ROSETTA STONE INC
Form 10-Q
November 07, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2013

Commission File Number: 1-34283

ROSETTA STONE INC.

(Exact name of Registrant as specified in its charter)

Delaware	**043837082**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1919 North Lynn St., 7th Fl.	
Arlington, Virginia (Address of Principal Executive Offices)	**22209** (Zip Code)

800-788-0822

(Registrant s telephone number, including zip code)

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

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 x No o

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of stock, as of the latest practicable date.

As of October 31, 2013, 21,889,614 shares of the registrant s Common Stock, $.00005 par value, were outstanding.

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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)

	September 30, 2013	December 31, 2012 (As Adjusted)*
Assets		
Current assets:		
Cash and cash equivalents	$ 113,104	$ 148,190
Restricted cash	82	73
Accounts receivable (net of allowance for doubtful accounts of $1,182 and $1,297, respectively)	46,339	49,946
Inventory	7,038	6,581
Prepaid expenses and other current assets	10,391	8,651
Income tax receivable	648	1,104
Deferred income taxes	79	30
Total current assets	177,681	214,575
Property and equipment, net	18,029	17,213
Goodwill	49,972	34,896
Intangible assets, net	29,801	10,825
Deferred income taxes	218	257
Other assets	3,225	1,680
Total assets	$ 278,926	$ 279,446
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 7,588	$ 6,064
Accrued compensation	13,094	16,830
Other current liabilities	30,482	36,387
Deferred revenue	62,168	59,195
Total current liabilities	113,332	118,476
Deferred revenue	10,463	4,221
Deferred income taxes	9,251	8,400
Other long-term liabilities	2,627	155
Total liabilities	135,673	131,252
Commitments and contingencies (Note 12)		

Stockholders equity:				
Preferred stock, $0.001 par value; 10,000 and 10,000 authorized; zero and zero shares issued and outstanding September 30, 2013 and December 31, 2012, respectively				
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 22,650 and 21,951 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively		2		2
Additional paid-in capital		168,026		160,693
Accumulated loss		(25,444)		(13,158)
Accumulated other comprehensive income		669		657
Total stockholders equity		143,253		148,194
Total liabilities and stockholders equity	$	278,926	$	279,446

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012 (As Adjusted) *	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted) *
Revenue:				
Product	$ 34,038	$ 42,462	$ 107,087	$ 127,534
Subscription and service	26,834	21,817	79,847	67,006
Total revenue	60,872	64,279	186,934	194,540
Cost of revenue:				
Cost of product revenue	7,325	7,858	21,263	24,087
Cost of subscription and service revenue	3,419	3,327	9,969	11,892
Total cost of revenue	10,744	11,185	31,232	35,979
Gross profit	50,128	53,094	155,702	158,561
Operating expenses				
Sales and marketing	34,844	36,830	104,904	110,518
Research and development	8,797	5,177	25,248	17,944
General and administrative	13,987	14,474	40,209	41,050
Lease abandonment	7		835	
Total operating expenses	57,635	56,481	171,196	169,512
Loss from operations	(7,507)	(3,387)	(15,494)	(10,951)
Other income and (expense):				
Interest income	21	42	105	141
Interest expense	(9)		(54)	
Other (expense) income	(305)	(27)	105	(71)
Total other income (expense)	(293)	15	156	70
Loss before income taxes	(7,800)	(3,372)	(15,338)	(10,881)
Income tax (benefit) provision	(3,631)	28,691	(3,052)	27,739
Net loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Net loss per share:				
Basic	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)
Diluted	$ (0.19)	$ (1.52)	$ (0.57)	$ (1.84)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,827	21,073	21,587	21,004
Diluted weighted average shares	21,827	21,073	21,587	21,004

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(in thousands)

(Unaudited)

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012 (As Adjusted)*	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted)*
Net loss	$ (4,169)	$ (32,063)	$ (12,286)	$ (38,620)
Other comprehensive income (loss), net of tax:				
Foreign currency translation gain (loss)	373	230	12	205
Unrealized gain on available-for-sale securities		5		23
Other comprehensive income (loss)	373	235	12	228
Comprehensive loss	$ (3,796)	$ (31,828)	$ (12,274)	$ (38,392)

