ROSETTA STONE INC
Form 10-Q
November 04, 2015
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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 September 30, 2015
Commission file number: 1-34283
Rosetta Stone Inc.
(Exact name of registrant as specified in its charter)

Delaware (State of incorporation)	043837082 (I.R.S. Employer Identification No.)
1919 North Lynn St., 7th Fl. Arlington, Virginia (Address of principal executive offices)	22209 (Zip Code)

703-387-5800
(Registrant's telephone number, including area code)

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

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

As of October 30, 2015, there were 21,796,485 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)

	September 30, 2015	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$34,367	$64,657
Restricted cash	121	123
Accounts receivable (net of allowance for doubtful accounts of $1,899 and $1,434, at September 30, 2015 and December 31, 2014, respectively)	47,541	76,757
Inventory, net	7,720	6,500
Deferred sales commissions	13,275	10,740
Prepaid expenses and other current assets	4,945	5,038
Income tax receivable	1,391	464
Land and building improvements held for sale	1,570	—
Total current assets	110,930	164,279
Deferred sales commissions	6,063	4,362
Property and equipment, net	22,915	25,277
Goodwill	56,397	58,584
Intangible assets, net	29,693	34,377
Other assets	1,845	1,525
Total assets	$227,843	$288,404
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$10,512	$19,548
Accrued compensation	8,752	14,470
Obligations under capital lease	378	594
Other current liabilities	30,874	56,157
Deferred revenue	102,711	95,240
Total current liabilities	153,227	186,009
Deferred revenue	36,671	32,929
Deferred income taxes	2,062	1,554
Obligations under capital lease	2,628	3,154
Other long-term liabilities	895	1,313
Total liabilities	195,483	224,959
Commitments and contingencies (Note 16)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	—	—
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 23,135 and 22,936 shares issued and 22,135 and 21,936 shares outstanding at September 30, 2015 and December 31, 2014, respectively	2	2
Additional paid-in capital	184,036	178,554

Accumulated loss	(138,358)	(102,998)
Accumulated other comprehensive loss	(1,885)	(678)
Treasury stock, at cost, 1,000 and 1,000 shares at September 30, 2015 and December 31, 2014, respectively	(11,435)	(11,435)
Total stockholders' equity	32,360	63,445
Total liabilities and stockholders' equity	$227,843	$288,404

See accompanying notes to consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue:				
Product	$13,905	$32,392	$48,088	$92,888
Subscription and service	35,897	32,123	111,567	89,707
Total revenue	49,802	64,515	159,655	182,595
Cost of revenue:				
Cost of product revenue	3,372	7,916	12,728	23,010
Cost of subscription and service revenue	5,294	5,071	16,260	14,109
Total cost of revenue	8,666	12,987	28,988	37,119
Gross profit	41,136	51,528	130,667	145,476
Operating expenses:				
Sales and marketing	30,234	43,771	100,939	120,700
Research and development	7,056	8,689	22,981	25,830
General and administrative	12,053	14,748	39,727	44,805
Impairment	358	—	809	2,199
Lease abandonment and termination	—	(53)	—	3,635
Total operating expenses	49,701	67,155	164,456	197,169
Loss from operations	(8,565)	(15,627)	(33,789)	(51,693)
Other income and (expense):				
Interest income	1	3	12	13
Interest expense	(90)	(46)	(271)	(153)
Other income and (expense)	819	(752)	(1,265)	(772)
Total other income and (expense)	730	(795)	(1,524)	(912)
Loss before income taxes	(7,835)	(16,422)	(35,313)	(52,605)
Income tax expense (benefit)	(534)	(244)	47	(435)
Net loss	$(7,301)	$(16,178)	$(35,360)	$(52,170)
Loss per share:				
Basic	$(0.34)	$(0.76)	$(1.65)	$(2.46)
Diluted	$(0.34)	$(0.76)	$(1.65)	$(2.46)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,771	21,305	21,493	21,228
Diluted weighted average shares	21,771	21,305	21,493	21,228

See accompanying notes to consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Net loss	$(7,301)	$(16,178)	$(35,360)	$(52,170)
Other comprehensive loss, net of tax:				
Foreign currency translation loss	(814)	(994)	(1,207)	(1,095)
Other comprehensive loss	(814)	(994)	(1,207)	(1,095)
Comprehensive loss	$(8,115)	$(17,172)	$(36,567)	$(53,265)

See accompanying notes to consolidated financial statements

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

	Nine Months Ended September 30, 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(35,360)	$(52,170)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense	5,369	5,468
Loss on foreign currency transactions	1,345	756
Bad debt expense	1,603	2,023
Depreciation and amortization	10,175	10,229
Deferred income tax expense (benefit)	572	(1,116)
Loss on disposal of equipment	56	181
Amortization of debt issuance costs	104	—
Loss on impairment	809	2,199
(Income) from equity method investments	(9)	—
Gain on divestiture of subsidiary	(660)	—
Net change in:		
Restricted cash	3	(21)
Accounts receivable	26,340	93
Inventory	(1,631)	648
Deferred sales commissions	(4,301)	(5,989)
Prepaid expenses and other current assets	(60)	240
Income tax receivable	(937)	(431)
Other assets	(205)	973
Accounts payable	(8,930)	885
Accrued compensation	(4,974)	(776)
Other current liabilities	(21,381)	(6,302)
Other long-term liabilities	(418)	537
Deferred revenue	13,117	30,517
Net cash used in operating activities	(19,373)	(12,056)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(7,205)	(7,227)
Decrease in restricted cash for Vivity acquisition	—	12,314
Acquisitions, net of cash acquired	(1,688)	(41,687)
Net cash outflow from divestiture of subsidiary	(186)	—
Other investing activities	(286)	—
Net cash used in investing activities	(9,365)	(36,600)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	114	646
Payment of financing fees	(125)	—
Payments under capital lease obligations	(468)	(480)
Net cash (used in) provided by financing activities	(479)	166
Decrease in cash and cash equivalents	(29,217)	(48,490)
Effect of exchange rate changes in cash and cash equivalents	(1,073)	(974)
Net decrease in cash and cash equivalents	(30,290)	(49,464)

Cash and cash equivalents—beginning of period	64,657	98,825
Cash and cash equivalents—end of period	$34,367	$49,361
SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$167	$153
Income taxes	$1,222	$1,276
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	$99	$378

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

On March 11, 2015, the Company announced a plan (the "2015 Restructuring Plan") to accelerate and prioritize its focus on satisfying the needs of more passionate Corporate and K-12 learners, and emphasizing those who need to speak and read English. In the first quarter of 2015, the Company began reductions to areas including Consumer sales and marketing, Consumer product investment, and general and administrative costs. See Note 2 "Summary of Significant Accounting Policies," Note 14 "Restructuring," Note 17 "Segment Information" and Item 2 "Management's Discussion and Analysis of Financial Condition and Results of Operations" within Part 1 for additional information about these strategic undertakings and the associated impact to the Company's financial statements and financial results.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

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

The equity method is used to account for investments in entities if the investment provides the Company with the ability to exercise significant influence over operating and financial policies of the investee. The Company determines its level of influence over an equity method investment by considering key factors such as ownership interest, representation on the board of directors, participation in policy-making decisions, and technological dependencies. The Company's proportionate share of the net income or loss of any equity method investments is reported in "Other income and (expense)" and included in the net loss on the consolidated statement of operations. The carrying value of any equity method investment is reported in "Other assets" on the consolidated balance sheets.

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 16, 2015. The September 30, 2015 consolidated balance sheet included herein includes account balances as of December 31, 2014 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.

