

ROSETTA STONE INC  
Form 10-Q  
August 02, 2018  
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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 June 30, 2018

Commission file number: 1-34283

Rosetta Stone Inc.

(Exact name of registrant as specified in its charter)

Delaware 043837082  
(State of incorporation) (I.R.S. Employer  
Identification No.)

1621 North Kent Street, Suite 1200 22209  
Arlington, Virginia (Zip Code)  
(Address of principal executive offices)

703-387-5800

(Registrant’s telephone number, including area code)

N/A

(Former name or former address, if changed since last report)

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, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

|                          |                                     |                          |                           |                          |
|--------------------------|-------------------------------------|--------------------------|---------------------------|--------------------------|
| Large accelerated filer  | Accelerated filer                   | Non-accelerated filer    | Smaller reporting company | Emerging growth company  |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/>  | <input type="checkbox"/> |

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 July 27, 2018, there were 22,808,542 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)

(unaudited)

|  | June 30,<br>2018 | December 31,<br>2017 |
|--|------------------|----------------------|
| Assets   |                  |                      |
| Current assets:  |                  |                      |
| Cash and cash equivalents  | \$20,925         | \$ 42,964            |
| Restricted cash  | 73               | 72                   |
| Accounts receivable (net of allowance for doubtful accounts of \$342 and \$375, at June 30, 2018 and December 31, 2017, respectively)  | 23,253           | 24,517               |
| Inventory  | 2,114            | 3,536                |
| Deferred sales commissions   | 9,495            | 14,466               |
| Prepaid expenses and other current assets  | 4,357            | 4,543                |
| Total current assets   | 60,217           | 90,098               |
| Deferred sales commissions   | 6,614            | 3,306                |
| Property and equipment, net  | 33,550           | 30,649               |
| Goodwill   | 49,471           | 49,857               |
| Intangible assets, net   | 17,369           | 19,184               |
| Other assets   | 2,027            | 1,661                |
| Total assets   | \$ 169,248       | \$ 194,755           |
| Liabilities and stockholders' (deficit) equity   |                  |                      |
| Current liabilities:   |                  |                      |
| Accounts payable   | \$10,557         | \$ 8,984             |
| Accrued compensation   | 6,336            | 10,948               |
| Income tax payable   | 48               | 384                  |
| Obligations under capital lease  | 452              | 450                  |
| Other current liabilities  | 12,628           | 16,454               |
| Deferred revenue   | 93,530           | 110,670              |
| Total current liabilities  | 123,551          | 147,890              |
| Deferred revenue   | 46,187           | 40,593               |
| Deferred income taxes  | 2,084            | 1,968                |
| Obligations under capital lease  | 1,589            | 1,850                |
| Other long-term liabilities  | 32               | 31                   |
| Total liabilities  | 173,443          | 192,332              |
| Commitments and contingencies (Note 15)  |                  |                      |
| Stockholders' (deficit) equity:  |                  |                      |
| Preferred stock, \$0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively  | —                | —                    |
| Non-designated common stock, \$0.00005 par value, 190,000 and 190,000 shares authorized, 24,262 and 23,783 shares issued and 23,262 and 22,783 shares outstanding at June 30, 2018 and December 31, 2017, respectively | 2                | 2                    |
| Additional paid-in capital   | 198,896          | 195,644              |
| Accumulated loss   | (188,679 )       | (178,890 )           |
| Accumulated other comprehensive loss   | (2,979 )         | (2,898 )             |

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|  |           |            |
|--|-----------|------------|
| Treasury stock, at cost, 1,000 and 1,000 shares at June 30, 2018 and December 31, 2017, respectively | (11,435 ) | (11,435 )  |
| Total stockholders' (deficit) equity   | (4,195 )  | 2,423      |
| Total liabilities and stockholders' (deficit) equity   | \$169,248 | \$ 194,755 |

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      |            | Six Months Ended |           |
|--|-------------------|------------|------------------|-----------|
|  | Ended<br>June 30, |            | June 30,         |           |
|  | 2018              | 2017       | 2018             | 2017      |
| Revenue:                                   |                   |            |                  |           |
| Subscription and service                   | \$42,678          | \$41,985   | \$84,176         | \$83,435  |
| Product                                    | 824               | 3,920      | 2,134            | 10,163    |
| Total revenue                              | 43,502            | 45,905     | 86,310           | 93,598    |
| Cost of revenue:                           |                   |            |                  |           |
| Cost of subscription and service revenue   | 7,258             | 6,058      | 14,632           | 12,592    |
| Cost of product revenue                    | 672               | 1,533      | 2,732            | 3,140     |
| Total cost of revenue                      | 7,930             | 7,591      | 17,364           | 15,732    |
| Gross profit                               | 35,572            | 38,314     | 68,946           | 77,866    |
| Operating expenses:                        |                   |            |                  |           |
| Sales and marketing                        | 24,874            | 24,037     | 49,065           | 48,205    |
| Research and development                   | 6,019             | 6,348      | 12,325           | 12,762    |
| General and administrative                 | 8,324             | 8,594      | 16,856           | 16,619    |
| Total operating expenses                   | 39,217            | 38,979     | 78,246           | 77,586    |
| (Loss) income from operations              | (3,645 )          | (665 )     | (9,300 )         | 280       |
| Other income and (expense):                |                   |            |                  |           |
| Interest income                            | 23                | 17         | 48               | 30        |
| Interest expense                           | (81 )             | (130 )     | (164 )           | (245 )    |
| Other income and (expense)                 | (1 )              | 425        | (229 )           | 736       |
| Total other income and (expense)           | (59 )             | 312        | (345 )           | 521       |
| (Loss) income before income taxes          | (3,704 )          | (353 )     | (9,645 )         | 801       |
| Income tax expense                         | 454               | 782        | 915              | 1,482     |
| Net loss                                   | \$(4,158 )        | \$(1,135 ) | \$(10,560 )      | \$(681 )  |
| Loss per share:                            |                   |            |                  |           |
| Basic                                      | \$(0.18 )         | \$(0.05 )  | \$(0.47 )        | \$(0.03 ) |
| Diluted                                    | \$(0.18 )         | \$(0.05 )  | \$(0.47 )        | \$(0.03 ) |
| Common shares and equivalents outstanding: |                   |            |                  |           |
| Basic weighted average shares              | 22,663            | 22,248     | 22,561           | 22,187    |
| Diluted weighted average shares            | 22,663            | 22,248     | 22,561           | 22,187    |

See accompanying notes to consolidated financial statements

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(in thousands)

(unaudited)

|  | Three Months |            | Six Months  |          |
|--|--------------|------------|-------------|----------|
|  | Ended        |            | Ended       |          |
|  | June 30,     |            | June 30,    |          |
|  | 2018         | 2017       | 2018        | 2017     |
| Net loss                                       | \$ (4,158)   | \$ (1,135) | \$ (10,560) | \$ (681) |
| Other comprehensive (loss) income, net of tax: |              |            |             |          |
| Foreign currency translation (loss) gain       | (610 )       | 377        | (81 )       | 334      |
| Other comprehensive (loss) income              | (610 )       | 377        | (81 )       | 334      |
| Comprehensive loss                             | \$ (4,768)   | \$ (758 )  | \$ (10,641) | \$ (347) |

See accompanying notes to consolidated financial statements

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

|  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2018                         | 2017      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                   |                              |           |
| Net loss   | \$(10,560)                   | \$(681 )  |
| Adjustments to reconcile net loss to cash used in operating activities:        |                              |           |
| Stock-based compensation expense   | 1,936                        | 1,506     |
| Loss (gain) on foreign currency transactions                                   | 120                          | (452 )    |
| Bad debt expense (recovery)  | 61                           | (300 )    |
| Depreciation and amortization  | 7,089                        | 6,062     |
| Deferred income tax expense  | 117                          | 630       |
| Gain on disposal of equipment  | (17 )                        | —         |
| Amortization of deferred financing fees  | 68                           | 156       |
| Loss from equity method investments  | —                            | 100       |
| Gain on sale of subsidiary   | —                            | (506 )    |
| Net change in:   |                              |           |
| Accounts receivable  | 1,131                        | 4,195     |
| Inventory  | 1,423                        | 932       |
| Deferred sales commissions   | 1,648                        | 2,127     |
| Prepaid expenses and other current assets                                      | 90                           | (671 )    |
| Income tax receivable or payable   | (347 )                       | (245 )    |
| Other assets   | (401 )                       | 192       |
| Accounts payable   | 1,609                        | (1,254 )  |
| Accrued compensation   | (4,588 )                     | (3,397 )  |
| Other current liabilities  | (3,548 )                     | (5,652 )  |
| Other long-term liabilities  | —                            | (485 )    |
| Deferred revenue   | (10,565 )                    | (7,257 )  |
| Net cash used in operating activities  | (14,734 )                    | (5,000 )  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                   |                              |           |
| Purchases of property and equipment  | (8,136 )                     | (5,393 )  |
| Proceeds from sale of fixed assets   | 17                           | 2         |
| Proceeds from the sale of subsidiary   | —                            | 110       |
| Net cash used in investing activities  | (8,119 )                     | (5,281 )  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                   |                              |           |
| Proceeds from the exercise of stock options                                    | 1,316                        | 441       |
| Payment of deferred financing costs  | —                            | (143 )    |
| Payments under capital lease obligations                                       | (225 )                       | (344 )    |
| Net cash provided by (used in) financing activities                            | 1,091                        | (46 )     |
| Decrease in cash, cash equivalents, and restricted cash                        | (21,762 )                    | (10,327 ) |
| Effect of exchange rate changes in cash, cash equivalents, and restricted cash | (276 )                       | 138       |
| Net decrease in cash, cash equivalents, and restricted cash                    | (22,038 )                    | (10,189 ) |
| Cash, cash equivalents, and restricted cash - beginning of period              | 43,036                       | 36,597    |
| Cash, cash equivalents, and restricted cash - end of period                    | \$20,998                     | \$26,408  |
| <b>SUPPLEMENTAL CASH FLOW DISCLOSURE:</b>                                      |                              |           |
| Cash paid during the periods for:  |                              |           |



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|   |         |         |
|---|---------|---------|
| Interest  | \$97    | \$89    |
| Income taxes, net of refunds                                | \$1,028 | \$1,037 |
| Noncash financing and investing activities:                 |         |         |
| Accrued liability for purchase of property and equipment    | \$1,068 | \$690   |
| Equipment acquired under capital lease                      | \$25    | \$—     |
| See accompanying notes to consolidated financial statements |         |         |

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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-learning and literacy solutions consisting of web-based software subscriptions, perpetual software products, online and professional services, audio practice products and mobile applications. The Company's offerings are sold on a direct basis and through select third party retailers and distributors. The Company provides its solutions to customers through the sale of web-based software subscriptions and packaged software, 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.

Basis of Presentation

The accompanying consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and applicable rules and regulations of the Securities and Exchange Commission ("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 most recent Annual Report on Form 10-K filed with the SEC on March 14, 2017. The June 30, 2018 consolidated balance sheet included herein includes account balances as of December 31, 2017 that were derived from the audited financial statements as of that date. The Consolidated Financial Statements and the Notes to the Consolidated Financial Statements do not include all disclosures required for annual financial statements and notes.

As discussed in this Note 2, the Company adopted certain recently issued accounting standards effective January 1, 2018. The new revenue recognition standard ("ASC 606") was adopted using the modified retrospective method. As such, the comparative information has not been restated under ASC 606 and continues to be reported under the accounting standards in effect for those prior comparative periods. See the Company's Annual Report on Form 10-K filed with the SEC on March 14, 2017 for revenue recognition policies that were in effect in prior periods before adoption of ASC 606. Additionally, accounting standard update 2016-18 ("ASU 2016-18") related to the presentation of restricted cash in the statements of cash flow was adopted retrospectively for all comparative periods.

Except as noted above, 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 statements of financial position at June 30, 2018 and December 31, 2017, the Company's results of operations for the three and six months ended June 30, 2018 and 2017 and its cash flows for the six months ended June 30, 2018 and 2017 have been made. The results for the three and six months ended June 30, 2018 are not necessarily indicative of the results to be expected for the year ending December 31, 2018. All references to June 30, 2018 or to the three and six months ended June 30, 2018 and 2017 in the notes to the consolidated financial statements are unaudited.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make certain estimates and assumptions. The amounts reported in the consolidated financial statements include significant estimates and assumptions that have been made, including, but not limited to, those related to revenue recognition, allowance for doubtful accounts, estimated sales returns and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, disclosure of contingent assets and liabilities, disclosure of contingent litigation, allowance for valuation of deferred tax assets, and the Company's quarterly going concern assessment. The Company bases its

estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Recently Issued Accounting Standards

Accounting Standards Adopted During the Period: During 2018, the Company adopted the following recently issued Accounting Standard Updates ("ASU"):

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230) Restricted Cash a consensus of the FASB Emerging Issues Task Force. Under ASU 2016-18, amounts generally described as restricted cash should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statements of cash flows. The Company retrospectively adopted ASU 2016-18 beginning January 1, 2018. The Company does not consider its restricted cash balances to be material for further disclosure or reconciliation. The adoption of this guidance did not impact the Company's consolidated financial position, results of operations, or footnote disclosures.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("ASU 2018-02").

ASU 2018-02 provided financial statement preparers with an option to reclassify stranded tax effects within accumulated other comprehensive income to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act of 2017 (or portion thereof) was recorded. ASU 2018-02 is effective for fiscal years beginning after December 15, 2018. Early adoption is permitted for any interim period for which financial statements have not been issued. The Company adopted ASU 2018-02 effective January 1, 2018. Due to the presence of a full valuation allowance, adoption did not have a material impact on the Company's consolidated financial statements and the disclosure requirements under ASU 2018-02 were not applicable.

In May 2014, the FASB issued ASC 606 which provided a new standard related to revenue recognition. Under ASC 606, revenue is recognized when a customer obtains control of promised goods or services in an amount that reflects the consideration the entity expects to receive in exchange for those goods or services. In addition, the standard requires disclosure of the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

The Company adopted ASC 606 effective January 1, 2018. As a result, the Company has changed its accounting for revenue. The Company adopted ASC 606 using the modified retrospective method applied using hindsight to those contracts that were not complete as of January 1, 2018. The cumulative effect of initially applying ASC 606 totaled \$0.8 million and was recognized as an adjustment to reduce the opening balance of accumulated loss at January 1, 2018. The comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods.

The Company implemented or modified certain internal controls and key system functionality to enable the preparation of financial information under ASC 606.

The most significant impact of ASC 606 to the Company related to the accounting for offerings that contained perpetual software for which customers took possession, which occurs only in the Company's Consumer Language segment. Prior to the adoption of ASC 606, revenue was recognized at the time of delivery for these perpetual software products due to the fact that the Company had established vendor specific objective evidence of the fair value ("VSOE") for the undelivered services in the arrangement. To the extent that VSOE was not established for undelivered services bundled with perpetual software, all revenue was deferred and recognized as the services were provided. Under the new guidance in ASC 606, the requirement to establish VSOE of the undelivered services in order to recognize revenue at the time of delivery no longer exists and revenue is allocated to performance obligations by estimating the standalone selling price and using a relative value allocation method. Revenue recognition related to subscription services and professional services remained substantially unchanged. Adoption had no tax impact due to the presence of a full valuation allowance. The impact of adoption to the Company's consolidated statement of operations for the three and six months ended June 30, 2018 was as follows (in thousands):



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

| Consolidated Statement of Operations Data: | Three Months Ended June 30, 2018 |                                 |                                      | Six Months Ended June 30, 2018 |                                 |                                      |
|--|----------------------------------|---------------------------------|--------------------------------------|--------------------------------|---------------------------------|--------------------------------------|
|  | As reported                      | Effect of change higher/(lower) | Balances without adoption of ASC 606 | As reported                    | Effect of change higher/(lower) | Balances without adoption of ASC 606 |
| Revenue:                                   |                                  |                                 |                                      |                                |                                 |                                      |
| Subscription and service                   | \$42,678                         | \$ (57 )                        | \$42,735                             | \$84,176                       | \$ (306 )                       | \$84,482                             |
| Product                                    | 824                              | 311                             | 513                                  | 2,134                          | 1,355                           | 779                                  |
| Total revenue                              | 43,502                           | 254                             | 43,248                               | 86,310                         | 1,049                           | 85,261                               |
| Gross profit                               | 35,572                           | 254                             | 35,318                               | 68,946                         | 1,049                           | 67,897                               |
| Loss from operations                       | (3,645 )                         | 254                             | (3,899 )                             | (9,300 )                       | 1,049                           | (10,349 )                            |
| Loss before income taxes                   | (3,704 )                         | 254                             | (3,958 )                             | (9,645 )                       | 1,049                           | (10,694 )                            |
| Net loss                                   | \$(4,158 )                       | \$ 254                          | \$(4,412 )                           | \$(10,560 )                    | \$ 1,049                        | \$(11,609 )                          |

Adoption of ASC 606 had impacts to the consolidated balance sheet as well, primarily related to the presentation of deferred commissions and the reduction to deferred revenue. The Company's prior methodology was to bifurcate deferred commissions between current and non-current classifications. Under ASC 606, deferred commissions are classified as non-current unless the original amortization period is one year or less. Deferred revenue decreased on adoption of ASC 606 due to the changes in the timing of revenue recognition noted above. The impact of adoption to the Company's consolidated balance sheet as of June 30, 2018 was as follows (in thousands):

As of June 30, 2018

| Consolidated Balance Sheet Data:       | As reported | Effect of change higher/(lower) | Balances without adoption of ASC 606 |
|--|-------------|---------------------------------|--------------------------------------|
| Deferred sales commissions current     | 9,495       | (3,583 )                        | 13,078                               |
| Total current assets                   | 60,217      | (3,583 )                        | 63,800                               |
| Deferred sales commissions non-current | 6,614       | 3,583                           | 3,031                                |
| Other current liabilities              | 12,628      | (171 )                          | 12,799                               |
| Deferred revenue current               | 93,530      | (1,649 )                        | 95,179                               |
| Total current liabilities              | 123,551     | (1,820 )                        | 125,371                              |
| Total liabilities                      | 173,443     | (1,820 )                        | 175,263                              |
| Accumulated loss                       | (188,679)   | 1,820                           | (190,499)                            |
| Total stockholders' deficit            | (4,195 )    | 1,820                           | (6,015 )                             |

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The impact of adoption to the Company's reportable segments for the three and six months ended June 30, 2018 was as follows (in thousands):

| Consolidated Segment Data:              | Three Months Ended June 30, 2018 |                                 |                                      | Six Months Ended June 30, 2018 |                                 |                                      |
|---|----------------------------------|---------------------------------|--------------------------------------|--------------------------------|---------------------------------|--------------------------------------|
|   | As reported                      | Effect of change higher/(lower) | Balances without adoption of ASC 606 | As reported                    | Effect of change higher/(lower) | Balances without adoption of ASC 606 |
| Revenue by Segment:                     |                                  |                                 |                                      |                                |                                 |                                      |
| Literacy                                | \$12,695                         | \$ 79                           | \$12,616                             | \$25,079                       | \$ 113                          | \$24,966                             |
| Enterprise & Education ("E&E") Language | 15,356                           | (14 )                           | 15,370                               | 30,792                         | 22                              | 30,770                               |
| Consumer Language                       | 15,451                           | 189                             | 15,262                               | 30,439                         | 914                             | 29,525                               |
| Total revenue                           | \$43,502                         | \$ 254                          | \$43,248                             | \$86,310                       | \$ 1,049                        | \$85,261                             |

Accounting Standards Not Yet Adopted: The following ASUs were recently issued but have not yet been adopted by the Company:

In January 2017, the FASB issued ASU No. 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment ("ASU 2017-04"). ASU 2017-04 simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. ASU 2017-04 is effective for annual and interim goodwill tests beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates on or after January 1, 2017. The Company is in the process of evaluating the guidance. Given the prospective adoption application, there is no impact on the Company's historical consolidated financial statements and disclosures.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes the methodology for measuring credit losses of financial instruments and the timing of when such losses are recorded. ASU 2016-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures. However based on a preliminary assessment and as the Company does not hold significant financial instruments, the Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02") that requires lessees to recognize assets and liabilities for most leases. In July 2018, the FASB issued ASU No. 2018-10, Leases (Topic 842): Codification Improvements which impacts narrow aspects of the guidance issued under ASU 2016-02. In July 2018, the FASB issued ASU No. 2018-11, Leases (Topic 842): Targeted Improvements which provides a new transition method and a practical expedient for separating components of a contract. Collectively these ASUs comprise the new lease standard ("New Lease Standard"). Under the New Lease Standard, entities will be required to record most leases on their balance sheets. A lessee would recognize a lease liability for the obligation to make lease payments and a right-of-use asset for the right to use the underlying asset for the lease term. Lease expense recognition is largely unchanged. The New Lease Standard is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted, however the Company does not expect to early adopt this guidance. The New Lease Standard is required to be adopted using a modified retrospective approach. The Company expects to recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption and continue to report comparative prior period information under the accounting standards in effect for those prior comparative periods. The Company expects its leases designated as operating leases

in Note 15, "Commitments and Contingencies," will be reported on the consolidated balance sheets upon adoption. The Company is in the process of evaluating the other impacts of the new guidance on the Company's consolidated financial statements and disclosures.

Revenue Recognition

Nature of Revenue: The Company accounts for revenue contracts with customers by applying the requirements of ASC 606, which includes the following steps:

1. Identification of the contract, or contracts with a customer.



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Identification of the performance obligations in the contract.

Determination of the transaction price.

Allocation of the transaction price to the performance obligations in the contract.

Recognition of the revenue when, or as, the Company satisfies a performance obligation.

The Company's primary sources of revenue are web-based software subscriptions, mobile application, online services, perpetual product software, and bundles of perpetual product software and online services. The Company also generates revenue from the sale of audio practice products and professional services.

Revenue is recognized upon transfer of control of promised goods or services to customers in an amount that reflects the consideration expected to be received in exchange for those goods or services. Revenue is recognized net of allowances for returns. Revenue is also recognized net of any taxes collected from customers, which are subsequently remitted to governmental authorities.

Subscription and service revenue consists of fees associated with non-cancellable web-based software subscriptions, online services, professional services, and mobile applications. Subscription revenue is generated from contracts with customers that provide access to hosted software over a contract term without the customer taking possession of the software. Subscription revenue is recognized ratably over the contract period as the performance obligation is satisfied. Subscription revenue is generated by all three reportable segments and range from short-term to multi-year contracts. Online services are typically sold in short-term service periods and include dedicated online conversational coaching services and access to online communities of language learners. Professional services include implementation services. Online services revenue and professional services revenue are recognized as the services are provided. Expired services are forfeited and revenue is recognized upon expiry.

Product revenue primarily consists of revenue from perpetual language-learning software and audio practice products. Audio practice products are often combined with language-learning software and sold as a solution. Perpetual software revenue is recognized at the point in time when the software is made available to the customer. Audio practice products are recognized at the point in time that the audio practice products are delivered to the customer. As post-contract support ("PCS") is provided to customers who purchase perpetual software at no charge, a portion of the transaction price is allocated to PCS service revenue and recognized as the PCS services are provided, which is typically up to three months from the date of purchase.

See Note 16 - "Segment Information" for further information on the disaggregation of revenue, including revenue by reportable segment, geographic area, and revenue type.

**Performance Obligations:** A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account in ASC 606. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied. The Company's performance obligations are satisfied at a point in time or over time as delivery occurs or as work progresses.