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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ROSETTA STONE INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012 (As Adjusted)*
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (12,286)	$ (38,620)
Adjustments to reconcile net loss to cash (used in) provided by operating activities:		
Stock-based compensation expense	6,229	6,208
Bad debt expense	682	1,335
Depreciation and amortization	7,005	6,230
Deferred income tax (benefit) expense	(4,527)	25,846
Loss on disposal of equipment	246	752
Net change in:		
Restricted cash	(9)	15
Accounts receivable	5,672	11,149
Inventory	(506)	1
Prepaid expenses and other current assets	(1,593)	662
Income tax receivable	391	(2,080)
Other assets	(1,662)	(78)
Accounts payable	961	(377)
Accrued compensation	(4,180)	1,476
Other current liabilities	(8,092)	(6,690)
Other long term liabilities	329	(44)
Deferred revenue	7,606	5,707
Net cash (used in) provided by operating activities	(3,734)	11,492
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(6,415)	(2,939)
Proceeds from available-for-sale securities		9,711
Acquisitions, net of cash acquired	(25,675)	
Net cash (used in) provided by investing activities	(32,090)	6,772
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	2,379	830
Repurchase of shares from exercised stock options	(1,040)	
Tax benefit of stock options exercised		
Proceeds from equity offering, net of issuance costs	(228)	
Payments under capital lease obligations	(213)	(5)
Net cash provided by financing activities	898	825
(Decrease) increase in cash and cash equivalents	(34,926)	19,089
Effect of exchange rate changes in cash and cash equivalents	(160)	441
Net (decrease) increase in cash and cash equivalents	(35,086)	19,530
Cash and cash equivalents beginning of year	148,190	106,516
Cash and cash equivalents end of period	$ 113,104	$ 126,046
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$ 10	$
Income taxes	$ 2,745	$ 3,487

Noncash financing and investing activities:				
Accrued liability for purchase of property and equipment	$	1,147	$	316
Equipment acquired under capital lease	$	586	$	
Accrued merger consideration	$	3,375		

See accompanying notes to consolidated financial statements

* Certain amounts have been adjusted for the retrospective change in accounting principle for sales commissions (See Note 2).

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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 and reading learning solutions consisting of software products, online services and audio practice tools under the Rosetta Stone, Lexia and Livemocha brand names. The Company s software products are sold on a direct basis and through select retailers. The Company provides its software applications to customers through the sale of packaged software and online subscriptions, domestically and in certain international markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Rosetta Stone Inc. and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Basis of Presentation

The accompanying consolidated financial statements are unaudited. These unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and applicable rules and regulations of the 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 omitted pursuant to such rules and regulations. Accordingly, these interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K filed with the SEC on March 7, 2013. The December 31, 2012 consolidated balance sheet included herein was derived from the audited financial statements as of that date, but does not include all disclosures, including notes, required by GAAP, except for the Company s voluntary change for sales commissions as described below.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and in the opinion of management include all normal recurring adjustments necessary for the fair presentation of the Company s consolidated statement of financial position at September 30, 2013 and December 31, 2012, the Company s results of operations for the three and nine months ended September 30, 2013 and 2012 and its cash flows for the nine months ended September 30, 2013 and 2012. The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013. All references to September 30, 2013 or to the three and nine months ended September 30, 2013 and 2012 in the notes to the consolidated financial statements are unaudited.

Use of Estimates

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

Changes in Accounting Principle

In the third quarter of 2013, the Company voluntarily changed its accounting policy for sales commissions related to non-cancellable Software-as-a-Service (SaaS) contracts, from recording an expense when incurred, to deferral of the sales commission in proportion to the consideration allocated to each of the elements in the arrangement and in, or over, the same period the revenue is recognized for each of the elements in the arrangement (i.e. over the non-cancellable term of the contract for the SaaS deliverable). The Company is anticipating a significant increase in contracts with multi-year subscriptions and a corresponding increase in sales commissions due, among other reasons, to its acquisition of Lexia Learning Systems, Inc. (Lexia) in August 2013. Lexia provides services using a SaaS model and has historically had long-term arrangements with material sales commissions paid to its network of resellers and has applied a sales commission deferral and amortization policy.

The Company believes the deferral method described above is preferable primarily because (i) the sales commission charges are so closely related to obtaining the revenue from the non-cancellable contracts that they should be deferred and charged to expense over the same period that the related revenue is recognized; and (ii) it provides a single accounting policy, consistent with that used by Lexia, that makes it easier for financial statement users to understand. Deferred commission amounts are recoverable through the future revenue streams under the non-cancellable arrangements.

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Short-term deferred commissions are included in prepaid expenses and other current assets, while long-term deferred commissions are included in other assets in the accompanying consolidated balance sheets. The amortization of deferred commissions is included in sales and marketing expense in the accompanying consolidated statements of operations.

