 2014, respectively. Revenue and net loss from Vivity were \$1.6 million and \$1.3 million for the nine months ended September 30, 2014, respectively.

## 4. NET LOSS PER SHARE

Net loss per share is computed under the provisions of ASC topic 260 - Earnings Per Share. Basic loss per share is computed using net loss and the weighted average number of shares of common stock outstanding. Diluted earnings per share reflect the weighted average number of shares of common stock outstanding plus any potentially dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, restricted stock awards, restricted stock units and conversion of shares of preferred stock. Common stock equivalent shares are excluded from the diluted computation if their effect is anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per common share (in thousands, except per share amounts):

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 4. NET LOSS PER SHARE (Continued)

|   | Three Months Ended |             | Nine Months Ended |              |
|---|--------------------|-------------|-------------------|--------------|
|   | September 30,      |             | September 30,     |              |
|   | 2014               | 2013        | 2014              | 2013         |
| Numerator:                                |                    |             |                   |              |
| Net Loss                                  | \$ (16,178         | ) \$ (4,169 | ) \$ (52,170      | ) \$ (12,286 |
| Denominator:                              |                    |             |                   |              |
| Weighted average number of common shares: |                    |             |                   |              |
| Basic                                     | 21,305             | 21,827      | 21,228            | 21,587       |
| Diluted                                   | 21,305             | 21,827      | 21,228            | 21,587       |
| Loss per common share:                    |                    |             |                   |              |
| Basic                                     | \$ (0.76           | ) \$ (0.19  | ) \$ (2.46        | ) \$ (0.57   |
| Diluted                                   | \$ (0.76           | ) \$ (0.19  | ) \$ (2.46        | ) \$ (0.57   |

For the three and nine months ended September 30, 2014 and 2013, no common stock equivalent shares were included in the calculation of the Company's diluted net income per share.

The following is a summary of common stock equivalents for the securities outstanding during the respective periods that have been excluded from the earnings per share calculations as their impact was anti-dilutive.

|                                      | Three Months Ended |         | Nine Months Ended |         |
|--------------------------------------|--------------------|---------|-------------------|---------|
|                                      | September 30,      |         | September 30,     |         |
|                                      | 2014               | 2013    | 2014              | 2013    |
| Stock options                        | 44,000             | 227,000 | 71,000            | 317,000 |
| Restricted stock units               | 110,000            | 91,000  | 98,000            | 91,000  |
| Restricted stocks                    | 30,000             | 246,000 | 81,000            | 245,000 |
| Total common stock equivalent shares | 184,000            | 564,000 | 250,000           | 653,000 |

## 5. INVENTORY

Inventory consisted of the following (in thousands):

|                 | September 30, December 31, |          |
|-----------------|----------------------------|----------|
|                 | 2014                       | 2013     |
| Raw materials   | \$ 3,699                   | \$ 3,267 |
| Finished goods  | 2,791                      | 3,372    |
| Total inventory | \$ 6,490                   | \$ 6,639 |

## 6. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisitions of Livemocha and Lexia in 2013 and the acquisitions of Vivity and Tell Me More in January 2014.

The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC 350, or more frequently, if impairment indicators arise. The Company's reporting units are: North America Consumer (excluding Vivity), Vivity, Rest of World Consumer, Global Enterprise & Education (excluding Lexia), and Lexia. Both Vivity and Lexia are components of larger operating segments; however, each of these businesses is considered a reporting unit for goodwill impairment testing purposes. Prior to the acquisitions of Vivity and Lexia, the Company's reporting units were the same as its operating segments.



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 6. GOODWILL (Continued)

The following table shows the balance and changes in goodwill for the Company's operating segments for the nine months ended September 30, 2014 (in thousands):

|   | North<br>America<br>Consumer | Rest of<br>World<br>Consumer | Global<br>Enterprise &<br>Education | Total    |
|---|------------------------------|------------------------------|-------------------------------------|----------|
| Balance as of December 31, 2013           | \$17,971                     | \$2,200                      | \$29,888                            | \$50,059 |
| Acquisition of Vivity                     | 9,353                        | —                            | —                                   | 9,353    |
| Acquisition of Tell Me More               | —                            | —                            | 21,436                              | 21,436   |
| Impairment charge                         | —                            | (2,199)                      | —                                   | (2,199)  |
| Effect of change in foreign currency rate | (445)                        | (1)                          | (931)                               | (1,377)  |
| Balance as of September 30, 2014          | \$26,879                     | \$—                          | \$50,393                            | \$77,272 |

## ROW Consumer Goodwill Impairment

As discussed in more detail in “Note 2” to the Company’s audited consolidated financial statements included in the Annual Report, goodwill is tested annually for impairment on June 30 of each year or more frequently if impairment indicators arise. In connection with the annual goodwill impairment analysis performed in the prior year at June 30, 2013, the Company determined that the fair value of each of the Company's reporting units exceeded its carrying value, and therefore no goodwill impairment charge was recorded in 2013.

During the three months ended March 31, 2014, the Company determined sufficient indication existed to require performance of an interim goodwill impairment analysis as of March 31, 2014 for the ROW Consumer reporting unit (“ROW Consumer”). This indicator was due to a further unexpected decline in the operations of the ROW Consumer reporting unit, with further decreases in revenue and bookings within the reporting unit driving lower than expected operating results for the quarter and impacting the forecast going forward. In this interim goodwill impairment test, the ROW Consumer reporting unit failed step one.

The combination of the lower reporting unit fair value calculated in step one and the identification of unrecognized fair value changes to the carrying values of other assets and liabilities (primarily tradename and deferred revenue) in the second step of the interim goodwill impairment test, resulted in an implied fair value of goodwill below the carrying value of goodwill for ROW Consumer. As a result, the Company recorded its best estimate of the goodwill impairment loss of \$2.2 million, which represents a full impairment of ROW Consumer’s goodwill. In the second quarter we finalized the measurement of the impairment with no adjustment to the estimated impairment loss initially recorded in the first quarter.

## Annual Impairment Testing of Goodwill

In connection with the annual goodwill impairment analysis performed as of June 30, 2014, the Company determined that the fair value of each of the Company's reporting units with material goodwill balances exceeded its carrying value, and therefore no goodwill impairment charges were recorded in connection with the annual analysis.

## Interim Impairment Review

The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company’s internal control framework. The North America Consumer (excluding Vivity), Global Enterprise & Education, Lexia, and Vivity reporting units were evaluated to determine if a triggering event has occurred. As of September 30, 2014, the Company concluded that there are no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of our reporting units is less than the carrying value. Accordingly, a



detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment review.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. INTANGIBLE ASSETS

Intangible assets consisted of the following items as of the dates indicated (in thousands):

|                        | September 30, 2014    |                          |                     | December 31, 2013     |                          |                     |
|------------------------|-----------------------|--------------------------|---------------------|-----------------------|--------------------------|---------------------|
|                        | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Tradename/trademark *  | \$12,558              | \$ (857 )                | \$ 11,701           | \$11,807              | \$ (158 )                | \$ 11,649           |
| Core technology        | 16,146                | (5,086 )                 | 11,060              | 9,954                 | (3,207 )                 | 6,747               |
| Customer relationships | 27,102                | (13,725 )                | 13,377              | 22,152                | (11,720 )                | 10,432              |
| Website                | 12                    | (12 )                    | —                   | 12                    | (12 )                    | —                   |
| Patents                | 300                   | (151 )                   | 149                 | 300                   | (122 )                   | 178                 |
| Total                  | \$56,118              | \$ (19,831 )             | \$36,287            | \$44,225              | \$ (15,219 )             | \$29,006            |

\* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of September 30, 2014, the carrying value of the tradename asset was \$10.6 million.

## Acquired Long-lived Intangible Assets

The intangible assets recorded as a result of the Vivity Labs Merger are included in the September 30, 2014 balances. The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|                        | Preliminary Estimated Useful Lives | Preliminary Estimated Value January 2, 2014 |
|------------------------|------------------------------------|---|
| Tradename              | 3 years                            | \$ 188                                      |
| Technology platform    | 5 years                            | 2,448                                       |
| Customer relationships | 3 years                            | 941   |
| Total assets           |                                    | \$3,577                                     |

The intangible assets recorded as a result of the Tell Me More Merger are included in the September 30, 2014 balances. The acquired amortizable intangible assets and the related estimated useful lives consist of the following (in thousands):

|                        | Preliminary Estimated Useful Lives | Preliminary Estimated Value January 8, 2014 |
|------------------------|------------------------------------|---|
| Customer relationships | 5 years                            | \$4,348                                     |
| Technology platform    | 5 years                            | 4,144                                       |
| Tradename              | 1 year                             | 613   |
| Total assets           |                                    | \$9,105                                     |

## Amortization Expense for the Long-lived Intangible Assets

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table presents amortization of intangible assets included in the related financial statement line items during the respective periods (in thousands):

|                          | Three Months Ended |        | Nine Months Ended |          |
|--------------------------|--------------------|--------|-------------------|----------|
|                          | September 30,      |        | September 30,     |          |
|                          | 2014               | 2013   | 2014              | 2013     |
| Cost of revenue          | \$ 146             | \$ 98  | \$ 439            | \$ 98    |
| Sales and marketing      | 919                | 374    | 2,783             | 557      |
| Research and development | 501                | 180    | 1,516             | 370      |
| Total                    | \$ 1,566           | \$ 652 | \$ 4,738          | \$ 1,025 |

The increase in amortization expense is due to the amortization of intangible assets recorded as a result of the Livemocha and Lexia acquisitions in 2013 and the Vivity and Tell Me More acquisitions in 2014.

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining three months of 2014 and years thereafter (in thousands):

|                | As of September 30, |
|----------------|---------------------|
|                | 2014                |
| 2014-remaining | \$ 1,538            |
| 2015           | 5,495               |
| 2016           | 5,013               |
| 2017           | 4,502               |
| 2018           | 3,889               |
| Thereafter     | 5,242               |
| Total          | \$ 25,679           |

**Impairment Reviews of Intangible Assets**

The Company also routinely reviews indefinite-lived intangible assets and long-lived assets for potential impairment as part of the Company's internal control framework. As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of September 30, 2014 to determine if indicators of impairment exist. The Company concluded that there are no potential indicators of impairment related to this indefinite-lived intangible asset. Additionally all long-lived intangible assets were evaluated to determine if indicators of impairment exist and the Company concluded that there are no potential indicators of impairment.

**8. OTHER CURRENT LIABILITIES**

The following table summarizes other current liabilities (in thousands):

|  | September 30, December 31, |           |
|--|----------------------------|-----------|
|  | 2014                       | 2013      |
| Accrued marketing expenses                     | \$ 18,878                  | \$ 19,885 |
| Accrued professional and consulting fees       | 2,627                      | 4,570     |
| Sales return reserve                           | 2,342                      | 4,834     |
| Sales, withholding and property taxes payable  | 4,365                      | 3,968     |
| Accrued purchase price of business acquisition | 1,688                      | 1,688     |
| Other  | 6,606                      | 6,991     |
| Total other current liabilities                | \$ 36,506                  | \$ 41,936 |

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. CAPITAL LEASES

The Company enters into capital leases under non-committed arrangements for equipment and software. In addition, as a result of the Tell Me More Merger, the Company assumed a capital lease for a building near Versailles, France, where Tell Me More's headquarters are located. The fair value of the lease liability at the date of acquisition was \$4.0 million.

During the nine months ended September 30, 2013 the Company acquired \$0.6 million in equipment and software through the issuance of capital leases. During the nine months ended September 30, 2014 no equipment or software was acquired through the issuance of capital leases. This non-cash investing activity has been excluded from the consolidated statement of cash flows.

Future minimum payments under capital leases with initial terms of one year or more are as follows (in thousands):

|   | As of September 30, |
|---|---------------------|
|   | 2014                |
| 2014-remaining                              | \$158               |
| 2015  | 778                 |
| 2016  | 576                 |
| 2017  | 576                 |
| 2018  | 569                 |
| Thereafter                                  | 2,130               |
| Total minimum lease payments                | 4,787               |
| Less amount representing interest           | 767                 |
| Present value of net minimum lease payments | 4,020               |
| Less current portion                        | 620                 |
| Obligations under capital lease, long-term  | \$3,400             |

## 10. INCOME TAXES

In accordance with ASC topic 740, Income Taxes ("ASC 740"), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the nine months ended September 30, 2014 is based on the estimated annual effective tax rate for fiscal year 2014. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, may change and may create a different relationship between domestic and foreign income and loss.

The Company accounts for uncertainty in income taxes under ASC subtopic 740-10-25, Income Taxes: Overall: Background ("ASC 740-10-25"). ASC 740-10-25 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740-10-25 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

As of September 30, 2014, the Company is under audit in the United States for the 2009, 2010, 2011, and 2012 tax years. Currently we expect IRS field work to be completed in the fourth quarter 2014 and will provide additional information at that time. While the ultimate results cannot be predicted with certainty, the Company believes that the resulting adjustments, if any, will not have a material adverse effect on its consolidated financial condition or results of operations.