**Significant Judgments:** Some of the Company's contracts with customers include promises to transfer multiple products and services to a customer. Determining whether products and services are considered distinct performance obligations that should be accounted for separately, versus together, requires significant judgment. This includes determining whether distinct services are part of a series of distinct services that are substantially the same. When subscription services are sold with professional services, judgment is required to determine whether the professional services are distinct and can be accounted for separately. In the E&E Language segment, the Company has concluded that each promised service within the language-learning subscription is delivered concurrently with all other promised services over the contract term and, as such, concluded that these promises are a single performance obligation that includes a series of distinct services that have the same pattern of transfer to the customer. When there are multiple performance obligations, revenue is allocated to each performance obligation based on its relative standalone selling price ("SSP"). Judgment is required to determine the SSP for each distinct performance obligation where SSP is not directly observable, such as when the product or service is not sold separately, SSP is determined using internally published price lists which include suggested sales prices for each performance obligation based on the type of client

and volume purchased. These price lists are derived from past experience and from the expectation of obtaining a reasonable margin based on the cost to fulfill each performance obligation.

Subscription revenue is recognized ratably over the contract period as the performance obligation is satisfied. Certain Consumer Language offerings have contracts with no fixed duration and are marketed as lifetime subscriptions. For these lifetime subscriptions, the Company estimates the expected contract period as the greater of the typical customer usage period

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

or the longest fixed-period duration subscription that is currently marketed. The Company's current expected contract period for lifetime subscriptions is 24 months.

Certain Consumer Language offerings are sold with a right of return and the Company may provide other credits or incentives. These rights are accounted for as variable consideration when estimating the amount of revenue to recognize by utilizing the expected value method. Returns and credits are estimated at contract inception based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors. Reserves for returns and credits are updated at the end of each reporting period as additional information becomes available.

The Company distributes its products and services both directly to the end customer and indirectly through resellers. Resellers earn commissions generally calculated as a fixed percentage of the gross sale amount to the end customer. The Company evaluates each of its reseller relationships to determine whether it is the principal (where revenue is recognized at the gross amount) or agent (where revenue is recognized net of the reseller commission). In making this determination the Company evaluates a variety of factors including the amount of control the Company is able to exercise over the transactions.

Contract Balances: The timing of revenue recognition, invoicing, and cash collection results in accounts receivable and deferred revenue in the consolidated balance sheets. Payment from customers is often received in advance of services being provided, resulting in deferred revenue. Accounts receivable is recorded when there is an executed customer contract and the right to the consideration becomes unconditional. Contract assets such as unbilled receivables are not material.

The allowance for doubtful accounts reflects the best estimate of probable losses inherent in the accounts receivable balance. The Company establishes an allowance for doubtful accounts based on specific risks identified, historical experience, and other currently available evidence.

Payment terms and conditions vary by contract type and customer. For the E&E Language and Literacy segments, payment terms generally range from 30 to 90 days. In the Consumer Language segment, resellers are generally granted payment terms of 45 days. Within Consumer Language, sales to end customers via the Rosetta Stone ecommerce website are done by credit card, which generally are settled within 7-10 days and may be made in installments. In instances where the timing of revenue recognition differs from the timing of invoicing, the Company has determined that contracts generally do not include a significant financing component. The primary purpose of invoicing terms is to provide customers with simplified and predictable ways of purchasing products and services and not to provide customers with financing.

Deferred revenue is comprised mainly of unearned revenue related to subscription services which is recognized ratably over the subscription period. Deferred revenue also includes payments for professional services and online services to be performed in the future which are earned as revenue when the service is provided. Our practice is to ship our products promptly upon receipt of purchase orders from customers; consequently, contract backlog is not material.

The opening and closing balances of the Company's accounts receivable and deferred revenue are as follows:

|                                       | Accounts<br>Receivable | Deferred<br>Revenue<br>(current) | Deferred<br>Revenue<br>(non-current) |
|---------------------------------------|------------------------|----------------------------------|--------------------------------------|
| Opening balance as of January 1, 2018 | \$ 24,517              | \$ 110,670                       | \$ 40,593                            |
| Increase/(decrease), net              | (1,264 )               | (17,140 )                        | 5,594                                |
| Ending balance as of June 30, 2018    | \$ 23,253              | \$ 93,530                        | \$ 46,187                            |

The amount of revenue recognized in the three months ended June 30, 2018 that was included in the opening April 1, 2018 deferred revenue balance was \$38.4 million. The amount of revenue recognized in six months ended June 30, 2018 that was included in the opening January 1, 2018 deferred revenue balance was \$71.9 million. The vast majority of this revenue consists of deferred subscription revenue. The amount of revenue recognized from performance

obligations satisfied in prior periods was not material.

The following table sets forth deferred revenue by reportable segment which represents the Company's unfulfilled performance obligations as of June 30, 2018 and the estimated revenue expected to be recognized in the future related to these performance obligations:

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

|                   | As of June 30, 2018 |                        |              |              |                         |
|-------------------|---------------------|------------------------|--------------|--------------|-------------------------|
|                   | Total               | Less<br>than<br>1 Year | 1-3<br>Years | 3-5<br>Years | More<br>than<br>5 Years |
| Literacy          | \$31,364            | \$22,673               | \$8,123      | \$534        | \$34                    |
| E&E Language      | 54,242              | 40,304                 | 11,327       | 2,378        | 233                     |
| Consumer Language | 54,111              | 30,553                 | 9,600        | 1,764        | 12,194                  |
| Total             | \$139,717           | \$93,530               | \$29,050     | \$4,676      | \$12,461                |

The Company entered into a series of agreements with SOURCENEXT Corporation, (“SOURCENEXT”), comprising a single performance obligation associated with the perpetual license of certain intellectual property, software, and product code for exclusive development and sale of language and education-related products in Japan. The Company estimated a 20 year period to recognize the performance obligation. As of June 30, 2018, deferred revenue associated with SOURCENEXT totaled \$16.6 million, which will be recognized ratably through April 2037 and comprised the majority of the Consumer Language non-current deferred revenue. As this customer relationship progresses, the Company will prospectively reassess the recognition period as needed.

Assets Recognized from Costs to Obtain a Contract with a Customer: The Company recognizes an asset for the incremental costs of obtaining a contract with a customer, which primarily represents sales commissions paid when a customer contract is either recorded as revenue or deferred revenue. Sales commissions paid to obtain non-cancellable subscription contracts are deferred and amortized in proportion to the period over which the revenue is recognized from the related contract. Deferred sales commissions are amortized to Sales and marketing expense on the consolidated statements of operations. Deferred sales commissions are classified as non-current unless the associated amortization period is one year or less. As of June 30, 2018, the total deferred sales commissions balance was \$16.1 million. Amortization of deferred sales commissions recognized during the three months ended June 30, 2018 was \$5.6 million. Amortization of deferred sales commission recognized during the six months ended June 30, 2018 was \$11.0 million.

**Restructuring Costs**

Restructuring plans were initiated in 2015, 2016 and 2017 to reduce headcount and other costs in order to support the strategic shift in business focus. In connection with these plans, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included within Cost of sales and Sales and marketing, Research and development, and General and administrative operating expense categories in the Company's consolidated statements of operations.

Employee severance and related benefit costs primarily include cash payments, outplacement services, continuing health insurance coverage, and other benefits. Where no substantive involuntary termination plan previously existed, these severance costs are generally considered “one-time” benefits and recognized at fair value in the period in which a detailed plan has been approved by management and communicated to the terminated employees. Severance costs pursuant to ongoing benefit arrangements, including termination benefits provided for in existing employment contracts, are recognized when probable and reasonably estimable.

Contract termination costs include penalties to cancel certain service and license contracts and costs to terminate operating leases. Contract termination costs are recognized at fair value in the period in which the contract is terminated in accordance with the contract terms.

Other related costs generally include external consulting and legal costs associated with the strategic shift in business focus. Such costs are recognized at fair value in the period in which the costs are incurred. See Note 13

"Restructuring" for additional disclosures.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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. See Note 10 "Income Taxes" for additional disclosures including the impact and additional disclosures associated with the recent Tax Cuts and Jobs Act of 2017 enacted on December 22, 2017.

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of June 30, 2018. 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, 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 topic 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.

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance with 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. For options granted with service and/or performance conditions, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model. For options granted with market-based conditions, the fair value of each grant is estimated on the date of grant using the Monte-Carlo simulation model. These methods require the use of estimates, including future stock price volatility, expected term and forfeitures.

As the Company does not have sufficient historical option exercise experience that spans the full 10-year contractual term for determining the expected term of options granted, the Company estimates the expected term of options using a combination of historical information and the simplified method for estimating the expected term. The Company uses its own historical stock price data to estimate its forfeiture rate and expected volatility over the most recent period commensurate with

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

the estimated expected term of the awards. For the risk-free interest rate, the Company uses a U.S. 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. Stock compensation expense associated with service-based equity awards is recognized in the statements of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statements of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. Changes in the probability estimates associated with performance-based awards will be accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimates. In any period in which the Company determines that achievement of the performance metrics is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the performance-based award is reversed. For equity awards granted with market-based conditions, stock compensation expense is recognized in the statements of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions. See Note 11 "Stock-Based Compensation" for additional disclosures.

**Basic and Diluted 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 by dividing net loss by the weighted average number of common shares outstanding during the period. Diluted loss per share is computed by dividing net loss by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares are included in the diluted computation when dilutive. Potentially dilutive shares are computed using the treasury stock method and primarily 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. When there is a net loss, there is a presumption that there are no dilutive shares as these would be anti-dilutive. See Note 3 "Basic and Diluted Net Loss Per Share" for additional disclosures.

**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 U.S. 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 accumulated other comprehensive loss in stockholders' (deficit) equity.

Cash flows of consolidated foreign subsidiaries, whose functional currency is their local currency, are translated to U.S. 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, cash equivalents and restricted cash during the period.

The following table presents the effect of exchange rate changes on total comprehensive (loss) income (in thousands):

|  | Three Months |           | Six Months |         |
|--|--------------|-----------|------------|---------|
|  | Ended        |           | Ended      |         |
|  | June 30,     |           | June 30,   |         |
|  | 2018         | 2017      | 2018       | 2017    |
| Net loss                                 | \$(4,158)    | \$(1,135) | \$(10,560) | \$(681) |
| Foreign currency translation (loss) gain | (610 )       | 377       | (81 )      | 334     |
| Comprehensive loss                       | \$(4,768)    | \$(758 )  | \$(10,641) | \$(347) |
| Comprehensive Loss                       |              |           |            |         |

Comprehensive loss consists of net loss and other comprehensive (loss) income. Other comprehensive (loss) income refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' (deficit) equity. For the three and six months ended June 30, 2018 and 2017, the Company's comprehensive loss consisted of net loss and foreign currency translation (losses) and gains.



The other comprehensive (loss) income presented in the consolidated financial statements and the notes are presented net of tax. There has been no tax expense or benefit associated with the components of other comprehensive (loss) income due to the presence of a full valuation allowance for each of the three and six months ended June 30, 2018 and 2017.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three months ended June 30, 2018 and June 30, 2017 was \$5.7 million and \$6.2 million, respectively. Advertising expense for the six months ended June 30, 2018 and June 30, 2017 was \$11.7 million and \$12.8 million, respectively.

Going Concern Assessment

As part of its internal control framework, the Company routinely performs a quarterly going concern assessment in accordance with ASC sub-topic 205-40, Presentation of Financial Statements - Going Concern ("ASC 205-40"). Under ASC 205-40, management is required to assess the Company's ability to continue as a going concern. As further described below, management has concluded based on projections that the cash balance, funds available from the line of credit, and the cash flows from operations are sufficient to meet the liquidity needs through the one year period following the financial statement issuance date.

The consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Management has evaluated whether relevant conditions or events, considered in the aggregate, indicate that there is substantial doubt about the Company's ability to continue as a going concern. Substantial doubt exists when conditions and events, considered in the aggregate, indicate it is probable that the Company will be unable to meet its obligations as they become due within one year after the financial statement issuance date. The assessment is based on the relevant conditions that are known or reasonably knowable as of August 2, 2018.

The assessment of the Company's ability to meet its future obligations is inherently judgmental, subjective and susceptible to change. The inputs that are considered important in the Company's going concern analysis, include, but are not limited to, the Company's 2018 cash flow forecast, 2018 operating budget, and long-term plan that extends beyond 2018. These inputs consider information including, but not limited to, the Company's financial condition, liquidity sources, obligations due within one year after the financial statement issuance date, funds necessary to maintain operations, and financial conditions, including negative financial trends or other indicators of possible financial difficulty.

The Company has considered both quantitative and qualitative factors as part of the assessment that are known or reasonably knowable as of August 2, 2018, and concluded that conditions and events considered in the aggregate, do not indicate that it is probable that the Company will be unable to meet obligations as they become due through the one year period following the financial statement issuance date.

3. BASIC AND DILUTED 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 loss per share reflects the weighted average number of shares of common stock outstanding plus any dilutive shares outstanding during the period. Potentially dilutive shares consist of shares issuable upon the exercise of stock options, restricted stock awards, and restricted stock units.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 3. BASIC AND DILUTED NET LOSS PER SHARE (Continued)

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

|  | Three Months<br>Ended<br>June 30, |           | Six Months Ended<br>June 30, |          |
|--|-----------------------------------|-----------|------------------------------|----------|
|  | 2018                              | 2017      | 2018                         | 2017     |
| Numerator:   |                                   |           |                              |          |
| Net loss   | \$(4,158)                         | \$(1,135) | \$(10,560)                   | \$(681)  |
| Denominator:   |                                   |           |                              |          |
| Basic shares:  |                                   |           |                              |          |
| Weighted average number of common shares - basic   | 22,663                            | 22,248    | 22,561                       | 22,187   |
| Diluted shares:  |                                   |           |                              |          |
| Weighted average number of common shares - basic   | 22,663                            | 22,248    | 22,561                       | 22,187   |
| Number of dilutive common stock equivalent shares included in diluted shares calculation | —                                 | —         | —                            | —        |
| Weighted average number of common shares - diluted                                       | 22,663                            | 22,248    | 22,561                       | 22,187   |
| Loss per common share:   |                                   |           |                              |          |
| Basic  | \$(0.18)                          | \$(0.05)  | \$(0.47)                     | \$(0.03) |
| Diluted  | \$(0.18)                          | \$(0.05)  | \$(0.47)                     | \$(0.03) |

The Company calculates dilutive common stock equivalent shares using the treasury stock method. In periods where the Company has a net loss, no dilutive common stock equivalent shares are included in the calculation for diluted shares as they are considered anti-dilutive. The following table sets forth dilutive common stock equivalent shares calculated using the treasury stock method (in thousands):

|                                      | Three<br>Months<br>Ended<br>June 30, |      | Six Months<br>Ended<br>June 30, |      |
|--------------------------------------|--------------------------------------|------|---------------------------------|------|
|                                      | 2018                                 | 2017 | 2018                            | 2017 |
| Stock options                        | 639                                  | 301  | 602                             | 207  |
| Restricted stock units               | 230                                  | 154  | 230                             | 192  |
| Restricted stocks                    | 490                                  | 262  | 522                             | 216  |
| Total common stock equivalent shares | 1,359                                | 717  | 1,354                           | 615  |

Share-based awards to purchase approximately 0.2 million and 0.5 million shares of common stock that had an exercise price in excess of the average market price of the common stock during the three months ended June 30, 2018 and 2017, respectively, were not included in the calculation of diluted loss per share because they were anti-dilutive. Share-based awards to purchase approximately 0.2 million and 0.7 million shares of common stock that had an exercise price in excess of the average market price of the common stock during the six months ended June 30, 2018 and 2017, respectively, were not included in the calculation of diluted loss per share because they were anti-dilutive.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 4. INVENTORY

Inventory consisted of the following (in thousands):

|                 | June 30, December 31, |          |
|-----------------|-----------------------|----------|
|                 | 2018                  | 2017     |
| Raw materials   | \$ 1,018              | \$ 2,893 |
| Finished goods  | 1,096                 | 643      |
| Total inventory | \$ 2,114              | \$ 3,536 |

The total inventory balance as of June 30, 2018 reflected the Company's ongoing efforts to transition the Consumer Language segment to a software-as-a-service ("SaaS") model. The June 30, 2018 inventory balance also reflected a \$1.3 million inventory obsolescence charge during the six months ended June 30, 2018 in the retail and direct-to-consumer channels of the Consumer Language business.

## 5. PROPERTY AND EQUIPMENT

For the three months ended June 30, 2018 and June 30, 2017 the Company capitalized \$3.9 million and \$3.3 million, respectively, of internal-use software development costs. For the six months ended June 30, 2018 and June 30, 2017 the Company capitalized \$7.8 million and \$5.9 million, respectively, of internal-use software development costs.

Depreciation and amortization expense related to property and equipment includes depreciation related to its physical assets and amortization expense related to amounts capitalized in the development of internal-use software.

Depreciation and amortization expense associated with property and equipment consisted of the following (in thousands):

|  | Three Months Ended |          | Six Months Ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,           |          | June 30,         |          |
|  | 2018               | 2017     | 2018             | 2017     |
| Included in cost of revenue:             |                    |          |                  |          |
| Cost of subscription and service revenue | \$ 1,721           | \$ 974   | \$ 3,175         | \$ 1,968 |
| Cost of product revenue                  | 187                | 248      | 593              | 492      |
| Total included in cost of revenue        | 1,908              | 1,222    | 3,768            | 2,460    |
| Included in operating expenses:          |                    |          |                  |          |
| Sales and marketing                      | 231                | 136      | 412              | 279      |
| Research and development                 | 2                  | 4        | 4                | 7        |
| General and administrative               | 529                | 675      | 1,105            | 1,426    |
| Total included in operating expenses     | 762                | 815      | 1,521            | 1,712    |
| Total                                    | \$ 2,670           | \$ 2,037 | \$ 5,289         | \$ 4,172 |

## 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 acquisition of Livemocha, Inc. ("Livemocha") in April 2013, the acquisition of Lexia Learning Systems, Inc. ("Lexia") in August 2013, and the acquisition of Tell Me More S.A. ("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 topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.

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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 six months ended June 30, 2018 (in thousands):

|   | Literacy | E&E<br>Language | Consumer<br>Language | Total     |
|---|----------|-----------------|----------------------|-----------|
| Balance as of January 1, 2018             |          |                 |                      |           |
| Gross Goodwill                            | \$ 9,962 | \$ 39,895       | \$ 27,514            | \$ 77,371 |
| Accumulated Impairment                    | —        | —               | (27,514 )            | (27,514 ) |
| Goodwill as of January 1, 2018            | \$ 9,962 | \$ 39,895       | \$ —                 | \$ 49,857 |
| Effect of change in foreign currency rate | —        | (386 )          | —                    | (386 )    |
| Balance as of June 30, 2018               |          |                 |                      |           |
| Gross Goodwill                            | \$ 9,962 | \$ 39,509       | \$ 27,514            | \$ 76,985 |
| Accumulated Impairment                    | —        | —               | (27,514 )            | (27,514 ) |
| Goodwill as of June 30, 2018              | \$ 9,962 | \$ 39,509       | \$ —                 | \$ 49,471 |

## Annual Impairment Testing of Goodwill

The Company exercised its option to bypass the qualitative test and began its June 30, 2018 annual goodwill test with the quantitative test for its reporting units with remaining goodwill balances. As of June 30, 2018, the Company determined that the fair values of the Literacy and E&E Language reporting units substantially exceeded their carrying values. Therefore, no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

## 7. INTANGIBLE ASSETS

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

|                               | Trademark<br>/<br>tradename<br>* | Core<br>technology | Customer<br>relationships | Patents<br>and<br>Other | Total     |
|-------------------------------|----------------------------------|--------------------|---------------------------|-------------------------|-----------|
| Gross Carrying Amount         | \$ 12,505                        | \$ 15,636          | \$ 26,656                 | \$ 312                  | \$ 55,109 |
| Accumulated Amortization      | (1,755 )                         | (12,222 )          | (20,515 )                 | (278 )                  | (34,770 ) |
| Accumulated Impairment        | (26 )                            | (1,001 )           | (128 )                    | —                       | (1,155 )  |
| Balance as of January 1, 2018 | \$ 10,724                        | \$ 2,413           | \$ 6,013                  | \$ 34                   | \$ 19,184 |
| Gross Carrying Amount         | 12,483                           | 15,458             | 26,510                    | 312                     | 54,763    |
| Accumulated Amortization      | (1,834 )                         | (12,903 )          | (21,233 )                 | (292 )                  | (36,262 ) |
| Accumulated Impairment        | (25 )                            | (981 )             | (126 )                    | —                       | (1,132 )  |
| Balance as of June 30, 2018   | \$ 10,624                        | \$ 1,574           | \$ 5,151                  | \$ 20                   | \$ 17,369 |

\* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of June 30, 2018, the carrying value of the tradename asset was \$10.6 million.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 7. INTANGIBLE ASSETS (Continued)

## Amortization Expense for the Long-lived Intangible Assets

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

|  | Three<br>Months<br>Ended<br>June 30,<br>2018 2017 |        | Six Months<br>Ended<br>June 30,<br>2018 2017 |          |
|--|---|--------|--|----------|
| Included in cost of revenue:             |   |        |  |          |
| Cost of subscription and service revenue | \$ 133  | \$ 117 | \$ 247                                       | \$ 234   |
| Cost of product revenue                  | 14  | 30     | 46   | 59       |
| Total included in cost of revenue        | 147   | 147    | 293  | 293      |
| Included in operating expenses:          |   |        |  |          |
| Sales and marketing                      | 475   | 460    | 956  | 915      |
| Research and development                 | 188   | 343    | 552  | 682      |
| General and administrative               | —   | —      | —  | —        |
| Total included in operating expenses     | 663   | 803    | 1,508  | 1,597    |
| Total                                    | \$ 810  | \$ 950 | \$ 1,801                                     | \$ 1,890 |

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining six months of 2018 and years thereafter (in thousands):

|                  | As of<br>June<br>30,<br>2018 |
|------------------|------------------------------|
| 2018 - remaining | \$ 1,520                     |
| 2019             | 1,532                        |
| 2020             | 1,282                        |
| 2021             | 940                          |
| 2022             | 940                          |
| Thereafter       | 548                          |
| Total            | \$ 6,762                     |

## 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 June 30, 2018 to determine if indicators of impairment exist. The Company concluded that there were no potential indicators of impairment related to this indefinite-lived intangible asset. Additionally all other 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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**8. OTHER CURRENT LIABILITIES**

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

|   | June 30,<br>2018 | December 31,<br>2017 |
|---|------------------|----------------------|
| Accrued marketing expenses                    | \$3,036          | \$ 5,316             |
| Accrued professional and consulting fees      | 1,060            | 1,609                |
| Sales return reserve                          | 458              | 1,176                |
| Sales, withholding and property taxes payable | 3,565            | 3,616                |
| Other   | 4,509            | 4,737                |
| Total other current liabilities               | \$12,628         | \$ 16,454            |

**9. FINANCING ARRANGEMENTS****Credit Facility**

On October 28, 2014, Rosetta Stone Ltd. ("RSL"), a wholly owned subsidiary of parent company Rosetta Stone Inc., executed a Loan and Security Agreement with Silicon Valley Bank ("Bank") to obtain a \$25.0 million revolving credit facility (the "credit facility"). Since the original date of execution, the Company and the Bank have executed several amendments to the credit facility to reflect updates to the Company's financial outlook and extend the credit facility. Under the amended agreement, the Company may borrow up to \$25.0 million, including a sub-facility, which reduces available borrowings, for letters of credit in the aggregate availability amount of \$4.0 million. Borrowings by RSL under the credit facility are guaranteed by the Company as the ultimate parent. The credit facility has a term that expires on April 1, 2020, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

The total obligations under the credit facility cannot exceed the lesser of (i) the total revolving commitment of \$25.0 million or (ii) the borrowing base, which is calculated as 80% of eligible accounts receivable. As a result, the borrowing base will fluctuate and the Company expects it will follow the general seasonality of cash and accounts receivable (lower in the first half of the year and higher in the second half of the year). If the borrowing base less any outstanding amounts, plus the cash held at the Bank ("Availability") is greater than \$25.0 million, then the Company may borrow up to an additional \$5.0 million, but in no case can borrowings exceed \$25.0 million. Interest on borrowings accrues at the Prime Rate provided that the Company maintains a minimum cash and Availability balance of \$17.5 million. If cash and Availability is below \$17.5 million, interest will accrue at the Prime Rate plus 1%.