The accompanying consolidated financial statements and related notes have been adjusted to reflect the impact of this change and the associated deferred tax impact retrospectively to all prior periods. Under the as previously reported basis, there was no book / tax basis difference related to commission expense. Under the as adjusted basis, the deferred commission asset creates a deferred tax liability related to commissions expense which has been deducted for tax purposes.

The following tables present the effects of the retrospective application of the voluntary change in accounting principle for sales commissions related to non-cancellable SaaS contracts for all periods presented, effective as of January 1, 2012 (in thousands):

Consolidated Balance Sheet (in thousands)

	September 30, 2013			December 31, 2012		
	Computed under Prior Method	Impact of Commission Adjustment	As Reported	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Prepaid expenses and other current assets	$ 6,457	$ 3,934	$ 10,391	$ 5,204	$ 3,447	$ 8,651
Deferred income taxes (current)	$ 141	$ (62)	$ 79	$ 79	$ (49)	$ 30
Total current assets	$ 173,809	$ 3,872	$ 177,681	$ 211,177	$ 3,398	$ 214,575
Other assets	$ 3,060	$ 165	$ 3,225	$ 1,484	$ 196	$ 1,680
Deferred income taxes (non-current)	$ 221	$ (3)	$ 218	$ 260	$ (3)	$ 257
Total assets	$ 274,892	$ 4,034	$ 278,926	$ 275,855	$ 3,591	$ 279,446
Accumulated loss	$ (29,478)	$ 4,034	$ (25,444)	$ (16,749)	$ 3,591	$ (13,158)
Total stockholders equity	$ 139,219	$ 4,034	$ 143,253	$ 144,603	$ 3,591	$ 148,194
Total liabilities and stockholders equity	$ 274,892	$ 4,034	$ 278,926	$ 275,855	$ 3,591	$ 279,446

Consolidated Statement of Operations (in thousands, except per share data)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 38,404	$ 166	$ 38,570
Loss from operations	$ (2,359)	$ (166)	$ (2,525)
Income tax provision (benefit)	$ (742)	$ (66)	$ (808)
Net loss	$ (1,903)	$ (100)	$ (2,003)
Basic net loss per share	$ (0.09)	$ (0.01)	$ (0.10)
Diluted net loss per share	$ (0.09)	$ (0.01)	$ (0.10)

Shares used in computing basic net loss per share	20,942	20,942
Shares used in computing diluted net loss per share	20,942	20,942

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 35,125	$ (6)	$ 35,119	$ 73,529	$ 160	$ 73,689
Loss from operations	$ (5,045)	$ 6	$ (5,039)	$ (7,404)	$ (160)	$ (7,564)
Income tax provision (benefit)	$ (160)	$ 16	$ (144)	$ (902)	$ (50)	$ (952)
Net loss	$ (4,544)	$ (10)	$ (4,554)	$ (6,447)	$ (110)	$ (6,557)
Basic net loss per share	$ (0.22)	$ 0.00	$ (0.22)	$ (0.31)	$	$ (0.31)
Diluted net loss per share	$ (0.22)	$ 0.00	$ (0.22)	$ (0.31)	$	$ (0.31)
Shares used in computing basic net loss per share	20,995		20,995	20,969		20,969
Shares used in computing diluted net loss per share	20,995		20,995	20,969		20,969

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Consolidated Statement of Operations (in thousands, except per share data), continued

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 37,113	$ (283)	$ 36,830	$ 110,641	$ (123)	$ 110,518
Loss from operations	$ (3,670)	$ 283	$ (3,387)	$ (11,074)	$ 123	$ (10,951)
Income tax provision (benefit) (1)	$ 29,735	$ (1,044)	$ 28,691	$ 28,833	$ (1,094)	$ 27,739
Net loss	$ (33,390)	$ 1,327	$ (32,063)	$ (39,837)	$ 1,217	$ (38,620)
Basic net loss per share	$ (1.58)	$ 0.06	$ (1.52)	$ (1.90)	$ 0.06	$ (1.84)
Diluted net loss per share	$ (1.58)	$ 0.06	$ (1.52)	$ (1.90)	$ 0.06	$ (1.84)
Shares used in computing basic net loss per share	21,073		21,073	21,004		21,004
Shares used in computing diluted net loss per share	21,073		21,073	21,004		21,004

(1) During the third quarter of 2012 the Company established a full valuation allowance to reduce the deferred tax assets of its operations in Brazil, Japan and the U.S. The amount of the valuation allowance recorded in the third quarter of 2012 would have been reduced by the amount of the deferred tax liability arising from the deferred commission asset had commissions expense been accounted for under the as adjusted policy which resulted in the $1.0 million and $1.1 million income tax benefit shown as the adjustment for the three and nine month periods ended September 30, 2012, respectively.