As of September 30, 2014 and December 31, 2013, the Company had \$140,000 and \$143,000, respectively, of unrecognized tax benefits, which if recognized, \$99,000 would affect income tax expense. These liabilities for unrecognized tax benefits are presented as a reduction to the related deferred tax asset where appropriate and the

remaining amount is included in "Other Long Term Liabilities." Interest and penalties related to uncertain tax positions are recorded as part of the income tax provision and are approximately \$21,000 as of September 30, 2014.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. INCOME TAXES (Continued)

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of September 30, 2014, the analysis of the need for a valuation allowance on US deferred tax assets considered that the US entity has incurred a three-year cumulative loss. As previously disclosed, if the Company does not have sufficient objective positive evidence to overcome a three-year cumulative loss, a valuation allowance may be necessary. In evaluating whether to record a valuation allowance, the guidance in ASC 740 deems that the existence of cumulative losses in recent years is a significant piece of objectively verifiable negative evidence that is difficult to overcome. An enterprise that has cumulative losses is generally prohibited from using an estimate of future earnings to support a conclusion that realization of an existing deferred tax asset is more likely than not.

Consideration has been given to the following positive and negative evidence:

• Three-year cumulative evaluation period ended September 30, 2014 results in a cumulative US pre-tax loss;

• from 2006, when the US entity began filing as a C-corporation for income tax purposes, through 2010, the US entity generated taxable income each year;

• the Company has a history of utilizing all operating tax loss carryforwards and has not had any tax loss carryforwards or credits expire unused;

• lengthy loss carryforward periods of 20 years for US federal and most state jurisdictions apply; and

• the Company incurred a US federal jurisdiction net operating loss for the most recently completed calendar year and has additional net operating loss carryforwards subject to limitation pursuant to IRC Section 382.

As of September 30, 2014, a full valuation allowance was provided for the US, Korea, Japan, China, Hong Kong, Mexico, Spain and Brazil where the Company has determined the deferred tax assets will not more likely than not be realized. Further, in France a partial valuation allowance has been recorded on these deferred tax assets that the Company believes are not more likely than not to be realized.

Evaluation of the remaining jurisdictions as of September 30, 2014 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company's financial position and results of operations.

As of September 30, 2014, and December 31, 2013, the Company's US deferred tax liability was \$10.1 million and \$9.6 million, respectively, related to its goodwill and indefinite lived intangibles. As of September 30, 2014 the Company had foreign net deferred tax liabilities of \$0.7 million compared to net deferred tax assets of \$36 thousand at December 31, 2013.

For the nine months ended September 30, 2014 the Company recorded an income tax benefit of \$0.4 million. The benefit in the current year is made up of tax benefits related to current year losses in Canada and France and a tax benefit related to the goodwill impairment charge taken by the Company during the first quarter of 2014 related to the ROW Consumer reporting unit. The goodwill that was written off related to acquisitions from prior years, a portion of

which resulted in a tax benefit as a result of writing off of a deferred tax liability previously recorded (i.e., goodwill had tax basis and was amortized for tax). These tax benefit amounts were offset by income tax expense related to current year profits of operations in Germany and the U.K., and foreign withholding taxes recorded during the period. Further offsetting the tax benefit was tax expense related to the tax impact of the amortization of indefinite lived intangibles, and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION

## 2006 Stock Incentive Plan

On January 4, 2006, the Company established the Rosetta Stone Inc. 2006 Stock Incentive Plan (the "2006 Plan") under which the Company's Board of Directors, at its discretion, could grant stock options to employees and certain directors of the Company and affiliated entities. The 2006 Plan initially authorized the grant of stock options for up to 1,942,200 shares of common stock. On May 28, 2008, the Board of Directors authorized the grant of additional stock options for up to 195,000 shares of common stock under the plan, resulting in total stock options available for grant under the 2006 Plan of 2,137,200 as of December 31, 2008. The stock options granted under the 2006 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. Stock issued as a result of exercises of stock options will be issued from the Company's authorized available stock.

## 2009 Omnibus Incentive Plan

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 new stock incentive awards or options including Incentive and Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Units, Performance Shares, Performance based Restricted Stock, Share Awards, Phantom Stock and Cash Incentive Awards. The stock incentive awards and options granted under the 2009 Plan generally expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. On May 26, 2011 the Board of Directors authorized and the Company's shareholders' approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company's shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan. On May 20, 2014, the Board of Directors authorized and the Company's shareholders approved the allocation of 500,000 additional shares of common stock to the 2009 Plan.

Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. At September 30, 2014 there were 2,845,723 shares available for future grant under the 2009 Plan.

In accordance with ASC 718, the fair value of stock-based awards to employees is calculated as of the date of grant. Compensation expense is then recognized on a straight-line basis over the requisite service period of the award. The Company uses the Black-Scholes pricing model to value its stock options, which requires the use of estimates, including future stock price volatility, expected term and forfeitures. Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates were applied in the expense calculation.

## Stock Options

The following table summarizes the Company's stock option activity from January 1, 2014 to September 30, 2014:

|  | Options<br>Outstanding | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Contractual<br>Life (years) | Aggregate<br>Intrinsic<br>Value |
|--|------------------------|--|--|---------------------------------|
| Options Outstanding, January 1, 2014           | 1,927,552              | \$ 13.61                                 | 7.54   | \$ 2,829,380                    |
| Options granted                                | 633,121                | 11.56                                    |  |                                 |
| Options exercised                              | (112,673)              | ) 5.73                                   |  |                                 |
| Options canceled                               | (413,399)              | ) 14.30                                  |  |                                 |
| Options Outstanding, September 30, 2014        | 2,034,601              | 13.27                                    | 7.62   | 324,166                         |
| Vested and expected to vest September 30, 2014 | 1,881,996              | 13.35                                    | 7.49   | 324,026                         |
| Exercisable at September 30, 2014              | 854,205                | \$ 14.44                                 | 6.20   | \$ 319,740                      |



As of September 30, 2014, there were approximately \$6.9 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 2.52 years.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION (Continued)

Stock options are granted at the discretion of the Board of Directors or the Compensation Committee (or its authorized member(s)) and expire 10 years from the date of the grant. Options generally vest over a four-year period based upon required service conditions. No options have performance or market conditions. The Company calculates the pool of additional paid-in capital associated with excess tax benefits using the "simplified method" in accordance with ASC 718.

## Restricted Stock Awards

The following table summarizes the Company's restricted stock award activity from January 1, 2014 to September 30, 2014:

|                                      | Nonvested<br>Outstanding | Weighted<br>Average<br>Grant Date<br>Fair Value | Aggregate<br>Intrinsic<br>Value |
|--------------------------------------|--------------------------|---|---------------------------------|
| Nonvested Awards, January 1, 2014    | 634,031                  | \$ 12.28  | \$ 7,785,901                    |
| Awards granted                       | 227,244                  | 11.78   |                                 |
| Awards vested                        | (240,936                 | ) 10.65   |                                 |
| Awards canceled                      | (113,743                 | ) 13.55   |                                 |
| Nonvested Awards, September 30, 2014 | 506,596                  | \$ 12.58  | \$ 6,372,420                    |

As of September 30, 2014, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the consolidated statement of operations was \$5.7 million and is expected to be recognized over a period of 2.61 years.

Restricted stock awards are granted at the discretion of the Board of Directors or Compensation Committee (or its authorized member(s)). Restricted stock awards generally vest over a four-year period based upon required service conditions.

## Restricted Stock Units

During the nine months ended September 30, 2014, 34,498 restricted stock units were granted. The Company did not grant any restricted stock units prior to April 2009.

## Long Term Incentive Program

On February 21, 2013, the Company's board of directors approved the 2013 Rosetta Stone Inc. Long Term Incentive Program ("2013 LTIP"). The 2013 LTIP is administered under the Rosetta Stone Inc. 2009 Omnibus Incentive Plan (the "2009 Plan") and the shares awarded under the 2013 LTIP will be taken from the shares reserved under the 2009 Plan. The purpose of the 2013 LTIP is to: motivate senior management and other executives to achieve key financial and strategic business objectives of the Company; offer eligible executives of the Company a competitive total compensation package; reward executives in the success of the Company; provide ownership in the Company; and retain key talent. The 2013 LTIP is effective from January 1, 2013 until December 31, 2014.

Executives designated by the board of directors will be eligible to receive performance stock awards and cash upon the Company's achievement of specified performance goals between January 1, 2013 and December 31, 2014. In order for the granting of any performance stock award or any cash payment to be made under the 2013 LTIP, the Company must meet the minimum threshold requirements for a performance goal for the 2014 fiscal year in addition to the cumulative threshold performance goals for the two year period ended December 31, 2014. Each performance goal is mutually exclusive. Each performance goal has a range of payout levels depending on the achievement of the goal ranging from zero to 200% of the incentive target.

The maximum number of shares to be issued as performance share awards is 482,629 and the maximum cash payout is \$2.5 million. However, executives hired after the approval of the 2013 LTIP may be allowed to participate at the discretion of the board of directors, which could raise the overall share awards and cash payouts. The minimum number of shares to be issued as performance stock awards is zero, and the minimum cash payout is zero. If performance stock awards are granted, the shares will be 100% vested as of the date of grant. There will be no subsequent holding period requirement.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. STOCK-BASED COMPENSATION (Continued)

Before any granting of performance stock awards or payment of cash pursuant to an award granted under the 2013 LTIP can be made, the material terms of the performance goals must be disclosed to, and subsequently approved by, the stockholders, in accordance with Treasury Regulation Section 1.162-27(e)(4).

The Company's stockholders approved the material terms of the performance goals on May 23, 2013, the grant date for the performance stock awards.

12. STOCKHOLDERS' EQUITY

At September 30, 2014, the Company's board of directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of \$0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of \$0.001 per share. At September 30, 2014, the Company had shares of common stock issued of 22,819,233 and shares of common stock outstanding of 21,819,233.

On May 8, 2013, the Company filed a universal shelf registration statement which became effective on May 30, 2013. The registration statement permitted certain holders of the Company's stock to offer the shares of common stock held by them. On June 11, 2013 the selling shareholders, ABS Capital Partners IV Trust and Norwest Equity Partners VIII, LP, sold a combined total of 3,490,000 shares at an offering price of \$16.00. During November and December 2013, ABS Capital Partners IV Trust sold the remainder of its common stock holdings in the Company. As of September 30, 2014, Norwest Equity Partners VIII, LP continues to hold only a nominal number of shares of common stock. The shelf also provides the Company with the flexibility to offer an amount of equity or issue debt in the amount of \$150.0 million. The Company issued and sold an additional 10,000 shares at a per share price of \$16.00 in the offering.

On August 22, 2013, the Company's Board of Directors approved a share repurchase program under which the Company is authorized to repurchase up to \$25 million of its outstanding common stock from time to time in the open market or in privately negotiated transactions depending on market conditions, other corporate considerations and applicable legal requirements. The Company expects to fund the repurchases through existing cash balances and cash generated from operations. For the year ended December 31, 2013, the Company paid \$11.4 million to repurchase 1.0 million shares

at a weighted average price of \$11.44 per share as part of this program. No shares were repurchased during the nine months ended September 30, 2014. Shares repurchased under the program were recorded as treasury stock on the Company's consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether shares purchased under this program will be retired or reissued.

13. EMPLOYEE SEVERANCE

France Reduction in Force

On January 9, 2014, the Company completed its acquisition of Tell Me More, a company organized under the laws of France. At acquisition, the plan was to fully integrate Tell Me More into the operations of the Company. Following the acquisition, the Company undertook a plan to review the financial performance of the Company and of the French entity and as a result the Company identified the need to reduce expenses. In the second quarter of 2014, the Company began to create a plan to address the economic issues of the business through the reduction of expense. The result of this economic planning was to reduce headcount within certain business units of the French entity.

Under the requirements of French Labour Law, there is an expectation on the part of both the employer and employee that if an employee is terminated, the employer will be required to pay a minimum amount of severance. Accordingly, the Company has concluded that the termination benefits to be paid to certain employees as the result of the reduction in force in France are payable based upon an ongoing benefit arrangement. A severance liability becomes probable and estimable when the Company received approval from the French Labour Administration and the specific

employees to be impacted were determined. As of September 30, 2014, these criteria were met and the Company recorded an accrual and the related expense of \$1.0 million. Severance payments related to this reduction in force are anticipated to be paid during the fourth quarter of 2014.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 14. LEASE ABANDONMENT AND TERMINATION

As part of the Company's effort to reduce general and administrative expenses through a planned space consolidation at its Arlington, Virginia headquarters location, the Company incurred a lease abandonment charge of \$3.2 million for the nine months ended September 30, 2014. Prior to January 31, 2014, the Company occupied the 6<sup>th</sup> and 7<sup>th</sup> floors at its Arlington, Virginia headquarters. The Company estimated the liability under operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, Exit or Disposal Cost Obligation ("ASC 420"), as the Company has no future economic benefit from the abandoned space and the lease does not terminate until December 31, 2018. All leased space related to the 6<sup>th</sup> floor was abandoned and ceased to be used by the Company on January 31, 2014.

In March 2013 Rosetta Stone Japan Inc. partially abandoned its Japan office as a result of excess office space due to reduction in staff along with overall local operations business performance. The Company estimated the liability under the operating lease agreement reduced for anticipated sublease income in accordance with ASC 420 as the Company has no future economic benefit from the abandoned space and the lease does not terminate until February 28, 2015. As of March 31, 2014, the Company ceased to use the remaining office space in this facility and simultaneously negotiated and paid a lease termination fee of \$0.4 million. The Company has been released from all obligations under the lease arrangement as of September 30, 2014.