Proceeds of loans made under the credit facility may be used as working capital or to fund general business requirements. All obligations under the credit facility, including letters of credit, are secured by a security interest on substantially all of the Company's assets including intellectual property rights and by a stock pledge by the Company of 100% of its ownership interests in U.S. subsidiaries and 66% of its ownership interests in certain foreign subsidiaries.

The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict the ability to, among other things, incur additional indebtedness, dispose of assets, execute a material change in business, acquire or dispose of an entity, grant liens, make share repurchases, and make distributions, including payment of dividends. The Company is required to maintain compliance with a minimum liquidity amount and minimum financial performance requirements, as defined in the credit facility. As of June 30, 2018, the Company was in compliance with all covenants.

The credit facility contains customary events of default, including among others, non-payment defaults, covenant defaults, bankruptcy and insolvency defaults, and a change of control default, in each case, subject to customary exceptions. The occurrence of a default event could result in the Bank's acceleration of repayment obligations of any loan amounts then outstanding.

As of June 30, 2018, there were no borrowings outstanding and the Company was eligible to borrow \$10.9 million of available credit, less \$4.0 million in letters of credit that have been issued by the Bank on the Company's behalf, resulting in a net borrowing availability of \$6.9 million. A quarterly commitment fee accrues on any unused portion of

the credit facility at a nominal annual rate.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 9. FINANCING ARRANGEMENTS (Continued)

## 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 acquisition, the Company assumed a capital lease for a building near Versailles, France, where Tell Me More's headquarters were located. The fair value of the lease liability at the date of acquisition was \$4.0 million.

During the six months ended June 30, 2018, the Company acquired \$25,000 in equipment or software through the issuance of capital leases.

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

|   | As of   |
|---|---------|
|   | June    |
|   | 30,     |
|   | 2018    |
| 2018-remaining                              | \$268   |
| 2019  | 534     |
| 2020  | 530     |
| 2021  | 527     |
| 2022  | 395     |
| Thereafter                                  | 1       |
| Total minimum lease payments                | \$2,255 |
| Less amount representing interest           | 214     |
| Present value of net minimum lease payments | \$2,041 |
| Less current portion                        | 452     |
| Obligations under capital lease, long-term  | \$1,589 |

## 10. INCOME TAXES

New tax legislation, commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act"), was enacted on December 22, 2017. Given the significance of the Tax Act, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118"), which allowed registrants to record provisional amounts during a one year "measurement period" similar to that used when accounting for business combinations. However, the measurement period is deemed to have ended earlier when the registrant has obtained, prepared and analyzed the information necessary to finalize its accounting. During the measurement period, impacts of the Tax Act are expected to be recorded at the time a reasonable estimate for all or a portion of the effects can be made, and provisional amounts can be recognized and adjusted as information becomes available, prepared or analyzed.

SAB 118 summarizes the process to be applied at each reporting period to account for and qualitatively disclose: (1) the effects of the change in tax law for which accounting is complete; (2) provisional amounts (or adjustments to provisional amounts) for the effects of the tax law where accounting is not complete, but that a reasonable estimate has been determined; and (3) a reasonable estimate cannot yet be made and therefore taxes are reflected in accordance with law prior to the enactment of the Tax Act.

During the year of enactment, the Company recorded reasonable estimates of the effects of the Tax Act which principally related to a) the reduction in the U.S. corporate income tax rate from 35% to 21% and b) the change in the carryforward period of net operating losses. In the fourth quarter of 2017, the Company recorded an income tax benefit of \$2.4 million to remeasure deferred tax liabilities associated with indefinite-lived intangible assets that will reverse at the new 21% rate. Absent this deferred tax liability, the Company was in a net deferred tax asset position that was offset by a full valuation allowance. Though the impact of the rate change has a net tax effect of zero, the accounting to determine the gross change in the deferred tax position and the offsetting valuation resulted in a \$26.3 million reduction in both. Additionally, the Company recorded an income tax benefit of \$3.1 million in the fourth

quarter of 2017 related to the release of the valuation allowance associated with the post-2017 reversing deferred tax assets to offset 80% of the deferred tax liability associated with the Company's indefinite-lived intangible asset. During the six months ended June 30, 2018, there were no updates to these estimates and the estimates made in the year of enactment represent the Company's best estimates. The Company continues to assess the impact of the Tax Act, however, the

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. INCOME TAXES (Continued)

final impact of the Tax Act may differ from these estimates, due to, among other things, changes in interpretations, additional guidance that may be issued by the Internal Revenue Service or state and local authorities, and any updates or changes to estimates the Company has utilized to calculate the transition impact. Therefore, as of June 30, 2018, the Company's accounting for the elements of the Tax Act is incomplete. The Company will complete the accounting for these items during 2018, after completion of the 2017 U.S. income tax return.

The Tax Act includes a one-time mandatory repatriation transition tax on the net accumulated earnings and profits of a U.S. taxpayer's foreign subsidiaries.

Other significant Tax Act provisions that may impact income taxes include: an exemption from U.S. tax on dividends of future foreign earnings, a limitation of net operating losses generated after 2017 to 80% of taxable income, the inclusion of commissions and performance based compensation in determining the excess compensation limitation, and a minimum tax on certain foreign earnings in excess of 10% of the foreign subsidiaries tangible assets (i.e., global intangible low-taxed income or GILTI). The Company is still evaluating its policy election to treat the GILTI tax as a period expense or to provide U.S. deferred taxes on foreign temporary differences that are expected to generate GILTI income when they reverse in future years.

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 six months ended June 30, 2018 is based on the estimated annual effective tax rate for fiscal year 2018. 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.

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 June 30, 2018, the analysis of the need for a valuation allowance on U.S. deferred tax assets considered that the U.S. 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 June 30, 2018 results in a cumulative U.S. pre-tax loss;
  - from 2006, when the U.S. entity began filing as a C-corporation for income tax purposes, through 2010, the U.S. 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 or indefinite loss carryforward periods for U.S. federal and most state jurisdictions apply; and

• the Company incurred a U.S. 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 June 30, 2018, a valuation allowance was provided for the U.S., Hong Kong, Mexico, Spain, France, and Brazil where the Company has determined the deferred tax assets will not more likely than not be realized.



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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 10. INCOME TAXES (Continued)

Evaluation of the remaining jurisdictions as of June 30, 2018, 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 allowance will be adjusted accordingly, which could materially affect the Company's financial position and results of operations.

As of June 30, 2018, and December 31, 2017, the Company's U.S. deferred tax liability was \$2.0 million and \$1.9 million, respectively, related to its goodwill and indefinite lived intangibles. As of June 30, 2018 the Company had foreign net deferred tax liabilities of \$0.1 million compared to foreign net deferred tax liabilities of \$0.1 million at December 31, 2017. As of June 30, 2018, and December 31, 2017, the Company had no unrecognized tax benefits. For the six months ended June 30, 2018 the Company recorded an income tax expense of \$0.9 million for deferred tax expense related to the tax impact of amortization of indefinite lived intangible assets and current tax expense related to our operations in U.K., Germany, Canada and China.

## 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. All unissued stock associated with the 2006 Stock Incentive Plan expired in 2016 at the end of the ten year contractual term.

## 2009 Omnibus Incentive Plan

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provided the Company the ability to grant up to 2,437,744 of 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. Service, performance and market-based restricted stock awards are considered outstanding at the time of grant as the stockholder is entitled to voting rights and to receive any dividends declared subject to the loss of the right to receive accumulated dividends if the award is forfeited prior to vesting. Performance units and restricted stock units do not have voting rights. 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. Concurrent with the approval of the 2009 Plan, the 2006 Plan was terminated for purposes of future grants. Since the establishment of the 2009 Plan, the Board of Directors authorized and the Company's shareholders' approved the allocation of additional shares of common stock to the 2009 Plan as follows:

| Authorization Dates of 2009 Plan Additions | Number of<br>Common<br>Stock<br>Shares<br>Authorized<br>to 2009<br>Plan |
|--|---|
| February 27, 2009                          | 2,437,744   |
| May 26, 2011                               | 1,000,000   |

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|               |           |
|---------------|-----------|
| May 23, 2012  | 1,122,930 |
| May 23, 2013  | 2,317,000 |
| May 20, 2014  | 500,000   |
| June 12, 2015 | 1,200,000 |
| May 24, 2017  | 1,900,000 |

At June 30, 2018, there were 1,112,739 shares available for future grant under the 2009 Plan.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION (Continued)

## Valuation Assumptions

The determination of fair value of our stock-based awards is affected by assumptions regarding subjective and complex variables. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. 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 over the requisite service period of the award. Stock-based compensation expense recognized is based on the estimated portion of the awards that is expected to vest. Estimated forfeiture rates are applied in the expense calculation. The Company determines the fair values of stock-based awards as follows:

Service-Based Restricted Stock Awards, Restricted Stock Units, Performance-Based Restricted Stock Awards, and Performance Share Units: Fair value is determined based on the quoted market price of our common stock on the date of grant.

Service-Based Stock Options and Performance-Based Stock Options: Fair value is determined using the Black-Scholes pricing model, which requires the use of estimates, including the risk-free interest rate, expected volatility, expected dividends, and expected term.

Market-Based Restricted Stock Awards and Market-Based Stock Options: The fair value of the market-based awards is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the number of market-based awards that would be awarded which is reflected in the fair value on the grant date. There have been no market based awards or options granted in the periods presented.

For the six months ended June 30, 2018 and June 30, 2017, the fair value of stock options granted was calculated using the following assumptions in the Black-Scholes model:

|                                 | Six Months Ended |         |
|---------------------------------|------------------|---------|
|                                 | June 30,         |         |
|                                 | 2018             | 2017    |
| Expected stock price volatility | 39.0% - 39.8%    | 44.6%   |
| Expected term of options        | 6 years          | 6 years |
| Expected dividend yield         | —                | —       |
| Risk-free interest rate         | 2.73% - 2.85%    | 1.92%   |

## Stock-Based Compensation Expense

Stock compensation expense associated with service-based equity awards is recognized in the statements of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statements of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. Changes in the probability estimates associated with performance-based awards are accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimates. In any period in which the Company determines that achievement of the performance metrics is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the performance-based award is reversed. For equity awards granted with market-based conditions, stock compensation is recognized in the statements of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION (Continued)

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

|  | Three Months<br>Ended<br>June 30,<br>2018 |         | Six Months<br>Ended<br>June 30,<br>2018 |         |
|--|---|---------|---|---------|
|  | 2017                                      |         | 2017                                    |         |
| Included in cost of revenue:             |   |         |   |         |
| Cost of subscription and service revenue | \$13                                      | \$4     | \$(26 )                                 | \$(11 ) |
| Cost of product revenue                  | 1   | (3 )    | (12 )                                   | 24      |
| Total included in cost of revenue        | 14  | 1       | (38 )                                   | 13      |
| Included in operating expenses:          |   |         |   |         |
| Sales and marketing                      | 337                                       | 245     | 236                                     | 17      |
| Research and development                 | 186                                       | 181     | 170                                     | 30      |
| General and administrative               | 816                                       | 932     | 1,568                                   | 1,446   |
| Total included in operating expenses     | 1,339                                     | 1,358   | 1,974                                   | 1,493   |
| Total                                    | \$1,353                                   | \$1,359 | \$1,936                                 | \$1,506 |

## Service-Based Restricted Stock Awards

The following table summarizes the Company's service-based restricted stock award activity from January 1, 2018 to June 30, 2018:

|  | Service<br>Based<br>Awards | Weighted<br>Average<br>Grant<br>Date<br>Fair<br>Value | Aggregate<br>Intrinsic<br>Value |
|--|----------------------------|---|---------------------------------|
| Non-vested Service-based Awards, January 1, 2018 | 431,118                    | \$ 8.07   | \$3,477,484                     |
| Service-based awards granted                     | 212,873                    | 13.80   |                                 |
| Service-based awards vested                      | (166,262)                  | 8.43  |                                 |
| Service-based awards canceled                    | (20,553 )                  | 8.78  |                                 |
| Non-vested Service-Based Awards, June 30, 2018   | 457,176                    | \$ 10.57  | \$4,833,630                     |

As of June 30, 2018, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the service-based restricted stock awards not yet recognized in the consolidated statement of operations was \$3.6 million and is expected to be recognized over a weighted average period of 2.72 years.

Service-based 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.

## Performance-Based Restricted Stock Units

Beginning in the first quarter of 2017, the Company began granting annual performance-based restricted stock units ("PSUs") to certain employees which will become earned or eligible to vest based on the Company's achievement of certain pre-defined key operating performance goals during a one to three-year period. The number of PSUs earned or eligible to vest following the performance period is subject to approval by the Compensation Committee of the Board of Directors. Once earned, certain PSUs are then subject to additional service and vesting requirements, while certain PSUs vest shortly after being earned. PSUs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results relative to target, actual issuance of PSUs can be eligible for vest anywhere between a maximum of 200% and 0% of the target number of PSUs originally granted.





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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION (Continued)

The following table summarizes the Company's PSU activity from January 1, 2018 to June 30, 2018:

|                                  | PSUs      | Weighted<br>Average<br>Grant<br>Date<br>Fair<br>Value | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|-----------|---|---------------------------------|
| Non-vested PSUs, January 1, 2018 | 433,588   | \$ 9.43   | \$5,406,842                     |
| PSUs granted                     | 322,313   | 13.81   |                                 |
| PSUs vested                      | (54,298 ) | 9.43  |                                 |
| PSUs canceled                    | (21,335 ) | 9.43  |                                 |
| Non-vested PSUs, June 30, 2018   | 680,268   | \$ 11.51  | \$ 10,904,696                   |

As of June 30, 2018, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the PSUs not yet recognized in the consolidated statement of operations was \$2.6 million and is expected to be recognized over a weighted average period of 1.56 years.

## Service-Based Stock Options

The following table summarizes the Company's service-based stock option activity from January 1, 2018 to June 30, 2018:

|  | Service-based<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Contractual<br>Life (years) | Aggregate<br>Intrinsic<br>Value |
|--|--------------------------|--|--|---------------------------------|
| Service-based Options Outstanding, January 1, 2018 | 1,628,711                | \$ 9.81                                  | 6.79   | \$5,203,196                     |
| Service-based options granted                      | 60,603                   | 16.05                                    |  |                                 |
| Service-based options exercised                    | (139,106 )               | 9.46                                     |  |                                 |
| Service-based options canceled                     | (47,175 )                | 14.40                                    |  |                                 |
| Service-based Options Outstanding, June 30, 2018   | 1,503,033                | 9.95                                     | 6.54   | 9,297,957                       |
| Vested and expected to vest June 30, 2018          | 1,483,105                | 9.95                                     | 6.51   | 9,177,615                       |
| Exercisable at June 30, 2018                       | 1,241,693                | \$ 9.98                                  | 6.23   | \$7,667,843                     |

As of June 30, 2018, future compensation cost, net of estimated forfeitures, related to the non-vested portion of the service-based stock option awards not yet recognized in the consolidated statement of operations was \$1.1 million and is expected to be recognized over a weighted average period of 1.29 years.

Service-based 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. Service-based stock options generally vest over a four year period based upon required service conditions and do not have performance or market conditions.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. STOCK-BASED COMPENSATION (Continued)

## Restricted Stock Units

The following table summarizes the Company's restricted stock unit activity from January 1, 2018 to June 30, 2018:

|  | Units<br>Outstanding | Weighted<br>Average<br>Grant<br>Date Fair<br>Value | Aggregate<br>Intrinsic<br>Value |
|--|----------------------|--|---------------------------------|
| Units Outstanding, January 1, 2018           | 234,658              | \$ 10.19   | \$2,926,185                     |
| Units granted                                | 31,929               | 16.03  | 511,761                         |
| Units released                               | (30,682 )            | 8.74   |                                 |
| Units cancelled                              | —                    | —  |                                 |
| Units Outstanding, June 30, 2018             | 235,905              | 11.17  | 3,781,557                       |
| Vested and expected to vest at June 30, 2018 | 232,946              | 15.53  | 3,734,130                       |
| Vested and deferred at June 30, 2018         | 202,256              | \$ 10.43   | \$3,242,164                     |

Restricted stock units are granted to members of the Board of Directors as part of their compensation packages.

Restricted stock units convert to common stock following the separation of service with the Company. Restricted stock unit awards vest quarterly over a one year period from the date of grant, with expense recognized straight-line over the vesting period. The Company's restricted stock units 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 Company did not grant any restricted stock units prior to April 2009.

## CEO 2016 Performance and Market Conditioned Restricted Stock Awards and Stock Options Grants

On April 4, 2016, the Company named Mr. John Hass as President, CEO and Chairman of the Board. In conjunction with his appointment, the Compensation Committee approved a stock-based compensation package for Mr. Hass aimed to provide significant reward potential for achieving outstanding Company operating performance results and building stockholder value. The package was comprised of 70,423 performance-based restricted stock awards (PRSAs), 314,465 performance-based stock options (PSOs), 70,423 market-based restricted stock awards (MRSAs), and 314,465 market-based stock options (MSOs). The April 4, 2016 grant date fair values associated with these grants were \$7.10, \$3.24, \$6.17 and \$0.94, respectively.

On February 20, 2017, the Compensation Committee approved 64,719 PRSAs and 144,497 PSOs as eligible for further service vesting requirements. The non-eligible 5,704 and 169,968 PRSAs and PSOs, respectively, were cancelled as of February 20, 2017. PRSAs and PSOs vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively. During the six months ended June 30, 2018, 16,180 PRSAs vested and 36,124 PSOs vested. Future compensation cost related to the non-vested portion of the PRSAs and PSOs not yet recognized in the consolidated statement of operations was \$0.1 million and is expected to be recognized over a weighted average period of 0.76 years.

On February 22, 2018, the Compensation Committee approved the maximum quantity of 140,846 MRSAs and 314,465 MSOs as eligible for further service vesting requirements. MRSAs and MSOs vest annually on a pro-rata basis over three years beginning April 4, 2018. During the six months ended June 30, 2018, 46,949 MRSAs vested and 104,822 MSOs vested. Future compensation cost related to the non-vested portion of the MRSAs and MSOs not yet recognized in the consolidated statement of operations was \$0.2 million and is expected to be recognized over a weighted average period of 1.46 years.

## 12. STOCKHOLDERS' (DEFICIT) EQUITY

At June 30, 2018, 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 June 30, 2018, the Company had shares of

common stock issued of 24,262,308 and shares of common stock outstanding of 23,262,308.

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, debt facility covenants and other contractual limitations, and applicable legal requirements. For the year ended December 31, 2013, the Company paid

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 12. STOCKHOLDERS' EQUITY (DEFICIT) (Continued)

\$11.4 million to repurchase 1,000,000 shares at a weighted average price of \$11.44 per share as part of this program. No shares were repurchased during 2014, 2015, 2016, 2017 or the six months ended June 30, 2018. Shares repurchased under the program were recorded as treasury stock on the Company's consolidated balance sheets. 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. RESTRUCTURING AND OTHER EMPLOYEE SEVERANCE

## 2016 Restructuring Plan

In the first quarter of 2016, the Company announced and initiated actions to withdraw the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of E&E Language offerings. There was approximately \$0.1 million of remaining accrued severance costs as of December 31, 2017 and June 30, 2018, with only minor changes in activity during the six months ended June 30, 2018. The remaining amount is expected to be settled by the end of 2018.

## Other Employee Severance Actions

In 2017, the Company initiated actions to reduce headcount in its Fit Brains business and in the U.S. and China locations within consumer product operations, primarily comprised of severance costs. There was approximately \$0.1 million of remaining accrued severance costs as of December 31, 2017. During the six months ended June 30, 2018, the Company made final payments of \$0.1 million in accrued severance costs.

## Restructuring Cost

The following table summarizes the major types of costs associated with the restructuring actions for the three and six months ended June 30, 2018 and 2017 (in thousands):

|                            | Three<br>Months<br>Ended<br>June 30,<br>2018 |       | Six Months<br>Ended<br>June 30,<br>2017 |       |
|----------------------------|--|-------|---|-------|
| Severance costs            | \$(23)                                       | \$178 | \$(13)                                  | \$932 |
| Contract termination costs | —  | 36    | —                                       | 36    |
| Other costs                | —  | (9)   | 21                                      | 17    |
| Total                      | \$(23)                                       | \$205 | \$8                                     | \$985 |

The following table presents total restructuring costs associated with the restructuring actions included in the related line items of our statements of operations (in thousands):

|                            | Three<br>Months<br>Ended<br>June 30,<br>2018 |       | Six<br>Months<br>Ended<br>June 30,<br>2017 |       |
|----------------------------|--|-------|--|-------|
| Cost of revenue            | \$(13)                                       | \$40  | \$22                                       | \$205 |
| Sales and marketing        | (4)  | 4     | (2)  | 335   |
| Research and development   | —  | 127   | —  | 345   |
| General and administrative | (6)  | 34    | (12)                                       | 100   |
| Total                      | \$(23)                                       | \$205 | \$8  | \$985 |

These restructuring expenses are not allocated to any reportable segment under our definition of segment contribution as defined in Note 16 "Segment Information."

At each reporting date, the Company will evaluate its accrued restructuring costs to ensure the liabilities reported are still appropriate. Any changes to the estimated costs of executing approved restructuring plans will be reflected in the Company's consolidated statements of operations.

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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 lease abandonment charges of \$3.2 million in the first quarter of 2014. Prior to January 31, 2014, the Company occupied the 6th and 7th 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 6th floor was abandoned and ceased to be used by the Company on January 31, 2014.

In a further effort to reduce general and administrative expenses through a planned space consolidation, the Company relocated its headquarters location to 1621 North Kent Street, Suite 1200, Arlington, Virginia 22209. The previously leased space at the 7th floor of 1919 North Lynn Street was abandoned and ceased to be used by the Company on October 10, 2016 and resulted in \$1.6 million in lease abandonment expense in the fourth quarter of 2016.

A summary of the Company's lease abandonment activity for the six months ended June 30, 2018 and 2017 is as follows (in thousands):

|  | As of June 30, |         |
|--|----------------|---------|
|  | 2018           | 2017    |
| Accrued lease abandonment costs, beginning of period | \$1,081        | \$2,123 |
| Costs incurred and charged to expense                | —              | —       |
| Principal reductions                                 | (289 )         | (505 )  |
| Accrued lease abandonment costs, end of period       | \$792          | \$1,618 |
| Accrued lease abandonment costs liability:           |                |         |
| Short-term - included in "Other current liabilities" | \$792          | \$1,067 |
| Long-term  | —              | 551     |
| Total  | \$792          | \$1,618 |

## 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.

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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 six months of 2018 and the years thereafter (in thousands):

|                             | As of<br>June<br>30,<br>2018 |
|-----------------------------|------------------------------|
| Periods Ending December 31, |                              |
| 2018-remaining              | \$2,684                      |
| 2019                        | 1,953                        |
| 2020                        | 1,155                        |
| 2021                        | 948                          |
| 2022                        | 977                          |
| 2023                        | 743                          |
| Thereafter                  | —                            |
| Total                       | \$8,460                      |

Total expenses under operating leases are \$0.6 million and \$0.6 million for the three months ended June 30, 2018 and 2017, respectively. Total expenses under operating leases are \$1.2 million and \$1.3 million for the six months ended June 30, 2018 and 2017, 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.