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 37,060	$ 213	$ 37,273
Loss from operations	$ (4,138)	$ (213)	$ (4,351)
Income tax provision (benefit)	$ 977	$ (9)	$ 968
Net loss	$ (4,700)	$ (204)	$ (4,904)
Basic net loss per share	$ (0.22)	$ (0.01)	$ (0.23)
Diluted net loss per share	$ (0.22)	$ (0.01)	$ (0.23)
Shares used in computing basic net loss per share	21,360		21,360
Shares used in computing diluted net loss per share	21,360		21,360

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 33,144	$ (357)	$ 32,787	$ 70,203	$ (144)	$ 70,059
Loss from operations	$ (3,991)	$ 357	$ (3,634)	$ (8,130)	$ 144	$ (7,986)
Income tax provision (benefit)	$ (400)	$ 13	$ (387)	$ 576	$ 4	$ 580
Net loss	$ (3,557)	$ 344	$ (3,213)	$ (8,257)	$ 140	$ (8,117)
Basic net loss per share	$ (0.16)	$ 0.01	$ (0.15)	$ (0.38)	$	$ (0.38)
Diluted net loss per share	$ (0.16)	$ 0.01	$ (0.15)	$ (0.38)	$	$ (0.38)
Shares used in computing basic net loss per share	21,569		21,569	21,465		21,465

Shares used in computing diluted net loss per share	21,569	21,569	21,465	21,465

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Consolidated Statement of Operations (in thousands, except per share data), continued

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Sales and marketing	$ 35,156	$ (312)	$ 34,844	$ 105,360	$ (456)	$ 104,904
Loss from operations	$ (7,819)	$ 312	$ (7,507)	$ (15,950)	$ 456	$ (15,494)
Income tax provision (benefit)	$ (3,640)	$ 9	$ (3,631)	$ (3,065)	$ 13	$ (3,052)
Net loss	$ (4,472)	$ 303	$ (4,169)	$ (12,729)	$ 443	$ (12,286)
Basic net loss per share	$ (0.20)	$ 0.01	$ (0.19)	$ (0.59)	$ 0.02	$ (0.57)
Diluted net loss per share	$ (0.20)	$ 0.01	$ (0.19)	$ (0.59)	$ 0.02	$ (0.57)
Shares used in computing basic net loss per share	21,827		21,827	21,587		21,587
Shares used in computing diluted net loss per share	21,827		21,827	21,587		21,587

Consolidated Statement of Comprehensive Loss (in thousands)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (1,903)	$ (100)	$ (2,003)
Other comprehensive income (loss)	$ (1,601)	$ (100)	$ (1,701)

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,544)	$ (10)	$ (4,554)	$ (6,447)	$ (110)	$ (6,557)
Other comprehensive income (loss)	$ (4,853)	$ (10)	$ (4,863)	$ (6,454)	$ (110)	$ (6,564)

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (33,390)	$ 1,327	$ (32,063)	$ (39,837)	$ 1,217	$ (38,620)
Other comprehensive income (loss)	$ (33,155)	$ 1,327	$ (31,828)	$ (39,609)	$ 1,217	$ (38,392)

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,700)	$ (204)	$ (4,904)
Other comprehensive income (loss)	$ (5,181)	$ (204)	$ (5,385)

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (3,557)	$ 344	$ (3,213)	$ (8,257)	$ 140	$ (8,117)
Other comprehensive income (loss)	$ (3,437)	$ 344	$ (3,093)	$ (8,618)	$ 140	$ (8,478)

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,472)	$ 303	$ (4,169)	$ (12,729)	$ 443	$ (12,286)
Other comprehensive income (loss)	$ (4,099)	$ 303	$ (3,796)	$ (12,717)	$ 443	$ (12,274)

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Consolidated Statement of Cash Flows (in thousands)

	Three Months Ended March 31, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (1,903)	$ (100)	$ (2,003)
Deferred income tax provision (benefit)	$ (1,314)	$ (66)	$ (1,380)
Prepaid expenses and other current assets	$ 503	$ 118	$ 621
Other assets	$ (1,209)	$ 48	$ (1,161)
Net cash provided by (used in) operating activities	$ 2,656	$	$ 2,656