A summary of the Company's lease abandonment activity for the nine months ended September 30, 2014 is as follows (in thousands):

|  | As of September 30, |        |
|--|---------------------|--------|
|  | 2014                | 2013   |
| Accrued lease abandonment costs, beginning of period | \$413               | \$—    |
| Costs incurred and charged to expense                | 3,635               | 770    |
| Principal reductions                                 | (2,344              | ) (237 |
| Accrued lease abandonment costs, end of period       | \$1,704             | \$533  |
| Accrued lease abandonment costs liability:           |                     |        |
| Short-term   | \$434               | \$381  |
| Long-term  | 1,270               | 152    |
| Total  | \$1,704             | \$533  |

## 15. COMMITMENTS AND CONTINGENCIES

## Operating Leases

The Company leases copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. Building, warehouse and office space leases range from 12 months to 72 months. Certain leases also include lease renewal options.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. COMMITMENTS AND CONTINGENCIES (Continued)

The following table summarizes future minimum operating lease payments for the remaining three months of 2014 and the years thereafter (in thousands):

| Periods Ending December 31, | As of September 30,<br>2014 |
|-----------------------------|-----------------------------|
| 2014-remaining              | \$ 1,373                    |
| 2015                        | 4,307                       |
| 2016                        | 3,410                       |
| 2017                        | 2,856                       |
| 2018                        | 2,551                       |
| Thereafter                  | 4                           |
| Total                       | \$ 14,501                   |

Rent expense was \$1.4 million and \$1.7 million for the three months ended September 30, 2014 and 2013, respectively. Rent expense was \$4.3 million and \$5.3 million for the nine months ended September 30, 2014 and 2013, respectively.

The Company accounts for its leases under the provisions of ASC topic 840, Accounting for Leases ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense. The deferred rent liability was \$0.5 million and \$0.5 million at September 30, 2014 and December 31, 2013, respectively. The deferred rent asset was \$20 thousand and \$5 thousand at September 30, 2014 and December 31, 2013, respectively. The deferred rent asset is classified in prepaid and other assets as all associated leases have less than one year remaining on their term.

## Litigation

In June 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG ("Langenscheidt") in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone GmbH's use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. In January 2012, the District Court of Cologne ordered an injunction of Rosetta Stone GmbH's use of the color yellow in packaging, on its website and in television commercials and declared Rosetta Stone liable for damages, attorneys' fees and costs to Langenscheidt. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH's product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt's trademark. The Court of Appeals in Cologne affirmed the District Court's decision. Rosetta Stone GmbH appealed that decision on grounds of law to the German Federal Supreme Court which affirmed the lower court's decision on September 18, 2014. The Company has filed special complaints with the German Federal Supreme Court and the German Constitutional Court directed to constitutional issues in the German Federal Supreme Court's decision.

In August 2011, Rosetta Stone GmbH commenced a separate proceeding for the cancellation of Langenscheidt's German trademark registration of yellow as an abstract color mark. In June 2012, the German Patent and Trademark Office rendered a decision in the cancellation proceeding denying our request to cancel Langenscheidt's German trademark registration. Rosetta Stone GmbH filed an appeal on grounds of law to the German Federal Supreme

Court. A hearing on the appeal was held and the German Federal Supreme Court rejected Rosetta Stone GmbH's further appeal on October 23, 2014.

At this point, the Company cannot predict the amount of damages which Langenscheidt may ultimately be awarded based on the trademark infringement nor when any damages will be required to be paid. However, the Company has concluded that it will be required to pay court costs and opposing counsel fees and has recorded a liability of \$0.3 million as of September 30, 2014. The Company will continue to incur legal fees and other costs in connection with the resolution of this case.



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. COMMITMENTS AND CONTINGENCIES (Continued)

From time to time, we have been subject to various claims and legal actions in the ordinary course of our business. We are not currently involved in any legal proceeding the ultimate outcome of which, in our judgment based on information currently available, would have a material impact on our business, financial condition or results of operations.

## 16. SEGMENT INFORMATION

The Company is managed in three operating segments—North America Consumer, Rest of World ("ROW") Consumer and Global Enterprise & Education. These segments also represent the Company's reportable segments. Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. The Company does not allocate expenses beneficial to all segments, which include certain general and administrative expenses, facilities and communication expenses, purchasing expenses and manufacturing support and logistic expenses. These expenses are included in the unallocated expenses section of the table presented below. Revenue from transactions between the Company's operating segments is not material.

With the exception of goodwill, the Company does not identify or allocate its assets by operating segment.

Consequently, the Company does not present assets or liabilities by operating segment.

Operating results by segment for the three and nine months ended September 30, 2014 and 2013 were as follows (in thousands):

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|-----------|------------------------------------|------------|
|   | 2014                                | 2013      | 2014                               | 2013       |
| Revenue:  |                                     |           |                                    |            |
| North America Consumer                          | \$36,371                            | \$38,699  | \$105,018                          | \$120,018  |
| Rest of World Consumer                          | 5,612                               | 7,165     | 17,749                             | 23,213     |
| Global Enterprise & Education                   | 22,532                              | 15,008    | 59,828                             | 43,703     |
| Total revenue                                   | \$64,515                            | \$60,872  | \$182,595                          | \$186,934  |
| Segment contribution:                           |                                     |           |                                    |            |
| North America Consumer                          | \$7,113                             | \$15,266  | \$28,626                           | \$50,746   |
| Rest of World Consumer                          | 180                                 | (537)     | 191                                | (1,089)    |
| Global Enterprise & Education                   | 6,425                               | 5,200     | 13,951                             | 15,488     |
| Total segment contribution                      | 13,718                              | \$19,929  | \$42,768                           | \$65,145   |
| Unallocated expenses, net:                      |                                     |           |                                    |            |
| Unallocated cost of sales                       | 2,517                               | \$1,504   | \$7,293                            | \$3,005    |
| Unallocated sales and marketing                 | 4,006                               | 3,708     | 12,849                             | 12,480     |
| Unallocated research and development            | 8,689                               | 8,797     | 25,830                             | 25,248     |
| Unallocated general and administrative          | 14,186                              | 13,420    | 42,655                             | 39,071     |
| Unallocated non-operating expense/(income)      | 795                                 | 293       | 912                                | (156)      |
| Unallocated goodwill impairment                 | —                                   | —         | 2,199                              | —          |
| Unallocated lease abandonment expense/(benefit) | (53)                                | 7         | 3,635                              | 835        |
| Total unallocated expenses, net                 | 30,140                              | \$27,729  | \$95,373                           | \$80,483   |
| Loss before income taxes                        | \$(16,422)                          | \$(7,800) | \$(52,605)                         | \$(15,338) |

## Geographic Information

Revenue by major geographic region is based primarily upon the geographic location of the customers who purchase the Company's products. The geographic locations of distributors and resellers who purchase and resell the Company's products may be different from the geographic locations of end customers.

The information below summarizes revenue from customers by geographic area for the three and nine months ended September 30, 2014 and 2013 (in thousands):

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

|               | Three Months Ended |           | Nine Months Ended |            |
|---------------|--------------------|-----------|-------------------|------------|
|               | September 30,      |           | September 30,     |            |
|               | 2014               | 2013      | 2014              | 2013       |
| United States | \$ 51,592          | \$ 51,013 | \$ 147,689        | \$ 155,966 |
| International | 12,923             | 9,859     | 34,906            | 30,968     |
| Total         | \$ 64,515          | \$ 60,872 | \$ 182,595        | \$ 186,934 |

The information below summarizes long-lived assets by geographic area as of September 30, 2014 and December 31, 2013 (in thousands):

|               | September 30, | December 31, |
|---------------|---------------|--------------|
|               | 2014          | 2013         |
| United States | \$ 19,977     | \$ 17,205    |
| International | 5,139         | 561          |
| Total         | \$ 25,116     | \$ 17,766    |

## Revenue by Product and Service

The Company earns revenue from the sale of language-learning, literacy and brain fitness products and services. The information below summarizes revenue by type for the three and nine months ended September 30, 2014 and 2013 (in thousands):

|                   | Three Months Ended |           | Nine Months Ended |            |
|-------------------|--------------------|-----------|-------------------|------------|
|                   | September 30,      |           | September 30,     |            |
|                   | 2014               | 2013      | 2014              | 2013       |
| Language learning | \$ 60,874          | \$ 60,605 | \$ 174,838        | \$ 186,667 |
| Literacy          | 2,850              | 267       | 6,183             | 267        |
| Brain fitness     | 791                | —         | 1,574             | —          |
| Total             | \$ 64,515          | \$ 60,872 | \$ 182,595        | \$ 186,934 |

## 17. SUBSEQUENT EVENTS

On October 28, 2014, the Company's wholly-owned subsidiary, Rosetta Stone Ltd. (the "Borrower"), entered into a \$25 million revolving credit Loan and Security Agreement (the "Loan Agreement") with Silicon Valley Bank. The Loan Agreement has a term of three (3) years during which the Borrower may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions. Presently, no borrowings have been made under the Loan Agreement. Interest on borrowed amounts accrue at either a LIBOR rate plus a margin of 2.25 percent or a prime rate plus a margin of 1.25 percent. The Borrower may select LIBOR interest periods of certain defined intervals ranging from one month to one year. All or portions of outstanding loans may be converted by Borrower from one interest rate method to the other. The Company and each of its other U.S. subsidiaries (the "Guarantors") have agreed to guarantee the Borrower's obligations under the Loan Agreement. The Borrower's obligations are also secured by a security interest on substantially all its and the Guarantors' assets including their intellectual property rights and by a stock pledge by the Guarantors and the Borrower of 100% of their ownership interests in U.S. subsidiaries and 66% of their ownership interests in certain foreign subsidiaries. The Company and its subsidiaries are subject to certain covenants under the Loan Agreement including financial covenants and limitations on indebtedness, encumbrances, investments and distributions and dispositions of assets. The Loan Agreement contains customary events of default, the occurrence of which could result in the Bank's acceleration of the Borrower's repayment obligation of any loan amount then outstanding.

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

This Quarterly Report on Form 10-Q (this "Report") contains "forward-looking statements" that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended.

Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "will," "plan," "project," "seek," "should," "target," "would" expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 3, 2014. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. Unless the context otherwise requires, references in this Report to "we," "us" or "our" shall mean the Company.

### Overview

Rosetta Stone Inc. ("Rosetta Stone," the "Company," "we" or "us") is dedicated to changing the way the world learns. Our innovative, technology-driven language-learning, literacy, and brain fitness solutions have been purchased by millions of individuals and used by thousands of schools, businesses, and government organizations around the world.

Founded in 1992, Rosetta Stone pioneered the use of interactive software to accelerate language learning. Today we offer courses in 30 languages across a broad range of formats, including online subscriptions, digital downloads, mobile apps and perpetual CD-Rom packages. Rosetta Stone has invested more in language learning and expanded beyond language learning and deeper into education-technology with its acquisitions of Livemocha, Inc.

("Livemocha") and Lexia Learning Systems, Inc. ("Lexia") in 2013 and Vivity Labs Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014.

We derive our revenues from sales to both individual consumers and organizations. Our global consumer distribution channel comprises a mix of our call centers, websites, third party e-commerce websites such as Digital River and Apple iTunes, select retail resellers, such as Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Staples Sam's Club, and Costco, daily deal partners such as Groupon, home shopping networks such as GS Home Shopping in Korea and consignment distributors, such as Wynit Distribution and Software Packaging Associates. Our Global Enterprise & Education distribution model is focused on targeted sales activity primarily through a direct sales force in five markets: K-12 schools; colleges and universities; federal government agencies; corporations; and not-for-profit organizations, as well as through a network of third-party resellers of our literacy solutions. Rosetta Stone's management team has communicated a strategic business plan designed to guide the Company through 2016.

The key areas of focus are:

- 1.leveraging the brand;
- 2.innovating the platform; and
- 3.expanding distribution.

In pursuing these priorities, we plan to grow the business by continuing to invest in research and development of new products while focusing on maintaining costs and margins at appropriate levels.

We have three operating segments, North America Consumer, Rest of World ("ROW") Consumer and Global Enterprise & Education. We will discuss the profitability of each segment in terms of segment contribution. Segment contribution is the measure of profitability used by our Chief Operating Decision Maker ("CODM"). Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expense and bad debt expense. North America Consumer segment contribution decreased from \$50.7 million for the nine months ended September 30, 2013 to \$28.6

million for the nine months ended September 30, 2014. The decrease in North America Consumer segment contribution is due to a decrease in retail and direct-to-consumer revenues. ROW Consumer segment contribution increased from a loss of \$1.1 million for the nine months ended September 30, 2013 to break-even for the nine months ended September 30, 2014 driven by a reduction in expenses primarily the result of the reduced size of operations in Japan and Korea. Global Enterprise & Education segment contribution decreased to \$14.0 million for the nine months ended September 30, 2014 as compared to \$15.5 million for the nine months ended September 30, 2013, due to an increase in sales and marketing expense related to the addition of sales staff, particularly from the Lexia and Tell Me More acquisitions and the lower margin on Tell Me More service offerings. The cost of service from the legacy Tell Me More language-learning services is a greater portion of revenue than that of the legacy Rosetta Stone language-

learning services. We are working to condense our combined language-learning service offering to allow for profitable growth. The decline in Global Enterprise & Education segment contribution is also due to the greater amount of commission earned by resellers of our literacy services.