**Litigation**

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

**16. SEGMENT INFORMATION**

The Literacy segment derives the majority of its revenue from the sales of literacy solutions to educational institutions serving grades K through 12. The E&E Language segment derives revenue from sales of language-learning solutions to educational institutions, corporations, and government agencies worldwide. The Consumer Language segment derives the majority of its revenue from sales of language-learning solutions to individuals and retail partners. Revenue from transactions between the Company's operating segments is not material. The Company's current operating segments also represent the Company's reportable segments. Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Segment revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

The Company and its Chief Operating Decision Maker ("CODM") assess profitability and performance of each of its current operating segments in terms of segment contribution. Segment contribution is calculated as segment revenue less expenses directly incurred by or allocated to the segment. Direct segment expenses include materials costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. In addition to the previously referenced expenses, the Literacy segment includes direct research and development expenses and



Combined Language includes shared research and development expenses, cost of revenue, and sales and marketing expenses applicable to the Consumer Language and E&E Language segments. Segment contribution excludes depreciation, amortization, stock compensation, restructuring and other related expenses. The Company does not allocate expenses beneficial to all segments, which include certain general and administrative expenses such as legal fees, payroll processing fees, accounting related expenses, lease abandonment,

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

impairment, and non-operating income and expense. These expenses are included below the segment contribution line in the unallocated expenses section of the tables presented below.

The E&E Language segment and Consumer Language segment are characterized as "Language" since both of these segments primarily address the language-learning market and share many of the same costs. These shared language costs are included in the "Shared Services" column of the tables presented below. General and administrative expenses directly incurred by the Language segments consist only of bad debt expense, net of recoveries. Additionally, research and development expenses are included as shared Language costs. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

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 months ended June 30, 2018 were as follows (in thousands):

|                               | Literacy<br>Segment | Language<br>E&E<br>Language<br>Segment | Consumer<br>Language<br>Segment | Shared<br>Services | Combined<br>Language | Total<br>Company |
|-------------------------------|---------------------|--|---------------------------------|--------------------|----------------------|------------------|
| Revenue                       | \$12,695            | \$15,356                               | \$15,451                        | \$—                | \$30,807             | \$43,502         |
| Cost of revenue               | 1,872               | 1,692                                  | 2,293                           | 19                 | 4,004                | 5,876            |
| Sales and marketing           | 6,757               | 7,927                                  | 8,548                           | 387                | 16,862               | 23,619           |
| Research and development      | 1,732               | —                                      | —                               | 3,668              | 3,668                | 5,400            |
| General and administrative    | 511                 | 74                                     | 60                              | —                  | 134                  | 645              |
| Segment contribution          | \$1,823             | \$5,663                                | \$4,550                         | \$(4,074)          | \$6,139              | \$7,962          |
| Segment contribution margin % | 14.4                | % 36.9                                 | % 29.4                          | %                  |                      |                  |

Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:

|                            |       |
|----------------------------|-------|
| Cost of revenue            | 2,054 |
| Sales and marketing        | 1,255 |
| Research and development   | 619   |
| General and administrative | 1,348 |
| Subtotal                   | 5,276 |

Corporate unallocated expenses, net:

|  |       |
|--|-------|
| Unallocated general and administrative | 6,331 |
| Unallocated non-operating expense      | 59    |
| Subtotal                               | 6,390 |

Loss before income taxes \$(3,704 )

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

Operating results by segment for the three months ended June 30, 2017 were as follows (in thousands):

|                               | Literacy<br>Segment | Language<br>E&E<br>Language<br>Segment | Consumer<br>Language<br>Segment | Shared<br>Services | Combined<br>Language | Total<br>Company |
|-------------------------------|---------------------|--|---------------------------------|--------------------|----------------------|------------------|
| Revenue <sup>(1)</sup>        | \$10,370            | \$17,260                               | \$18,275                        | \$—                | \$ 35,535            | \$45,905         |
| Cost of revenue               | 1,329               | 1,855                                  | 3,001                           | (3 )               | 4,853                | \$6,182          |
| Sales and marketing           | 5,626               | 8,020                                  | 9,132                           | 414                | 17,566               | \$23,192         |
| Research and development      | 1,431               | —                                      | —                               | 4,261              | 4,261                | \$5,692          |
| General and administrative    | 393                 | 28                                     | 82                              | —                  | 110                  | \$503            |
| Segment contribution          | \$1,591             | \$7,357                                | \$6,060                         | \$(4,672)          | \$8,745              | \$10,336         |
| Segment contribution margin % | 15.3                | % 42.6                                 | % 33.2                          | %                  |                      |                  |

Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:

|                            |       |
|----------------------------|-------|
| Cost of revenue            | 1,409 |
| Sales and marketing        | 845   |
| Research and development   | 656   |
| General and administrative | 1,656 |
| Subtotal                   | 4,566 |

Corporate unallocated expenses, net:

|  |        |
|--|--------|
| Unallocated general and administrative | 6,435  |
| Unallocated non-operating income       | (312 ) |
| Subtotal                               | 6,123  |

Loss before income taxes \$(353 )

(1) Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Segment revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

Operating results by segment for the six months ended June 30, 2018 were as follows (in thousands):

|                               | Literacy<br>Segment | Language<br>E&E<br>Language<br>Segment | Consumer<br>Language<br>Segment | Shared<br>Services | Combined<br>Language | Total<br>Company |
|-------------------------------|---------------------|--|---------------------------------|--------------------|----------------------|------------------|
| Revenue                       | \$25,079            | \$30,792                               | \$30,439                        | \$—                | \$ 61,231            | \$86,310         |
| Cost of revenue               | 3,880               | 3,304                                  | 6,098                           | 38                 | 9,440                | 13,320           |
| Sales and marketing           | 12,985              | 15,916                                 | 17,655                          | 616                | 34,187               | 47,172           |
| Research and development      | 3,547               | —                                      | —                               | 7,576              | 7,576                | 11,123           |
| General and administrative    | 972                 | 19                                     | 51                              | —                  | 70                   | 1,042            |
| Segment contribution          | \$3,695             | \$11,553                               | \$6,635                         | \$(8,230)          | \$ 9,958             | \$13,653         |
| Segment contribution margin % | 14.7                | % 37.5                                 | % 21.8                          | %                  |                      |                  |

Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:

|                            |       |
|----------------------------|-------|
| Cost of revenue            | 4,044 |
| Sales and marketing        | 1,893 |
| Research and development   | 1,202 |
| General and administrative | 2,680 |
| Subtotal                   | 9,819 |

Corporate unallocated expenses, net:

|  |        |
|--|--------|
| Unallocated general and administrative | 13,134 |
| Unallocated non-operating expense      | 345    |
| Subtotal                               | 13,479 |

Loss before income taxes \$ (9,645 )

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

Operating results by segment for the six months ended June 30, 2017 were as follows (in thousands):

|                               | Literacy<br>Segment | Language<br>E&E<br>Language<br>Segment | Consumer<br>Language<br>Segment | Shared<br>Services | Combined<br>Language | Total<br>Company |
|-------------------------------|---------------------|--|---------------------------------|--------------------|----------------------|------------------|
| Revenue <sup>(1)</sup>        | \$20,540            | \$33,760                               | \$39,298                        | \$—                | \$73,058             | \$93,598         |
| Cost of revenue               | 3,157               | 3,699                                  | 5,912                           | (6 )               | 9,605                | \$12,762         |
| Sales and marketing           | 11,140              | 15,655                                 | 18,957                          | 906                | 35,518               | \$46,658         |
| Research and development      | 2,935               | —                                      | —                               | 8,762              | 8,762                | \$11,697         |
| General and administrative    | 756                 | (70 )                                  | 12                              | —                  | (58 )                | \$698            |
| Segment contribution          | \$2,552             | \$14,476                               | \$14,417                        | \$(9,662)          | \$19,231             | \$21,783         |
| Segment contribution margin % | 12.4                | % 42.9                                 | % 36.7                          | %                  |                      |                  |

Unallocated depreciation and amortization, stock compensation, restructuring and other expenses (net) included in:

|                            |       |
|----------------------------|-------|
| Cost of revenue            | 2,970 |
| Sales and marketing        | 1,547 |
| Research and development   | 1,065 |
| General and administrative | 3,192 |
| Subtotal                   | 8,774 |

Corporate unallocated expenses, net:

|  |        |
|--|--------|
| Unallocated general and administrative | 12,729 |
| Unallocated non-operating income       | (521 ) |
| Subtotal                               | 12,208 |

Income before income taxes

\$801

(1) Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Segment revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

**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.

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 16. SEGMENT INFORMATION (Continued)

The information below summarizes revenue from customers by geographic area for the three and six months ended June 30, 2018 and 2017 (in thousands):

|               | Three Months Ended |                     | Six Months Ended |                     |
|---------------|--------------------|---------------------|------------------|---------------------|
|               | June 30,           |                     | June 30,         |                     |
|               | 2018               | 2017 <sup>(1)</sup> | 2018             | 2017 <sup>(1)</sup> |
| United States | \$37,759           | \$39,384            | \$74,724         | \$80,625            |
| International | 5,743              | 6,521               | 11,586           | 12,973              |
| Total         | \$43,502           | \$45,905            | \$86,310         | \$93,598            |

(1) Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Geographic revenue in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

The information below summarizes long-lived assets by geographic area classified as held and used as of June 30, 2018 and December 31, 2017 (in thousands):

|               | June 30, December 31, |           |
|---------------|-----------------------|-----------|
|               | 2018                  | 2017      |
| United States | \$30,878              | \$ 27,647 |
| International | 2,672                 | 3,002     |
| Total         | \$33,550              | \$ 30,649 |

## Revenue by Type

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 six months ended June 30, 2018 and 2017 (in thousands):

|                   | Three Months Ended |                     | Six Months Ended |                     |
|-------------------|--------------------|---------------------|------------------|---------------------|
|                   | June 30,           |                     | June 30,         |                     |
|                   | 2018               | 2017 <sup>(1)</sup> | 2018             | 2017 <sup>(1)</sup> |
| Language learning | \$30,369           | \$34,790            | \$60,327         | \$71,420            |
| Literacy          | 12,695             | 10,370              | 25,079           | 20,540              |
| Brain fitness     | 438                | 745                 | 904              | 1,638               |
| Total             | \$43,502           | \$45,905            | \$86,310         | \$93,598            |

(1) Effective January 1, 2018 the Company adopted ASC 606 using the modified retrospective approach. Revenue by type in prior comparative periods reflects amounts previously reported and has not been restated. See Note 2 "Summary of Significant Accounting Policies" for additional disclosures regarding revenue recognition and the impact of adoption of ASC 606.

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

This Quarterly Report on Form 10-Q (this "Report") and other statements or presentations made from time to time by the Company, including the documents incorporated by reference, contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements can be identified by non-historical statements and often include words such as "outlook," "potential," "believes," "expects," "anticipates," "estimates," "intends," "plans," "seeks" or words of similar meaning, or future-looking or conditional verbs, such as "will," "should," "could," "may," "might," "aims," "intends," "projects," or similar words or phrases. These statements may include, but are not limited to, statements related to: our business strategy; guidance or projections related to revenue, Adjusted EBITDA, sales, and other measures of future economic performance; the contributions and performance of our businesses including acquired businesses and international operations; projections for future capital expenditures; and other guidance, projections, plans, objectives, and related estimates and assumptions. A forward-looking statement is neither a prediction nor a guarantee of future events or circumstances. In addition, forward-looking statements are based on the Company's current assumptions, expectations and beliefs and are subject to certain risks and uncertainties that could cause actual results to differ materially from our present expectations or projections. Some important factors that could cause actual results, performance or achievement to differ materially from those expressed or implied by these forward-looking statements include, but are not limited to: the risk that we are unable to execute our business strategy; declining demand for our language learning solutions; the risk that we are not able to manage and grow our business; the impact of any revisions to our pricing strategy; the risk that we might not succeed in introducing and producing new products and services; the impact of foreign exchange fluctuations; the adequacy of internally generated funds and existing sources of liquidity, such as bank financing, as well as our ability to raise additional funds; the risk that we cannot effectively adapt to and manage complex and numerous technologies; the risk that businesses acquired by us might not perform as expected; and the risk that we are not able to successfully expand internationally. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future developments or otherwise, except as required by law. These factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements risks and uncertainties that are more fully described in the Company's filings with the U.S. Securities and Exchange Committee (SEC), including those described below, those discussed in the sections titled "Risk Factors" in Part II, Item 1A of this Report and those updated from time to time in our future reports filed with the Securities and Exchange Commission. This section should be read together with our unaudited consolidated financial statements and related notes set forth elsewhere in this Report, "Management's Discussion and Analysis of Financial Condition and Results of Operations", and should be read together with our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 7, 2018.

## Overview

Rosetta Stone Inc. ("Rosetta Stone," the "Company," "we" or "us") is dedicated to changing people's lives through the power of language and literacy education. Our innovative digital solutions drive positive learning outcomes for the inspired learner at home or in schools and workplaces around the world. Founded in 1992, Rosetta Stone's language division uses cloud-based solutions to help all types of learners read, write, and speak more than 30 languages. Lexia Learning, Rosetta Stone's literacy education division, was founded more than 30 years ago and is a leader in the literacy education space. Today, Lexia helps students build foundational reading skills through its rigorously researched, independently evaluated, and widely respected instruction and assessment programs. Rosetta Stone Inc. was incorporated in Delaware in 2005.

The Literacy segment derives the majority of its revenue from sales of literacy solutions to educational institutions serving grades K through 12. The Enterprise & Education ("E&E") Language segment derives revenue from sales of language-learning solutions to educational institutions, corporations, and government agencies worldwide. The Consumer Language segment derives the majority of revenue from sales of language-learning solutions to individuals and retail partners. Our Literacy distribution channel utilizes a direct sales force as well as relationships with third-party resellers focused on the sale of Lexia Learning solutions to K-12 schools. Our E&E Language 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. Our Consumer

Language distribution channel comprises a mix of our call centers, websites, app-stores, third party e-commerce websites, select retail resellers, such as Amazon.com, Barnes & Noble, Target, Best Buy, Books-a-Million, Staples, consignment distributors such as Software Packaging Associates, and daily deal partners.

As our Company has evolved, we believe that our current portfolio of language and literacy products and transition to a software-as-a-service ("SaaS")-based delivery model provides multiple opportunities for long-term value creation. We also believe the demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe, and we are uniquely positioned with the power of our global brand to meet the growing needs of global learners.

We continue to emphasize the development of products and solutions for Corporate and K-12 learners who need to speak and read English. This focus extends to the Consumer Language segment, where we continue to make product investments



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serving the needs of passionate language learners who are mobile, results focused and value a quality language-learning experience.

To position the organization for success, our focus is on the following priorities:

- 1. Grow literacy sales by providing fully aligned digital instruction and assessment tools for K-12, building a direct distribution sales force to augment our historical reseller model, and continuing to develop our implementation services business;
- 2. Position our E&E Language business for profitable growth by focusing our direct sales on our best geographies and customer segments, partnering with resellers in other geographies and successfully delivering our Catalyst™ product to Corporate customers. Catalyst integrates our Foundations, Advantage and Advanced English for Business products with enhanced reporting, assessment and administrator tools that offers a simple, more modern, metrics-driven suite of tools that are results-oriented and easily integrated with leading corporate language-learning systems;
- 3. Seek to maximize the benefit of the changes we have made in our Consumer Language products and successfully transition to SaaS delivery to seek additional growth opportunities with greater emphasis on a streamlined, mobile-oriented product portfolio focused on customers' demand, while optimizing our marketing spend appropriately;
- 4. Seek opportunities to leverage our language assets including our content, tools and pedagogy, as well as our well-known Rosetta Stone brand, through partnerships with leading players in key markets around the world; and
- 5. Continue to identify opportunities to become more efficient.

As of June 30, 2018, we currently have three operating segments, Literacy, E&E Language, and Consumer Language. We 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"). See Note 16 "Segment Information" of Part 1 - Item 1, Financial Statements for information about recent changes in the definition and presentation of segment contribution.

Over the last few years, our Consumer Language strategy has been to shift more and more of our Consumer Language business to online subscriptions, which feature access across the web and apps, and away from perpetual digital download and CD packages. We believe that these online subscription formats provide customers with an overall better experience, flexibility to use our products on multiple platforms (tablets, smartphones and computers), and provide a more economical and relevant way for us to deliver our products to customers. We expect the trend in Consumer Language subscription sales to continue as customer preferences move towards mobile experiences. Literacy segment contribution increased to \$1.8 million with segment contribution margin of 14% for the three months ended June 30, 2018, as compared to a segment contribution of \$1.6 million and segment contribution margin of 15% for the three months ended June 30, 2017. The dollar increase was primarily due to the larger revenue base on which segment contribution is calculated, partially offset by an increase in direct sales and marketing expense due to the continued transition to a direct sales team. E&E Language segment contribution decreased to \$5.7 million with segment contribution margin of 37% for the three months ended June 30, 2018, as compared to segment contribution of \$7.4 million and segment contribution margin of 43% for the three months ended June 30, 2017. The dollar and margin decreases were primarily due to the \$1.9 million decline in E&E Language revenue. Consumer Language segment contribution decreased to \$4.6 million with a segment contribution margin of 29% for the three months ended June 30, 2018, from \$6.1 million with a segment contribution margin of 33% for the three months ended June 30, 2017. The dollar and margin decreases in Consumer Language segment contribution were primarily attributable to the transition to subscription sales that are recognized over-time compared to perpetual software sales that are recognized at a point-in-time.

Literacy segment contribution increased to \$3.7 million with segment contribution margin of 15% for the six months ended June 30, 2018, as compared to a segment contribution of \$2.6 million and segment contribution margin of 12% for the six months ended June 30, 2017. The dollar and margin increases were primarily due to the larger revenue base on which segment contribution is calculated, partially offset by an increase in direct sales and marketing expenses due to the transition to a direct sales team. E&E Language segment contribution decreased to \$11.6 million with segment contribution margin of 38% for the six months ended June 30, 2018, as compared to segment contribution of \$14.5

million and segment contribution margin of 43% for the six months ended June 30, 2017. The dollar and margin decreases were primarily due to lower segment revenue. Consumer Language segment contribution decreased to \$6.6 million with a segment contribution margin of 22% for the six months ended June 30, 2018, from \$14.4 million with a segment contribution margin of 37% for the six months ended June 30, 2017. The Consumer Language segment contribution dollar and margin decreased primarily due the transition to subscription sales that are recognized over-time compared to perpetual software sales that are recognized at a point-in-time.

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For additional information regarding our segments, see Note 16 "Segment Information" of Part 1 - Item 1, Financial Statements. For additional information regarding fluctuations in segment revenue, see Results of Operations, below.

### Components of Our Statements of Operations

#### Revenue

We derive revenue from sales of language-learning and literacy solutions. Revenue is presented as subscription and service revenue or product revenue in our consolidated financial statements. Subscription and service revenue consists of fees associated with web-based software subscriptions, online services, professional services, and mobile applications. As discussed in Note 2 of Part 1 - Item 1, Financial Statements, we adopted the new revenue recognition accounting standard ("ASC 606") effective January 1, 2018 using the modified retrospective method. As such, the comparative information has not been restated under ASC 606 and continues to be reported under the accounting standards in effect for those prior comparative periods.

Subscription revenue is generated from contracts with customers that provide access to hosted software over a contract term without the customer taking possession of the software. Subscription revenue is recognized ratably over the contract period as the performance obligation is satisfied. Subscription revenue is generated by all three reportable segments and range from short-term to multi-year contracts. Online services are typically sold in short-term service periods and include dedicated online conversational coaching services and access to online communities of language learners. Professional services include training and implementation services. Online services revenue and professional services revenue are recognized as the services are provided. Expired services are forfeited and revenue is recognized upon expiry.

Product revenue primarily consists of revenue from perpetual language-learning software and audio practice products. Audio practice products are often combined with language-learning software and sold as a solution. Perpetual software revenue is recognized at the point in time when the software is made available to the customer. Audio practice products are recognized at the point in time that the audio practice products are delivered to the customer. As post-contract support ("PCS") is provided to customers who purchase perpetual software at no charge, a portion of the transaction price is allocated to PCS service revenue and recognized as the PCS services are provided, which is typically three months from the date of purchase.

We sell our solutions directly and indirectly to individuals, educational institutions, corporations, and governmental agencies. We sell to enterprise and education organizations primarily through our direct sales force as well as through our network of resellers and organizations who typically gain access to our solutions under a web-based subscription service. We distribute our Consumer Language products predominantly through our direct sales channels, primarily utilizing our websites and call centers, which we refer to as our direct-to-consumer ("DTC") channel. We also distribute our Consumer Language products through select third-party retailers and distributors. For purposes of explaining variances in our revenue, we separately discuss changes in our E&E Language, Literacy, and our Consumer Language segments because the customers and revenue drivers of these channels are different.

Literacy segment sales are seasonally strongest in the third quarter of the calendar year corresponding to school district budget years. Within our E&E Language segment, sales in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Consumer Language sales are affected by seasonal trends associated with the holiday shopping season. We expect these trends to continue.

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

Cost of subscription and service revenue primarily represents costs associated with supporting our web-based subscription services and online language-learning services, 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 subscription and service revenue and cost of product 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.

#### Operating Expenses

We classify our operating expenses into the following categories: sales and marketing, research and development, and general and administrative. When certain events occur, we also recognize operating expenses related to asset impairment and operating lease terminations.

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. Included within our

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operating expenses are restructuring costs that consist primarily of employee severance and related benefit costs, contract termination costs, and other related costs associated with our restructuring activities.

**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. Sales commissions are generally paid when a customer contract is either recorded as revenue or deferred revenue. However, sales commissions are deferred and recognized as expense in proportion to when the related revenue is recognized.

**Research and Development.** Research and development expenses consist primarily of employee compensation costs, consulting fees, and overhead costs associated with development of our solutions. Our development efforts are primarily based in the U.S. and are devoted to modifying and expanding our offering portfolio through the addition of new content, as well as new paid and complementary products and services to our language-learning and literacy solutions.

**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 other corporate expenses.

### **Interest and Other Income (Expense)**

Interest and other income (expense) primarily consist of interest income, interest expense, and foreign exchange gains and losses. Interest income represents interest received on our cash and cash equivalents. Interest expense is primarily related to interest on our capital leases and amortization of deferred financing fees associated with our revolving credit facility. Fluctuations in foreign currency exchange rates in our foreign subsidiaries cause foreign exchange gains and losses.

### **Income Tax Expense**

Income tax expense consists of federal, state and foreign income taxes. We regularly evaluate the recoverability of our deferred tax assets and establish a valuation allowance, if necessary, to reduce the deferred tax assets to an amount that is more likely than not to be realized (a likelihood of more than 50 percent). Significant judgment is required to determine whether a valuation allowance is necessary and the amount of such valuation allowance, if appropriate.

The establishment of a valuation allowance has no effect on the ability to use the deferred tax assets in the future to reduce cash tax payments. We assess the likelihood that the deferred tax assets will be realizable at each reporting period, and the valuation allowance will be adjusted accordingly, which could materially affect our financial position and results of operations.

