ROSETTA STONE INC
Form 10-Q
August 06, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 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 July 31, 2015, there were 21,739,894 shares of the registrant's Common Stock, $.00005 par value, outstanding.

ROSETTA STONE INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
ROSETTA STONE INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)
(unaudited)

	June 30, 2015	December 31, 2014
Assets		
Current assets:		
Cash and cash equivalents	$29,803	$64,657
Restricted cash	100	123
Accounts receivable (net of allowance for doubtful accounts of $1,514 and $1,434, at June 30, 2015 and December 31, 2014, respectively)	43,530	76,757
Inventory, net	7,636	6,500
Deferred sales commissions	11,426	10,740
Prepaid expenses and other current assets	6,472	5,038
Income tax receivable	1,100	464
Total current assets	100,067	164,279
Deferred sales commissions	5,088	4,362
Property and equipment, net	25,231	25,277
Goodwill	56,892	58,584
Intangible assets, net	31,081	34,377
Other assets	1,898	1,525
Total assets	$220,257	$288,404
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$8,762	$19,548
Accrued compensation	10,148	14,470
Obligations under capital lease	372	594
Other current liabilities	33,786	56,157
Deferred revenue	88,590	95,240
Total current liabilities	141,658	186,009
Deferred revenue	34,577	32,929
Deferred income taxes	1,910	1,554
Obligations under capital lease	2,696	3,154
Other long-term liabilities	991	1,313
Total liabilities	181,832	224,959
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000 and 10,000 shares authorized, zero and zero shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively	—	—
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 23,156 and 22,936 shares issued and 22,156 and 21,936 shares outstanding at June 30, 2015 and December 31, 2014, respectively	2	2
Additional paid-in capital	181,986	178,554
Accumulated loss	(131,057)	(102,998)

Accumulated other comprehensive loss	(1,071)	(678)
Treasury stock, at cost, 1,000 and 1,000 shares at June 30, 2015 and December 31, 2014, respectively	(11,435)	(11,435)
Total stockholders' equity	38,425	63,445
Total liabilities and stockholders' equity	$220,257	$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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenue:				
Product	$14,209	$28,125	$34,183	$60,497
Subscription and service	37,202	29,190	75,670	57,583
Total revenue	51,411	57,315	109,853	118,080
Cost of revenue:				
Cost of product revenue	3,719	7,269	9,356	15,093
Cost of subscription and service revenue	5,301	4,691	10,966	9,038
Total cost of revenue	9,020	11,960	20,322	24,131
Gross profit	42,391	45,355	89,531	93,949
Operating expenses:				
Sales and marketing	30,555	37,833	70,705	76,930
Research and development	6,953	8,368	15,925	17,142
General and administrative	11,920	14,002	27,674	30,055
Impairment	160	—	451	2,199
Lease abandonment and termination	—	118	—	3,688
Total operating expenses	49,588	60,321	114,755	130,014
Loss from operations	(7,197)	(14,966)	(25,224)	(36,065)
Other income and (expense):				
Interest income	7	5	11	10
Interest expense	(93)	(50)	(181)	(106)
Other income and (expense)	(503)	(248)	(2,084)	(22)
Total other income and (expense)	(589)	(293)	(2,254)	(118)
Loss before income taxes	(7,786)	(15,259)	(27,478)	(36,183)
Income tax expense (benefit)	389	491	581	(191)
Net loss	$(8,175)	$(15,750)	$(28,059)	$(35,992)
Loss per share:				
Basic	$(0.38)	$(0.74)	$(1.31)	$(1.70)
Diluted	$(0.38)	$(0.74)	$(1.31)	$(1.70)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,689	21,252	21,355	21,188
Diluted weighted average shares	21,689	21,252	21,355	21,188

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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net loss	$(8,175)	$(15,750)	$(28,059)	$(35,992)
Other comprehensive loss, net of tax:				
Foreign currency translation gain (loss)	754	263	(393)	(101)
Other comprehensive gain (loss)	754	263	(393)	(101)
Comprehensive loss	$(7,421)	$(15,487)	$(28,452)	$(36,093)