Over the last few years, our strategy has been to shift more and more of our business to online subscriptions, digital downloads and mobile apps and away from perpetual CD-Rom packages. We believe that these online subscription formats provide customers with an overall better experience and the flexibility to use our products on multiple platforms (i.e., tablets and mobile phones), and is a more economical and relevant way for us to deliver our products to customers. One challenge to encouraging customers to enter into or renew a subscription arrangement is that usage of our product varies greatly, ranging from customers that purchase but don't have any usage to customers with high usage. The majority of purchasers tend towards the lower end of that spectrum, with most usage coming in the first few months after purchase and declining over time - similar to a gym membership.

For additional information regarding our segments, see Note 16 of Item 1, Financial Statements. For additional information regarding fluctuations in segment revenue, see Results of Operations, below. Prior periods are presented consistent with our current operating segments and definition of segment contribution.

#### Business Metrics

Management uses the following key business metrics to measure the success of sales of our Rosetta Stone language-learning and literacy solutions in our combined North America and ROW Consumer segments. Management does not review these metrics at a disaggregated segment level. In addition, management does not currently use any comparable metrics to measure success of our Global Enterprise & Education segment.

**Product software units.** A unit is a perpetual software license sold as either tangible packaged software or as an online download.

**Average revenue per product software unit.** Consumer revenues derived from product software units divided by the number of product software units sold in the same period. Revenue from product software includes product revenue associated with product licenses in addition to service revenues associated with short-term online subscriptions that are bundled with our Version 4 TOTALE offering. Currently, \$25 in revenue per unit is derived from service revenues associated with this short-term online subscription.

**Paid online learners.** The number of paid, active learners derived from the sale of a primarily online offering as of the end of a specified period. Applicable online offerings include purchases of subscription-based licenses for Rosetta Stone TOTALE, ReFLEX subscriptions, and purchasers of our product software who subsequently purchase renewals of their short-term online services.

**Average revenue per paid online learner.** Service revenues derived from paid online learners for a specified period divided by the average number of paid online learners during the same period, adjusted to a monthly rate. The average number of paid online learners for a quarter is calculated as the average of the beginning and ending number of paid online learners for the specified period. The average number of paid online learners for a year-to-date period is calculated as the average of the average number of paid online learners for quarters included in the specified year-to-date period.

The following table sets forth these unit and online learner metrics for the three and nine months ended September 30, 2014 and 2013 (in thousands, except unit and per unit amounts):

|   | Three Months Ended |           | Nine Months Ended |            |
|---|--------------------|-----------|-------------------|------------|
|   | September 30,      |           | September 30,     |            |
|   | 2014               | 2013      | 2014              | 2013       |
| Product software revenue                  | \$ 35,078          | \$ 39,368 | \$ 102,351        | \$ 124,511 |
| Paid online learner revenues*             | 5,875              | 6,316     | 17,713            | 18,314     |
| Total consumer revenues                   | \$ 40,953          | \$ 45,684 | \$ 120,064        | \$ 142,825 |
| Product software units                    | 166,367            | 157,706   | 429,318           | 448,105    |
| Total paid online learners*               | 129,452            | 88,633    | 129,452           | 88,633     |
| Average revenue per product software unit | \$ 211             | \$ 250    | \$ 238            | \$ 278     |
| Average revenue per online learner*       | \$ 16              | \$ 24     | \$ 18             | \$ 25      |

\*Excludes revenue and learners from Fit Brains, Tell Me More and Livemocha operations and mobile applications.  
Product software

Product software revenue includes sales of our Rosetta Stone Version 4 TOTALe product. We anticipate the mix of product units will shift from our traditional CD-ROM product to digital downloads and subscriptions in future periods. Worldwide consumer revenue from product software decreased \$4.3 million from the three months ended September 30, 2013 to the three months ended September 30, 2014, driven by a 16% decrease in the average revenue per unit and slightly tempered by a 5% increase in the number of units sold, compared to the prior year period.

Worldwide consumer revenue from product software decreased \$22.2 million from the nine months ended September 30, 2013 to the nine months ended September 30, 2014, driven by a 14% decrease in the average revenue per unit and a 4% decrease in the number of units sold, compared to the prior period.

Average Revenue Per Product Software Unit (ARPU)

Worldwide ARPU decreased \$39, or 16%, from \$250 for the three months ended September 30, 2013 to \$211 for the three months ended September 30, 2014. The decline in ARPU was the result of multiple factors. During the third quarter of 2014, greater promotional activity and deeper discounting activity caused the majority of the decline, offset minimally by a shift in channel mix from retail distribution to direct-to-consumer sales.

Worldwide ARPU decreased \$40, or 14%, from \$278 for the nine months ended September 30, 2013 to \$238 for the nine months ended September 30, 2014. More extensive promotional activity and deeper discounting accounted for a \$44 decrease in ARPU year-over-year, while a shift in channel mix in favor of direct-to-consumer and away from retail had a \$4 beneficial impact.

Although the Company is testing strategies to mitigate the downward trend in prices, in the near term the Company expects ARPU to continue to decline. If lowering prices does not result in increased units sales volume, our overall profitability could be negatively impacted.

Paid online learners

Revenue from paid online learners decreased \$0.4 million from the three months ended September 30, 2013 to the three months ended September 30, 2014, driven by a decrease in the average revenue per online learner due to the decrease in paid online subscription price points implemented in September 2013.

Revenue from paid online learners decreased \$0.6 million from the nine months ended September 30, 2013 to the nine months ended September 30, 2014, driven by a decrease in the average revenue per online learner due to the decrease in paid online subscription price points implemented in September 2013.

Bookings

In addition to the unit and learner metrics described above, management also uses bookings to evaluate the overall health of the business and evaluate performance. Bookings are a non-GAAP financial measure that represent executed sales contracts received by the Company that are either recorded immediately as revenue or as deferred revenue. Management believes that bookings provides useful information to investors regarding certain financial and business trends relating to the





Company's financial condition and results of operations. Bookings are calculated in total and at the operating segment level as revenue plus the change in deferred revenue.

#### Components of Our Statement of Operations

##### Revenue

We derive revenue from sales of language, literacy and brain fitness solutions consisting of product software, audio practice products, professional services, and online software subscriptions. Revenue is presented as product revenue or subscription and service revenue in our consolidated financial statements. Our audio practice products are normally combined with our product software products and sold as a solution.

Our professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone TOTALe. Rosetta Stone TOTALe online combines dedicated conversational coaching and an online software subscription. Rosetta Stone Version 4 TOTALe combines product software and dedicated conversational coaching. The content of our product software and subscription offerings are the same. We offer our customers the ability to choose which format they prefer without differentiating the learning experience. We bundle time-based subscription licenses of our web-based TOTALe services with perpetual licenses of our Rosetta Stone language learning solutions in the North America Consumer market. As a result, we typically defer 10%-35% of each of these bundled sales over the term of the subscription license.

We sell our solutions directly to individuals, educational institutions, corporations, and government agencies. We distribute our consumer products predominantly through our direct sales channels, primarily our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our consumer products through select third-party retailers. Consumer products and services include our product software and audio practice products, online software subscriptions and professional services. We sell to enterprise and education organizations primarily through our direct enterprise and education sales force as well as our network of resellers. Most organizations elect to license our products on a subscription basis. For purposes of explaining variances in our revenue, we separately discuss changes in our consumer and enterprise and education sales channels because the customers and revenue drivers of these channels are different.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2013 accounted for 29% of our annual revenue in 2013. Our Global Enterprise & Education revenue is seasonally stronger in the second and third quarters of the calendar year due to education and government purchasing cycles. We expect these trends to continue.

##### Cost of Product and Subscription and Service Revenue

Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute our products. Such costs include packaging materials, computer headsets, freight, inventory receiving, personnel costs associated with product assembly, third-party royalty fees and inventory storage, obsolescence and shrinkage. The cost of subscription and service revenue primarily represents costs associated with supporting our online language learning service, which includes online language conversation coaching, hosting costs and depreciation. We also include the cost of credit card processing and customer technical support in both cost of product revenue and cost of subscription and service revenue. We are also exploring additional measures to further address coaching costs including unbundling studio sessions from our product software offering.

##### Operating Expenses

We classify our operating expenses into three categories: sales and marketing, research and development and general and administrative.

Our operating expenses primarily consist of personnel costs, direct advertising and marketing expenses and professional fees associated with contract product development, legal, accounting and consulting. Personnel costs for each category of operating expenses include salaries, bonuses, stock-based compensation and employee benefit costs.

##### Sales and Marketing

Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs for our sales and marketing staff and commissions earned by our sales personnel and resellers, particularly resellers of our literacy services. Sales commissions are generally paid at the time the customer is invoiced. However, sales commissions are deferred and recognized as expense in

proportion to when the related revenue is recognized. We intend to continue to expand our sales activities within some of our existing regions as well as to expand our presence into new countries, in addition to expanding our media and advertising campaigns in the US. We expect

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sales and marketing expenses to increase in future periods as we seek to stabilize and expand our operations in existing and new markets.

#### Research and Development

Research and development expenses consist primarily of personnel costs and contract development fees associated with the development of our solutions. Our development efforts are primarily based in the US and are devoted to modifying and expanding our product portfolio through the addition of new content and new paid and complementary products and services to our language learning, literacy and brain fitness solutions. We expect our investment in research and development expenses to increase in future years as we deliver new products that will provide us with significant benefits in the future. In 2013 we restructured our product team, including the elimination of approximately seventy positions in our Harrisonburg, Virginia office and hiring personnel in Austin, Texas and San Francisco, California. We acquired Livemocha and gained additional product personnel in Seattle, Washington. We also acquired Vivity and Tell Me More and gained additional product personnel in Vancouver, Canada, near Versailles, France and Beijing, China. Payroll expenses have increased during 2014 due to hiring product team members in these more competitive labor markets. Rent has also increased due to our additional offices opened in 2014.

#### General and Administrative

General and administrative expenses consist primarily of shared services, such as personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees including professional service fees related to acquisitions and other corporate expenses. In 2014, there have been, and we expect that there will continue to be, increases to certain general and administrative expenses to support our due diligence efforts, the integration of our recent acquisitions and continued expansion into international markets. However, we are also taking steps to reduce certain general and administrative expenses as we realign our cost structure to help fund investment in areas of growth.

#### Interest and Other Income (Expense)

Interest and other income (expense) primarily consist of interest income, interest expense, foreign exchange gains and losses, and income from litigation settlements. Interest expense is primarily related to interest on our capital leases. Interest income represents interest received on our cash and cash equivalents. Fluctuations in foreign currency exchange rates in our foreign subsidiaries cause foreign exchange gains and losses. Legal settlements are related to agreed upon settlement payments from various anti-piracy enforcement efforts.

#### Income Tax (Benefit) Expense

For the three and nine months ended September 30, 2014, we incurred an income tax benefit of \$0.2 million and an income tax benefit of \$0.4 million, respectively, despite incurring losses before taxes of \$16.4 million and \$52.6 million, respectively, resulting in worldwide effective tax rates of 1.5% and 0.8%, respectively. The tax rate resulted from tax expense related to current year income of operations in Germany and the UK, foreign withholding taxes, and the tax impact of amortization of indefinite lived intangibles. This was offset by tax benefits related to current year losses in Canada and newly acquired Tell Me More and tax impact of goodwill impairment charge.

For the year ended December 31, 2013, the Company recorded income tax benefit of \$1.9 million primarily attributable to a partial valuation allowance release of \$5.4 million related to the net deferred tax liabilities acquired with the Livemocha and Lexia acquisitions. This was offset by income tax expense related to current year profits of operations in Canada, Germany, and the UK, foreign withholding taxes and the impact related to amortization of indefinite lived intangibles.

#### Critical Accounting Policies and Estimates

In presenting our financial statements in conformity with accounting principles generally accepted in the US, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures.

Some of the estimates and assumptions we are required to make relate to matters that are inherently uncertain as they pertain to future events. We base these estimates and assumptions on historical experience or on various other factors that we believe to be reasonable and appropriate under the circumstances. On an ongoing basis, we reconsider and

evaluate our estimates and assumptions. Our future estimates may change if the underlying assumptions change. Actual results may differ significantly from these estimates.

For further information on our critical and other significant accounting policies, see our Annual Report on Form 10-K filed with the SEC on March 3, 2014.

We believe that the following critical accounting policies involve our more significant judgments, assumptions and estimates and, therefore, could have the greatest potential impact on our consolidated financial statements:

- Revenue Recognition
- Stock-based Compensation
- Income Taxes
- Allowance for Doubtful Accounts Receivable
- Sales Return Reserve
- Goodwill
- Other Intangible Assets

#### Goodwill

We test goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of Accounting Standards Codification topic 350, Intangibles—Goodwill and Other ("ASC 350") or more frequently, if impairment indicators arise. This guidance provides the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying value, a "Step 0" analysis. If, based on a review of qualitative factors, it is more likely than not that the fair value of a reporting unit is less than its carrying value we perform "Step 1" of the traditional two-step goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. If the carrying value exceeds the fair value, we measure the amount of impairment loss, if any, by comparing the implied fair value of the reporting unit goodwill to its carrying amount.