For the three months ended June 30, 2018, we incurred an income tax expense of \$0.5 million with \$3.7 million loss before taxes, resulting in a worldwide effective tax rate of (12.3)%. The three month tax expense of \$0.5 million related to current year income from operations in Canada, China, Germany, and the U.K., as well as the deferred tax impact of amortization of indefinite lived intangibles, and foreign withholding taxes.

For the six months ended June 30, 2018, we incurred an income tax expense of \$0.9 million after incurring loss before taxes of \$9.6 million, resulting in worldwide effective tax rate of (9.5)%. The six month tax expense related to current year income from operations in Germany, China, Canada and the U.K., as well as the tax impact of amortization of indefinite lived intangibles, and foreign withholding taxes.

For the year ended December 31, 2017, we recorded an income tax benefit of \$2.5 million on a loss before tax of \$4.0 million resulting in worldwide effective tax rate of 61.8%. The tax rate resulted from the tax benefit associated with the Tax Cuts and Jobs Act of 2017 enacted on December 22, 2017 (the "Tax Act"), partially offset by tax expense related to income of operations in Canada, China, Germany, and the U.K., foreign withholding taxes, the deferred tax impact of amortization of indefinite lived intangible assets.

### **Critical Accounting Policies and Estimates**

In presenting our financial statements in conformity with U.S. generally accepted accounting principles ("GAAP"), 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

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

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. In addition, we believe that a discussion of these policies is necessary for readers to understand and evaluate our consolidated financial statements contained in this quarterly report on Form 10-Q:

- Revenue Recognition
- Stock-based Compensation
- Goodwill
- Intangible Assets
- Valuation of Long-Lived Assets
- Restructuring Costs
- Income Taxes
- Going Concern Assessment

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 7, 2018. Due to the adoption of the new revenue recognition guidance in ASC 606, we made updates to the critical accounting policies associated with revenue recognition. See Note 2 of Part 1 - Item 1, Financial Statements for additional information and significant judgments on revenue recognition. Other than revenue recognition, there have been no significant changes in the above critical accounting policies and estimates since those disclosed in our most recent Annual Report on Form 10-K.

#### Goodwill

We test goodwill for impairment annually on June 30 of each year at the reporting unit level 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. The factors that we consider important, and which could trigger a quantitative test, 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. 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 a quantitative 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.

For our annual goodwill test performed at June 30, we exercised our option to bypass the qualitative assessment and began our annual test with the quantitative test using a fair value approach. In estimating the fair value of our reporting units, 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. As of June 30, 2018, we determined that the fair values of our reporting units with remaining goodwill balances substantially exceeded their carrying values. Accordingly, no goodwill impairment charges were recorded in connection with the annual impairment test. For additional risk factors which could affect the assumptions used in our valuation of our reporting units, see the section titled "Risk Factors" in Part II, Item 1A of this Report. Accordingly, we cannot provide assurance that the assumptions, estimates and values used in our assessment will be realized and actual results could vary materially.

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## Results of Operations

Comparison of the three months ended June 30, 2018 and the three months ended June 30, 2017

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

|  | Three Months Ended June 30, |            | 2018 Versus 2017 |          |   |
|--|-----------------------------|------------|------------------|----------|---|
|  | 2018                        | 2017       | Change           | % Change |   |
| Revenue:                                 |                             |            |                  |          |   |
| Subscription and service                 | \$42,678                    | \$41,985   | \$693            | 1.7      | % |
| Product                                  | 824                         | 3,920      | (3,096 )         | (79.0 )  | % |
| Total revenue                            | 43,502                      | 45,905     | (2,403 )         | (5.2 )   | % |
| Cost of revenue:                         |                             |            |                  |          |   |
| Cost of subscription and service revenue | 7,258                       | 6,058      | 1,200            | 19.8     | % |
| Cost of product revenue                  | 672                         | 1,533      | (861 )           | (56.2 )  | % |
| Total cost of revenue                    | 7,930                       | 7,591      | 339              | 4.5      | % |
| Gross profit                             | 35,572                      | 38,314     | (2,742 )         | (7.2 )   | % |
| Operating expenses:                      |                             |            |                  |          |   |
| Sales and marketing                      | 24,874                      | 24,037     | 837              | 3.5      | % |
| Research and development                 | 6,019                       | 6,348      | (329 )           | (5.2 )   | % |
| General and administrative               | 8,324                       | 8,594      | (270 )           | (3.1 )   | % |
| Total operating expenses                 | 39,217                      | 38,979     | 238              | 0.6      | % |
| Loss from operations                     | (3,645 )                    | (665 )     | (2,980 )         | 448.1    | % |
| Other income and (expense):              |                             |            |                  |          |   |
| Interest income                          | 23                          | 17         | 6                | 35.3     | % |
| Interest expense                         | (81 )                       | (130 )     | 49               | (37.7 )  | % |
| Other income and (expense)               | (1 )                        | 425        | (426 )           | (100.2)  | % |
| Total other income and (expense)         | (59 )                       | 312        | (371 )           | (118.9)  | % |
| Loss before income taxes                 | (3,704 )                    | (353 )     | (3,351 )         | 949.3    | % |
| Income tax expense                       | 454                         | 782        | (328 )           | (41.9 )  | % |
| Net loss                                 | \$(4,158 )                  | \$(1,135 ) | \$(3,023 )       | 266.3    | % |

Total revenue decreased \$2.4 million to \$43.5 million for the three months ended June 30, 2018 from \$45.9 million for the three months ended June 30, 2017. The overall change in revenue was due to a decrease in Consumer Language revenue of \$2.8 million reflecting the transition from perpetual product sales to subscription-based sales, and a decrease in E&E Language revenue of \$1.9 million, partially offset by an increase in Literacy revenue of \$2.3 million.

The operating loss for the three months ended June 30, 2018, totaled \$3.6 million, compared to operating loss of \$0.7 million for the three months ended June 30, 2017. The change in operating loss was primarily driven by the decline in revenue.

The following table sets forth revenue for our three operating segments for the three months ended June 30, 2018 and 2017 (in thousands, except percentages):

|                   | Three Months Ended June 30, |        |          |        | 2018 Versus 2017 |          |
|-------------------|-----------------------------|--------|----------|--------|------------------|----------|
|                   | 2018                        |        | 2017     |        | Change           | % Change |
| Literacy          | 12,695                      | 29.2 % | 10,370   | 22.6 % | 2,325            | 22.4 %   |
| E&E Language      | 15,356                      | 35.3 % | 17,260   | 37.6 % | (1,904 )         | (11.0)%  |
| Consumer Language | 15,451                      | 35.5 % | 18,275   | 39.8 % | (2,824 )         | (15.5)%  |
| Total Revenue     | \$43,502                    | 100.0% | \$45,905 | 100.0% | \$(2,403 )       | (5.2 )%  |





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## Literacy Segment

Literacy revenue increased \$2.3 million, or 22%, from \$10.4 million for the three months ended June 30, 2017, to \$12.7 million for the three months ended June 30, 2018. The growth in Literacy revenue was driven by sales growth and strong retention rates. We anticipate additional investments in product and sales personnel in the Literacy business to grow this segment and achieve scale.

## E&amp;E Language Segment

E&E Language revenue decreased \$1.9 million, or 11%, from \$17.3 million for the three months ended June 30, 2017, to \$15.4 million for the three months ended June 30, 2018. Revenue declined approximately \$1.4 million, or 14% in the enterprise category reflecting our strategic decision to exit certain geographies and approximately \$0.5 million, or 7% in the education category. We expect to continue to balance investments and adjust our cost structure to align scale without impacting growth.

## Consumer Language Segment

Consumer Language revenue decreased \$2.8 million, or 15%, from the three months ended June 30, 2017, to \$15.4 million for the three months ended June 30, 2018. This decrease largely reflects the continued transition of the segment to subscription-based sales, which are recognized over time, from the sale of perpetual products that were historically recognized up front. The SaaS transition within the Consumer Language segment's DTC channel was largely completed by the end of 2017 and the migration from CD-based product sales to subscriptions in the retail channel was initiated in mid-2017 and was completed in the second quarter of 2018. We expect revenue within the global retail sales channel will decline in 2018 as we complete the retail transition from perpetual product to subscriptions. In connection with our recent shift in strategy, we will invest in the mobile and English-learning to drive growth. Our Consumer business is seasonal and consumer sales typically peak in the fourth quarter during the holiday shopping season.

## Revenue by Subscription and Service Revenue and Product Revenue

The following table sets forth revenue for subscription and service and product for the three months ended June 30, 2018 and 2017 (in thousands, except percentages):

|                          | Three Months Ended June 30, |                 | 2018 Versus 2017 |          |
|--------------------------|-----------------------------|-----------------|------------------|----------|
|                          | 2018                        | 2017            | Change           | % Change |
| Subscription and service | \$42,678 98.1 %             | \$41,985 91.5 % | \$693            | 1.7 %    |
| Product                  | 824 1.9 %                   | 3,920 8.5 %     | (3,096 )         | (79.0)%  |
| Total revenue            | \$43,502 100.0%             | \$45,905 100.0% | \$(2,403)        | (5.2 )%  |

## Subscription and Service Revenue

Subscription and service revenue increased \$0.7 million, or 2% to \$42.7 million for the three month period ended June 30, 2018, from \$42.0 million for the three month period ended June 30, 2017. The Literacy segment falls entirely within the subscription and service revenue category, which increased \$2.3 million year over year. As earlier noted, the 22% growth in Literacy revenue was driven by sales growth and strong retention rates. Consumer subscription and service revenue slightly increased by \$0.1 million. These improvements were offset by a revenue decline in the E&E Language segment. The \$1.7 million decline in E&E Language subscription and services revenue was primarily due in part to the marketplaces exited in unprofitable geographies.

## Product Revenue

Product revenue decreased \$3.1 million, or 79%, to \$0.8 million during the three months ended June 30, 2018, from \$3.9 million during the three months ended June 30, 2017. The primary driver of the decrease in product revenue was a decline of \$2.3 million in the DTC sales channel due to the SaaS migration that was substantially completed in late 2017. Product revenue also declined in the homeschool channel by \$0.4 million and the global consumer retail sales channel by \$0.3 million. The completion of the global retail transition to subscription sales was completed in the second quarter of 2018 and we expect the revenue impact from this migration will be realized in 2018 which will result in a decline in product revenue in the future. Going forward product revenue will primarily represent the sale of headsets which will continue to be recognized upon delivery.



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

The following table sets forth cost of subscription and service revenue and product revenue, as well as gross profit for the three months ended June 30, 2018 and 2017 (in thousands, except percentages):

|  | Three Months Ended<br>June 30, |          | 2018 Versus 2017 |             |
|--|--------------------------------|----------|------------------|-------------|
|  | 2018                           | 2017     | Change           | %<br>Change |
| Revenue:                                 |                                |          |                  |             |
| Subscription and service                 | \$42,678                       | \$41,985 | \$693            | 1.7 %       |
| Product                                  | 824                            | 3,920    | (3,096 )         | (79.0)%     |
| Total revenue                            | 43,502                         | 45,905   | (2,403 )         | (5.2 )%     |
| Cost of revenue:                         |                                |          |                  |             |
| Cost of subscription and service revenue | 7,258                          | 6,058    | 1,200            | 19.8 %      |
| Cost of product revenue                  | 672                            | 1,533    | (861 )           | (56.2)%     |
| Total cost of revenue                    | 7,930                          | 7,591    | 339              | 4.5 %       |
| Gross profit                             | \$35,572                       | \$38,314 | \$(2,742)        | (7.2 )%     |
| Gross margin percentages                 | 81.8 %                         | 83.5 %   | (1.7 )%          |             |

## Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the three months ended June 30, 2018, was \$7.3 million, an increase of \$1.2 million, or 20%, from the three months ended June 30, 2017. As a percentage of subscription and service revenue, cost of subscription and service revenue increased to 17% for the three months ended June 30, 2018 from 14% for the three months ended June 30, 2017. The increase in cost and the decrease in margin were primarily due to an increase in amortization expense from capitalized internal-use software costs and an increase in allocated costs from a higher allocation rate associated with the shift in revenue mix in favor of subscription and service revenue. We expect the cost of subscription and service revenue will increase as we complete the migration of our Consumer Language business to our subscription-based products.

## Cost of Product Revenue

Cost of product revenue for the three months ended June 30, 2018, was \$0.7 million, a decrease of 56%, from \$1.5 million for the three months ended June 30, 2017. As a percentage of product revenue, cost of product revenue was 82% for the three months ended June 30, 2018, compared to 39% the three months ended June 30, 2017. The decrease in cost of product revenue is due to the switch from packaged perpetual software products to subscription-based software offerings in the retail and DTC channels of the Consumer Language segment. Product margin decreased as second quarter 2018 product sales were primarily comprised of audio practice materials, like headsets, which have a higher inventory cost than packaged software product.

## Gross Profit

Gross profit for the three months ended June 30, 2018 was \$35.6 million, a decrease of 7% for the three months ended June 30, 2018, compared to \$38.3 million the three months ended June 30, 2017. Gross profit percentage decreased slightly to 82% for the three months ended June 30, 2018, from 83% for the three months ended June 30, 2017. The decline in gross profit and margin was primarily driven by the year-over-year decline in revenue associated with the switch from packaged perpetual products to subscription-based offerings in the retail and direct-to-consumer channels of the Consumer Language segment.

## Operating Expenses

|                                    | Three Months<br>Ended June 30, |          | 2018 Versus<br>2017 |             |
|------------------------------------|--------------------------------|----------|---------------------|-------------|
|                                    | 2018                           | 2017     | Change              | %<br>Change |
| (in thousands, except percentages) |                                |          |                     |             |
| Sales and marketing                | \$24,874                       | \$24,037 | \$837               | 3.5 %       |
| Research and development           | 6,019                          | 6,348    | (329 )              | (5.2 )%     |

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|                            |          |          |        |         |
|----------------------------|----------|----------|--------|---------|
| General and administrative | 8,324    | 8,594    | (270 ) | (3.1 )% |
| Total operating expenses   | \$39,217 | \$38,979 | \$238  | 0.6 %   |

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## Sales and Marketing Expenses

Sales and marketing expenses increased \$0.8 million, or 3%, to \$24.9 million for the three months ended June 30, 2018, compared to \$24.0 million for the three months ended June 30, 2017. As a percentage of total revenue, sales and marketing expenses increased to 57% from 52% for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. These increases are primarily due to investment in sales and marketing for Lexia. We anticipate sales and marketing expenses will increase year-over-year as the Company funds its growth initiatives in both the Literacy and Language segments.

## Research and Development Expenses

Research and development expenses decreased \$0.3 million, or 5%, to \$6.0 million for the three months ended June 30, 2018, compared to \$6.3 million for the three months ended June 30, 2017. As a percentage of total revenue, research and development expenses were flat at 14% for the three months ended June 30, 2018 and June 30, 2017. We anticipate research and development expenses will increase year-over-year as the Company funds its growth initiatives in both the Literacy and Language segments.

## General and Administrative Expenses

General and administrative expenses decreased \$0.3 million, or 3%, to \$8.3 million for the three months ended June 30, 2018, compared to \$8.6 million for the three months ended June 30, 2017. As a percentage of revenue, general and administrative expenses were flat at 19% for the three months ended June 30, 2018 and June 30, 2017.

## Interest and Other Income (Expense)

|                                  | Three<br>Months<br>Ended June<br>30, |        | 2018 Versus<br>2017 |             |
|----------------------------------|--------------------------------------|--------|---------------------|-------------|
|                                  | 2018                                 | 2017   | Change              | %<br>Change |
|                                  | (in thousands, except percentages)   |        |                     |             |
| Interest income                  | \$23                                 | \$17   | \$6                 | 35.3 %      |
| Interest expense                 | (81 )                                | (130 ) | 49                  | (37.7 )%    |
| Other income and (expense)       | (1 )                                 | 425    | (426 )              | (100.2)%    |
| Total other income and (expense) | \$(59)                               | \$312  | \$(371)             | (118.9)%    |

Interest income for the three months ended June 30, 2018 was \$23,000, up slightly from \$17,000 for the three months ended June 30, 2017. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the three months ended June 30, 2018 and June 30, 2017, was flat at \$0.1 million, attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other income and (expense) changed \$0.4 million for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. The change is due to the second quarter 2017 gain on sale of the Japan entity of \$0.4 million.

## Income Tax Expense

|                    | Three<br>Months<br>Ended June<br>30, |       | 2018 Versus<br>2017 |             |
|--------------------|--------------------------------------|-------|---------------------|-------------|
|                    | 2018                                 | 2017  | Change              | %<br>Change |
|                    | (in thousands, except percentages)   |       |                     |             |
| Income tax expense | \$454                                | \$782 | \$(328)             | (41.9)%     |

Our income tax expense for the three months ended June 30, 2018, was \$0.5 million, compared to \$0.8 million for the three months ended June 30, 2017. The decrease to tax expense was primarily due to a reduced federal income tax rate associated with the Tax Act and the ability to use post-2017 net operating losses to reduce deferred tax expense associated with amortization of indefinite-lived intangible assets.

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Comparison of the six months ended June 30, 2018 and the six months ended June 30, 2017

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

|  | Six Months Ended<br>June 30, |          | 2018 Versus 2017 |           |        |
|--|------------------------------|----------|------------------|-----------|--------|
|  | 2018                         | 2017     | Change           | %         | Change |
| <b>Revenue:</b>                          |                              |          |                  |           |        |
| Subscription and service                 | \$84,176                     | \$83,435 | \$741            | 0.9       | %      |
| Product                                  | 2,134                        | 10,163   | (8,029 )         | (79.0 )   | %      |
| Total revenue                            | 86,310                       | 93,598   | (7,288 )         | (7.8 )    | %      |
| <b>Cost of revenue:</b>                  |                              |          |                  |           |        |
| Cost of subscription and service revenue | 14,632                       | 12,592   | 2,040            | 16.2      | %      |
| Cost of product revenue                  | 2,732                        | 3,140    | (408 )           | (13.0 )   | %      |
| Total cost of revenue                    | 17,364                       | 15,732   | 1,632            | 10.4      | %      |
| Gross profit                             | 68,946                       | 77,866   | (8,920 )         | (11.5 )   | %      |
| <b>Operating expenses:</b>               |                              |          |                  |           |        |
| Sales and marketing                      | 49,065                       | 48,205   | 860              | 1.8       | %      |
| Research and development                 | 12,325                       | 12,762   | (437 )           | (3.4 )    | %      |
| General and administrative               | 16,856                       | 16,619   | 237              | 1.4       | %      |
| Total operating expenses                 | 78,246                       | 77,586   | 660              | 0.9       | %      |
| (Loss) income from operations            | (9,300 )                     | 280      | (9,580 )         | (3,421.4) | %      |
| <b>Other income and (expense):</b>       |                              |          |                  |           |        |
| Interest income                          | 48                           | 30       | 18               | 60.0      | %      |
| Interest expense                         | (164 )                       | (245 )   | 81               | (33.1 )   | %      |
| Other income and (expense)               | (229 )                       | 736      | (965 )           | (131.1 )  | %      |
| Total other income and (expense)         | (345 )                       | 521      | (866 )           | (166.2 )  | %      |
| (Loss) income before income taxes        | (9,645 )                     | 801      | (10,446 )        | (1,304.1) | %      |
| Income tax expense                       | 915                          | 1,482    | (567 )           | (38.3 )   | %      |
| Net loss                                 | \$(10,560)                   | \$(681 ) | \$(9,879)        | 1,450.7   | %      |

Total revenue declined \$7.3 million to \$86.3 million for the six months ended June 30, 2018 compared to \$93.6 million for the six months ended June 30, 2017. Within the change in total revenue, Consumer Language revenue decreased \$8.9 million and E&E Language revenue decreased \$3.0 million. These declines were partially offset by an increase in Literacy revenue of \$4.5 million,

Loss from operations for the six months ended June 30, 2018 totaled \$9.3 million, compared to operating income of \$0.3 million for the six months ended June 30, 2017. The change in operating loss was driven primarily by the decline in revenue.

The following table sets forth revenue for our three operating segments for the six months ended June 30, 2018 and 2017 (in thousands, except percentages):

|                   | Six Months Ended June 30, |        |          |        | 2018 Versus 2017 |         |
|-------------------|---------------------------|--------|----------|--------|------------------|---------|
|                   | 2018                      |        | 2017     |        | Change           | %       |
| Literacy          | \$25,079                  | 29.0 % | \$20,540 | 21.9 % | \$4,539          | 22.1 %  |
| E&E Language      | 30,792                    | 35.7 % | 33,760   | 36.1 % | (2,968 )         | (8.8 )% |
| Consumer Language | 30,439                    | 35.3 % | 39,298   | 42.0 % | (8,859 )         | (22.5)% |
| Total Revenue     | \$86,310                  | 100.0% | \$93,598 | 100.0% | \$(7,288)        | (7.8 )% |



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## Literacy Segment

Literacy revenue increased \$4.5 million, or 22%, from \$20.5 million for the six months ended June 30, 2017 to \$25.1 million for the six months ended June 30, 2018. The growth in Literacy revenue was driven by sales growth and strong retention rates. We anticipate additional investments in product and sales personnel in the Literacy business to grow this segment and achieve scale.

## E&amp;E Language Segment

E&E Language revenue decreased \$3.0 million, or 9%, from \$33.8 million for the six months ended June 30, 2017 to \$30.8 million for the six months ended June 30, 2018. Revenue declined approximately \$1.8 million, or 9% in the enterprise category reflecting our strategic decision to exit certain geographies and approximately \$1.2 million, or 8% in the education category. We expect to continue to balance investments and adjust our cost structure to align scale without impacting growth.

## Consumer Language Segment

Consumer Language revenue decreased \$8.9 million, or 23%, from \$39.3 million for the six months ended June 30, 2017 to \$30.4 million for the six months ended June 30, 2018. This decrease largely reflects the continued transition of the segment to subscription-based sales, which are recognized over time, from the sale of perpetual products that were historically recognized up front. The SaaS transition within the Consumer Language segment's DTC channel was largely completed by the end of 2017 and the migration from CD-based product sales to subscriptions in the retail channel was initiated in mid-2017 and was completed in the second quarter of 2018. We expect revenue within the global retail sales channel will decline in 2018 as we complete the retail transition from perpetual product to subscriptions. In connection with our recent shift in strategy, we will invest in the mobile and English-learning to drive growth. Our Consumer business is seasonal and consumer sales typically peak in the fourth quarter during the holiday shopping season.

## Revenue by Subscription and Service Revenue and Product Revenue

The following table sets forth revenue for subscription and services and product for the six months ended June 30, 2018 and 2017 (in thousands, except percentages):

|                          | Six Months Ended June 30, |          | 2018 Versus 2017 |          |
|--------------------------|---------------------------|----------|------------------|----------|
|                          | 2018                      | 2017     | Change           | % Change |
| Subscription and service | \$84,176                  | \$83,435 | \$741            | 0.9 %    |
| Product                  | 2,134                     | 10,163   | (8,029)          | (79.0)%  |
| Total revenue            | \$86,310                  | \$93,598 | \$(7,288)        | (7.8)%   |

## Subscription and Service Revenue

Subscription and service revenue was \$84.2 million for the six months ended June 30, 2018, an increase of \$0.7 million from \$83.4 million for the six months ended June 30, 2017. The Literacy segment falls entirely within the subscription and service revenue category, which increased \$4.5 million year over year. As earlier noted, the 22% increase in Literacy revenue was driven by sales growth and strong retention rates. This improvement was offset by revenue decline in the Consumer subscription and service revenue of \$1.4 million and E&E Language subscription and service revenue of \$2.3 million. The primary driver of the decline in Consumer subscription and service revenue was the continued transition of the global consumer retail sales channel to subscription and the absence of Fit Brains subscription revenue.