The unaudited interim consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements. In the opinion of management, all adjustments, consisting only of normal recurring adjustments, necessary for the fair presentation of the Company’s statement of financial position at September 30, 2015 and December 31, 2014, the Company’s results of operations for the three and nine months ended September 30, 2015 and 2014 and its cash flows for the nine months ended September 30, 2015 and 2014 have been made. The results for the three and nine months ended September 30, 2015 are not necessarily indicative of the results to be expected for the year ending December 31, 2015. All references to September 30, 2015 or to the three and nine months ended September 30, 2015 and 2014 in the notes to the consolidated financial statements are unaudited.

ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, inventory reserve, disclosure of contingent assets and liabilities, disclosure of contingent litigation, and allowance for valuation of deferred tax assets. Actual results may differ from these estimates.

Revenue Recognition

The Company's primary sources of revenue are web-based software subscriptions, online services, perpetual product software, and bundles of perpetual product software and short-term online services. The Company also generates revenue from the sale of audio practice products, mobile applications, and professional 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. Revenue is recorded net of discounts.

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

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

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

In the U.S. and Canada, the Company offers consumers who purchase packaged software and audio practice products directly from the Company a 30-day, unconditional, full money-back refund. The Company also permits some of our retailers and distributors to return unsold packaged products, subject to certain limitations. In accordance with ASC subtopic 985-605, Software: Revenue Recognition ("ASC 985-605"), the Company estimates and establishes revenue reserves for packaged product returns at the time of sale based on historical return rates, estimated channel inventory levels, the timing of new product introductions and other factors.

The Company distributes its products and services both directly to the end customer and indirectly through resellers. Resellers earn commissions generally calculated as a fixed percentage of the gross sale to the end customer. The Company

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

evaluates each of its reseller relationships in accordance with ASC subtopic 605-45, Revenue Recognition - Principal Agent Considerations ("ASC 605-45") to determine whether the revenue recognized from indirect sales should be the gross amount of the contract with the end customer or reduced for the reseller commission. In making this determination the Company evaluates a variety of factors including whether it is the primary obligor to the end customer. Revenue is recorded net of taxes.

Revenue for online services and web-based subscriptions is recognized ratably over the term of the service or subscription period, assuming all revenue recognition criteria have been met. The CD and digital download formats of Rosetta Stone language-learning products are bundled with a short-term online service where customers are allowed to begin their short-term online services at any point during a registration window, which is up to six months from the date of purchase from us or an authorized reseller. The short-term online services that are not activated during this registration window are forfeited and revenue is recognized upon expiry. Revenue from non-refundable upfront fees that are not related to products already delivered or services already performed is deferred and recognized over the term of the related arrangement because the period over which a customer is expected to benefit from the service that is included within our subscription arrangements does not extend beyond the contractual period. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement.

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

The Company offers customers the ability to make payments for packaged software purchases in installments over a period of time, which typically ranges between three and five months. Given that these installment payment plans are for periods less than 12 months, a successful collection history has been established and these fees are fixed and determinable, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met.

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

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

Restructuring Costs

In the first quarter of 2015, as part of the 2015 Restructuring Plan, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. In connection with this plan, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included in our operating expense line items on the Statement 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 exists, 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.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Contract termination costs include penalties to cancel certain service and license contracts. 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 of the Company’s Consumer business. Such costs are recognized at fair value in the period in which the costs are incurred.

Income Taxes

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

Deferred Tax Valuation Allowance

The Company has recorded a valuation allowance offsetting certain of its deferred tax assets as of September 30, 2015. 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.

Divestitures

The Company deconsolidates divested subsidiaries when there is a loss of control or when appropriate when evaluated under the variable interest entity model. The Company recognizes a gain or loss at divestiture equal to the difference between the fair value of any consideration received and the carrying amount of the former subsidiary’s assets and liabilities. Any resulting gain or loss is reported in "Other income and (expense)" on the consolidated statement of operations.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Business Combinations
The Company recognizes all of the assets acquired, liabilities assumed and contractual contingencies from an acquired company as well as contingent consideration at fair value on the acquisition date. The excess of the total purchase price over the fair value of the assets and liabilities acquired is recognized as goodwill. Acquisition-related costs are recognized separately from the acquisition and expensed as incurred. Generally, restructuring costs incurred in periods subsequent to the acquisition date are expensed when incurred. Subsequent changes to the purchase price (i.e., working capital adjustments) or other fair value adjustments determined during the measurement period are recorded as adjustments to goodwill.
Stock-Based Compensation
The Company accounts for its stock-based compensation in accordance ASC topic 718, Compensation—Stock Compensation ("ASC 718"). Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date and recognized as expense in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.
The Company reviews a group of comparable industry-related companies and its own data to estimate its expected volatility over the most recent period commensurate with the estimated expected term of the awards. In addition to analyzing our own and peer group data, the Company also considers the contractual option term and vesting period when determining the expected option life and forfeiture rate. The Company estimates the expected term of options using a combination of peer company information and the simplified method for estimating the expected term. 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. The grant date fair value is based on the market price of the Company’s common stock at the date of grant.
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 other comprehensive loss in stockholders' 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 and cash equivalents during the period.
The following table presents the effect of exchange rate changes on total comprehensive loss (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Net loss	$(7,301)	$(16,178)	$(35,360)	$(52,170)
Foreign currency translation loss	(814)	(994)	(1,207)	(1,095)
Comprehensive loss	$(8,115)	$(17,172)	$(36,567)	$(53,265)

Comprehensive Loss
Comprehensive loss consists of net loss and other comprehensive loss. Other comprehensive loss refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' equity. For the three and nine months ended September 30, 2015 and 2014, the Company's comprehensive loss consisted of net loss and foreign currency translation losses.
Upon divestiture of an investment in a foreign entity, the amount attributable to the accumulated translation adjustment component of that foreign entity is removed as a component of other comprehensive loss and reported as

part of the gain or loss on sale or liquidation of the investment. During the period ended September 30, 2015, a transfer of $0.5 million was made from accumulated other comprehensive loss and recognized as a gain within net income related to the divestiture of a foreign subsidiary.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Components of accumulated other comprehensive loss as of September 30, 2015 are as follows (in thousands):

	Foreign Currency	Total
Balance at the beginning of the period on January 1, 2015	$(678)	$(678)
Other comprehensive loss before reclassifications	(1,662)	(1,662)
Amounts reclassified from accumulated other comprehensive loss related to divestiture of foreign subsidiary	455	455
Net current period other comprehensive loss	(1,207)	(1,207)
Accumulated other comprehensive loss at September 30, 2015	(1,885)	(1,885)

Advertising Costs

Costs for advertising are expensed as incurred. Advertising expense for the three and nine months ended September 30, 2015 was $10.1 million and $32.3 million, respectively, and for the three and nine months ended September 30, 2014 was $20.3 million and $50.4 million, respectively.

Recently Issued Accounting Standards Not Yet Adopted

In April 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2015-05, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Fees Paid in a Cloud Computing Arrangement ("ASU 2015-05"). ASU 2015-05 provides guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the entity should account for the arrangement as a service contract. ASU 2015-05 does not change the accounting for service contracts. ASU 2015-05 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted. The Company does not expect to early adopt the guidance and does not believe that the adoption of this guidance will have a material impact on the Company's financial statements and disclosures.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30) Simplifying the Presentation of Debt Issuance Costs ("ASU 2015-03"). ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in ASU 2015-03. ASU 2015-03 will be effective for interim and annual financial statements issued for fiscal years beginning after December 15, 2015. Early adoption is permitted for financial statements that have not been previously issued. The Company does not believe that the adoption of this guidance will have a material impact on the Company's financial statements and disclosures.