	Six Months Ended June 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (6,447)	$ (110)	$ (6,557)
Deferred income tax provision (benefit)	$ (1,156)	$ (50)	$ (1,206)
Prepaid expenses and other current assets	$ 649	$ 140	$ 789
Other assets	$ (1,065)	$ 20	$ (1,045)
Net cash provided by (used in) operating activities	$ 6,068	$	$ 6,068

	Nine Months Ended September 30, 2012		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (39,837)	$ 1,217	$ (38,620)
Deferred income tax provision (benefit)	$ 26,940	$ (1,094)	$ 25,846
Prepaid expenses and other current assets	$ 785	$ (123)	$ 662
Other assets	$ (78)	$	$ (78)
Net cash provided by (used in) operating activities	$ 11,492	$	$ 11,492

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Consolidated Statement of Cash Flows (in thousands)

	Three Months Ended March 31, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (4,700)	$ (204)	$ (4,904)
Deferred income tax provision (benefit)	$ 298	$ (9)	$ 289
Prepaid expenses and other current assets	$ (2,559)	$ 113	$ (2,446)
Other assets	$ 5	$ 100	$ 105
Net cash provided by (used in) operating activities	$ (5,635)	$	$ (5,635)

	Six Months Ended June 30, 2013		
	As Previously Reported	Impact of Commission Adjustment	As Adjusted
Net loss	$ (8,257)	$ 140	$ (8,117)
Deferred income tax provision (benefit)	$ (627)	$ 4	$ (623)
Prepaid expenses and other current assets	$ (2,568)	$ (176)	$ (2,744)
Other assets	$ 10	$ 32	$ 42
Net cash provided by (used in) operating activities	$ (3,147)	$	$ (3,147)

	Nine Months Ended September 30, 2013		
	Computed under Prior Method	Impact of Commission Adjustment	As Adjusted
Net loss	$ (12,729)	$ 443	$ (12,286)
Deferred income tax provision (benefit)	$ (4,539)	$ 12	$ (4,527)
Prepaid expenses and other current assets	$ (1,106)	$ (487)	$ (1,593)
Other assets	$ (1,694)	$ 32	$ (1,662)
Net cash provided by (used in) operating activities	$ (3,734)	$	$ (3,734)

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The change in accounting principle resulted in an increase to accumulated income of $2,878 thousand as of January 1, 2012 to $21,960 thousand from $19,082 thousand, as previously reported.

Revenue Recognition

The Company s primary products include Rosetta Stone *TOTALe* online and Rosetta Stone Version 4 *TOTALe*. Rosetta Stone *TOTALe* online combines an online software subscription with conversational coaching and is available in a selection of time-based offers (e.g. three, six and 12 month durations). Version 4 *TOTALe* includes a *TOTALe* online subscription bundled with perpetual software available as a CD-ROM or download. Revenue is also derived from the sale of audio practice products and professional services, which include training and implementation services.

Revenue is recognized when all of the following criteria are met: there is persuasive evidence of an arrangement; the product has been delivered or services have been rendered; the fee is fixed or determinable; and collectability is reasonably assured. Revenues are recorded net of discounts. The Company recognizes revenue for software products and related services in accordance with Accounting Standards Codification (ASC) subtopic 985-605, *Software: Revenue Recognition* (ASC 985-605).

For multiple element arrangements that include *TOTALe* online software subscriptions bundled with auxiliary items, such as headsets and audio practice products which provide stand-alone value to the customer, the Company allocates revenue to all deliverables based on their relative selling prices in accordance with ASC subtopic 605-25 *Revenue Recognition Multiple-Element Arrangements* (ASC 605-25). The Company has identified two deliverables generally contained in sales of Rosetta Stone *TOTALe* online software subscriptions. The first deliverable is the auxiliary items, which are delivered at the time of sale, and the second deliverable is the online services.

For Rosetta Stone Version 4 *TOTALe*, which is a multiple-element arrangement that includes perpetual software bundled with the subscription and conversational coaching components of the *TOTALe* online service, the Company allocates revenue to all deliverables based on vendor-specific objective evidence of fair value (VSOE), in accordance with ASC subtopic 985-605-25 *Software: Revenue Recognition Multiple-Element Arrangements* (ASC 985-605-25). The Company has identified two

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deliverables generally contained in Rosetta Stone V4 *TOTALe* software arrangements. The first deliverable is the perpetual software, which is delivered at the time of sale, and the second deliverable is subscription service. Revenue is allocated between these two deliverables using the residual method based on the existence of VSOE of the subscription service.