## Product Revenue

Product revenue decreased \$8.0 million, or 79%, to \$2.1 million during the six months ended June 30, 2018 from \$10.2 million during the six months ended June 30, 2017. Product revenue decreased \$5.5 million in the DTC sales channel and \$1.2 million in the global consumer retail sales channel due to the SaaS migration. The completion of the global retail transition to subscription sales was completed in the second quarter of 2018 and we expect the revenue impact from this migration will be realized in 2018 which will result in a decline in product revenue in the future. Going forward product revenue will primarily represent the sale of headsets which will continue to be recognized upon delivery.



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

The following table sets forth cost of subscription and service revenue and product revenue, as well as gross profit for the six months ended June 30, 2018 and 2017 (in thousands, except percentages):

|  | Six Months Ended<br>June 30, |          | 2018 Versus 2017 |             |
|--|------------------------------|----------|------------------|-------------|
|  | 2018                         | 2017     | Change           | %<br>Change |
| Revenue:                                 |                              |          |                  |             |
| Subscription and service                 | \$84,176                     | \$83,435 | \$741            | 0.9 %       |
| Product                                  | 2,134                        | 10,163   | (8,029 )         | (79.0)%     |
| Total revenue                            | 86,310                       | 93,598   | (7,288 )         | (7.8 )%     |
| Cost of revenue:                         |                              |          |                  |             |
| Cost of subscription and service revenue | 14,632                       | 12,592   | 2,040            | 16.2 %      |
| Cost of product revenue                  | 2,732                        | 3,140    | (408 )           | (13.0)%     |
| Total cost of revenue                    | 17,364                       | 15,732   | 1,632            | 10.4 %      |
| Gross profit                             | \$68,946                     | \$77,866 | \$(8,920)        | (11.5)%     |
| Gross margin percentages                 | 79.9 %                       | 83.2 %   | (3.3 )%          |             |

## Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the six months ended June 30, 2018 was \$14.6 million, an increase of \$2.0 million, or 16%, from \$12.6 million for the six months ended June 30, 2017. As a percentage of subscription and service revenue, cost of subscription and service revenue was 17% for the six months ended June 30, 2018, an increase from 15% for the six months ended June 30, 2017. The increase in cost and the decrease in margin were primarily due to an increase in amortization expense from capitalized internal-use software costs and an increase in allocated costs from a higher allocation rate associated with the shift in revenue mix in favor of subscription and service revenue. We expect the cost of subscription and service revenue will increase as we complete the migration of our Consumer Language business to our subscription-based products.

## Cost of Product Revenue

Cost of product revenue for the six months ended June 30, 2018 was \$2.7 million, a decrease of \$0.4 million, or 13%, from \$3.1 million for the six months ended June 30, 2017. As a percentage of product revenue, cost of product revenue exceeded product revenue by 128% for the six months ended June 30, 2018, compared to 31% for the six months ended June 30, 2017. These variances were primarily due to a \$1.3 million inventory obsolescence charge in the first quarter of 2018 associated with the switch from packaged perpetual products to subscription-based offerings in the retail and DTC channels of the Consumer Language segment. Additionally, product margin decreased as 2018 product sales were primarily comprised of audio practice materials, like headsets, which have a higher inventory cost than packaged software product.

## Gross Profit

Gross profit decreased \$8.9 million to \$68.9 million for the six months ended June 30, 2018 compared to \$77.9 million for the six months ended June 30, 2017. Gross profit percentage decreased to 80% for the six months ended June 30, 2018 as compared to 83% and the six months ended June 30, 2017.

## Operating Expenses

|                                    | Six Months<br>Ended June 30, |          | 2018 Versus<br>2017 |             |
|------------------------------------|------------------------------|----------|---------------------|-------------|
|                                    | 2018                         | 2017     | Change              | %<br>Change |
| (in thousands, except percentages) |                              |          |                     |             |
| Sales and marketing                | \$49,065                     | \$48,205 | \$860               | 1.8 %       |
| Research and development           | 12,325                       | 12,762   | (437 )              | (3.4 )%     |
| General and administrative         | 16,856                       | 16,619   | 237                 | 1.4 %       |
| Total operating expenses           | \$78,246                     | \$77,586 | \$660               | 0.9 %       |



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## Sales and Marketing Expenses

Sales and marketing expenses for the six months ended June 30, 2018 were \$49.1 million, an increase of \$0.9 million, or 2%, from the six months ended June 30, 2017. As a percentage of total revenue, sales and marketing expenses increased to 57% for the six months ended June 30, 2018 from 52% for the six months ended June 30, 2017. These increases are primarily due to investment in sales and marketing for Lexia. We anticipate sales and marketing expenses will increase year-over-year as the Company funds its growth initiatives in both the Literacy and Language segments.

## Research and Development Expenses

Research and development expenses were \$12.3 million for the six months ended June 30, 2018, a slight decrease of \$0.4 million, or 3%, from the six months ended June 30, 2017. As a percentage of total revenue, research and development expenses were flat at 14% for the six months ended June 30, 2018 and the six months ended June 30, 2017. We anticipate research and development expenses will increase year-over-year as the Company funds its growth initiatives in both the Literacy and Language segments.

## General and Administrative Expenses

General and administrative expenses increased \$0.2 million to \$16.9 million for the six months ended June 30, 2018 compared to \$16.6 million for the six months ended June 30, 2017. As a percentage of revenue, general and administrative expenses increased slightly to 20% for the six months ended June 30, 2018 from 18% for the six months ended June 30, 2017.

## Interest and Other Income (Expense)

|                                  | Six Months<br>Ended June<br>30,       |        | 2018 Versus<br>2017 |             |
|----------------------------------|---------------------------------------|--------|---------------------|-------------|
|                                  | 2018                                  | 2017   | Change              | %<br>Change |
|                                  | (in thousands, except<br>percentages) |        |                     |             |
| Interest income                  | \$48                                  | \$30   | \$18                | 60.0 %      |
| Interest expense                 | (164 )                                | (245 ) | 81                  | (33.1 )%    |
| Other income and (expense)       | (229 )                                | 736    | (965 )              | (131.1)%    |
| Total other income and (expense) | \$(345)                               | \$521  | \$(866)             | (166.2)%    |

Interest income for the six months ended June 30, 2018 was \$48,000, an increase of \$18,000, from the six months ended June 30, 2017. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the six months ended June 30, 2018 was \$0.2 million, flat as compared to the six months ended June 30, 2017. Interest expense relates to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other income and expense for the six months ended June 30, 2018 was expense of \$0.2 million, an unfavorable change of \$1.0 million, from income of \$0.7 million for the six months ended June 30, 2017. The change is primarily attributable to unfavorable foreign exchange fluctuations and a \$0.4 million gain on the sale of our Japan entity in 2017.

## Income Tax Expense

|                    | Six Months<br>Ended June<br>30,       |         | 2018 Versus<br>2017 |             |
|--------------------|---------------------------------------|---------|---------------------|-------------|
|                    | 2018                                  | 2017    | Change              | %<br>Change |
|                    | (in thousands, except<br>percentages) |         |                     |             |
| Income tax expense | \$915                                 | \$1,482 | \$(567)             | (38.3)%     |

Our income tax expense for the six months ended June 30, 2018 was \$0.9 million, compared to \$1.5 million for the six months ended June 30, 2017. The decrease to tax expense was primarily due to a reduced federal income tax rate associated with the Tax Act and the ability to use post-2017 net operating losses to reduce deferred tax expense associated with amortization of indefinite-lived intangible assets.

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### Liquidity and Capital Resources

#### Liquidity

Our principal source of liquidity at June 30, 2018, consisted of \$20.9 million in cash and cash equivalents and short-term investments, a decrease of \$22.0 million compared to December 31, 2017. Our primary operating cash requirements include the payment of salaries, employee benefits and other personnel related costs, as well as direct advertising expenses, costs of office facilities, and costs of information technology systems. Historically, we have primarily funded these requirements through cash flows from our operating activities.

Our operating segments are affected by different sales-to-cash patterns. Within our E&E Language and Literacy segments, revenue in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Our Consumer Language revenue is affected by seasonal trends associated with the holiday shopping season. Consumer Language sales typically turn to cash more quickly than E&E Language and Literacy sales, which tend to have longer collection cycles. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash. We expect the trend to use cash in the first half of the year and generate cash in the second half of the year to continue.

On October 28, 2014, we executed a Loan and Security Agreement with Silicon Valley Bank (“Bank”) to obtain a \$25.0 million revolving credit facility. Since the original date of execution, we have executed several amendments to the credit facility to reflect updates to our financial outlook and extend the credit facility. Under the amended agreement, we may borrow up to \$25.0 million, including a sub-facility, which reduces available borrowings, for letters of credit in the aggregate availability amount of \$4.0 million. The credit facility has a term that expires on April 1, 2020, during which time we may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

The total obligations under the credit facility cannot exceed the lesser of (i) the total revolving commitment of \$25.0 million or (ii) the borrowing base, which is calculated as 80% of eligible accounts receivable. As a result, the borrowing base will fluctuate and we expect it will follow the general seasonality of cash and accounts receivable (lower in the first half of the year and higher in the second half of the year). If the borrowing base less any outstanding amounts, plus the cash held at the Bank is greater than \$25.0 million, then we may borrow up to an additional \$5.0 million, but in no case can borrowings exceed \$25.0 million. Interest on borrowings accrues at the Prime Rate provided that we maintain a minimum cash and Availability balance of \$17.5 million. If cash and Availability is below \$17.5 million, interest will accrue at the Prime Rate plus 1%.

As of the date of this filing, no borrowings have been made under the revolving credit agreement and we were eligible to borrow \$10.9 million of available credit less \$4.0 million in letters of credit have been issued by the Bank on our behalf, resulting in a net borrowing availability of \$6.9 million. We are subject to certain financial and restrictive covenants under the credit facility. We are required to maintain compliance with a minimum liquidity ratio and maintain a minimum Adjusted EBITDA. As of June 30, 2018, we were in compliance with all of the covenants under the revolving credit agreement.

The total amount of cash that was held by foreign subsidiaries as of June 30, 2018 was \$5.4 million. As of June 30, 2018, if we were to repatriate this foreign cash, no tax liability would result due to the current period and carryforward net operating losses.

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.

#### Capital Resources

We believe our current cash and cash equivalents, short-term investments, and funds generated from our sales will be sufficient to meet our cash needs for at least the next twelve months from the date of issuance of this report. We have generated significant operating losses as reflected in our accumulated loss and we may continue to incur operating losses in the future that may continue to require additional working capital to execute strategic initiatives. 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 optimization of

office space in the U.S. and worldwide, building the infrastructure necessary to support our growth, the response of competitors to our products and services, and our relationships with suppliers. We extend payments to certain vendors in order to minimize the amount of working capital deployed in the business. In order to maximize our cash position, we will continue to manage our existing inventory, accounts receivable, and accounts payable balances. Borrowings under our credit facility can be utilized to meet working capital requirements, anticipated capital expenditures, and other obligations.



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## Cash Flow Analysis

|   | Six Months Ended                   |           | 2018 Versus 2017 |            |
|---|------------------------------------|-----------|------------------|------------|
|   | June 30,<br>2018                   | 2017      | Change           | % Change   |
|   | (in thousands, except percentages) |           |                  |            |
| Net cash used in operating activities               | \$(14,734)                         | \$(5,000) | \$(9,734)        | 194.7 %    |
| Net cash used in investing activities               | \$(8,119 )                         | \$(5,281) | \$(2,838)        | 53.7 %     |
| Net cash provided by (used in) financing activities | \$1,091                            | \$(46 )   | \$1,137          | (2,471.7)% |
| <b>Net Cash Used in Operating Activities</b>        |                                    |           |                  |            |

Net cash used in operating activities for the six months ended June 30, 2018, was \$14.7 million. The factors affecting our operating cash flows during the period were our net loss of \$10.6 million, adjusted for non-cash charges totaling \$9.4 million and a change in net operating assets and liabilities of \$13.5 million. Non-cash items primarily consisted of \$7.1 million in depreciation and amortization expense and \$1.9 million in stock compensation expense. Depreciation and amortization expense increased due to the release of the PowerUp Literacy offering and its commencement of amortization in early January of 2018. Stock based compensation increased related to the additional expense associated with the renewed performance-based incentive stock plan. Contributing to the cash inflows in 2018 was a cash receipt of \$4.5 million from SOURCENEXT Corporation ("SOURCENEXT") for additional software licensing, which will be recognized into revenue ratably through 2037.

Net cash used in operating activities for the six months ended June 30, 2017, was \$5.0 million. The factors affecting our operating cash flows during the period were our net loss of \$0.7 million, adjusted for non-cash charges totaling \$7.2 million, which was more than offset by an unfavorable overall change in operating assets and liabilities of \$11.5 million. Non-cash items primarily consisted of \$6.1 million in depreciation and amortization expense and \$1.5 million related to stock based compensation, partially offset by a \$0.5 million gain on the sale of our Japan subsidiary. The primary drivers of the change in operating assets and liabilities were a decrease in accounts receivable of \$4.2 million and \$7.3 million decrease in deferred revenue. The decrease in accounts receivable was primarily related to the timing of sales during the fourth quarter 2016 holiday season compared to when payments are typically made. The decrease in deferred revenue was primarily due to the seasonality of our offerings, specifically due to the higher Consumer sales coinciding with the fourth quarter holiday shopping season and the timing of renewals in the corporate sales channel in the fourth quarter. Contributing to the cash inflows in 2017 was a cash receipt of \$11.5 million from SOURCENEXT for the perpetual license of certain intellectual property for exclusive use and sale in Japan.

## Net Cash Used in Investing Activities

Net cash used in investing activities was \$8.1 million for the six months ended June 30, 2018, compared to \$5.3 million for the six months ended June 30, 2017, a change of \$2.8 million. Purchases of property and equipment, which primarily relates to capitalized labor increased \$1.2 million related to Literacy projects and \$1.4 million related to Language and corporate projects.

## Net Cash Provided by (Used in) Financing Activities

Net cash provided by financing activities was \$1.1 million for the six-month period ended June 30, 2018, compared to net cash used in financing activities of \$46,000 for the six-month period ended June 30, 2017, a favorable change of \$1.1 million. Proceeds from the exercise of stock options increased due to the recent rise in our stock price.

## Off-Balance Sheet Arrangements

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

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## Contractual Obligations

As discussed in Notes 9 and 15 of Part 1 - Item 1, Financial Statements, we lease buildings, parking spaces, equipment, and office space under operating lease agreements. We also lease a building in France, certain equipment, and certain software under capital lease agreements. The following table summarizes our future minimum rent payments under non-cancellable operating and capital lease agreements as of June 30, 2018, and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

|   | Total          | Less than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
|---|----------------|------------------|-----------|-----------|-------------------|
|   | (in thousands) |                  |           |           |                   |
| Capitalized leases and other financing arrangements | \$2,255        | \$537            | \$1,059   | \$659     | \$ —              |
| Operating leases                                    | 8,460          | 3,659            | 2,601     | 1,952     | 248               |
| Total   | \$10,715       | \$4,196          | \$3,660   | \$2,611   | \$ 248            |

## 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 in 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 U.S. 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 interest rate exposure.

## Credit Risk

Accounts receivable and cash and cash equivalents present the highest potential concentrations of credit risk. We reserve for credit losses and do not require collateral on our trade accounts receivable. In addition, we maintain cash and investment balances in accounts at various banks and brokerage firms. We have not experienced any losses on cash and cash equivalent accounts to date. We sell products to retailers, resellers, government agencies, and individual consumers and extend credit based on an evaluation of the customer's financial condition, without requiring collateral. Exposure to losses on accounts receivable is principally dependent on each customer's financial condition. We monitor exposure for credit losses and maintain allowances for anticipated losses. We maintain trade credit insurance for certain customers to provide coverage, up to a certain limit, in the event of insolvency of some customers.

## Item 4. Controls and Procedures

## Evaluation of Disclosure Controls and Procedures

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 June 30, 2018. 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 June 30, 2018, our

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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 were no changes 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 June 30, 2018 that had materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. We implemented internal controls to ensure we adequately evaluated our contracts and properly assessed the impact of ASC 606 to facilitate its adoption on January 1, 2018. There were no significant changes to our internal control over financial reporting due to the adoption of ASC 606.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In late December 2017, we received a demand letter on behalf of two California customers who alleged that they were improperly charged for automatic renewal of their products. This matter has been resolved in a manner that was not material to the Company.

See Note 15 "Commitments and Contingencies" of Part I – Item 1, Financial Statements – for information about our legal proceedings.

Item 1A. Risk Factors

The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with our business previously disclosed in our Annual Report on Form 10-K filed on March 7, 2018 with the SEC for the period ended December 31, 2017. An investment in our common stock involves a substantial risk of loss. Investors should carefully consider these risk factors, together with all of the other information included herewith, before deciding to purchase shares of our common stock. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our common stock could decline and all or part of an investment may be lost.

The risks described below are not the only ones facing us. Our business is also subject to the risks that affect many other companies, such as general economic conditions and geopolitical events. Further, additional risks not currently known to us or that we currently believe are immaterial could have a material adverse effect on our business, financial condition, cash flows and results of operations. In addition to the other information set forth in this quarterly report on Form 10-Q, you should carefully consider the risk factors discussed below and in other documents we file with the SEC that could materially affect our business, financial condition, cash flows or future results.

We might not be successful in executing our strategy of focusing on corporate and K-12 learners and passionate language learners.

We are continuing to implement our strategy to emphasize the development of products and solutions for corporate and K-12 learners who need to speak and read English. This focus extends to the Consumer Language segment, where we continue to make product investments serving the needs of passionate language learners who are mobile, results-focused and value a quality language-learning experience. If we do not successfully execute our strategy, our revenue and profitability could decline, which could have an adverse effect on our business and financial results.

Our actual operating results may differ significantly from our guidance.

Historically, our practice has been to release guidance regarding our future performance that represents management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based on projections prepared by management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party confirms or examines the projections and, accordingly, no such person expresses any opinion or any other form of assurance with respect thereto.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We generally state possible outcomes as high and low ranges or as single point estimates, but actual results could differ materially. The principal reason that we release guidance is to provide a basis for management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such persons.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions in the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. We expressly disclaim any obligations to update or revise any guidance, whether as a result of new information, future events or otherwise, except as required by law. In light of the foregoing, investors are urged not to rely upon, or otherwise consider, our guidance in making an investment decision

in respect of our common stock.

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Any failure to successfully implement our strategy or the occurrence of any of the events or circumstances set forth in these "Risk Factors" and elsewhere in this quarterly report on Form 10-Q could result in the actual operating results being different from our guidance, and such differences may be adverse and material.

Intense competition in our industry may hinder our ability to attract and retain customers and generate revenue, and may diminish our margins.

The business environment in which we operate is rapidly evolving, highly fragmented and intensely competitive, and we expect competition to persist and intensify. Increased competition could adversely affect operating results by causing lower demand for our products and services, reduced revenue, more product returns, price reductions or concessions, reduced gross margins and loss of customers.

Many of the current and potential competitors in our Literacy and E&E Language segments have substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition in some locations, as well as in some cases, lower costs. Some competitors offer more differentiated products (for example, online learning as well as physical classrooms and textbooks) that may allow them to more flexibly meet changing customer preferences. The resources of our competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements and preferences and to offer lower prices than ours or to offer free language-learning software or online services. We may not be able to compete successfully against current or future competitors.

There are a number of free online language-learning opportunities to learn grammar, pronunciation, vocabulary (including specialties in areas such as medicine and business), reading, and conversation by means of podcasts and MP3s, mobile applications, audio courses and lessons, videos, games, stories, news, digital textbooks, and through other means, which compete with our Consumer Language segment. We estimate that there are thousands of free mobile applications on language-learning; free products are provided in at least 50 languages by private companies, universities, and government agencies. Low barriers to entry allow start-up companies with lower costs and less pressure for profitability to compete with us. Competitors that are focused more on user acquisition rather than profitability and funded by venture capital may be able to offer products at significantly lower prices or for free. As free online translation services improve and become more widely available and used, people may generally become less interested in language learning. Although we also offer free products such as mobile apps, if we cannot successfully attract users of these free products and convert a sufficient portion of these free users into paying customers, our business could be adversely affected. If free products become more engaging and competitive or gain widespread acceptance by the public, demand for our products could decline or we may have to lower our prices, which could adversely impact our revenue and other results.

Historically a substantial portion of our revenue has been generated from our Consumer Language business. If we fail to accurately anticipate consumer demand and trends in consumer preferences, our brands, sales and customer relationships may be harmed.

Demand for our consumer focused language-learning software products and related services is subject to rapidly changing consumer demand and trends in consumer preferences. Therefore, our success depends upon our ability to:

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- provide appealing solutions that engage our customers;
- adapt and offer our products and services using rapidly evolving, widely varying and complex technologies;
- anticipate and meet consumer demand for additional languages, learning levels and new platforms for delivery;
- effectively position and market our products and services;
- identify and secure cost-effective means of marketing our products to reach the appropriate consumers;
- identify cost-effective sales distribution channels and other sales outlets where interested consumers will buy our products;
- anticipate and respond to consumer price sensitivity and pricing changes of competitive products;
- and
- identify and successfully implement ways of building brand loyalty and reputation.

We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers might not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We might not achieve significant revenue from new product and service investments for a number of years, if at all. We also might not be able to develop new solutions or enhancements in time to capture business opportunities or achieve sustainable acceptance in new or existing marketplaces. Furthermore, consumers may defer purchases of our solutions



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in anticipation of new products or new versions from us or our competitors. A decline in consumer demand for our solutions, or any failure on our part to satisfy such changing consumer preferences, could harm our business and profitability.

If the recognition by schools and other organizations of the value of technology-based education does not continue to grow, our ability to generate revenue from organizations could be impaired.

Our success depends in part upon the continued adoption by organizations and potential customers of technology-based education initiatives. Some academics and educators oppose online education in principle and have expressed concerns regarding the perceived loss of control over the education process that could result from offering courses online. If the acceptance of technology-based education does not continue to grow, our ability to continue to grow our Literacy and E&E Language businesses could be impaired.

We depend on discretionary consumer spending in the Consumer Language segment of our business. Adverse trends in general economic conditions, including retail and online shopping patterns or consumer confidence, as well as other external consumer dynamics may compromise our ability to generate revenue.

The success of our business depends to a significant extent upon discretionary consumer spending, which is subject to a number of factors, including general economic conditions, consumer confidence, employment levels, business conditions, interest rates, availability of credit, inflation and taxation. Adverse trends in any of these economic indicators may cause consumer spending to decline, which could adversely affect our sales and profitability.

Because a portion of our Consumer Language sales are made to or through retailers and distributors, none of which has any obligation to sell our products, the failure or inability of these parties to sell our products effectively could reduce our revenue and profitability.

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers and distributors are concentrated on a key group that is comprised of a mix of websites, such as Amazon.com and the Apple App Store, select retail resellers such as Barnes & Noble, Best Buy, Target, Books-a-Million, and Staples, and consignment distributors such as Software Packaging Associates.

We have no control over the quantity of products that these retailers and distributors purchase from us or sell on our behalf, we do not have long-term contracts with any of them, and they have no obligation to offer or sell our products or to give us any particular shelf space or product placement within their stores. Thus, there is no guarantee that this source of revenue will continue at the same level as it has in the past or that these retailers and distributors will not promote competitors' products over our products or enter into exclusive relationships with our competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a significant decline in our revenue and profitability. Furthermore, product display locations and promotional activities that retailers undertake can affect the sales of our products. The fact that we also sell our products directly could cause retailers or distributors to reduce their efforts to promote our products or stop selling our products altogether.