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

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

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"), which replaces the current revenue accounting guidance. In July 2015, the FASB voted to defer the effective date of the updated guidance on revenue recognition by one year to make ASU 2014-09 effective for annual periods beginning after December 15, 2017. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply a five step model to 1) identify the contract(s) with a customer, 2) identify the performance obligations in the contract, 3) determine the transaction price, 4) allocate the transaction price to the performance obligations in the contract and 5) recognize revenue when (or as) the entity satisfies a performance obligation. Entities may choose from two adoption methods, with certain practical expedients. The Company is in the process of evaluating the impact of the new guidance on the Company's financial statements and disclosures and the adoption method.

3. ACQUISITIONS AND DIVESTITURES

2015 Divestitures:

As part of the shift in strategy initiated in early 2015, the Company determined that its consumer-oriented Rosetta Stone Korea Ltd. ("RSK") entity no longer fit in with the Company’s overall strategy to focus on the Enterprise & Education business. In September 2015, the Company completed the divestiture of 100% of the Company's capital stock of RSK to the current President of RSK for consideration equal to the assumption of RSK's net liabilities at the date of sale. This divestiture resulted in a pre-tax gain of $0.7 million reported in “Other income and (expense)” of the consolidated statement of operations. This gain was comprised of a gain of $0.2 million equal to the value of the net liabilities transferred and a $0.5 million gain on the transfer of the foreign subsidiary's cumulative translation adjustment on the date of sale.

As part of the transaction, the Company has agreed to continue to provide to RSK certain of its online product offerings and RSK is committed to purchase those products, for an initial term ending December 31, 2025. In addition, the Company has loaned RSK $0.5 million as of October 2, 2015, which will be repaid in five equal installments due every six months beginning December 31, 2016. As a result of this loan and the level of financial support it represents, the Company concluded that it holds a variable interest in RSK whereby the Company is not the primary beneficiary. The Company's variable interest is the loan receivable, which will be recorded in the period that the loan is made. The maximum exposure to loss as a result of this involvement in the variable interest entity is limited to the $0.5 million amount of the loan.

2014 Acquisitions:

In January 2014, the Company acquired Vivity Labs, Inc. and Tell Me More S.A. Under the acquisition method of accounting, the total purchase price was allocated to the tangible and intangible assets acquired on the basis of their respective estimated fair values at the date of acquisition. The valuation of the identifiable intangible assets and their useful lives acquired reflects management's estimates.

Vivity Labs Inc.

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

The acquisition of Vivity resulted in goodwill of approximately $9.3 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Vivity Labs Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Vivity Labs Merger were zero and $57,000 during the nine months ended September 30, 2015 and 2014, respectively. The results of operations for Vivity have been included in the consolidated results of operations since January 2, 2014.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
3. ACQUISITIONS AND DIVESTITURES (Continued)

The Company has allocated the purchase price based on current estimates of the fair values of assets acquired and liabilities assumed in connection with the Vivity Labs Merger. The table below summarizes the estimates of fair value of the Vivity Labs assets acquired, liabilities assumed and related deferred income taxes as of the acquisition date. The Company finalized its allocation of the purchase price for Vivity as of December 31, 2014. The purchase price was allocated as follows (in thousands):

Cash	$14
Accounts receivable	452
Other current assets	(3)
Accounts payable and accrued expenses	(307)
Net deferred tax liability	(919)
Net tangible assets acquired	(763)
Goodwill	9,336
Amortizable intangible assets	3,577
Purchase price	$12,150

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

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

Tell Me More S.A.

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

The Tell Me More Merger resulted in goodwill of approximately $21.7 million, none of which is deductible for tax purposes. This amount represents the residual amount of the total purchase price after allocation to the assets acquired and liabilities assumed.

All expenditures incurred in connection with the Tell Me More Merger were expensed and are included in general and administrative expenses. Transaction costs incurred in connection with the Tell Me More Merger were zero and $1.0 million during the nine months ended September 30, 2015 and 2014, respectively. The results of operations for Tell Me More have been included in the consolidated results of operations since January 9, 2014.

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

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
3. ACQUISITIONS AND DIVESTITURES (Continued)

The Company finalized its allocation of the purchase price for Tell Me More as of December 31, 2014. The purchase price was allocated as follows (in thousands):

Cash	$2,323
Accounts receivable	2,979
Inventory	246
Prepaid expenses	243
Fixed assets	5,595
Other non-current assets	330
Accounts payable	(732)
Accrued compensation	(2,855)
Deferred revenue	(2,190)
Other current liabilities	(1,211)
Obligation under capital lease	(3,958)
Net deferred tax liability	(1,392)
Net tangible assets acquired	(622)
Goodwill	21,703
Amortizable intangible assets	9,105
Purchase price	$30,186

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

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

4. NET LOSS PER SHARE

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

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ROSETTA STONE INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

4. 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 Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Numerator:				
Net loss	$(7,301)	$(16,178)	$(35,360)	$(52,170)
Denominator:				
Weighted average number of common shares:				
Basic	21,771	21,305	21,493	21,228
Diluted	21,771	21,305	21,493	21,228
Loss per common share:				
Basic	$(0.34)	$(0.76)	$(1.65)	$(2.46)
Diluted	$(0.34)	$(0.76)	$(1.65)	$(2.46)

For the three and nine months ended September 30, 2015 and 2014, no common stock equivalent shares were included in the calculation of the Company’s diluted net income per share.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Stock options	31,000	44,000	38,000	71,000
Restricted stock units	182,000	110,000	96,000	98,000
Restricted stocks	27,000	30,000	78,000	81,000
Total common stock equivalent shares	240,000	184,000	212,000	250,000

5. INVENTORY

Inventory consisted of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials	$3,778	$3,163
Finished goods	3,942	3,337
Total inventory	$7,720	$6,500

6. ASSETS HELD FOR SALE

In September 2015, the Company entered into a binding agreement to sell one of its two office buildings and associated building improvements that are located in Harrisburg, Virginia. As of September 30, 2015, this property met the criteria to be classified as held for sale. As a result, the Company classified this portion of the Company's land and building improvements, which totaled $1.6 million, as held for sale on the accompanying consolidated balance sheet. The sale of this property is expected to close in the fourth quarter of 2015 and is subject to certain customary closing conditions. As of September 30, 2015 and based on the expected sales proceeds, the fair value of the property exceeds the carrying value.

The Company has also contracted to lease-back the property beginning November 30, 2015 for a short rental period at a monthly rental fee consistent with prevailing market rates.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
7. GOODWILL

The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisitions of Livemocha, Inc. ("Livemocha") in April 2013, Lexia Learning Systems, Inc. ("Lexia") in August 2013, and the acquisitions of Vivity and Tell Me More in January 2014.
The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.
The following table shows the balance and changes in goodwill for the Company's operating segments for the nine months ended September 30, 2015 (in thousands):

	Consumer	Enterprise & Education	Total
Balance as of December 31, 2014	$8,538	$50,046	$58,584
Effect of change in foreign currency rate	(1,137)	(1,050)	(2,187)
Balance as of September 30, 2015	$7,401	$48,996	$56,397

Annual Impairment Testing of Goodwill
In connection with the annual goodwill impairment analysis performed as of June 30, 2015, the Company determined that the fair value of each of the Company's reporting units with material goodwill balances substantially exceeded its carrying value, and therefore no goodwill impairment charges were recorded in connection with the annual analysis.
Interim Impairment Review
The Company also routinely reviews goodwill at the reporting unit level for potential impairment as part of the Company’s internal control framework. The Company's reporting units were evaluated to determine if a triggering event has occurred. As of September 30, 2015, the Company concluded that there are no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of our reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment review.
8. INTANGIBLE ASSETS
Intangible assets consisted of the following items as of the dates indicated (in thousands):