In estimating the fair value of our reporting units in Step 1, we use a variety of techniques including the income approach (i.e., the discounted cash flow method) and the market approach (i.e., the guideline public company method). Our projections are estimates that can significantly affect the outcome of the analysis, both in terms of our ability to accurately project future results and in the allocation of fair value between reporting units. The factors that we consider important, and which could trigger an interim impairment review, include, but are not limited to: a significant decline in the market value of our common stock for a sustained period; a material adverse change in economic, financial market, industry or sector trends; a material failure to achieve operating results relative to historical levels or projected future levels; and significant changes in operations or business strategy. We will continue to review for impairment indicators.

#### ROW Consumer Goodwill Impairment

During the first quarter, we determined sufficient indication existed to require performance of an interim goodwill impairment analysis as of March 31, 2014 for the ROW Consumer reporting unit. This indicator was due to a further unexpected decline in the operations of the ROW Consumer reporting unit, with further decreases in revenue and bookings within the reporting unit driving lower than expected operating results for the quarter and impacting the forecast going forward. In this interim goodwill impairment test, the ROW Consumer reporting unit failed step one.

In determining the fair value of the Company's ROW Consumer reporting unit for the interim impairment analysis, we used an income approach consistent with the approach used in the most recent prior annual impairment test as of June 30, 2013. The income approach incorporates the use of a discounted cash flow method in which the estimated future cash flows and terminal value for the ROW Consumer reporting unit were discounted to a present value using a discount rate. Cash flow projections are based on management's estimates of economic and market conditions which

drive key assumptions of revenue growth rates, operating margins, capital expenditures and working capital requirements. The discount rate is based on the specific risk characteristics of the reporting unit, the weighted average cost of capital and the underlying forecast. Based on our interim impairment analysis as of March 31, 2014, the carrying value of the Company's ROW Consumer reporting unit exceeded its fair value. Accordingly, step two of the goodwill impairment test was performed.

The combination of the lower reporting unit fair value calculated in step one and the identification of unrecognized fair value changes to the carrying values of other assets and liabilities (primarily tradename and deferred revenue) in the second step of the interim goodwill impairment test, resulted in an implied fair value of goodwill below the carrying value of goodwill for ROW Consumer. As a result, in the first quarter of 2014 we recorded our best estimate of the goodwill impairment loss of \$2.2 million, which represents a full impairment of ROW Consumer's goodwill. Upon finalizing the estimated impairment loss based on completion of the measurement of the impairment, no adjustment to the initial impairment charge was recognized in the second quarter of 2014.

### Annual Goodwill Impairment Test

In connection with the annual goodwill impairment analysis performed at June 30, 2014, we determined that the fair value of each of the Company's reporting units with a material goodwill balance exceeded its carrying value, and therefore no additional goodwill impairment charges were recorded in 2014.

In performing the Step 1 analysis as part of the annual impairment test as of June 30, 2014, we concluded that the North America Consumer reporting unit is not at risk of failing Step 1. The margin with which the fair value of the North America Consumer reporting unit exceeded its carrying value declined substantially from June 30, 2013 primarily due to continued decreases in our consumer pricing. The near-term projections for this reporting unit include a year-over-year decline in revenue during FY 2014 followed by modest increases in revenue in 2015 - 2016 due to the introduction of new products and services. If demand for our current consumer products is lower than is expected in our current projections or if we are unable to successfully launch new products and services, our future revenue projections may not be achieved and this reporting unit may be at risk for failing Step 1 of the goodwill impairment test in future periods. We have allocated \$18.0 million of goodwill to this reporting unit.

In performing the Step 1 analysis as part of the annual impairment test as of June 30, 2014, we concluded that the Vivity reporting unit is not at risk of failing Step 1 as this reporting unit's performance has met or exceeded the projections developed at the time of the acquisition. The fair value of the Vivity reporting unit exceeded its carrying value by 5% as of June 30, 2014. The margin between the carrying value and fair value is due to the proximity of the goodwill impairment testing date to the acquisition date of January 2, 2014. The near-term projections for this reporting unit include an increase in web-based subscriptions as we integrate the Vivity website with the Rosetta Stone website and introduce more higher priced web-based subscription services. If we are unsuccessful in growing subscription revenue for Fit Brains services, our future projections may not be achieved and this reporting unit may be at risk for failing Step 1 of the goodwill impairment test in future periods. We have allocated \$9.4 million of goodwill to this reporting unit.

For additional risk factors which could affect the assumptions used in our valuation of our reporting units see the section titled "Risk Factors" in our Form 10-K filed on March 3, 2014. Accordingly, the Company cannot provide assurance that the estimates, assumptions, and values reflected in the valuations will be realized, and actual results could vary materially.

### Interim Impairment Review

The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company's internal control framework. The North America Consumer (excluding Vivity), Vivity, Global Enterprise & Education (excluding Lexia), and Lexia reporting units were evaluated to determine if a triggering event has occurred. As of September 30, 2014, the Company concluded that there are no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of our reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment review.

## Results of Operations

The following table sets forth our consolidated statement of operations for the periods indicated (in thousands, except percentages):

|  | Three Months Ended<br>September 30, |             | 2014 versus 2013 |          |    |
|--|-------------------------------------|-------------|------------------|----------|----|
|  | 2014                                | 2013        | Change           | % Change |    |
| Revenue                                  |                                     |             |                  |          |    |
| Product                                  | \$ 32,392                           | \$ 34,038   | \$ (1,646        | ) (4.8   | )% |
| Subscription and service                 | 32,123                              | 26,834      | 5,289            | 19.7     | %  |
| Total Revenue                            | 64,515                              | 60,872      | 3,643            | 6.0      | %  |
| Cost of revenue                          |                                     |             |                  |          |    |
| Cost of product revenue                  | 7,916                               | 7,325       | 591              | 8.1      | %  |
| Cost of subscription and service revenue | 5,071                               | 3,419       | 1,652            | 48.3     | %  |
| Total cost of revenue                    | 12,987                              | 10,744      | 2,243            | 20.9     | %  |
| Gross profit                             | 51,528                              | 50,128      | 1,400            | 2.8      | %  |
| Operating expenses:                      |                                     |             |                  |          |    |
| Sales and marketing                      | 43,771                              | 34,844      | 8,927            | 25.6     | %  |
| Research and development                 | 8,689                               | 8,797       | (108             | ) (1.2   | )% |
| General and administrative               | 14,748                              | 13,987      | 761              | 5.4      | %  |
| Goodwill impairment                      | —                                   | —           | —                | —        | %  |
| Lease abandonment                        | (53                                 | ) 7         | (60              | ) (857.1 | )% |
| Total operating expenses                 | 67,155                              | 57,635      | 9,520            | 16.5     | %  |
| Loss from operations                     | (15,627                             | ) (7,507    | ) (8,120         | ) 108.2  | %  |
| Other income and expense:                |                                     |             |                  |          |    |
| Interest income                          | 3                                   | 21          | (18              | ) (85.7  | )% |
| Interest expense                         | (46                                 | ) (9        | ) (37            | ) 411.1  | %  |
| Other income                             | (752                                | ) (305      | ) (447           | ) 146.6  | %  |
| Interest and other income, net           | (795                                | ) (293      | ) (502           | ) 171.3  | %  |
| Loss before income taxes                 | (16,422                             | ) (7,800    | ) (8,622         | ) 110.5  | %  |
| Income tax (benefit)                     | (244                                | ) (3,631    | ) 3,387          | (93.3    | )% |
| Net loss                                 | \$ (16,178                          | ) \$ (4,169 | ) \$ (12,009     | ) 288.1  | %  |

Comparison of the three months ended September 30, 2014 and the three months ended September 30, 2013

Our revenue increased to \$64.5 million for the three months September 30, 2014 from \$60.9 million for the three months ended September 30, 2013. The change in revenue is due to an increase in Global Enterprise & Education revenues of \$7.5 million, partially offset by decreases in North America Consumer revenues of \$2.3 million and ROW Consumer revenues of \$1.6 million. Bookings increased to \$82.1 million for the three months ended September 30, 2014 from \$70.7 million for the three months ended September 30, 2013. The increase was due to a \$12.3 million increase in Global Enterprise & Education bookings and an increase in North America Consumer bookings of \$1.6 million, partially offset by a decrease of \$2.4 million in ROW Consumer bookings, compared to the prior year.

We reported an operating loss of \$15.6 million for the three months ended September 30, 2014 compared to an operating loss of \$7.5 million for the three months ended September 30, 2013. The increase in operating loss was due to an increase of \$8.9 million in sales and marketing expenses and an increase of \$0.8 million in general and administrative expenses, partially offset by a decrease of \$0.1 million in research and development expenses. The increase in operating expenses were partially offset by an increase in gross profit of \$1.4 million, driven by a \$3.6 million increase in revenue, partially offsetting a \$2.2 million increase in cost of revenue.





The following table sets forth revenue for each of our three operating segments for the three months ended September 30, 2014 and 2013 (in thousands, except percentages):

|                               | Three Months Ended September 30, |         |          |         | 2014 versus 2013 |          |   |
|-------------------------------|----------------------------------|---------|----------|---------|------------------|----------|---|
|                               | 2014                             |         | 2013     |         | Change           | % Change |   |
| North America Consumer        | \$36,371                         | 56.4 %  | \$38,699 | 63.6 %  | \$(2,328)        | (6.0)    | % |
| Rest of World Consumer        | 5,612                            | 8.7 %   | 7,165    | 11.8 %  | \$(1,553)        | (21.7)   | % |
| Global Enterprise & Education | 22,532                           | 34.9 %  | 15,008   | 24.7 %  | \$7,524          | 50.1     | % |
| Total Revenue                 | \$64,515                         | 100.0 % | \$60,872 | 100.0 % | \$3,643          | 6.0      | % |

North America Consumer revenue decreased \$2.3 million, or 6%, from the three months ended September 30, 2013 to the three months ended September 30, 2014. This decrease was due to reductions in revenue from our direct-to-consumer, global retail, kiosk and homeschool sales channels of \$1.4 million, \$1.2 million, \$0.3 million and \$0.3 million, respectively, offset by an increase of \$0.8 million in the Fit Brains sales channel. North America Consumer bookings increased \$1.6 million to \$40.2 million for the three months ended September 30, 2014 from \$38.6 million for the three months ended September 30, 2013. The bookings variance by sales channel includes direct-to-consumer increases of \$3.2 million and Fit Brains increases of \$1.1 million. These increases are partially offset by a decrease of \$2.4 million in our global retail sales channel as certain of the Company's larger retail partners significantly reduced inventory levels during the third quarter of this year, resulting in fewer units ordered and lower revenue compared to last year. In recent quarters we have focused on driving customers to purchase through our direct-to-consumer channel, particularly through our website. We have implemented more aggressive discounting and promotional activity, particularly in the direct-to-consumer channel, to combat the introduction of lower priced competitor products. We expect that the trend of lowering prices resulting in increased unit volume and overall increased sales will continue.

ROW Consumer revenue decreased \$1.6 million, or 22%, from the three months ended September 30, 2013 to the three months ended September 30, 2014. This decrease was due to reductions in revenue from Japan and Korea of \$1.3 million and \$0.1 million, respectively, due to the reduction of our Asian consumer operations. ROW Consumer bookings decreased to \$5.0 million for the three months ended September 30, 2014 from \$7.5 million for the three months ended September 30, 2013. ROW Consumer bookings decreased \$1.4 million, \$0.8 million, and \$0.3 million in Japan, Korea and the UK, respectively, offset by an increase of \$0.1 million in France. On January 10, 2014, we announced plans to streamline our Japan and Korea operations. We are using a partner model to continue to serve the Japanese market and reorganize our Korea operations to focus more directly on further scaling the Proctor Assisted Learning (“PAL”) channel.

Total Global Enterprise & Education revenue increased \$7.5 million, or 50%, from the three months ended September 30, 2013 to the three months ended September 30, 2014. Global Enterprise & Education language revenue increased \$2.3 million and \$1.7 million in our corporate and education channels, respectively. Global Enterprise & Education literacy revenue from Lexia, which was acquired on August 1, 2013, increased \$2.6 million. Total Global Enterprise & Education bookings increased \$12.3 million to \$36.9 million for the three months ended September 30, 2014 from \$24.6 million for the three months ended September 30, 2013. Global Enterprise & Education literacy bookings contributed to \$3.9 million of the increase due to the acquisition of Lexia. Global Enterprise & Education language bookings increased \$8.0 million. We have seen a decline in renewal rates from existing Global Enterprise & Education language customers while Global Enterprise & Education language bookings are increasing, primarily due to the sales of multi-year deals. With Global Enterprise & Education language bookings increasing, this means we are seeing an increase in bookings from new customers, which has a higher cost of acquisition when compared to the renewal of an existing customer. We expect renewal rates to improve over current levels through the remainder of 2014.

#### Revenue by Product Revenue and Subscription and Service Revenue

We categorize and report our revenue in two categories—product revenue and subscription and service revenue. Product revenue includes revenues allocated to our software products, revenues from the sale of audio practice products and mobile applications. Subscription and service revenue includes revenues allocated to time-based subscription licenses of our web-based services, as well as revenues from training and professional services. We bundle time-based

subscription licenses of our web-based TOTALe services with product licenses of our language-learning solutions. As a result, we typically defer 10%-35% of the revenue of each of these bundled sales. We recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, Software: Revenue Recognition. In the fourth quarter of 2013, we reduced the stand alone prices of renewals of our TOTALe services. Accordingly, the amount we defer related to each bundled sale has decreased.