Many traditional physical retailers are experiencing diminished foot traffic and sales. For our retail business, even though online sales have increased in popularity and are growing in importance, we continue to depend on sales that take place in physical stores and shopping malls. Reduced customer foot traffic in these stores and malls is likely to reduce their sales of our products. In addition, if one or more of these retailers or distributors are unable to meet their obligations with respect to accounts payable to us, we could be forced to write off accounts receivable with such accounts. Any bankruptcy, liquidation, insolvency or other failure of any of these retailers or distributors could result in significant financial loss and cause us to lose revenue in future periods.

Price changes and other concessions could reduce our revenue.

We continue to test and offer changes to the pricing of our products. If we reduce our prices in an effort to increase our sales, this could have an adverse impact on our revenue to the extent that unit sales do not increase in a sufficient amount to compensate for the lower pricing. Reducing our pricing to individual consumers could also cause us to have to lower pricing to our E&E Language customers. Any increase in the taxation of online sales could have the effect of a price increase to consumers and could cause us to have to lower our prices or could cause sales to decline. It is uncertain whether we will need to lower prices to effectively compete and what other short-term or long-term impacts

could be.

We also may provide our retailers and distributors with price protection on existing inventories, which would entitle these retailers and distributors to credit against amounts owed with respect to unsold packaged product under certain conditions. These price protection reserves could be material in future periods.

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In the U.S. and Canada, we offer consumers who purchase our packaged software and audio practice products directly from us a 30-day, unconditional, full money-back refund. We also permit some of our retailers and distributors to return packaged products, subject to certain limitations. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels, the timing of new product introductions and other factors. If packaged product returns exceed our reserve estimates, the excess would offset reported revenue, which could adversely affect our reported financial results.

Our future growth and profitability will depend in large part upon the effectiveness and efficiency of our marketing. Our future growth and profitability will depend in large part upon the effectiveness and efficiency of our marketing, including our ability to:

- appropriately and efficiently allocate our marketing for multiple products;
- accurately identify, target and reach our audience of potential customers with our marketing messages;
- select the right marketplace, media and specific media vehicle in which to advertise;
- identify the most effective and efficient level of spending in each marketplace, media and specific media vehicle;
- determine the appropriate creative message and media mix for advertising, marketing and promotional expenditures;
- effectively manage marketing costs, including creative and media expenses, in order to maintain acceptable customer acquisition costs;
- differentiate our products as compared to other products;
- create greater awareness of our new products, our brands and our learning solutions;
- drive traffic to our e-commerce website, call centers, distribution channels and retail partners; and
- convert customer inquiries into actual orders.

Our planned marketing may not result in increased revenue or generate sufficient levels of product and brand name awareness, and we may not be able to increase our net sales at the same rate as we increase our advertising expenditures.

We engage in an active public relations program, including through social media sites such as Facebook and Twitter. We also seek new customers through our online marketing efforts, including paid search listings, banner ads, text links and permission-based e-mails, as well as our affiliate and reseller programs. If one or more of the search engines or other online sources on which we rely for website traffic were to modify their general methodology for how they display our websites, resulting in fewer consumers clicking through to our websites, our sales could suffer. If any free search engine on which we rely begins charging fees for listing or placement, or if one or more of the search engines or other online sources on which we rely for purchased listings, modifies or terminates its relationship with us, our expenses could rise, we could lose customers and traffic to our websites could decrease.

We dynamically adjust our mix of marketing programs to acquire new customers at a reasonable cost with the intention of achieving overall financial goals. If we are unable to maintain or replace our sources of customers with similarly effective sources, or if the cost of our existing sources increases, our customer levels and marketing expenses may be adversely affected.

Our international businesses may not succeed and may impose additional and unique risks.

In March 2016, as part of the 2016 Restructuring Plan, we initiated actions to withdraw our direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of the E&E Language offerings, transitioning to indirect sales channels through reseller and other arrangements with third parties in those geographies. We also have optimized certain of our website sales channels in Europe, Asia and Latin America. If we are unable to conduct our international operations successfully and market, sell, deliver and support our products and services internationally to the extent we expect, our business, revenue and financial results could be harmed.

If we are unable to continually adapt our products and services to mobile devices and technologies other than personal computers and laptops, and to adapt to other technological changes and customer needs generally, we may be unable to attract and retain customers, and our revenue and business could suffer.

We need to anticipate, develop and introduce new products, services and applications on a timely and cost-effective basis that keeps pace with technological developments and changing customer needs. The process of developing new high technology products, services and applications and enhancing existing products, services and applications is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging

technological trends accurately could significantly harm our ability to attract and retain customers and our results of operations. For example, the number of individuals who access the Internet through devices other than a personal computer, such as tablet computers, mobile devices, televisions and set-top box devices, has increased dramatically and this trend is likely to continue. Our products and services may not work or be viewable on these devices because each manufacturer or distributor may establish unique technical standards for such devices. Accordingly, we may need to devote significant resources to the creation, support and maintenance

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of such versions. If we fail to develop or sell products and services on a cost-effective basis that respond to these or other technological developments and changing customer needs, we may be harmed in our ability to attract and retain customers, and our revenue and business could suffer. Furthermore, our customers who view our advertising via mobile devices might not buy our products to the same extent that they do when viewing our advertising via personal computers or laptops. Accordingly, if we cannot convince customers to purchase our products via mobile devices, our business and results of operations could be harmed to the extent that the trend to mobile devices continues.

We offer our software products on operating systems and platforms including Windows, Macintosh, Apple OS, Android, and Amazon apps. The demand for traditional desktop computers has been declining, while the demand for mobile devices such as notebook computers, smartphones and tablets has been increasing, which means that we must be able to market to potential customers and to provide customers with access to and use of our products and services on many platforms and operating systems, as they may be changed from time to time. To the extent new releases of operating systems, including for mobile and non-PC devices, or other third-party products, platforms or devices make it more difficult for our products to perform, and our customers use alternative technologies, our business could be harmed.

Our software products must interoperate with computer operating systems of our customers. If we are unable to ensure that our products interoperate properly with customer systems, our business could be harmed.

Our products must interoperate with our customers' computer systems, including the network, security devices and settings, and student learning management systems of our E&E Language and Literacy customers. As a result, we must continually ensure that our products interoperate properly with these varied and customized systems. Changes in operating systems, the technologies we incorporate into our products or the computer systems our customers use may damage our business.

Our products and internal systems rely on software that is highly technical and maintained by third parties and if such third-party software contains undetected errors or vulnerabilities or if it not supported or updated to keep pace with current computer hardware, our business could be adversely affected.

Our products and internal systems rely on software, including software developed or maintained internally and/or by third parties, that is highly technical and complex. In addition, our products and internal systems depend on the ability of such software to store, retrieve, process, and manage immense amounts of data. Such software has contained, and may now or in the future contain, undetected errors, bugs, or vulnerabilities. Some errors may only be discovered after the code has been released for external or internal use. Errors, vulnerabilities, or other design defects within the software on which we rely may result in a negative experience for users and marketers who use our products, delay product introductions or enhancements, result in measurement or billing errors, compromise our ability to protect the data of our users and/or our intellectual property or lead to reductions in our ability to provide some or all of our services.

For example, we rely on Adobe Flash as a platform for our software. Adobe Flash is one of the most versatile programming systems available and is unique in its ability to allow the integration of many forms of electronic formatted media into an interactive and user friendly system. However, in July 2015, certain vulnerabilities discovered in Adobe Flash led to temporary interruption of support for Adobe Flash by popular web browsers. As a result, some software makers are opting to exclude Adobe Flash from their web browsers. If similar interruptions occur in the future and disrupt our ability to provide our products to some or all of our users, our ability to generate revenue would be harmed. Additionally, if Adobe Flash were to become deleted from Adobe's product line or become not supported or updated to keep pace with current computer hardware, then our software products would become obsolete very quickly. Any errors, bugs, vulnerabilities, or defects discovered in the software on which we rely, and any associated degradations or interruptions of service, could result in damage to our reputation, loss of users, loss of revenue, or liability for damages, any of which could adversely affect our business and financial results.

If there are changes in the spending policies or budget priorities for government funding of colleges, universities, schools, other education providers, or government agencies, we could lose revenue.

Many of our E&E Language and Literacy customers are colleges, universities, primary and secondary schools and school districts, other education providers, armed forces and government agencies that depend substantially on government funding. Accordingly, any general decrease, delay or change in federal, state or local funding for colleges,

universities, primary and secondary schools and school districts, or other education providers or government agencies that use our products and services could cause our current and potential customers to reduce their purchases of our products and services, to exercise their right to terminate licenses, or to decide not to renew licenses, any of which could cause us to lose revenue. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenue and could adversely affect our overall gross margins.

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Some of our E&E Language and Literacy business is characterized by a lengthy and unpredictable sales cycle, which could delay new sales.

We face a lengthy sales cycle between our initial contact with some potential E&E Language and Literacy customers and the signing of license agreements with these customers. As a result of this lengthy sales cycle, we have only a limited ability to forecast the timing of such E&E Language and Literacy sales. A delay in or failure to complete license transactions could cause us to lose revenue, and could cause our financial results to vary significantly from quarter to quarter. Our sales cycle varies widely, reflecting differences in our potential E&E Language and Literacy customers' decision-making processes, procurement requirements and budget cycles, and is subject to significant risks over which we have little or no control, including:

- customers' budgetary constraints and priorities;
- the timing of our customers' budget cycles;
- the need by some customers for lengthy evaluations that often include administrators and faculties; and
- the length and timing of customers' approval processes.

As we pursue a 100% SaaS-based model for our Consumer Language business and sell our solutions as subscriptions, rather than packaged software, our revenue, results of operations and cash flow could be negatively impacted.

Historically, we have predominantly sold our packaged software programs under a perpetual license for a single upfront fee and recognized 65-90% of the revenue at the time of sale. Certain of our online products are sold under different subscription terms, from short-term (less than one year) to long-term (typically 12- to 36-months) subscriptions with a corresponding license term. Online subscription customers could be less likely to renew their subscriptions beyond the initial term with the effect that we could earn less revenue over time from each customer than historically which could have a substantially negative impact on our revenue, results of operations and cash flow in any quarterly reporting period.

Our revenue is subject to seasonal and quarterly variations, which could cause our financial results to fluctuate significantly.

We have experienced, and we believe we will continue to experience, substantial seasonal and quarterly variations in our revenue, cash flows and net income. These variations are primarily related to increased sales of our Consumer Language products and services in the fourth quarter, especially during the holiday selling season as well as higher sales to governmental, educational institutions, and corporations in the second half of the calendar year. We sell to a significant number of our retailers, distributors and E&E Language customers on a purchase order basis and we receive orders when these customers need products and services. As a result, their orders are typically not evenly distributed throughout the year. Our quarterly results of operations also may fluctuate significantly as a result of a variety of other factors, including the timing of holidays and advertising initiatives, changes in our products, services and advertising initiatives and changes in those of our competitors. Budgetary constraints of our E&E Language and Literacy customers may also cause our quarterly results to fluctuate.

As a result of these seasonal and quarterly fluctuations, we believe that comparisons of our results of operations between different quarters are not necessarily meaningful and that these comparisons are not reliable as indicators of our future performance. In addition, these fluctuations could result in volatility and adversely affect our cash flows. Any seasonal or quarterly fluctuations that we report in the future may differ from the expectations of market analysts and investors, which could cause the price of our common stock to fluctuate significantly.

Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business.

We have made and may continue to make acquisitions or enter into joint ventures and strategic alliances as part of our long-term business strategy. Such transactions may result in use of our cash resources, dilutive issuances of our equity securities, or incurrence of debt. Such transactions also involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not realize a satisfactory return on our investment, that we experience difficulty integrating new technology, employees, and business systems, that we divert management's attention from our other businesses or that we acquire undiscovered liabilities such as patent infringement claims or violations of the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws. It may take longer than expected to realize the full benefits, such as increased revenue, enhanced efficiencies, or more customers, or those benefits may ultimately be smaller than anticipated, or may not be realized. These events and circumstances could

harm our operating results or financial condition.

Our possession and use of personal information presents risks and expenses that could harm our business. If we are unable to protect our information technology network against service interruption or failure, misappropriation or unauthorized disclosure or manipulation of data, whether through breach of our network security or otherwise, we could be subject to costly government enforcement actions and litigation and our reputation may be damaged.

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Our business involves the collection, storage and transmission of personal, financial or other information that is entrusted to us by our customers and employees. Our information systems also contain the Company's proprietary and other confidential information related to our business. Our efforts to protect such information may be unsuccessful due to the actions of third parties, computer viruses, physical or electronic break-ins, catastrophic events, employee error or malfeasance or other attempts to harm our systems. Possession and use of personal information in conducting our business subjects us to legislative and regulatory obligations that could require notification of data breaches, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. Some of our commercial partners may receive or store information provided by us or our users through our websites. If these third parties fail to adopt or adhere to adequate information security practices, or fail to comply with our online policies, or in the event of a breach of their networks, our customers' data may be improperly accessed, used or disclosed. As our business and the regulatory environment evolve in the U.S. and internationally, we may become subject to additional and even more stringent legal obligations concerning our treatment of customer information. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

Despite our precautions and significant ongoing investments to protect against security risks, data protection breaches, cyber-attacks and other intentional disruptions of our products and offerings, we may be a target of attacks specifically designed to impede the performance of our products and offerings and harm our reputation as a company. If our systems are harmed or fail to function properly or if third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to repair or replace systems or to otherwise protect against security breaches or to address problems caused by the breaches. A major breach of our network security and systems could have serious negative consequences for our businesses, including possible fines, penalties and damages, reduced customer demand for our products and services, harm to our reputation and brand, and loss of our ability to accept and process customer credit card orders. Any such access, disclosure or loss of information could result in legal claims or proceedings and regulatory penalties, disrupt our operations or result in a loss of confidence in our products and services, which could lead to a material and adverse effect on our business, reputation or financial results.

We may incur significant costs related to maintaining data security and in the event of any data security breaches that could compromise our information technology network security, trade secrets and customer data.

The secure processing, maintenance and transmission of personal, financial or other information that is entrusted to us by our customers is critical to our operations and business strategy, and we devote significant resources to protecting such information. The expenses associated with protecting such information could reduce our operating margins. Additionally, threats to our information technology network security can take a variety of forms. Individual hackers and groups of hackers, and sophisticated organizations or individuals may threaten our information technology network security. Cyber attackers may develop and deploy malicious software to attack our services and gain access to our networks or data centers, hold access to critical systems or information for ransom, or act in a coordinated manner to launch distributed denial of service or other coordinated attacks. Cyber threats and attacks are constantly evolving, thereby increasing the difficulty of detecting and successfully implementing measures to defend against them. We may be unable to anticipate potential techniques or implement adequate preventative measures in time. Cyber threats and attacks can have cascading impacts that unfold with increasing speed across internal networks and systems. Breaches of our network, credit card processing information, or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, cause product development delays, compromise confidential or technical business information harming our competitive position, result in theft or misuse of our intellectual property or other assets, expose us to contractual or regulatory audit or investigation, require us to allocate additional resources to alternative and potentially more costly technologies more frequently than anticipated, or otherwise adversely affect our business. We maintain cyber risk insurance, but our policy coverage limits may not be sufficient to cover all of our losses caused by any future information security-related breaches or events.

Our business is subject to complex and evolving U.S. and foreign laws and regulations regarding privacy and data protection. Changes in regulations or customer concerns regarding privacy and protection of customer data, or any

failure to comply with such laws, could adversely affect our business.

Federal, state, and international laws and regulations govern the collection, use, retention, disclosure, sharing and security of data that we receive from and about our customers. The use of consumer data by online service providers and advertising networks is a topic of active interest among federal, state, and international regulatory bodies, and the regulatory environment is unsettled and rapidly evolving. Many states have passed new laws impacting required notifications to customers and/or state agencies where there is a security breach involving personal data, such as California's Information Practices Act.

We also face similar risks in international markets where our products, services and apps are offered. Foreign data protection, privacy, competition, and other laws and regulations can impose different obligations or be more restrictive than those in the United States. We are subject to international laws and regulations that dictate whether, how, and under what

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circumstances we can transfer, process and/or receive transnational data that is critical to our operations and ability to provision our products and perform services for our customers, including data relating to users, customers, or partners outside the United States, and those laws and regulations are uncertain and subject to change.

Recent legal developments in Europe have created complexity and compliance uncertainty regarding certain transfers of information from Europe to the U.S. For example, in October 2015, the European Court of Justice invalidated the 2000 US-EU Safe Harbor program as a legitimate and legally authorized basis on which U.S. companies, including Rosetta Stone, could rely for the transfer of personal data from the European Union to the United States. The European Union and United States recently agreed to an alternative transfer framework for data transferred from the European Union to the United States, called the Privacy Shield Framework. Rosetta Stone participates and has certified to its compliance to the Privacy Shield Framework. However, this new framework also faces a number of legal challenges, is subject to an annual review that could result in changes to our obligations, and also may be challenged by national regulators or private parties. In addition, other available bases on which to rely for the transfer of EU personal data outside of the European Economic Area, such as standard Model Contractual Clauses (MCCs), have also been subjected to regulatory or judicial scrutiny. This has resulted in some uncertainty, and compliance obligations could cause us to incur costs or require us to change our business practices in a manner adverse to our business.

If one or more of the legal bases for transferring personal data from Europe to the United States is invalidated, or if we are unable to transfer personal data between and among countries and regions in which Rosetta Stone operates, it could affect the manner in which we provide our services or adversely affect our financial results. Any failure, or perceived failure, by us to comply with or make effective modifications to our policies, or to comply with any federal, state, or international privacy, data-retention or data-protection-related laws, regulations, orders or industry self-regulatory principles could result in proceedings or actions against us by governmental entities or others, a loss of customer confidence, damage to the Rosetta Stone brands, and a loss of customers, which could potentially have an adverse effect on our business.

In addition, various federal, state and foreign legislative or regulatory bodies may enact new or additional laws and regulations concerning privacy, data-retention and data-protection issues, including laws or regulations mandating disclosure to domestic or international law enforcement bodies, which could adversely impact our business, our brand or our reputation with customers. For example, some countries are considering laws mandating that personal data regarding customers in their country be maintained solely in their country. Having to maintain local data centers and design product, service and business operations to limit personal data processing within individual countries could increase our operating costs significantly. In addition, the European Commission has approved a data protection regulation, known as the General Data Protection Regulation (GDPR), which came into force in May 2018. The GDPR includes additional operational and other requirements for companies that receive or process personal data of residents of the European Union as well as significant penalties for non-compliance. California recently enacted the Consumer Privacy Act of 2018, which will become effective January 1, 2020 and will require companies to give California consumers information about what data they collect, as well as to delete data about consumers if requested. The interpretation and application of privacy, data protection and data retention laws and regulations are often uncertain and in flux in the U.S. and internationally. Complying with these varying international requirements could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business and operating results. In addition, these laws may be interpreted and applied inconsistently from country to country and inconsistently with our current policies and practices, complicating long-range business planning decisions. If privacy, data protection or data retention laws are interpreted and applied in a manner that is inconsistent with our current policies and practices we may be deemed non-compliant, subject to legal or regulatory process, fined or ordered to change our business practices in a manner that could cause us to incur substantial costs, or that adversely impacts our business or operating results.

We are subject to U.S. and foreign government regulation of online services which could subject us to claims, judgments, and remedies, including monetary liabilities and limitations on our business practices.

We are subject to regulations and laws directly applicable to providers of online services. The application of existing domestic and international laws and regulations to us, relating to issues such as user privacy and data protection, data

security, defamation, promotions, billing, consumer protection, accessibility, content regulation, quality of services, and intellectual property ownership and infringement, is unclear or unsettled in many instances. Also, the collection and protection of information from children under the age of 13 is subject to the provisions of the Children's Online Privacy Protection Act (COPPA), which is particularly relevant to our learning solutions focused on children. In addition, we will also be subject to any new laws and regulations directly applicable to our domestic and international activities. Internationally, we may also be subject to laws regulating our activities in foreign countries and to foreign laws and regulations that are inconsistent from country to country. We may incur substantial liabilities for expenses necessary to defend litigation in connection with such regulations and laws or to comply with these laws and regulations, as well as potential substantial penalties for any failure to comply.

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Changes in how network operators handle and charge for access to data that travel across their networks could adversely impact our business.

We rely upon the ability of customers to access many of our products through the Internet. To the extent that network operators implement usage based pricing, including meaningful bandwidth caps, or otherwise try to monetize access to their networks by data providers, we could incur greater operating expenses and our customer acquisition and retention could be negatively impacted. Furthermore, to the extent network operators were to create tiers of Internet access service and either charge us for or prohibit us from being available through these tiers, our business could be negatively impacted.

We are exposed to risks associated with credit card and payment fraud, and with our obligations under rules on credit card processing and alternative payment methods, which could cause us to lose revenue or incur costs. We depend upon our credit card processors and payment card associations.

As an e-commerce provider that accepts debit and credit cards for payment, we are subject to the Payment Card Industry Data Security Standard ("PCI DSS"), issued by the PCI Council. PCI DSS contains compliance guidelines and standards with regard to our network security surrounding the physical and electronic storage, processing and transmission of individual cardholder data. Despite our compliance with these standards and other information security measures, we cannot guarantee that all our information technology systems are able to prevent, contain or detect any cyber attacks, cyber terrorism, or security breaches from currently known viruses or malware, or viruses or malware that may be developed in the future. To the extent any disruption results in the loss, damage or misappropriation of information, we may be adversely affected by claims from customers, financial institutions, regulatory authorities, payment card associations and others. In addition, the cost of complying with stricter privacy and information security laws and standards could be significant.

We are subject to rules, regulations and practices governing our accepted payment methods which could change or be reinterpreted to make it difficult or impossible for us to comply. A failure to comply with these rules or requirements could make us subject to fines and higher transaction fees and we could lose our ability to accept these payment methods. We depend upon our credit card processors to carry out our sales transactions and remit the proceeds to us. At any time, credit card processors have the right to withhold funds otherwise payable to us to establish or increase a reserve based on their assessment of the inherent risks of credit card processing and their assessment of the risks of processing our customers' credit cards. If our credit card processors exercise their right to establish or increase a reserve, it may adversely impact our liquidity. Our business and results of operations could be adversely affected if these changes were to occur.

The uncertainty surrounding the terms of the United Kingdom's withdrawal from the European Union and its consequences could cause disruptions and create uncertainty to our businesses and adversely impact consumer and investor confidence in our products and services.

In June 2016, a majority of voters in the United Kingdom elected to withdraw from the European Union in a national referendum (also referred to as "Brexit"). The referendum was advisory, and by the terms of the Treaty on European Union, any withdrawal is subject to a negotiation period that could last at least two years after the government of the United Kingdom formally initiates the withdrawal process. The ultimate effects of Brexit on us are difficult to predict, but because we currently conduct business in the United Kingdom and in Europe, the results of the referendum and any eventual withdrawal could cause disruptions and create uncertainty to our businesses, including affecting the business of and/or our relationships with our customers and suppliers, as well as altering the relationship among tariffs and currencies, including the value of the British pound and the Euro relative to the U.S. dollar. Such disruptions and uncertainties could adversely affect our financial condition, operating results, and cash flows. Additionally, Brexit could result in legal uncertainty and potentially divergent national laws and regulations as new legal relationships between the United Kingdom and the European Union are established. The ultimate effects of Brexit on us will also depend on the terms of any agreements the United Kingdom and the European Union make to retain access to each other's respective markets either during a transitional period or more permanently. Any of these effects, among others, could materially adversely affect our business, business opportunities, results of operations, and financial condition. The U.S. Congress and Trump administration may make substantial changes to fiscal, political, regulatory and other federal policies that may adversely affect our business, financial condition, operating results and cash flows.