	September 30, 2015			December 31, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Tradename/trademark *	$12,461	$(1,225)	$11,236	$12,526	$(1,062)	$11,464
Core technology	15,306	(7,295)	8,011	15,890	(5,661)	10,229
Customer relationships	26,365	(16,028)	10,337	26,889	(14,344)	12,545
Website	12	(12)	—	12	(12)	—
Patents	300	(191)	109	300	(161)	139
Total	$54,444	$(24,751)	$29,693	$55,617	$(21,240)	$34,377

* Included in the tradename/trademark line above is the Rosetta Stone tradename, which is the Company's only indefinite-lived intangible asset. As of September 30, 2015, the carrying value of the tradename asset was $10.6 million.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
8. 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 Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Included in cost of revenue:				
Cost of product revenue	$59	$89	200	$272
Cost of subscription and service revenue	88	57	239	167
Total included in cost of revenue	147	146	439	439
Included in operating expenses:				
Sales and marketing	693	919	2,115	2,783
Research and development	448	501	1,358	1,516
General and administrative	—	—	—	—
Total included in operating expenses	1,141	1,420	3,473	4,299
Total	$1,288	$1,566	3,912	4,738

The following table summarizes the estimated future amortization expense related to intangible assets for the remaining three months of 2015 and years thereafter (in thousands):

	As of September 30, 2015
2015 - remaining	$1,287
2016	4,690
2017	4,240
2018	3,626
2019	1,532
2020	1,282
Thereafter	2,429
Total	$19,086

Impairment Reviews of Intangible Assets

The Company also routinely reviews indefinite-lived intangible assets and long-lived assets for potential impairment as part of the Company’s internal control framework. As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of September 30, 2015 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 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)

9. OTHER CURRENT LIABILITIES

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

	September 30, 2015	December 31, 2014
Accrued marketing expenses	$15,383	$31,985
Accrued professional and consulting fees	1,895	2,804
Sales return reserve	1,713	3,570
Sales, withholding and property taxes payable	3,563	5,875
Accrued purchase price of business acquisition	—	1,688
Other	8,320	10,235
Total other current liabilities	$30,874	$56,157

10. FINANCING ARRANGEMENTS

Revolving Line of Credit

On October 28, 2014, Rosetta Stone Ltd (“RSL”), a wholly owned subsidiary of parent company Rosetta Stone, executed a Loan and Security Agreement with Silicon Valley Bank (“Bank”) to obtain a $25 million revolving credit facility (the “credit facility”). Borrowings by RSL under the credit facility are guaranteed by the Company as the ultimate parent. The credit facility has a term of three years during which RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions. RSL may elect to have interest on borrowed amounts accrue at either a LIBOR rate plus a margin of 2.25% percent or a prime rate plus a margin of 1.25% percent. RSL may select LIBOR interest periods of certain defined intervals ranging from one month to one year. All portions of outstanding loans may be converted from one interest rate method to the other. 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 Company is subject to certain financial and restrictive covenants under the credit facility. The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict our 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 ratio and maintain a minimum Adjusted EBITDA. To date, 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.

The Company executed the First Amendment to the credit facility with the Bank effective March 31, 2015, the Second Amendment effective May 1, 2015, and the Third Amendment effective June 29, 2015. The Company is subject to certain covenants under the Loan and Security Agreement including financial covenants and limitations on indebtedness, encumbrances, investments and distributions and dispositions of assets, certain of which covenants were amended in the First, Second, and Third Amendments to reflect the revised outlook in connection with the Company's 2015 Restructuring Plan. The Third Amendment also changed the definition of "change of control" to eliminate the clause referring to a change in a portion of the Board of Directors within a twelve-month period.

As of September 30, 2015, there were no borrowings outstanding and the Company was eligible to borrow $25.0 million of available credit and $4.0 million in letters of credit have been issued by the Bank on the Company's behalf. 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)
10. 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 Merger, 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 nine months ended September 30, 2015 and 2014, the Company acquired no 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 September 30, 2015
2015-remaining	$128
2016	509
2017	509
2018	503
2019	503
2020	502
Thereafter	878
Total minimum lease payments	$3,532
Less amount representing interest	526
Present value of net minimum lease payments	$3,006
Less current portion	378
Obligations under capital lease, long-term	$2,628

11. INCOME TAXES

In accordance with ASC topic 740, Income Taxes ("ASC 740"), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the nine months ended September 30, 2015 is based on the estimated annual effective tax rate for fiscal year 2015. 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.

During the third quarter of 2015, the U.S. audit for tax years 2009 to 2012 concluded. The conclusion of the audit resulted in the Company recording a $0.1 million tax benefit.

As of September 30, 2015 and December 31, 2014, the Company had zero and $0.4 million, respectively, of unrecognized tax benefits. The previously recorded $0.4 million of unrecognized tax benefits was settled as a result of the IRS audit concluded during the third quarter of 2015. These liabilities for unrecognized tax benefits were previously presented as a reduction to the related deferred tax asset where appropriate and the remaining amount is included in "Income Taxes Payable." Interest and penalties related to uncertain tax positions are recorded as part of the income tax provision. As of September 30, 2015, the Company had zero accrued in "Income Taxes Payable", compared to $26,000 as of December 31, 2014.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
11. INCOME TAXES (Continued)

Valuation Allowance Recorded for Deferred Tax Assets
The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of September 30, 2015, 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 September 30, 2015 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 loss carryforward periods of 20 years 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 September 30, 2015, a valuation allowance was provided for the U.S., Japan, China, Hong Kong, Mexico, Spain, France and Brazil where the Company has determined the deferred tax assets will not more likely than not be realized.
Evaluation of the remaining jurisdictions as of September 30, 2015 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company’s financial position and results of operations.
As of September 30, 2015, and December 31, 2014, the Company’s U.S. deferred tax liability was $4.5 million and $3.5 million, respectively, related to its goodwill and indefinite lived intangibles. As of September 30, 2015 the Company had foreign net deferred tax liabilities of $0.3 million compared to net deferred tax liabilities of $0.8 million at December 31, 2014.
For the nine months ended September 30, 2015 the Company recorded an income tax expense of $47,000. The expense in the current period is made up of tax expense related to current year profits of operations in Germany. Additionally, the tax expense relates to the tax impact of the amortization of indefinite-lived intangible assets and the inability to recognize tax benefits associated with current year losses of operations in all other foreign jurisdictions and in the U.S. due to the valuation allowance recorded against the deferred tax asset balances of these entities. These tax expenses are partially offset by tax benefits related to current year losses in the U.K. and Canada. Additionally, tax benefits were recorded related to the reversal of accrued witholding taxes as a result of an intercompany transaction.
12. STOCK-BASED COMPENSATION
2006 Stock Incentive Plan
On January 4, 2006, the Company established the Rosetta Stone Inc. 2006 Stock Incentive Plan (the "2006 Plan") under which the Company's Board of Directors, at its discretion, could grant stock options to employees and certain directors of the Company and affiliated entities. The 2006 Plan initially authorized the grant of stock options for up to 1,942,200 shares of common stock. On May 28, 2008, the Board of Directors authorized the grant of additional stock options for up to 195,000 shares of common stock under the plan, resulting in total stock options available for grant under the 2006 Plan of 2,137,200 as of December 31, 2008. The stock options granted under the 2006 Plan generally

expire at the earlier of a specified period after termination of service or the date specified by the Board or its designated committee at the date of grant, but not more than ten years from such grant date. Stock issued as a result of exercises of stock options will be issued from the Company's authorized available stock.

2009 Omnibus Incentive Plan

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 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. 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.