The following table sets forth revenue for products and subscription and services for the three months ended September 30, 2014 and 2013 (in thousands, except percentages):

|                                  | Three Months Ended September 30, |         |           | 2014 versus 2013 |            |         |
|----------------------------------|----------------------------------|---------|-----------|------------------|------------|---------|
|                                  | 2014                             | 2013    |           | Change           | % Change   |         |
| Product revenue                  | \$ 32,392                        | 50.2 %  | \$ 34,038 | 55.9 %           | \$(1,646 ) | (4.8 )% |
| Subscription and service revenue | 32,123                           | 49.8 %  | 26,834    | 44.1 %           | 5,289      | 19.7 %  |
| Total revenue                    | \$ 64,515                        | 100.0 % | \$ 60,872 | 100.0 %          | \$ 3,643   | 6.0 %   |

#### Product Revenue

Product revenue decreased \$1.6 million, or 5%, to \$32.4 million during the three months ended September 30, 2014 from \$34.0 million during the three months ended September 30, 2013. In particular, the product revenue decrease was driven by lower prices on our Rosetta Stone Version 4 TOTALe product software bundle due to promotional pricing in our North America Consumer retail channel.

#### Subscription and Service Revenue

Subscription and service revenue increased \$5.3 million, or 20%, to \$32.1 million for the three months ended September 30, 2014. The increase in subscription and service revenue was due to an increase of \$6.7 million in Global Enterprise & Education and a \$0.8 million increase in Fit Brains subscription revenue. These increases were offset by a decrease of \$2.6 million of consumer service revenue due to the decrease in the amount of revenue allocated to the subscription portion of our Version 4 TOTALe bundle.

We are currently evaluating changes to our existing solutions as well as the introduction of new solutions, including additional solutions for kids. If we implement additional subscription-based solutions, it could result in lower revenues over the next twelve months as revenues would be spread over the subscription period.

#### Cost of Product Revenue and Subscription and Service Revenue and Gross Profit

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the three months ended September 30, 2014 and 2013 (in thousands, except percentages):

|  | Three Months Ended September 30, |           | 2014 versus 2013 |          |  |
|--|----------------------------------|-----------|------------------|----------|--|
|  | 2014                             | 2013      | Change           | % Change |  |
| Revenue                                  |                                  |           |                  |          |  |
| Product                                  | \$ 32,392                        | \$ 34,038 | \$(1,646 )       | (4.8 )%  |  |
| Subscription and service                 | 32,123                           | 26,834    | 5,289            | 19.7 %   |  |
| Total revenue                            | 64,515                           | 60,872    | 3,643            | 6.0 %    |  |
| Cost of revenue                          |                                  |           |                  |          |  |
| Cost of product revenue                  | 7,916                            | 7,325     | 591              | 8.1 %    |  |
| Cost of subscription and service revenue | 5,071                            | 3,419     | 1,652            | 48.3 %   |  |
| Total cost of revenue                    | 12,987                           | 10,744    | 2,243            | 20.9 %   |  |
| Gross profit                             | \$ 51,528                        | \$ 50,128 | \$ 1,400         | 2.8 %    |  |
| Gross margin percentages                 | 79.9 %                           | 82.3 %    | (2.5 )%          |          |  |

#### Cost of Product Revenue

Cost of product revenue for the three months ended September 30, 2014 was \$7.9 million, an increase of \$0.6 million, or 8%, from the three months ended September 30, 2013. As a percentage of product revenue, cost of product revenue increased to 24% from 22% for the three months ended September 30, 2014 compared to the same prior year period.

The increase in cost as a percentage of revenue was primarily attributable to a decline in product revenue. The dollar increase in cost of product is primarily due to an increase of \$0.4 million in payroll and benefits as a result of the acquisitions that occurred during the first quarter of this year.

#### Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the three months ended September 30, 2014 was \$5.1 million, an increase of \$1.7 million, or 48%, from the three months ended September 30, 2013. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 16% from 13% for the three months ended September 30, 2013 compared to the same prior year period. The dollar increase in cost of subscription and service is primarily due to increased payroll and benefits as a result of the acquisitions that occurred during the first quarter of this year, and second and third quarters of 2013.

#### Operating Expenses

|                            | Three Months Ended                 |          | 2014 versus 2013 |          |   |
|----------------------------|------------------------------------|----------|------------------|----------|---|
|                            | September 30,<br>2014              | 2013     | Change           | % Change |   |
|                            | (in thousands, except percentages) |          |                  |          |   |
| Sales and marketing        | \$43,771                           | \$34,844 | \$8,927          | 25.6     | % |
| Research and development   | 8,689                              | 8,797    | (108)            | (1.2)    | % |
| General and administrative | 14,748                             | 13,987   | 761              | 5.4      | % |
| Lease abandonment          | (53)                               | 7        | (60)             | (857.1)  | % |
| Total operating expenses   | \$67,155                           | \$57,635 | \$9,520          | 16.5     | % |

#### Sales and Marketing Expenses

Sales and marketing expenses for the three months ended September 30, 2014 were \$43.8 million, an increase of \$8.9 million, or 26%, from the three months ended September 30, 2013. As a percentage of total revenue, sales and marketing expenses increased to 68% from 57% for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The dollar and percentage increases in sales and marketing expenses were primarily attributable to a \$2.1 million increase in payroll and benefits from the addition of Lexia, Tell Me More, and Vivity. Sales commission expense increased by \$1.4 million as a result of an increase in literacy bookings.

Depreciation and amortization expense increased \$0.5 million due to the amortization of intangible assets from the Lexia and Tell Me More acquisitions. In addition, there was a \$4.4 million increase in marketing expense which was expensed as incurred, approximately half of which related to a "millennial" advertising campaign using newly developed creative which runs across television, videos and our website. The other half of the increase was due to an increase in general media expenses to drive visits, leads and bookings. The marketing campaigns were rolled out in the middle of Q3 2014 without much time to experience any increases in revenues or bookings within the period. While the overall yield on marketing spend in our North America Consumer segment has declined, we expect that we will continue marketing and advertising media campaigns to generate sufficient web visits and leads in order to grow overall bookings.

#### Research and Development Expenses

Research and development expenses were \$8.7 million for the three months ended September 30, 2014, a decrease of \$0.1 million, or 1%, from the three months ended September 30, 2013. As a percentage of total revenue, research and development expenses decreased from 14% to 13% for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The dollar and percentage decreases were primarily attributable to a \$0.9 million reduction in payroll expense due to the increased level of capitalized labor costs related to new service offerings. These decreases were partially offset by increases in professional services expenses of \$0.5 million and depreciation and amortization of \$0.3 million, all driven from the acquisitions.

#### General and Administrative Expenses

General and administrative expenses for the three months ended September 30, 2014 were \$14.7 million, an increase of \$0.8 million, or 5%, from the three months ended September 30, 2013. As a percentage of revenue, general and administrative expenses remained flat at 23% for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The dollar increase was primarily attributable to a \$0.3 million increase in third party services and expenses associated with software and hardware maintenance levels and an \$0.3 million increase in other expenses primarily driven by Tell Me More business tax expense that did not exist in the three months ended September 30, 2014. These increases were partially offset by a \$0.2 million decrease in rent expense driven from the Japan office closure and the abandonment of the 6th floor of the Arlington, Virginia lease and a \$0.1 million decrease

in consulting and legal expenses. Additionally, the increase in general and administrative expenses is attributable to the termination expenses related to the France reduction in force amounting to \$1.0 million.

## Lease Abandonment and Termination

Lease abandonment and termination expenses for the three months ended September 30, 2014 were negative \$53,000.

## Interest and Other Income (Expense)

|                              | Three Months Ended<br>September 30, |         | 2014 Versus 2013 |          |
|------------------------------|-------------------------------------|---------|------------------|----------|
|                              | 2014                                | 2013    | Change           | % Change |
|                              | (in thousands, except percentages)  |         |                  |          |
| Interest income              | \$ 3                                | \$ 21   | \$(18)           | (85.7)%  |
| Interest expense             | (46)                                | (9)     | (37)             | 411.1%   |
| Other income and (expense)   | (752)                               | (305)   | (447)            | 146.6%   |
| Total other income (expense) | \$(795)                             | \$(293) | \$(502)          | 171.3%   |

Interest income represents interest earned on our cash and cash equivalents. Interest income for the three months ended September 30, 2014 was \$3,000, a decrease of \$18,000, or 86%, from the three months ended September 30, 2013.

Interest expense for the three months ended September 30, 2014 was \$46,000, an increase of \$37,000 from the three months ended September 30, 2013, attributable to interest on our capital leases.

Other expense for the three months ended September 30, 2014 was \$752,000, an increase of \$447,000, from the three months ended September 30, 2013, primarily attributable to foreign exchange losses.

## Income Tax (Benefit)

|                      | Three Months Ended<br>September 30, |           | 2014 versus 2013 |          |
|----------------------|-------------------------------------|-----------|------------------|----------|
|                      | 2014                                | 2013      | Change           | % Change |
|                      | (in thousands, except percentages)  |           |                  |          |
| Income tax (benefit) | \$(244)                             | \$(3,631) | \$3,387          | (93.3)%  |

Our income tax benefit for the three months ended September 30, 2014 was \$0.2 million, compared to a \$3.6 million income tax benefit for the three months ended September 30, 2013. The change was primarily resulted from the partial valuation allowance release during the same quarter in the previous year.

Comparison of the nine months ended September 30, 2014 and the nine months ended September 30, 2013

|  | Nine Months Ended<br>September 30, |            | 2014 versus 2013 |          |   |
|--|------------------------------------|------------|------------------|----------|---|
|  | 2014                               | 2013       | Change           | % Change |   |
|  | (in thousands, except percentages) |            |                  |          |   |
| Revenue                                  |                                    |            |                  |          |   |
| Product                                  | \$ 92,888                          | \$ 107,087 | \$(14,199)       | (13.3)   | % |
| Subscription and service                 | 89,707                             | 79,847     | 9,860            | 12.3     | % |
| Total revenue                            | 182,595                            | 186,934    | (4,339)          | (2.3)    | % |
| Cost of revenue                          |                                    |            |                  |          |   |
| Cost of product revenue                  | 23,010                             | 21,263     | 1,747            | 8.2      | % |
| Cost of subscription and service revenue | 14,109                             | 9,969      | 4,140            | 41.5     | % |
| Total cost of revenue                    | 37,119                             | 31,232     | 5,887            | 18.8     | % |
| Gross profit                             | 145,476                            | 155,702    | (10,226)         | (6.6)    | % |
| Operating expenses:                      |                                    |            |                  |          |   |
| Sales and marketing                      | 120,700                            | 104,904    | 15,796           | 15.1     | % |
| Research and development                 | 25,830                             | 25,248     | 582              | 2.3      | % |
| General and administrative               | 44,805                             | 40,209     | 4,596            | 11.4     | % |
| Goodwill impairment                      | 2,199                              | —          | 2,199            | 100.0    | % |
| Lease abandonment                        | 3,635                              | 835        | 2,800            | 335.3    | % |
| Total operating expenses                 | 197,169                            | 171,196    | 25,973           | 15.2     | % |
| Loss from operations                     | (51,693)                           | (15,494)   | (36,199)         | 233.6    | % |
| Other income and expense:                |                                    |            |                  |          |   |
| Interest income                          | 13                                 | 105        | (92)             | (87.6)   | % |
| Interest expense                         | (153)                              | (54)       | (99)             | 183.3    | % |
| Other income                             | (772)                              | 105        | (877)            | (835.2)  | % |
| Interest and other income, net           | (912)                              | 156        | (1,068)          | (684.6)  | % |
| Loss before income taxes                 | (52,605)                           | (15,338)   | (37,267)         | 243.0    | % |
| Income tax (benefit)                     | (435)                              | (3,052)    | 2,617            | (85.7)   | % |
| Net loss                                 | \$(52,170)                         | \$(12,286) | \$(39,884)       | 324.6    | % |

Our revenue decreased to \$182.6 million for the nine months ended September 30, 2014 from \$186.9 million for the nine months ended September 30, 2013. The change in revenue is due to decreases in North America Consumer revenues of \$15.0 million and ROW Consumer revenues of \$5.5 million, partially offset by an increase in Global Enterprise & Education revenues of \$16.1 million. Bookings increased to \$212.4 million for the nine months ended September 30, 2014 from \$194.1 million for the nine months ended September 30, 2013. The increase was due to a \$32.1 million increase in Global Enterprise & Education bookings, offset by decreases in North America Consumer bookings and ROW Consumer bookings of \$8.1 million and \$5.8 million, respectively, compared to the prior year.

We reported an operating loss of \$51.7 million for the nine months ended September 30, 2014 compared to an operating loss of \$15.5 million for the nine months ended September 30, 2013. The increase in operating loss was due to a decrease in gross profit of \$10.2 million, driven by a \$4.3 million decrease in revenue, and a \$5.9 million increase in cost of revenue. Operating expenses increased \$26.0 million due to increases of \$15.8 million in sales and marketing expenses, \$4.6 million in general and administrative expenses, \$2.8 million in lease abandonment expense, \$2.2 million in goodwill impairment, and \$0.6 million in research and development expenses.