Revenue for online service subscriptions including conversational coaching is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Rosetta Stone Version 4 *TOTALe* bundles, which include packaged software and an online service subscription including conversational coaching, allow customers to begin their online services at any point during a registration window, which is up to six months from the date of purchase from the Company or an authorized reseller. Online service subscriptions that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between six and 24 months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and 12 months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

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

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

In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, via telephone support at no additional cost for up to six months from time of purchase. As the fee for technical support is included in the initial licensing fee, the technical support and services are generally provided within one year, the estimated cost of providing such support is deemed insignificant and no unspecified upgrades/enhancements are offered, technical support revenues are recognized together with the software product and license revenue. Costs associated with the technical support are accrued at the time of sale.

Sales commissions from non-cancellable SaaS contracts are deferred and amortized in proportion to the revenue recognized from the related contract.

On April 1, 2013, the Company completed its acquisition of Livemocha, Inc. (Livemocha). Online subscription revenue from Livemocha is recognized ratably over the term of the subscription and is included in the Company s results from operations after the acquisition date.

On August 1, 2013, the Company completed its acquisition of Lexia. The Lexia product offering includes term licenses with software hosting arrangements and subscriptions. License and hosting revenues are recognized over the term of the arrangement. Subscription fees are recognized on a straight line basis over the term of the subscription. As part of the Lexia acquisition, the Company acquired $1.2 million of deferred revenue. The deferred revenue will be recognized as revenue, on a contract by contract basis over the remaining term of the arrangements, which expire at various dates through 2022. The Company is the primary obligor to its end-user customers and therefore acts as principal in customer sales transactions, with its resellers acting as agents. Revenue is recognized on a gross basis accordingly, with related reseller commissions charged to sales and marketing expense.

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

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the differences between the financial statement carrying amounts of assets and liabilities versus the respective tax bases of such assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The impact of tax rate changes on deferred tax assets and liabilities is recognized in the year that the change is enacted.

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2013. 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 in the 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.

On November 1, 2009, the Company acquired certain assets from SGLC International Co. Ltd. (SGLC), a software reseller headquartered in Seoul, South Korea. As the assets acquired constituted a business, this transaction was accounted for under ASC topic 805, *Business Combinations* (ASC 805). The purchase price consisted of an initial cash payment of $100,000, followed by three annual cash installment payments if the acquired company s revenues exceed certain targeted levels each of these years. The amount was calculated as the lesser of a percentage of the revenue generated or a fixed amount for each year, based on the terms of the agreement.

Based on these terms, the minimum additional cash payment would have been zero if none of the minimum revenue targets were met, and the maximum additional payment would have been $1.1 million, which amount was recorded as contingent consideration at its fair value of $850,000, resulting in a total purchase price of $950,000 including the initial cash payment of $100,000 above. Together with the initial cash payment and the first two contingent payments made, additional payments of zero and $300,000 were made in accordance with the terms of the purchase in 2013 and 2012, respectively.

See table below for a summary of the opening balances to the closing balances of the contingent purchase consideration (in thousands):

	As of September 30,	
	2013	**2012**
Contingent purchase price accrual, beginning of period	$	$ 300
Minimum revenue target met, increase in contingent liability charged to expense in the period		
Payment of contingent purchase liability		
Contingent purchase price accrual, end of period	$	$ 300

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See table below for a summary of the Company s financial instruments accounted for at fair value on a recurring basis, which consist only of short-term investments that are marked to fair value at each balance sheet date, as well as the fair value of the accrual for the contingent purchase price of the acquisition of SGLC in 2009 (in thousands):

	Fair Value as of September 30, 2013 using:				Fair Value as of September 30, 2012 using:			
	September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:								
Short-term investments	$	$	$	$	$	$	$	$
Total	$	$	$	$	$	$	$	$
Liabilities:								
Contingent purchase price accrual	$	$	$	$	$ 300	$	$	$ 300
Total	$	$	$	$	$ 300	$	$	$ 300

There were no changes in the valuation techniques or inputs used as the basis to calculate the contingent purchase price accrual.

Business Combinations

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

Stock-Based Compensation

The Company accounts for its stock-based compensation in accordance 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 and recognized as expense in the consolidated statement of operations on a straight-line basis over the requisite service period, which is the vesting period.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. For the nine months ended September 30, 2013 and 2012, the fair value of options granted was calculated using the following assumptions:

Nine Months Ended