On May 26, 2011 the Board of Directors authorized and the Company's shareholders' approved the allocation of an additional 1,000,000 shares of common stock to the 2009 Plan. On May 23, 2012, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,122,930 additional shares of common stock to the 2009 Plan. On May 23, 2013, the Board of Directors authorized and the Company's shareholders approved the allocation of 2,317,000 additional shares of common stock to the 2009 Plan. On May 20, 2014, the Board of Directors authorized and the Company's shareholders approved the allocation of 500,000 additional shares of common stock to the 2009 Plan. On June 12, 2015, the Board of Directors authorized and the Company's shareholders approved the allocation of 1,200,000 additional shares of common stock to the 2009 Plan. At September 30, 2015 there were 3,420,968 shares available for future grant under the 2009 Plan.

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

For the nine months ended September 30, 2015 and 2014, the fair value of options granted was calculated using the following assumptions:

	Nine Months Ended September 30,	
	2015	2014
Expected stock price volatility	49.1%-63.1%	63.7%-65.0%
Expected term of options	6 years	6 years
Expected dividend yield	—	—
Risk-free interest rate	1.19%-1.75%	1.46%-1.80%

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
12. STOCK-BASED COMPENSATION (Continued)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Included in cost of revenue:				
Cost of product revenue	$9	$16	$47	$78
Cost of subscription and service revenue	26	29	23	(15)
Total included in cost of revenue	35	45	70	63
Included in operating expenses:				
Sales and marketing	364	632	952	1,573
Research and development	342	437	653	869
General and administrative	1,233	995	3,694	2,963
Total included in operating expenses	1,939	2,064	5,299	5,405
Total	$1,974	$2,109	$5,369	$5,468

Stock Options
The following table summarizes the Company's stock option activity from January 1, 2015 to September 30, 2015:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Options Outstanding, January 1, 2015	2,017,642	$13.24	7.32	$760,925
Options granted	1,184,071	8.94		
Options exercised	(25,009)	4.55		
Options canceled	(1,290,386)	13.12		
Options Outstanding, September 30, 2015	1,886,318	10.74	7.82	130,898
Vested and expected to vest September 30, 2015	1,765,676	10.77	7.73	130,898
Exercisable at September 30, 2015	906,386	$11.47	6.63	$130,898

As of September 30, 2015, there was approximately $6.4 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 1.8 years.
Stock options are granted at the discretion of the Board of Directors or the Compensation Committee (or its authorized member(s)) and expire 10 years from the date of the grant. Options generally vest over a four-year period based upon required service conditions. No options have performance or market conditions. The Company calculates the pool of additional paid-in capital associated with excess tax benefits using the "simplified method" in accordance with ASC 718.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
12. STOCK-BASED COMPENSATION (Continued)

Restricted Stock Awards

The following table summarizes the Company's restricted stock award activity from January 1, 2015 to September 30, 2015:

	Nonvested Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Awards, January 1, 2015	482,645	$12.59	$6,074,136
Awards granted	412,913	9.38	
Awards vested	(428,313)	10.64	
Awards canceled	(157,868)	11.97	
Nonvested Awards, September 30, 2015	309,377	$11.30	$3,494,939

As of September 30, 2015, future compensation cost related to the nonvested portion of the restricted stock awards not yet recognized in the consolidated statement of operations was $4.0 million and is expected to be recognized over a period of 2.26 years.

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

Restricted Stock Units

During the nine months ended September 30, 2015, 63,436 restricted stock units were granted. The Company did not grant any restricted stock units prior to April 2009.

Long Term Incentive Program

On February 21, 2013, the Company’s board of directors approved the 2013 Rosetta Stone Inc. Long Term Incentive Program (the "2013 LTIP"). The 2013 LTIP was administered under the 2009 Plan and the shares awarded under the 2013 LTIP were taken from the shares reserved under the 2009 Plan. The 2013 LTIP was effective from January 1, 2013 through December 31, 2014.

The amount of share-based and cash-based compensation expense recognized related to the 2013 LTIP was $1.4 million and $0.3 million, respectively, for the nine months ended September 30, 2014. During the first quarter of 2015, the Company issued 160,860 performance share awards related to the conclusion of the 2013 LTIP.

13. STOCKHOLDERS' EQUITY

At September 30, 2015, the Company's board of directors had the authority to issue 200,000,000 shares of stock, of which 190,000,000 were designated as Common Stock, with a par value of $0.00005 per share, and 10,000,000 were designated as Preferred Stock, with a par value of $0.001 per share. At September 30, 2015, the Company had shares of common stock issued of 23,135,216 and shares of common stock outstanding of 22,135,216.

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

On August 22, 2013, the Company’s Board of Directors approved a share repurchase program under which the Company is authorized to repurchase up to $25 million of its outstanding common stock from time to time in the open market or in privately negotiated transactions depending on market conditions, other corporate considerations, debt facility covenants and other contractual limitations, and applicable legal requirements. For the year ended December 31, 2013, the Company paid $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

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were repurchased during 2014 or the nine months ended September 30, 2015. Shares repurchased under the program were recorded as treasury stock on the Company’s consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether shares purchased under this program will be retired or reissued.

14. RESTRUCTURING

In the first quarter of 2015, the Company announced and initiated actions to reduce headcount and other costs in order to support its strategic shift in business focus. The Company committed to the 2015 Restructuring Plan and has completed a large portion of the 2015 Restructuring Plan as of September 30, 2015. The Company expects to be substantially completed by the end of 2015.

Restructuring charges included in the Company’s unaudited consolidated statement of operations related to the 2015 Restructuring Plan include the following:

- Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in the U.S. and the U.K.;
- Contract termination costs; and
- Other related costs.

The following table summarizes activity with respect to the restructuring charges for the 2015 Restructuring Plan during the nine months ended September 30, 2015 (in thousands):

	Balance at January 1, 2015	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at September 30, 2015
Severance costs	$—	$7,257	$(5,678)	$(1,048)	$531
Contract termination costs	—	1,135	(567)	—	568
Other costs	—	417	(417)	—	—
Total	$—	$8,809	$(6,662)	$(1,048)	$1,099

(1) Other Adjustments includes non-cash period changes in the liability balance, which may include non-cash stock compensation expense and foreign currency translation adjustments.

The following table summarizes the major types of costs associated with the 2015 Restructuring Plan for the three and nine months ended September 30, 2015 and 2014, and total costs incurred through September 30, 2015 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,		Incurred through
	2015	2014	2015	2014	September 30, 2015
Severance costs	$98	$—	$7,257	$—	$7,257
Contract termination costs	—	—	1,135	—	1,135
Other costs	7	—	417	—	417
Total	$105	$—	$8,809	$—	$8,809

As of September 30, 2015, the entire restructuring liability of $1.1 million was classified as a current liability within accrued compensation and other current liabilities on the consolidated balance sheets.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
14. RESTRUCTURING (Continued)

The following table presents restructuring costs included in the related line items of our Statement of Operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Cost of revenue	$28	$—	$125	$—
Sales and marketing	(45)	—	4,369	—
Research and development	56	—	757	—
General and administrative	66	—	3,558	—
Total	$105	$—	$8,809	$—

These restructuring expenses are not allocated to any reportable segment under our definition of segment contribution as defined in Note 17 "Segment Information."
The Company does not expect to incur any additional restructuring costs in connection with the 2015 Restructuring Plan.
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.