## Revenue by Operating Segment

The following table sets forth revenue for each of our three operating segments for the nine months ended September 30, 2014 and 2013 (in thousands, except percentages):

|                               | Nine Months Ended September 30, |         |            |         | 2014 versus 2013 |          |
|-------------------------------|---------------------------------|---------|------------|---------|------------------|----------|
|                               | 2014                            |         | 2013       |         | Change           | % Change |
| North America Consumer        | \$ 105,018                      | 57.5 %  | \$ 120,018 | 64.2 %  | \$(15,000)       | (12.5)%  |
| Rest of World Consumer        | 17,749                          | 9.7 %   | 23,213     | 12.4 %  | \$(5,464)        | (23.5)%  |
| Global Enterprise & Education | 59,828                          | 32.8 %  | 43,703     | 23.4 %  | \$ 16,125        | 36.9%    |
| Total Revenue                 | \$ 182,595                      | 100.0 % | \$ 186,934 | 100.0 % | \$(4,339)        | (2.3)%   |

North America Consumer revenue decreased \$15.0 million, or 12%, from the nine months ended September 30, 2013 to the nine months ended September 30, 2014. This decrease was due to reductions in revenue from our direct-to-consumer, global retail, kiosk, and home school sales channels of \$7.6 million, \$4.9 million, \$3.7 million, and \$0.6 million, respectively; partially offset by an increase of approximately \$1.6 million in revenue from our Fit Brains sales channel. North America bookings decreased \$8.1 million to \$111.2 million for the nine months ended September 30, 2014 from \$119.3 million for the nine months ended September 30, 2013. The variance by sales channel is due to decreases of \$9.6 million and \$3.1 million in our global retail and kiosk sales channels, respectively, partially offset by an increase of \$3.6 million and \$1.5 million in our Fit Brains and direct-to-consumer sales channel, respectively. The decrease in our global retail sales channel was due to certain of the Company's larger retail partners significantly reducing inventory levels during the first nine months of this year, resulting in fewer units ordered and lower revenue compared to last year. In the second quarter of 2013 we closed our entire kiosk sales channel in the North America Consumer segment. In recent quarters we have focused on driving customers to purchase through our direct-to-consumer channel, particularly through our website. Lower pricing is one tactic we used to increase sales volume in this channel. The decreased overall pricing combined with the closure of our US kiosks resulted in lower North America Consumer bookings. We expect that the trend of lowering prices resulting in increased unit volume and overall increased sales will continue. While direct-to-consumer revenue is down, the direct-to-consumer bookings have increased, primarily due to the late 2013 change in sales models that increased the subscription periods from short-term subscriptions to 36-month subscriptions, thus increasing the period over which deferred revenue is accumulating on the books.

ROW Consumer revenue decreased \$5.5 million, or 24%, from the nine months ended September 30, 2013 to the nine months ended September 30, 2014. ROW Consumer revenues decreased \$2.8 million, \$2.1 million, and \$0.8 million in Japan, Korea, and UK, respectively, offset by an increase of \$0.4 million in revenue from indirect, digital resellers. ROW Consumer bookings decreased to \$16.9 million for the nine months ended September 30, 2014 from \$22.7 million for the nine months ended September 30, 2013. Bookings decreased primarily due to decreases of \$3.5 million and \$2.9 million in Japan and Korea, respectively, offset by an increase of \$0.7 million in bookings from indirect, digital resellers. On January 10, 2014, we announced plans to streamline our Japan and Korea operations. We plan to use a partner model to continue to serve the Japanese market and have reorganized our Korea operations to focus more directly on further scaling the Proctor Assisted Learning ("PAL") channel.

Total Global Enterprise & Education revenue increased \$16.1 million, or 37%, from the nine months ended September 30, 2013 to the nine months ended September 30, 2014. Global Enterprise & Education language revenue increased \$6.7 million, \$2.1 million, \$1.0 million, and \$0.8 million in France, the US, Germany, and the UK, respectively, due to the January 2014 acquisition of Tell Me More. Global Enterprise & Education literacy revenue increased \$5.9 million from Lexia, which was acquired on August 1, 2013. Total Global Enterprise & Education bookings increased \$32.1 million to \$84.4 million for the nine months ended September 30, 2014 from \$52.2 million for the nine months ended September 30, 2013. Global Enterprise & Education literacy bookings contributed to \$13.8 million of the increase due to the acquisition of Lexia. Global Enterprise & Education language bookings increased \$6.9 million in the US and \$11.4 internationally. The increase in the US includes a \$3.0 million, 5-year contract with a K12 customer which includes a blended Tell Me More and Rosetta Stone language-learning solution. We have seen a decline in renewal rates from existing Global Enterprise & Education language customers while Global Enterprise &

Education language bookings are increasing, primarily due to the sales of multi-year deals. With Global Enterprise & Education language bookings increasing, this means we are seeing an increase in bookings from new customers, which has a higher cost of acquisition when compared to the renewal of an existing customer. We expect renewal rates to improve over current levels through the remainder of 2014.

### Revenue by Product Revenue and Subscription and Service Revenue

We categorize and report our revenue in two categories—product revenue and subscription and service revenue. Product revenue includes revenues allocated to our software products, revenues from the sale of audio practice products and mobile applications. Subscription and service revenue includes revenues allocated to time-based subscription licenses of our web-based services, as well as revenues from training and professional services. We bundle time-based subscription licenses of our web-based TOTALe services with product licenses of our language-learning solutions. As a result, we typically defer 10%-35% of the revenue of each of these bundled sales. We recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, Software: Revenue Recognition. In the fourth quarter of 2013, we reduced the stand alone prices of renewals of our TOTALe services. Accordingly, the amount we defer related to each bundled sale has decreased.

The following table sets forth revenue for products and subscription and services for the nine months ended September 30, 2014 and 2013 (in thousands, except percentages):

|                                  | Nine Months Ended September 30, |         |           |         | 2014 versus 2013 |          |   |
|----------------------------------|---------------------------------|---------|-----------|---------|------------------|----------|---|
|                                  | 2014                            |         | 2013      |         | Change           | % Change |   |
| Product revenue                  | \$92,888                        | 50.9 %  | \$107,087 | 57.3 %  | \$(14,199)       | (13.3)   | % |
| Subscription and service revenue | 89,707                          | 49.1 %  | 79,847    | 42.7 %  | 9,860            | 12.3     | % |
| Total revenue                    | \$182,595                       | 100.0 % | \$186,934 | 100.0 % | \$(4,339)        | (2.3)    | % |

#### Product Revenue

Product revenue decreased \$14.2 million, or 13%, to \$92.9 million during the nine months ended September 30, 2014 from \$107.1 million during the nine months ended September 30, 2013. Product revenue decreased \$7.2 million, \$3.8 million and \$3.5 million in the global retail, direct-to-consumer, and kiosk sales channels, respectively. The decrease in product revenue is driven by lower prices on our Rosetta Stone Version 4 TOTALe product software bundle driven by promotional pricing in our North America Consumer segment, increased levels of daily deals and a shift in our sales channel mix.

#### Subscription and Service Revenue

Subscription and service revenue increased \$9.9 million, or 12%, to \$89.7 million for the nine months ended September 30, 2014. The increase in subscription and service revenues was due to increases of \$9.6 million from Global Enterprise & Education language, \$5.9 million from Global Enterprise & Education literacy due to the acquisition of Lexia in August 2013, and \$1.6 million in Fit Brains service revenues. These increases were partially offset by a decrease of \$7.2 in consumer service revenues. Consumer online service revenue related to our Version 4 TOTALe bundle decreased due to the decline in the amount of revenue allocated to the subscription service beginning in the fourth quarter of 2014.

We are currently evaluating changes to our existing solutions as well as the introduction of new solutions, including additional solutions for kids. If we implement additional subscription-based solutions, it could result in lower revenues over the next twelve months as revenues would be spread over the subscription period.

#### Cost of Product Revenue and Subscription and Service Revenue and Gross Profit

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the nine months ended September 30, 2014 and 2013 (in thousands, except percentages):

|  | Nine Months Ended     |           | 2014 versus 2013 |          |    |
|--|-----------------------|-----------|------------------|----------|----|
|  | September 30,<br>2014 | 2013      | Change           | % Change |    |
| Revenue                                  |                       |           |                  |          |    |
| Product                                  | \$92,888              | \$107,087 | \$(14,199 )      | (13.3    | )% |
| Subscription and service                 | 89,707                | 79,847    | 9,860            | 12.3     | %  |
| Total revenue                            | 182,595               | 186,934   | (4,339 )         | (2.3     | )% |
| Cost of revenue                          |                       |           |                  |          |    |
| Cost of product revenue                  | 23,010                | 21,263    | 1,747            | 8.2      | %  |
| Cost of subscription and service revenue | 14,109                | 9,969     | 4,140            | 41.5     | %  |
| Total cost of revenue                    | 37,119                | 31,232    | 5,887            | 18.8     | %  |
| Gross profit                             | \$145,476             | \$155,702 | \$(10,226 )      | (6.6     | )% |
| Gross margin percentages                 | 79.7                  | % 83.3    | % (3.6           | )%       |    |

#### Cost of Product Revenue

Cost of product revenue for the nine months ended September 30, 2014 was \$23.0 million, an increase of \$1.7 million, or 8% from the nine months ended September 30, 2013. As a percentage of product revenue, cost of product revenue increased to 25% from 20% for the nine months ended September 30, 2014 compared to the same prior year period. The increase in cost as a percentage of revenue was primarily attributable to a decline in product revenue. The dollar increase in cost of product is primarily due to increased payroll and benefits as a result of the acquisitions that occurred during the first quarter of this year offset by a decrease in freight expense.

#### Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the nine months ended September 30, 2014 was \$14.1 million, an increase of \$4.1 million, or 42% from the nine months ended September 30, 2013. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 16% from 12% for the nine months ended September 30, 2014 compared to the same prior year period. The dollar increase in cost of subscription and service is due to increased payroll and benefits as a result of the acquisitions that occurred during the first quarter of this year, and second and third quarters of 2013 and, also an increase in hosting expense.

#### Operating Expenses

|                            | Nine Months Ended                  |           | 2014 versus 2013 |          |   |
|----------------------------|------------------------------------|-----------|------------------|----------|---|
|                            | September 30,<br>2014              | 2013      | Change           | % Change |   |
|                            | (in thousands, except percentages) |           |                  |          |   |
| Sales and marketing        | \$120,700                          | \$104,904 | \$15,796         | 15.1     | % |
| Research and development   | 25,830                             | 25,248    | 582              | 2.3      | % |
| General and administrative | 44,805                             | 40,209    | 4,596            | 11.4     | % |
| Goodwill impairment        | 2,199                              | —         | 2,199            | 100.0    | % |
| Lease abandonment          | 3,635                              | 835       | 2,800            | 335.3    | % |
| Total operating expenses   | \$197,169                          | \$171,196 | \$25,973         | 15.2     | % |

### Sales and Marketing Expenses

Sales and marketing expenses for the nine months ended September 30, 2014 were \$120.7 million, an increase of \$15.8 million, or 15% from the nine months ended September 30, 2013. As a percentage of total revenue, sales and marketing expenses increased to 66% from 56% for the nine months ended September 30, 2014 compared to the nine months ended September 30, 2013. The dollar and percentage increases in sales and marketing expenses were primarily attributable to a \$5.5 million increase in payroll and a \$1.3 million increase in benefits from the additions of Lexia, Tell Me More and Vivity, inclusive of severance expenses incurred in the US and Asia, during the first quarter of 2014. In addition, there was a \$7.0 million increase in marketing expense. The increased costs related to a "millennial" advertising campaign using newly developed creative which runs across television, videos and our website and an increase in general media expenses to drive visits, leads and bookings. The marketing campaigns were rolled out in the middle of Q3 2014 without much time to experience any increases in revenues or bookings within the period. A \$4.0 million increase in sales commissions was a result of the increase in Global Enterprise & Education revenue compared to the nine months ended September 30, 2013. There was a \$1.3 million increase in third party services driven from increased email messaging and related overage fees and an increase in depreciation and amortization due to the Lexia and Tell Me More intangible assets. These increases were partially offset by a \$2.3 million decrease in professional services driven from decreased spend in call centers, \$1.7 million decrease in rent and related lease termination expenses due to the closure of the remaining kiosks in Q2 2013, and removal of kiosk staffing support that did not recur in 2014. We expect to continue to incur sales and marketing expenses for the remainder of 2014 as we move into our holiday selling season. While the overall yield on marketing spend in our North America Consumer segment has declined, we expect that we will continue marketing and advertising media campaigns to generate sufficient web visits and leads in order to grow overall bookings.

### Research and Development Expenses

Research and development expenses were \$25.8 million for the nine months ended September 30, 2014, an increase of \$0.6 million, or 2%, from the nine months ended September 30, 2013. As a percentage of total revenue, research and development expenses remained flat at 14% for the nine months ended September 30, 2014 and the nine months ended September 30, 2013. The dollar increase was primarily attributable to a \$0.7 million increase in benefits due to the addition of Lexia and Tell Me More employees, a \$1.2 million increase in amortization expense driven from the addition of Tell Me More and Vivity acquired intangible assets, and a \$0.4 million increase in rent expense due to the opening of new offices in Austin, TX and San Francisco, CA, and taking over leases through acquisitions in various locations, including Seattle, WA, Concord, MA, and near Versailles, France. These increases were partially offset by a \$1.3 million decrease in payroll expense due to the increased level of capitalized labor costs associated with the development of new service offerings and a decrease in severance compensation expenses driven from the product development team re-organization during the nine months ended September 30, 2013.