Changes in general economic or political conditions in the United States or other regions could adversely affect our business. For example, the administration under President Donald Trump has made, or has indicated that it may propose, significant changes with respect to a variety of issues, including education standards and funding, international trade agreements, import and export regulations, tariffs and customs duties, foreign relations, and immigration laws, that could have a materially adverse effect on our business, business opportunities, results of operations and financial condition.

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Uncertainty in the global geopolitical landscape from recent events may impede the implementation of our strategy outside the United States.

There may be uncertainty as to the position the United States government will take with respect to world affairs and events. This uncertainty may include such issues as U.S. support for existing treaty and trade relationships with other countries. This uncertainty, together with other key global events during recent years (such as the continuing uncertainty arising from the Brexit referendum in the United Kingdom as well as ongoing terrorist activity), may adversely impact (i) the ability or willingness of non-U.S. companies to transact business in the United States, including with the Company (ii) regulation and trade agreements affecting U.S. companies, (iii) global stock markets (including the New York Stock Exchange on which our common stock is traded), and (iv) general global economic conditions. All of these factors are outside of our control, but may nonetheless cause us to adjust our strategy in order to compete effectively in global markets.

Any significant interruptions in the operations of our website, call center or third-party call centers, especially during the holiday shopping season, could cause us to lose sales and disrupt our ability to process orders and deliver our solutions in a timely manner.

We rely on our website, an in-house call center and third-party call centers, over which we have little or no control, to sell our solutions, respond to customer service and technical support requests and process orders. These activities are especially important during the holiday season and in particular the period beginning on Black Friday through the end of the calendar year. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, or a failure of third-party call centers to handle higher volumes of use, could reduce our ability to receive and process orders and provide products and services, which could result in cancelled sales and loss of revenue and damage to our brand and reputation. These risks are more important during the holiday season, when many sales of our products and services take place.

We structure our marketing and advertising to drive potential customers to our website and call centers to purchase our solutions. If we experience technical difficulties with our website or if our call center operators do not convert inquiries into sales at expected rates, our ability to generate revenue could be impaired. Training and retaining qualified call center operators is challenging due to the expansion of our product and service offerings and the seasonality of our business. If we do not adequately train our call center operators, they may not convert inquiries into sales at an acceptable rate.

If any of our products or services contain defects or errors or if new product releases or services are delayed, our reputation could be harmed, resulting in significant costs to us and impairing our ability to sell our solutions.

If our products or services contain defects, errors or security vulnerabilities, our reputation could be harmed, which could result in significant costs to us and impair our ability to sell our products in the future. In the past, we have encountered product development delays due to errors or defects. We would expect that, despite our testing, errors could be found in new products and product enhancements in the future. Significant errors in our products or services could lead to, among other things:

- delays in or loss of marketplace acceptance of our products and services;
- diversion of our resources;
- a lower rate of license renewals or upgrades for Consumer Language, Literacy and E&E Language customers;
- injury to our reputation;
- increased service expenses or payment of damages; or
- costly litigation.

If we fail to effectively upgrade our information technology systems, we may not be able to accurately report our financial results or prevent fraud.

As part of our efforts to continue improving our internal control over financial reporting, we may decide to upgrade our existing financial information technology systems in order to automate controls that are currently performed manually. We may experience difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity, as personnel become familiar with these new systems. In addition, our management information systems will require modification and refinement as our business needs change, which could prolong

difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations. In addition, as a result of the automation of these manual processes, the data produced may cause us to question the accuracy of previously reported financial results.



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Failure to maintain the availability of the systems, networks, databases and software required to operate and deliver our Internet-based products and services could damage our reputation and cause us to lose revenue.

We rely on internal and external systems, networks and databases maintained by us and third-party providers to process customer orders, handle customer service requests, and host and deliver our Internet-based learning solutions. Any damage, interruption or failure of our systems, networks and databases could prevent us from processing customer orders and result in degradation or interruptions in delivery of our products and services. Notwithstanding our efforts to protect against interruptions in the availability of our e-commerce websites and Internet-based products and services, we do occasionally experience unplanned outages or technical difficulties. In addition, we do not have complete redundancy for all of our systems. In the event of an interruption or system event we may be unable to meet contract service level requirements, or we could experience an unrecoverable loss of data which could cause us to lose customers and could harm our reputation and cause us to face unexpected liabilities and expenses. If we continue to expand our business, we will put additional strains on these systems. As we continue to move additional product features to online systems or place more of our business online, all of these considerations will become more significant.

We may also need to grow, reconfigure or relocate our data centers in response to changing business needs, which may be costly and lead to unplanned disruptions of service.

We may incur losses associated with currency fluctuations and may not be able to effectively hedge our exposure, which could impair our financial performance.

Our operating results are subject to fluctuations in foreign currency exchange rates. We currently do not attempt to mitigate a portion of these risks through foreign currency hedging, based on our judgment of the appropriate trade-offs among risk, opportunity and expense. In the future, we might choose to engage in foreign currency hedging transactions, which would involve different risks and uncertainties.

Our revolving credit facility contains borrowing limitations and other restrictive covenants and the failure to maintain a sufficient borrowing base or to comply with such covenants could prevent us from borrowing funds, and could cause any outstanding debt to become immediately payable, which might adversely impact our business.

Our revolving credit facility contains borrowing limitations based on a combination of our cash balance and eligible accounts receivable balances and financial covenants currently applicable to us, as well as a number of restrictive covenants, including restrictions on incurring additional debt, making investments and other restricted payments, selling assets, paying dividends and redeeming or repurchasing capital stock and debt, subject to certain exceptions. Collectively, these borrowing limitations and covenants could constrain our ability to grow our business through acquisition or engage in other transactions. During the term of our \$25.0 million revolving credit facility, we are also subject to certain financial covenants that require us to maintain a minimum liquidity amount and minimum financial performance requirements, as defined in the credit agreement. If we are not able to comply with all of these covenants, for any reason, we would not be able to borrow funds under the facility, and some or all of any outstanding debt could become immediately due and payable which could have a material adverse effect on our liquidity and ability to conduct our business.

A significant deterioration in our profitability and/or cash flow caused by prolonged economic instability could reduce our liquidity and/or impair our financial ratios, and trigger a need to raise additional funds from the capital markets and/or renegotiate our banking covenants.

To the extent we face economic difficulties, our revenue, profitability and cash flows could be significantly reduced. A liquidity shortfall may delay certain development initiatives or may expose us to a need to negotiate further funding. While we anticipate that our existing cash and cash equivalents, together with availability under our existing revolving credit facility, cash balances and cash from operations, will be sufficient to fund our operations for at least the next 12 months, we may need to raise additional capital to fund operations in the future or to finance acquisitions. If we seek to raise additional capital in order to meet various objectives, including developing future technologies and services, increasing working capital, acquiring businesses and responding to competitive pressures, capital may not be available on favorable terms or may not be available at all. A lack of sufficient capital resources could significantly limit our ability to take advantage of business and strategic opportunities. Any additional capital raised through the sale of equity securities would dilute our stock ownership. If adequate additional funds are not available, we may be required

to delay, reduce the scope of, or eliminate material parts of our business strategy, including potential additional acquisitions or development of new products, services and technologies.

We might require additional funds from what we internally generate to support our business which might not be available on acceptable terms or at all.

We might need to further reduce costs or raise additional funds through public or private financings or borrowings in order to maintain our operations at their current level, develop or enhance products, fund expansion, respond to competitive

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pressures or to acquire complementary products, businesses or technologies. If required, additional financing might not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of debt, equity or convertible debt securities, these securities might have rights, preferences and privileges senior to those of our current stockholders.

If our goodwill or indefinite-lived intangible assets become impaired, we may be required to record a significant non-cash charge to earnings.

Under GAAP, we review our goodwill and indefinite lived intangible assets for impairment at least annually and when there are changes in circumstances. Factors that may be considered a change in circumstances include a decline in stock price and market capitalization, expected future cash flows and slower growth rates in our industry. We may be required to record significant charges to earnings in our financial statements during the period in which any impairment of our goodwill or indefinite lived intangible assets is determined, resulting in a negative effect on our results of operations.

We may have exposure to greater than anticipated tax liabilities.

We are subject to income and indirect tax in the U.S. and many foreign jurisdictions. The application of indirect taxes (such as sales and use tax, value-added tax, goods and services tax, business tax and gross receipt tax) to our businesses and to our users is complex, uncertain and evolving, in part because many of the fundamental statutes and regulations that impose indirect taxes were established before the adoption and growth of the Internet and e-commerce. We are subject to audit by multiple tax authorities throughout the world. Although we believe our tax estimates are reasonable and accurate, the final determination of tax audits and any related litigation could be materially different from our historical tax provisions and accruals. The results of an audit or litigation could have a material adverse effect on our financial statements in the period or periods for which that determination is made.

In addition, the United States government and other governments are considering and may adopt tax reform measures that could impact future effective tax rates favorably or unfavorably affected by changes in tax rates, changes in the valuation of our deferred tax assets or liabilities, or changes in tax laws or their interpretation. For instance, on December 22, 2017, President Donald Trump signed into U.S. law the Tax Cuts and Jobs Act of 2017. The exact ramifications of the legislation are subject to interpretation and could have a material impact on our financial position and/or results of operations. We continue to analyze the full impact of enacted legislation and additional guidance as provided. Further, any changes to the U.S. or any foreign jurisdictions' tax laws, tax rates, or the interpretation of such tax laws, including the Base Erosion Profit Shifting project being conducted by the Organization for Economic Co-operation and Development could significantly impact how U.S. multinational corporations are taxed. Although we cannot predict whether or in what form any other legislation changes may pass, if enacted it could have a material adverse impact on our tax expense, deferred tax assets and cash flows.

Our deferred tax assets may not be fully realizable.

We record tax valuation allowances to reflect uncertainties about whether we will be able to realize some of our deferred tax assets before they expire. Our tax valuation allowance is based on our estimates of taxable income for the jurisdictions in which we operate and the period over which our deferred tax assets will be realizable. In the future, we could be required to increase the valuation allowance to take into account additional deferred tax assets that we may be unable to realize. An increase in the valuation allowance would have an adverse impact, which could be material, on our income tax provision and net income in the period in which we record the increase.

Protection of our intellectual property is limited, and any misuse of our intellectual property by others, including software piracy, could harm our business, reputation and competitive position.

Our intellectual property is important to our success. We believe our trademarks, copyrights, trade secrets, patents, pending patent applications, trade dress and designs are valuable and integral to our success and competitive position. To protect our proprietary rights, we rely on a combination of patents, copyrights, trademarks, trade dress, trade secret laws, confidentiality procedures, contractual provisions and technical measures. However, even if we are able to secure such rights in the United States, the laws of other countries in which our products are sold may not protect our intellectual property rights to the same extent as the laws of the United States.

In addition to issued patents, we have several patent applications on file in the U.S. and other countries. However, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the

examination process will require us to narrow our claims. Even if patents are issued from our patent applications, which are not certain, they may be challenged, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, we have not emphasized patents as a source of significant competitive advantage and have instead sought to primarily protect our proprietary rights under laws affording

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protection for trade secrets, copyright and trademark protection of our products, brands, and other intellectual property where available and appropriate. These measures afford only limited protection and may be challenged, invalidated or circumvented by third parties. In addition, these protections may not be adequate to prevent our competitors or customers from copying or reverse-engineering our products. Third parties could copy all or portions of our products or otherwise obtain, use, distribute and sell our proprietary information without authorization. Third parties may also develop similar or superior technology independently by designing around our intellectual property, which would decrease demand for our products. In addition, our patents may not provide us with any competitive advantages and the patents of others may seriously impede our ability to conduct our business.

We protect our products, trade secrets and proprietary information, in part, by requiring all of our employees to enter into agreements providing for the maintenance of confidentiality and the assignment of rights to inventions made by them while employed by us. We also enter into non-disclosure agreements with our technical consultants, customers, vendors and resellers to protect our confidential and proprietary information. We cannot guarantee that our confidentiality agreements with our employees, consultants and other third parties will not be breached, that we will be able to effectively enforce these agreements, that we will have adequate remedies for any breach, or that our trade secrets and other proprietary information will not be disclosed or will otherwise be protected.

We rely on contractual and license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely, in many instances, on "click-wrap" and "shrink-wrap" licenses, which are not negotiated or signed by individual licensees. Accordingly, some provisions of our licenses, including provisions protecting against unauthorized use, copying, transfer, resale and disclosure of the licensed software program, could be unenforceable under the laws of several jurisdictions.

Protection of trade secret and other intellectual property rights in the places in which we operate and compete is highly uncertain and may involve complex legal questions. The laws of countries in which we operate may afford little or no protection to our trade secrets and other intellectual property rights. Although we defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques, preventing unauthorized use or infringement of our intellectual property rights is inherently difficult.

Despite our enforcement efforts against software piracy, we could lose significant revenue due to illegal use of our software and from counterfeit copies of our software. If piracy activities increase, it could further harm our business. We also suspect that competitors might try to illegally use our proprietary information and develop products that are similar to ours, which may infringe on our proprietary rights. In addition, we could potentially lose trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of trade secret protection could make it easier for third parties to compete with our products by copying functionality. In addition, any changes in, or unexpected interpretations of, the trade secret and other intellectual property laws in any country in which we operate may compromise our ability to enforce our trade secret and intellectual property rights. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our confidential information and trade secret protection. If we are unable to protect our proprietary rights or if third parties independently develop or gain access to our or similar technologies, our business, revenue, reputation and competitive position could be harmed.

Third-party use of our trademarks as keywords in Internet search engine advertising programs may direct potential customers to competitors' websites, which could harm our reputation and cause us to lose sales.

Competitors and other third parties, including counterfeiters, purchase our trademarks and confusingly similar terms as keywords in Internet search engine advertising programs in order to divert potential customers to their websites. Preventing such unauthorized use is inherently difficult. If we are unable to protect our trademarks and confusingly similar terms from such unauthorized use, competitors and other third parties may drive potential online customers away from our websites to competing and unauthorized websites, which could harm our reputation and cause us to lose sales.

Our trademarks are limited in scope and geographic coverage and might not significantly distinguish us from our competition.

We own several U.S. trademark registrations, including registrations of Rosetta Stone, the Blue Stone logo, Lexia, TruAccent, Lexia PowerUP Literacy, and Catalyst trademarks, as well as U.S. registrations of the color yellow as a trademark. In addition, we hold common law trademark rights and have trademark applications pending in the U.S. and abroad for additional trademarks. Even if federal registrations and registrations in other countries are granted to us, our trademark rights may be challenged. It is also possible that our competitors will adopt trademarks similar to ours, thus impeding our ability to build brand identity and possibly leading to customer confusion. In fact, various third parties have registered trademarks that are similar to ours in the U.S. and overseas. Furthermore, notwithstanding the fact that we may have secured trademark rights

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for our various trademarks in the U.S. and in some countries where we do business, in other countries we may not have secured similar rights and, in those countries there may be third parties who have prior use and prior or superior rights to our own. That prior use, prior or superior right could limit use of our trademarks and we could be challenged in our efforts to use our trademarks. We could incur substantial costs in prosecuting or defending trademark infringement suits. If we fail to effectively enforce our trademark rights, our competitive position and brand recognition may be diminished.

We must monitor and protect our Internet domain names to preserve their value. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe on or otherwise decrease the value of our trademarks. We own several domain names related to our business. Third parties may acquire substantially similar domain names or Top Level Domains ("TLDs") that decrease the value of our domain names and trademarks and other proprietary rights which may adversely affect our business. Third parties also may acquire country-specific domain names in the form of Country Code TLDs that include our trademarks or similar terms and which prevent us from operating country-specific websites from which customers can view our products and engage in transactions with us. Moreover, the regulation of domain names in the U.S. and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars, modify the requirements for holding domain names or release additional TLDs. As a result, we may have to incur additional costs to maintain control over potentially relevant domain names or may not maintain exclusive rights to all potentially relevant domain names in the U.S. or in other countries in which we conduct business, which could harm our business or reputation. Moreover, attempts may be made to register our trademarks as new TLDs or as domain names within new TLDs and we will have to make efforts to enforce our rights against such registration attempts.

Our business depends on our strong brands, and failing to maintain or enhance the Rosetta Stone brands in a cost-effective manner could harm our operating results.

Maintaining and enhancing our brands is an important aspect of our efforts to attract new customers and expand our business. We believe that maintaining and enhancing our brands will depend largely on our ability to provide high-quality, innovative products, and services, which we might not do successfully. Our brands may be negatively impacted by a number of factors such as service outages, product malfunctions, data protection and security issues, and exploitation of our trademarks by others without permission.

Further, while we attempt to ensure that the quality of our brands is maintained by our licensees, our licensees might take actions that could impair the value of our brands, our proprietary rights, or the reputation of our products. If we are unable to maintain or enhance our brands in a cost-effective manner, or if we incur excessive expenses in these efforts, our business, operating results and financial condition could be harmed.

Claims that we misuse the intellectual property of others could subject us to significant liability and disrupt our business.

As we expand our business and develop new technologies, products and services, we may become subject to material claims of infringement by competitors and other third parties with respect to current or future products, e-commerce and other web-related technologies, online business methods, trademarks or other proprietary rights. Our competitors, some of which may have made significant investments in competing products and technologies, and may have, or seek to apply for and obtain, patents, copyrights or trademarks that will prevent, limit or interfere with our ability to make, use and sell our current and future products and technologies, and we may not be successful in defending allegations of infringement of these patents, copyrights or trademarks. Further, we may not be aware of all of the patents and other intellectual property rights owned by third parties that may be potentially adverse to our interests. We may need to resort to litigation to enforce our proprietary rights or to determine the scope and validity of a third-party's patents or other proprietary rights, including whether any of our products, technologies or processes infringe the patents or other proprietary rights of third parties. We may incur substantial expenses in defending against third-party infringement claims regardless of the merit of such claims. The outcome of any such proceedings is uncertain and, if unfavorable, could force us to discontinue advertising and sale of the affected products or impose significant penalties, limitations or restrictions on our business. We do not conduct comprehensive patent searches to determine whether the technologies used in our products infringe upon patents held by others. In addition, product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications

pending, many of which are confidential when filed, with regard to similar technologies.

We do not own all of the software, other technologies and content used in our products and services, and the failure to obtain rights to use such software, other technologies and content could harm our business.

Some of our products and services contain intellectual property owned by third parties, including software that is integrated with internally developed software and voice recognition software, which we license from third parties.

From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be



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appropriately supported, maintained or enhanced by the licensors. If we are unable to obtain the rights necessary to use or continue to use third-party technology or content in our products and services, this could harm our business, by resulting in increased costs, or in delays or reductions in product shipments until equivalent software could be developed, identified, licensed and integrated.

Our use of open source software could impose limitations on our ability to commercialize our products.

We incorporate open source software into our products and may use more open source software in the future. The use of open source software is governed by license agreements. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that these licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. Therefore, we could be required to seek licenses from third parties in order to continue offering our products, make generally available, in source code form, proprietary code that links to certain open source modules, re-engineer our products, discontinue the sale of our products if re-engineering could not be accomplished on a cost-effective and timely basis, or become subject to other consequences. In addition, open source licenses generally do not provide warranties or other contractual protections regarding infringement claims or the quality of the code. Thus, we may have little or no recourse if we become subject to infringement claims relating to the open source software or if the open source software is defective in any manner. We offer Consumer language-learning packages that bundle software and online services that have increased our costs as a percentage of revenue, and these and future product introductions may not succeed and may harm our business, financial results and reputation.

Our Consumer language-learning packages integrate our language-learning software solutions with online services, which provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. The costs associated with the online services included with these software packages decrease margins. Customers may choose to not engage with conversation coaches or be willing to pay higher prices to do so. In addition, where perpetual product is bundled with online services, we are required to defer recognition of a portion of each sale of this packaged software over the duration of our online service periods. We cannot assure you that our future software package offerings will be successful or profitable, or if they are profitable, that they will provide an adequate return on invested capital. If our software package offerings are not successful, our business, financial results and reputation may be harmed.

Substantially all of our inventory is located in one warehouse facility. Any damage or disruption at this facility could cause significant financial loss, including loss of revenue and harm to our reputation.

Substantially all of our inventory is located in one warehouse facility. We could experience significant interruption in the operation of this facility or damage or destruction of our inventory due to natural disasters, accidents, failures of the inventory locator or automated packing and shipping systems or other events. If a material portion of our inventory were to be damaged or destroyed, we might be unable to meet our contractual obligations which could cause us significant financial loss, including loss of revenue and harm to our reputation. As our business continues to move online, we expect that this risk will diminish over time.

We rely on highly skilled personnel and, if we are unable to retain or motivate key personnel or hire qualified personnel, we may not be able to achieve results or grow effectively.

Our performance is largely dependent on the talents and efforts of highly skilled individuals. Our future success depends on our continuing ability to identify, hire, develop, motivate and retain highly skilled personnel for all areas of our organization.

We compete with other companies both within and outside of our industry for talented employees, and we may lose talented employees or fail to attract, train, and retain other talented employees. Any such loss or failure could adversely affect our product sales, financial condition, and operating results. In addition, we may not be able to locate suitable replacements for certain critical employees who leave, or offer employment to potential replacements on reasonable terms, all of which could adversely affect our product sales, financial condition, and operating results.

Our business could be impacted as a result of actions by activist stockholders or others.

We may be subject, from time to time, to legal and business challenges in the operation of our company due to proxy contests, stockholder proposals, media campaigns and other such actions instituted by activist stockholders or others. Responding to such actions could be costly and time-consuming, disrupt our operations, may not align with our

business strategies and could divert the attention of our Board of Directors and senior management from the pursuit of current business strategies. Perceived uncertainties as to our future direction as a result of stockholder activism or potential changes to the composition of the Board of Directors may lead to the perception of a change in the direction of the business or other instability

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that may make it more difficult to attract and retain qualified personnel and business partners, and could have a materially adverse effect on the Company's stock price.

Provisions in our organizational documents and in the Delaware General Corporation Law may prevent takeover attempts that could be beneficial to our stockholders.

Provisions in our second amended and restated certificate of incorporation and third amended and restated bylaws, and in the Delaware General Corporation Law, may make it difficult and expensive for a third party to pursue a takeover attempt we oppose even if a change in control of our Company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or third amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our Company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner.

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+ Purchase and Sale Agreement by and among Rosetta Stone Ltd., Rosetta Stone Japan Inc., and SOURCENEXT Corporation, dated April 25, 2017 (incorporated herein by reference to Exhibit 2.1 filed with the Company's Current Report on Form 8-K filed on April 25, 2017).
- 3.1 Second Amended and Restated Certificate of Incorporation of the Company (incorporated herein by reference to Exhibit 3.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
- 3.2 Third Amended and Restated Bylaws (incorporated herein by reference to Exhibit 3.1 filed with the Company's Current Report on Form 8-K filed on November 22, 2016).
- 4.1 Specimen certificate evidencing shares of Common Stock of the Company (incorporated herein by reference to Exhibit 4.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
- 31.1\* Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018.
- 31.2\* Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018.
- 32\*\* Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018.
- 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

+ Certain schedules and attachments referenced in this agreement have been omitted in accordance with Item 601(b)(2) of Regulation S-K. A copy of any omitted schedule and attachment will be furnished supplementally to the SEC upon request.

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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/ THOMAS M. PIERNO  
Thomas M. Pierno  
Chief Financial Officer

Date: August 2, 2018

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