15. 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 zero and $3.2 million during the nine months ended September 30, 2015 and 2014, respectively. 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 March 2013, Rosetta Stone Japan Inc. partially abandoned its Japan office as a result of excess office space due to reduction in staff along with overall local operations business performance. The Company estimated the liability under the operating lease agreement reduced for anticipated sublease income in accordance with ASC 420 as the Company had no future economic benefit from the abandoned space associated with the lease terminated on February 28, 2015. As of March 31, 2014, the Company ceased to use the remaining office space in this facility and simultaneously negotiated and paid a lease termination fee of $0.4 million. The Company has been released from all obligations under the lease arrangement since March 31, 2014.
A summary of the Company's lease abandonment activity for the nine months ended September 30, 2015 and 2014 is as follows (in thousands):

	As of September 30,	
	2015	2014
Accrued lease abandonment costs, beginning of period	$1,679	$413
Costs incurred and charged to expense	—	3,635
Principal reductions	(358)	(2,344)
Accrued lease abandonment costs, end of period	$1,321	$1,704
Accrued lease abandonment costs liability:		
Short-term	$426	$434
Long-term	895	1,270
Total	$1,321	$1,704

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

16. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company leases copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. Building, warehouse and office space leases range from 7 months to 74 months. Certain leases also include lease renewal options.

The following table summarizes future minimum operating lease payments for the remaining three months of 2015 and the years thereafter (in thousands):

	As of September 30, 2015
Periods Ending December 31,	
2015-remaining	$1,454
2016	5,553
2017	4,223
2018	3,672
2019	1,090
2020	918
Thereafter	589
Total	$17,499

Total expenses under operating leases are $1.3 million and $1.4 million for the three months ended September 30, 2015 and 2014, respectively. Total expenses under operating leases are $4.0 million and $4.3 million for the Nine months ended September 30, 2015 and 2014, respectively.

The Company accounts for its leases under the provisions of ASC topic 840, Accounting for Leases ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense.

The deferred rent liability is $0.5 million and $0.5 million at September 30, 2015 and December 31, 2014, respectively. The deferred rent asset is $21,000 and $20,000 at September 30, 2015 and December 31, 2014, respectively. The deferred rent asset is classified in prepaid and other assets as all associated leases have less than one year remaining on their term.

Litigation

In June 2011, Rosetta Stone GmbH, a subsidiary of the Company, was served with a writ filed by Langenscheidt KG ("Langenscheidt") in the District Court of Cologne, Germany alleging trademark infringement due to Rosetta Stone GmbH’s use of the color yellow on its packaging of its language-learning software and the advertising thereof in Germany. Langenscheidt sought relief in the form of monetary damages and injunctive relief; however there has not been a demand for a specific amount of monetary damages and there has been no specific damage amount awarded to Langenscheidt. In January 2012, the District Court of Cologne ordered an injunction against specific uses of the color yellow made by Rosetta Stone GmbH in packaging, on its website and in television commercials and declared Rosetta Stone GmbH liable for damages, attorneys’ fees and costs to Langenscheidt. In its decision, the District Court of Cologne also ordered the destruction of Rosetta Stone GmbH’s product and packaging which utilized the color yellow and which was deemed to have infringed Langenscheidt’s trademark. The Court of Appeals in Cologne and the German Federal Supreme Court have affirmed the District Court's decision. The Company has filed special complaints with the German Federal Supreme Court and the German Constitutional Court directed to constitutional issues in the German Federal Supreme Court’s decision.

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

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
16. COMMITMENTS AND CONTINGENCIES (Continued)

German Federal Supreme Court has denied Rosetta Stone GmbH's further appeal but has not yet issued its written decision denying further appeal. A constitutional complaint was filed with the German Federal Supreme Court in May 2015, which is still pending.

In October 2015, the parties subsequently engaged in further settlement discussions and executed a settlement agreement pursuant to which Rosetta Stone GmbH will pay a lump sum of $0.4 million in full settlement of all financial claims resulting from the proceedings, including damages and cost reimbursement to Langenscheidt. Both parties have also agreed to withdraw the pending motions. As of September 30, 2015, the Company has recorded a liability equal to the full settlement amount of $0.4 million.

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.

17. SEGMENT INFORMATION

In March 2015, the Company announced a strategic reorganization and realignment of the business to accelerate and prioritize and reorganize the business around the Enterprise & Education segment. As a result of this shift, the Company reevaluated its segment structure. Prior to the strategy shift, the Company was managed in three operating segments - "Global Enterprise & Education", "North America Consumer", and "Rest of World Consumer". Following the strategy shift, the Company is managed in two operating segments - "Enterprise & Education" and "Consumer", whereby the current Consumer segment includes the prior North America Consumer and Rest of World Consumer segments. The Company's current operating segments also represent the Company's reportable segments. The Company will continue to evaluate its management reporting and will update its operating and reportable segments as appropriate.

The Company assesses profitability of each segment in terms of segment contribution. Segment contribution is the measure of profitability used by our Chief Operating Decision Maker ("CODM"). The CODM assesses profitability and performance of the Company on its current operating segments. Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expenses, and bad debt expense. The Company does not allocate expenses beneficial to all segments, which include certain general and administrative expenses, facilities and communication expenses, purchasing expenses and manufacturing support and logistic expenses. These expenses are included in the unallocated expenses section of the table presented below. Revenue from transactions between the Company's operating segments is not material.

During the first quarter of 2015, the CODM was the Company's President and Chief Executive Officer ("CEO"). Effective April 1, 2015, the Company's CEO resigned and an Interim President and CEO was appointed. The CODM continues to be the Company's President and CEO following this change. As the Company adapts to the reorganization and realignment of the business to prioritize the Enterprise & Education segment, the Company will continue to evaluate the role of the CODM, the measure of profitability to be used by the CODM and the level at which the measure of profitability is reviewed by the CODM. Any changes to the CODM and conclusions around operating and reportable segments will be made on a prospective basis.

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.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
17. SEGMENT INFORMATION (Continued)

Operating results by segment for the three and nine months ended September 30, 2015 and 2014 were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue:				
Enterprise & Education	$25,332	$22,532	$71,791	$59,828
Consumer	24,470	41,983	87,864	122,767
Total revenue	$49,802	$64,515	$159,655	$182,595
Segment contribution:				
Enterprise & Education	7,985	6,425	20,787	13,951
Consumer	6,556	7,293	26,458	28,817
Total segment contribution	$14,541	$13,718	$47,245	$42,768
Unallocated expenses, net:				
Unallocated cost of sales	1,715	2,517	6,407	7,293
Unallocated sales and marketing	2,582	4,006	12,711	12,849
Unallocated research and development	7,056	8,689	22,981	25,830
Unallocated general and administrative	11,395	14,186	38,126	42,655
Unallocated non-operating expense/(income)	(730)	795	1,524	912
Unallocated impairment	358	—	809	2,199
Unallocated lease abandonment expense	—	(53)	—	3,635
Total unallocated expenses, net	$22,376	$30,140	$82,558	$95,373
Loss before income taxes	$(7,835)	$(16,422)	$(35,313)	$(52,605)

Geographic Information

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

The information below summarizes revenue from customers by geographic area for the three and nine months ended September 30, 2015 and 2014 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
United States	$40,639	$51,592	$128,367	$147,689
International	9,163	12,923	31,288	34,906
Total	$49,802	$64,515	$159,655	$182,595

The information below summarizes long-lived assets by geographic area classified as held and used as of September 30, 2015 and December 31, 2014 (in thousands):

	September 30, 2015	December 31, 2014
United States	$18,830	$20,451
International	4,085	4,826
Total	$22,915	$25,277

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
17. SEGMENT INFORMATION (Continued)

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 nine months ended September 30, 2015 and 2014 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Language learning	$43,253	$60,874	$142,131	$174,838
Literacy	5,784	2,850	14,687	6,183
Brain fitness	765	791	2,837	1,574
Total	$49,802	$64,515	$159,655	$182,595

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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 contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which can be identified by the fact that they do not relate strictly to historical or current facts, often include words such as "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," or "projects." However, the absence of these words or similar expressions does not mean that a statement is not forward-looking. These statements may relate to: our revised business strategy; guidance or projections related to revenue, Adjusted EBITDA, bookings, 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, and those future events or circumstances might not occur. Management believes that these forward-looking statements are reasonable as and when made. However, caution should be taken not to place undue reliance on any such forward-looking statements because such statements speak only as of the date when made. We expressly disclaim any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from our present guidance, expectations or projections. These risks and uncertainties include, but are not limited to, those described below, those discussed in the sections titled "Risk Factors" in Part II, Item 1A of this Report and those described 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 and should be read together with our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2015.