### General and Administrative Expenses

General and administrative expenses for the nine months ended September 30, 2014 were \$44.8 million, an increase of \$4.6 million, or 11%, from the nine months ended September 30, 2013. As a percentage of revenue, general and administrative expenses increased to 25% for the nine months ended September 30, 2014 compared to 22% for the nine months ended September 30, 2013. The dollar and percentage increases were primarily attributable to a \$1.4 million increase in payroll and benefits due to the addition of Tell Me More and Vivity, partially offset by decreased restricted stock and stock option expenses as a result of the decrease in our stock price during the nine months ended September 30, 2014. In addition, general and administrative expense increased \$0.9 million primarily driven from international administrative costs, and \$0.4 million in professional services due to increased acquisition related consulting and integration work performed during the nine months ended September 30, 2014.

Bad debt expense increased \$1.3 million driven from increased accounts receivable aging.

### Goodwill Impairment

We recorded a goodwill impairment charge of \$2.2 million during the nine months ended September 30, 2014 related to our ROW Consumer reporting unit.

### Lease Abandonment and Termination

Lease abandonment and termination expenses for the nine months ended September 30, 2014 were \$3.6 million, compared to \$0.8 million for the nine months ended September 30, 2013. The increase is attributable to the lease abandonment

of the sixth floor space in the Arlington, VA office of \$3.2 million, as well as, the closure of the Japan office resulting in lease abandonment costs of \$0.4 million.

## Interest and Other Income (Expense)

|                              | Nine Months Ended<br>September 30, |        | 2014 Versus 2013 |           |
|------------------------------|------------------------------------|--------|------------------|-----------|
|                              | 2014                               | 2013   | Change           | % Change  |
|                              | (in thousands, except percentages) |        |                  |           |
| Interest income              | \$ 13                              | \$ 105 | \$ (92 )         | (87.6 )%  |
| Interest expense             | (153 )                             | (54 )  | (99 )            | 183.3 %   |
| Other income (expense)       | (772 )                             | 105    | (877 )           | (835.2 )% |
| Total other income (expense) | \$ (912 )                          | \$ 156 | \$ (1,068 )      | (684.6 )% |

Interest income represents interest earned on our cash and cash equivalents. Interest income for the nine months ended September 30, 2014 was \$13,000, a decrease of \$92,000 or 88%, from the nine months ended September 30, 2013. Interest expense for the nine months ended September 30, 2014 was \$153,000, an increase of \$99,000, or 183% from the nine months ended September 30, 2013. This increase was primarily attributable to interest on our capital leases. Other expense for the nine months ended September 30, 2014 was \$772,000, a decrease of \$877,000, as compared to other income of \$105,000 for the nine months ended September 30, 2013. This decrease was primarily attributable to foreign exchange losses.

## Income Tax (Benefit) Expense

|                      | Nine Months Ended<br>September 30, |            | 2014 versus 2013 |          |
|----------------------|------------------------------------|------------|------------------|----------|
|                      | 2014                               | 2013       | Change           | % Change |
|                      | (in thousands, except percentages) |            |                  |          |
| Income tax (benefit) | \$(435 )                           | \$(3,052 ) | \$ 2,617         | (85.7 )% |

Our income tax benefit for the nine months ended September 30, 2014 was \$0.4 million, compared to an income tax benefit of \$3.1 million for the nine months ended September 30, 2013. The change from the prior year primarily resulted from a partial valuation allowance release in the prior year. The benefit in the current year is made up of tax benefits related to current year losses in Canada and France and a tax benefit related to the goodwill impairment charge taken by the Company during the first quarter of 2014 related to the ROW Consumer reporting unit. The goodwill that was written off related to acquisitions from prior years, a portion of which resulted in a tax benefit as a result of writing off of a deferred tax liability previously recorded (i.e., goodwill had tax basis and was amortized for tax). These tax benefit amounts were offset by tax expense related to income from certain foreign operations.

### Liquidity and Capital Resources

Our primary operating cash requirements include the payment of salaries, incentive compensation, employee benefits and other personnel related costs, as well as direct advertising expenses, costs of office facilities and costs of information technology systems. We fund these requirements through cash flow from our operations.

We expect that our future growth may continue to require additional working capital. Our future capital requirements will depend on many factors, including development of new products, market acceptance of our products, the levels of advertising and promotion required to launch additional products and improve our competitive position in the marketplace, the expansion of our sales, support and marketing organizations, the establishment of additional offices in the United States and worldwide and building the infrastructure necessary to support our growth, the response of competitors to our products and our relationships with suppliers and clients. Also, as our Global Enterprise & Education segment grows, a larger portion of our sales transactions occurs at the end of the quarter.

On October 28, 2014, the Company entered into a \$25 million revolving credit Loan and Security Agreement with Silicon Valley Bank. The revolving credit agreement has a term of three (3) years during which the Company may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

Presently, no borrowings have been made under the revolving credit agreement.

We believe our current cash and cash equivalents, short term investments, credit facility, and funds generated from our operations will be sufficient to meet our working capital and capital expenditure requirements through the foreseeable future, including at least the next 12 months. Thereafter, we may need to raise additional funds through public or private financings or borrowings to develop or enhance products, to fund expansion, to respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing may not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders will be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders. No assurance can be given that additional financing will be available or that, if available, such financing can be obtained on terms favorable to our stockholders and us.

We anticipate that our expenditures will increase in the future as we expand our product base and accelerate our strategy through acquisitions. In addition, our business is affected by variations in seasonal trends. These seasonal trends create a situation in which we typically expend cash in the first and second quarters of the year and generate cash in the third and fourth quarters of the year. We expect this trend to continue. We believe that anticipated cash flows from operations, existing cash reserves, and credit facility will provide sufficient liquidity to fund our business and meet our obligations for at least the next 12 months. In addition, we extend payments to certain vendors in order to minimize the amount of working capital deployed in the business.

The total amount of cash that was held by foreign subsidiaries as of September 30, 2014 was \$13.8 million. If we were to repatriate the cash from our foreign subsidiaries, a significant tax liability could result.

### Cash Flow Analysis

#### Net Cash Used in Operating Activities

Net cash used in operating activities was \$12.1 million for the nine months ended September 30, 2014 compared to \$3.7 million for the nine months ended September 30, 2013, an increase of \$8.3 million. The increase in net cash used in operating activities was primarily due to the increase in our net loss after adjusting for depreciation, amortization, stock compensation, loss on foreign currency transactions, bad debt expense, deferred income taxes, loss on disposal of equipment and loss on goodwill impairment. Net loss, adjusted for those items, totaled \$32.4 million for the nine months ended September 30, 2014 compared to \$2.7 million for the nine months ended September 30, 2013. The increase in net loss was offset by favorable fluctuations in working capital, primarily deferred revenue of \$22.9



million which is principally due to the sales of subscriptions services in our Global Enterprise & Education literacy, Global Enterprise & Education language, and FitBrains businesses.

#### Net Cash Used in Investing Activities

Net cash used in investing activities was \$36.6 million for the nine months ended September 30, 2014, compared to \$32.1 million for the nine months ended September 30, 2013, an increase of \$4.5 million. Net cash used by investing activities related primarily to the \$41.7 million used for the acquisitions (net of cash acquired) of Vivity and Tell Me More, which was

offset by a payment of \$12.3 million, representing funds in escrow at year end related to the pending acquisition of Vivity, a payment of \$1.7 million of the accrued Lexia purchase price liability and \$7.2 million in purchases of property and equipment.

#### Net Cash Provided By Financing Activities

Net cash provided by financing activities was \$0.2 million for the nine months ended September 30, 2014 compared to \$0.9 million for the nine months ended September 30, 2013. Net cash provided by financing activities during the nine months ended September 30, 2014 was primarily due to proceeds from the exercise of stock options. During the last three years, inflation has not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

#### Off-Balance Sheet Arrangements

We do not engage in any off-balance sheet financing arrangements. We do not have any interest in entities referred to as variable interest entities, which include special purpose entities and other structured finance entities.

#### Contractual Obligations

The following table summarizes our contractual obligations at September 30, 2014 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

|                         | Total          | Less than<br>1 Year | 1-3 Years | 3-5 Years | More than<br>5 Years |
|-------------------------|----------------|---------------------|-----------|-----------|----------------------|
|                         | (in thousands) |                     |           |           |                      |
| Contractual obligations | \$ 14,501      | \$ 4,711            | \$ 6,578  | \$ 3,212  | \$—                  |

The operating lease obligations reflected in the table above include our corporate office leases.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

##### Foreign Currency Exchange Risk

The functional currency of our foreign subsidiaries is their local currency. Accordingly, our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. The volatility of the prices and applicable rates are dependent on many factors that we cannot forecast with reliable accuracy. In the event our foreign sales and expenses increase, our operating results may be more greatly affected by fluctuations in the exchange rates of the currencies with which we do business. At this time we do not, but we may in the future, invest in derivatives or other financial instruments in an attempt to hedge our foreign currency exchange risk.

##### Interest Rate Sensitivity

Interest income and expense are sensitive to changes in the general level of US interest rates. However, based on the nature and current level of our marketable securities, which are primarily short-term investment grade and government securities and our notes payable, we believe that there is no material risk of exposure.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2014. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of



September 30, 2014, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or 15d-15(d) of the Exchange Act that occurred during the quarter ended September 30, 2014 that had materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In June 2011, Rosetta Stone GmbH was served with a writ filed by Langenscheidt KG (“Langenscheidt”) in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone GmbH’s use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. In January 2012, the District Court of Cologne ordered an injunction of Rosetta Stone GmbH’s use of the color yellow in packaging, on its website and in television commercials and declared Rosetta Stone liable for damages, attorneys’ fees and costs to Langenscheidt. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH’s product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt’s trademark. The Court of Appeals in Cologne affirmed the District Court’s decision. Rosetta Stone GmbH appealed that decision on grounds of law to the German Federal Supreme Court which affirmed the lower court’s decision on September 18, 2014. The Company has filed special complaints with the German Federal Supreme Court and the German Constitutional Court directed to constitutional issues in the German Federal Supreme Court’s decision.

In August 2011, Rosetta Stone GmbH commenced a separate proceeding for the cancellation of Langenscheidt’s German trademark registration of yellow as an abstract color mark. In June 2012, the German Patent and Trademark Office rendered a decision in the cancellation proceeding denying our request to cancel Langenscheidt’s German trademark registration. Rosetta Stone GmbH filed an appeal on grounds of law to the German Federal Supreme Court. A hearing on the appeal was held and the German Federal Supreme Court rejected Rosetta Stone GmbH’s further appeal on October 23, 2014.

At this point, the Company cannot predict the amount of damages which Langenscheidt may ultimately be awarded based on the trademark infringement nor when any damages will be required to be paid. However, the Company has concluded that it will be required to pay court costs and opposing counsel fees and has recorded a liability of \$0.3 million as of September 30, 2014. The Company will continue to incur legal fees and other costs in connection with the resolution of this case.

From time to time, we have been subject to various claims and legal actions in the ordinary course of our business. We are not currently involved in any legal proceeding the ultimate outcome of which, in our judgment based on information currently available, would have a material impact on our business, financial condition or results of operations.

### Item 1A. Risk Factors

There have been no material changes to our risk factors contained in our Annual Report on Form 10-K filed on March 3, 2014 with the US Securities and Exchange Commission for the period ended December 31, 2013. For a further discussion of our Risk Factors, refer to the “Risk Factors” discussion contained in our Annual Report on Form 10-K for the period ended December 31, 2013.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

### Item 3. Defaults Upon Senior Securities

None.

### Item 4. Mine Safety Disclosures

Not applicable.

### Item 5. Other Information

None.

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Item 6. Exhibits

Exhibits

- 2.1 (1) Agreement and Plan of Merger by and among Rosetta Stone Ltd., Liberty Merger Sub Inc., Livemocha, Inc. and Shareholder Representative Services LLC, dated April 1, 2013.
- 3.1(2) Second Amended and Restated Certificate of Incorporation of the Company.
- 3.2(2) Second Amended and Restated Bylaws of the Company.
- 4.1(2) Specimen certificate evidencing shares of Common Stock of the Company.
- 4.3(2) Registration Rights Agreement dated January 4, 2006 among the Company and the Investor Shareholders and other Shareholders listed on Exhibit A thereto.
- 31.1\* Certification of Chief Executive Officer (Principal Executive Officer) Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer (Principal Accounting Officer) Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* Certification of Chief Executive Officer (Principal Executive Officer) Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\*\* Certification of Chief Financial Officer (Principal Accounting Officer) Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS\* XBRL Instance Document.
- 101.SCH\* XBRL Taxonomy Extension Schema.
- 101.CAL\* XBRL Taxonomy Extension Calculation Linkbase.
- 101.DEF\* XBRL Taxonomy Extension Definition Linkbase.
- 101.LAB\* XBRL Taxonomy Extension Label Linkbase.
- 101.PRE\* XBRL Taxonomy Extension Presentation Linkbase.

\* Filed herewith

\*\* Furnished herewith

(1) Incorporated by reference to exhibit filed with Registrant's Current Report on Form 8-K filed on April 2, 2013.

(2) Incorporated by reference to exhibit filed with Registrant's registration statement on Form S-1 (File No. 333-153632), as amended.

SIGNATURES

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

ROSETTA STONE INC.  
/s/ STEPHEN M. SWAD

Stephen M. Swad  
Chief Executive Officer

Date: November 5, 2014

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