Overview

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

Rosetta Stone Inc. was incorporated in Delaware in 2005. Founded in 1992, Rosetta Stone pioneered the use of interactive software to accelerate language learning. Today we offer courses in 30 languages across a broad range of formats, including web-based software subscriptions, digital downloads, mobile applications, and perpetual CD packages. Rosetta Stone has continued to invest in language learning and expanded beyond language learning and deeper into education-technology with its acquisitions of Livemocha Inc. ("Livemocha") and Lexia Learning Systems Inc. ("Lexia") in 2013 and Vivity Labs, Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014. These acquisitions have enabled us to meet the changing needs of learners around the world. Rosetta Stone is managed in two operating segments—Enterprise & Education and Consumer. The Enterprise & Education segment derives revenue from sales to educational institutions, government agencies and corporations worldwide. The Consumer segment derives revenue from sales to individuals and retail partners.

Over the last two years, we have expanded the breadth of our language and literacy products with the acquisitions of Tell Me More and Lexia. These acquisitions have reinforced our belief that the Enterprise & Education segment is our largest opportunity for long-term value creation. The customers in these markets have demands that recur each year, creating a more predictable revenue opportunity. This demand profile also fits well with our suite of products and the well-known Rosetta Stone brand. We also believe the opportunity to deliver English language learning is growing around the globe.

As a result, we recently communicated a strategic reorganization and realignment of our business to accelerate and prioritize our focus on satisfying the needs of more passionate Corporate and K-12 learners, and emphasize those who need to speak and read English. This focus carries over to the Consumer segment to prioritize more passionate learners, rather than trying to address the entire Consumer marketplace. To position the organization for success, we have begun and will continue to focus on the following four priorities:

1.

Reorganize our business around our Enterprise & Education segment and accelerate the growth and penetration in language and literacy markets;

2. Focus our product investment on building effective, personalized English learning experiences that deliver clear and measurable outcomes and expand our literacy products to target grade levels;

3. Right-size the entire cost base of the Company, with the first steps to

optimize our media spend and other marketing costs in Consumer sales and marketing;

rationalize our Consumer investment; and,

reduce our general and administrative costs.

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4. Cut back on the number of new business initiatives we take on - particularly in Consumer - to improve focus and enhance efficacy.

In pursuing these priorities, we plan to grow the Enterprise & Education segment by focusing the majority of our resources and assets on providing a comprehensive language learning experience focused on more passionate language learners while at the same time accelerating the migration of our Consumer segment business to digital as well as reducing the number of marketing and promotional campaigns aimed at the casual learner, relying less on promotional pricing to generate Consumer sales, reducing the number of retailers that sell our products, and streamlining operations with a clear focus to support the Enterprise & Education segment.

To carry out the strategic reorganization and realignment of the business, we initiated our plan (the "2015 Restructuring Plan") to begin reductions to Consumer sales and marketing, Consumer product investment, and general and administrative costs. We originally expected to realize annualized cost savings of approximately $50 million in connection with the strategic reorganization and realignment of the business, of which the 2015 Restructuring Plan is an important part. We identified an additional $12 million and $3 million in annualized cost savings initiatives in the second and third quarters of 2015, respectively. Our results of operations are beginning to reflect the impact of these cost reductions as well as additional employee reductions that have occurred outside of the 2015 Restructuring Plan. These costs savings will mitigate expected declines in Consumer segment revenues. See Note 2 "Summary of Significant Accounting Policies" and Note 14 "Restructuring" of Part 1 - Item 1, Financial Statements for additional information about these strategic undertakings. In addition, Stephen M. Swad, who served as our President and Chief Executive Officer throughout 2014, resigned this position effective April 1, 2015. The Board of Directors appointed A. John Hass to serve as Interim President and Chief Executive Officer, also effective April 1, 2015, while the Company engages in a search for a chief executive officer.

In conjunction with the 2015 Restructuring Plan, outside financial and legal advisors have been retained to assist management and the Board of Directors with their ongoing comprehensive review to analyze potential options to improve financial performance and enhance shareholder value.

As a result of the strategic reorganization and realignment of the business, as of September 30, 2015, we currently have two operating segments, Enterprise & Education and Consumer, rather than the three operating segments (Global Enterprise & Education, North America Consumer, and Rest of World Consumer) we had as of December 31, 2014.

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"). Segment contribution includes segment revenue and expenses incurred directly by the segment, including material costs, service costs, customer care and coaching costs, sales and marketing expense and bad debt expense.

Enterprise & Education segment contribution increased to $8.0 million with segment contribution margin of 32% for the three months ended September 30, 2015 as compared to segment contribution of $6.4 million and segment contribution margin of 29% for the three months ended September 30, 2014. The dollar and margin increases were primarily due to the increase in Enterprise & Education revenue which was slightly offset by an increase in direct sales related expenses. Consumer segment contribution decreased from $7.3 million with a segment contribution margin of 17% for the three months ended September 30, 2014 to $6.6 million with a segment contribution margin of 27% for the three months ended September 30, 2015. The dollar decrease in Consumer segment contribution reflects the $17.5 million decrease in Consumer revenue. The Consumer segment contribution margin increased due to a reduction in media spend and other cost reduction initiatives to align Consumer segment spending with our strategic focus on the Enterprise & Education segment.

For the nine months ended September 30, 2015, Enterprise & Education segment contribution increased to $20.8 million with a segment contribution margin of 29% compared to $14.0 million for the nine months ended September 30, 2014 with a segment contribution margin of 23%. The dollar and margin increases are primarily due to the increase in Enterprise & Education revenue which was slightly offset by an increase in direct sales related expenses. Consumer segment contribution decreased from $28.8 million with a contribution margin of 23% for the nine months ended September 30, 2014 to $26.5 million with a contribution margin of 30% for the nine months ended September 30, 2015. The dollar decrease in Consumer segment contribution is primarily due to a decrease in Consumer revenue of $34.9 million. The Consumer segment contribution margin increased due to our cost reduction initiatives.

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

For additional information regarding our segments, see Note 17 "Segment Information" of Part 1 - Item 1, Financial Statements. For additional information regarding fluctuations in segment revenue, see Results of Operations, below. Prior periods have been reclassified to reflect our current operating segments presentation and definition of segment contribution.

Components of Our Statement of Operations

Revenue

We derive revenue from sales of language-learning, literacy, and brain fitness solutions. Revenue is presented as product revenue or subscription and service revenue in our consolidated financial statements. Product revenue primarily consists of revenue from our perpetual language-learning product software, our audio practice products, and certain mobile applications. Our audio practice products are often combined with our language-learning software and sold as a solution. Subscription and service revenue consists of sales from web-based software subscriptions, online services, professional services, and certain mobile applications. Our 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. Our professional services include training and implementation services.

In the Consumer market, our perpetual product software is often bundled with our short-term online conversational coaching and online community services and sold as a package. Approximately $25 to $39 in revenue per unit is derived from these short-term online services. As a result, we typically defer 10%-35% of the revenue of each of these bundled sales to be recognized over the term of the service period. The content of our perpetual product software and our web-based language-learning subscription offerings are the same. We offer our customers the ability to choose which format they prefer without differentiating the learning experience.

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 Enterprise & Education sales force as well as our network of resellers and organizations who typically gain access to our solutions under a web-based subscription service. We distribute our Consumer products predominantly through our direct sales channels, primarily our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our Consumer products through select third-party retailers. For purposes of explaining variances in our revenue, we separately discuss changes in our Enterprise & Education and our Consumer sales channels because the customers and revenue drivers of these channels are different.

Within our Enterprise & Education segment, revenue in our education, government, and corporate sales channels are seasonally stronger in the second, third and fourth quarters, respectively, of the calendar year due to purchasing and budgeting cycles. Our Consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2014 accounted for 29% of our annual revenue in 2014. We expect these trends to continue.

Cost of Product and Subscription and Service Revenue

Cost of product revenue consists of the direct and indirect materials and labor costs to produce and distribute our products. Such costs include packaging materials, computer headsets, freight, inventory receiving, personnel costs associated with product assembly, third-party royalty fees and inventory storage, obsolescence and shrinkage. The cost of subscription and service revenue primarily represents costs associated with supporting our 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 product revenue and cost of subscription and service revenue.

Operating Expenses

We classify our operating expenses into the following categories: sales and marketing, research and development, general and administrative, impairment, and lease abandonment and termination.

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 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 associated with our planned and strategic shift in business focus. When certain events occur, we also recognize operating expenses related to asset impairment and operating lease terminations.

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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 at the time the customer is invoiced. However, sales commissions are deferred and recognized as expense in proportion to when the related revenue is recognized. In connection with our new strategy of focusing on the Enterprise & Education segment, we intend to continue to reduce the number of marketing and promotional campaigns that we run, focusing more on brand messaging that withstands the test of time, and less on promotional pricing.

Research and Development. Research and development expenses consist primarily of personnel costs and contract development fees associated with the development of our solutions. Our development efforts are primarily based in the U.S. and are devoted to modifying and expanding our offering portfolio through the addition of new content and new paid and complementary products and services to our language-learning, literacy, and brain fitness 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 acquisition and other corporate expenses. We expect our general and administrative expenses to continue to decline as we take steps to reduce our non-Enterprise & Education headcount as well as other cost reductions.

Impairment. Impairment expenses consist primarily of goodwill impairment and impairment expense related to the abandonment of previously capitalized internal-use software projects.

Lease Abandonment and Termination. Lease abandonment and termination expenses include the recognition of costs associated with the termination or abandonment of certain of our office operating leases, such as early termination fees and expected lease termination costs.

Interest and Other Income (Expense)

Interest and other income (expense) primarily consist of interest income, interest expense, foreign exchange gains and losses, income from litigation settlements, and income or loss from equity method investments. Interest expense is primarily related to interest on our capital leases and our revolving credit facility. Interest income represents interest received on our cash and cash equivalents. Fluctuations in foreign currency exchange rates in our foreign subsidiaries cause foreign exchange gains and losses. Legal settlements are related to agreed upon settlement payments from various anti-piracy enforcement efforts. Income or loss from equity method investments represents our proportionate share of the net income or loss of our investment in entities accounted for under the equity method.

Income Tax Expense (Benefit)

Income tax expense (benefit) consists of federal, state and foreign income taxes. For the three and nine months ended September 30, 2015, we incurred an income tax benefit of $0.5 million and and income tax expense of $47,000, respectively, despite incurring losses before taxes of $7.8 million and $35.3 million, respectively, resulting in worldwide effective tax rates of 6.8% and (0.1)%, respectively. These tax rates resulted from tax expense related to current year income of operations in Germany and the tax impact of amortization of indefinite lived intangibles. This was offset by tax benefits related to current year losses in the U.K., and Canada, and tax benefits related to the reversal of withholding taxes resulting from an intercompany transaction.

For the year ended December 31, 2014, we recorded an income tax benefit of $6.5 million primarily attributable to losses before tax of $80.2 million resulting in worldwide effective tax rate of 8.1%. The tax rate resulted from tax benefits related to the tax impact of the goodwill impairment charges taken in the first and fourth quarters of 2014 and tax benefits related to current year losses in Canada and France. The tax benefits were only partially offset by tax expense related to income of operations in Germany and the U.K., foreign withholding taxes, and the tax impact of amortization of indefinite lived intangible assets.

Critical Accounting Policies and Estimates

In presenting our financial statements in conformity with 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 estimates and assumptions. Our future estimates may change if the underlying assumptions change. Actual results may differ significantly from these estimates.

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

- Revenue Recognition
- Stock-based Compensation
- Restructuring Costs
- Income Taxes
- Allowance for Doubtful Accounts Receivable
- Sales Returns and Reserves
- Goodwill
- Other Intangible Assets

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 16, 2015. There have been no significant changes in such critical accounting policies and estimates since those disclosed in our most recent Annual Report on Form 10-K, other than the addition of accounting policies related to Restructuring Costs, as disclosed in Note 2, "Summary of Significant Accounting Policies" of Part 1 - Item 1, Financial Statements and the changes described in the following section.

Goodwill

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

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

Annual Goodwill Impairment Test

For our annual goodwill impairment test performed at June 30, 2015, we exercised our option to bypass Step 0 and began our annual test with Step 1. In connection with our annual goodwill impairment test, we determined that the fair value of each of our reporting units with a material goodwill balance substantially exceeded its carrying value, and therefore no goodwill impairment charges were recorded as a result of the 2015 annual test.

Interim Impairment Review

We routinely review goodwill at the reporting unit level for potential impairment as part of our internal control framework. We evaluated our reporting units to determine if a triggering event has occurred. As of September 30, 2015, we concluded that there are no indicators of impairment that would cause us to believe that it is more likely than not that the fair value of our reporting units is less than the carrying value. Accordingly, a detailed impairment test has not been performed and no goodwill impairment charges were recorded in connection with the interim impairment review.

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 estimates, assumptions, and values reflected in the valuations will be realized, and actual results could vary materially.

Reporting Units

Prior to 2013, our reporting units were the same as our operating segments. In 2013 and 2014 we reassessed our reporting units as a result of our business acquisitions and diversification into additional education technology spaces. In the first quarter of 2015, we reevaluated our reporting units following our strategic shift in business. Accordingly, the North America Consumer Language and the Rest of World Consumer Language reporting units (both of which had zero remaining

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goodwill as of the beginning of 2015 due to prior year impairments) were combined into the Consumer Language reporting unit. There have been no changes to our reporting unit structure since the first quarter of 2015.

As of September 30, 2015, our reporting units are: Enterprise & Education Language, Enterprise & Education Literacy, Consumer Language, and Consumer Fit Brains. The Enterprise & Education Language and Enterprise & Education Literacy reporting units are components of the Enterprise & Education operating segment. The Consumer segment is comprised of the Consumer Language and Consumer Fit Brains reporting units.

Equity Method Investment

The equity method is used to account for investments in entities if the investment provides us with the ability to exercise significant influence over operating and financial policies of the investee. We determine the level of influence we have over an equity method investment by considering key factors such as ownership interest, representation on the board of directors, participation in policy-making decisions, and technological dependencies.

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Results of Operations

Comparison of the three months ended September 30, 2015 and the three months ended September 30, 2014

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

	Three Months Ended September 30,		2015 Versus 2014	
	2015	2014	Change	% Change
Revenue:				
Product	$13,905	$32,392		