See accompanying notes to consolidated financial statements

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

	Six Months Ended June 30, 2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(28,059)	$(35,992)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense	3,395	3,359
Loss on foreign currency transactions	1,695	—
Bad debt expense	952	1,472
Depreciation and amortization	6,683	6,894
Deferred income tax expense (benefit)	379	(464)
Loss (gain) on disposal of equipment	(2)	109
Amortization of debt issuance costs	68	—
Loss on impairment	451	2,199
(Income) from equity method investments	(9)	—
Net change in:		
Restricted cash	24	17
Accounts receivable	31,665	12,852
Inventory	(1,167)	(347)
Deferred sales commissions	(1,447)	(3,934)
Prepaid expenses and other current assets	(1,499)	423
Income tax receivable	(633)	(652)
Other assets	(159)	737
Accounts payable	(10,738)	(680)
Accrued compensation	(4,090)	(3,457)
Other current liabilities	(19,875)	(12,053)
Other long-term liabilities	(321)	(250)
Deferred revenue	(3,919)	11,663
Net cash used in operating activities	(26,606)	(18,104)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(5,153)	(4,544)
Decrease in restricted cash for Vivity acquisition	—	12,314
Acquisitions, net of cash acquired	(1,688)	(41,687)
Other investing activities	(280)	—
Net cash used in investing activities	(7,121)	(33,917)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	37	642
Payment of financing fees	(34)	—
Payments under capital lease obligations	(375)	(366)
Net cash (used in) provided by financing activities	(372)	276
Decrease in cash and cash equivalents	(34,099)	(51,745)
Effect of exchange rate changes in cash and cash equivalents	(755)	(241)
Net decrease in cash and cash equivalents	(34,854)	(51,986)
Cash and cash equivalents—beginning of period	64,657	98,825
Cash and cash equivalents—end of period	$29,803	$46,839

SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$113	$106
Income taxes	$1,040	$1,034
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	$262	$374

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 13 "Restructuring," Note 16 "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. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current period presentation which primarily relate to the discrete presentation of deferred sales commissions in the consolidated statements of cash flows.

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 June 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 June 30, 2015 and December 31, 2014, the Company’s results of operations for the three and six months ended June 30, 2015 and 2014 and its cash flows for the six months ended June 30, 2015 and 2014 have been made. The results for the three and six months ended June 30, 2015 are not necessarily indicative of the results to be expected for the year ending December 31, 2015. All references to June 30, 2015 or to the three and six months ended June 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.

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 June 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.

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.

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

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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net loss	$(8,175)	$(15,750)	$(28,059)	$(35,992)
Foreign currency translation gain (loss)	754	263	(393)	(101)
Comprehensive loss	$(7,421)	$(15,487)	$(28,452)	$(36,093)

Advertising Costs
Costs for advertising are expensed as incurred. Advertising expense for the three and six months ended June 30, 2015 was $8.8 million and $22.2 million, respectively, and for the three and six months ended June 30, 2014 was $14.5 million and $30.2 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

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

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.
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. BUSINESS COMBINATIONS
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

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

the six months ended June 30, 2015 and 2014, respectively. The results of operations for Vivity have been included in the consolidated results of operations since January 2, 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 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 six months ended June 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.

ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
3. BUSINESS COMBINATIONS (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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Numerator:				
Net loss	$(8,175)	$(15,750)	$(28,059)	$(35,992)
Denominator:				
Weighted average number of common shares:				
Basic	21,689	21,252	21,355	21,188
Diluted	21,689	21,252	21,355	21,188
Loss per common share:				
Basic	$(0.38)	$(0.74)	$(1.31)	$(1.70)
Diluted	$(0.38)	$(0.74)	$(1.31)	$(1.70)

For the three and six months ended June 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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Stock options	39,000	71,000	40,000	90,000
Restricted stock units	108,000	97,000	114,000	92,000
Restricted stocks	37,000	37,000	86,000	81,000
Total common stock equivalent shares	184,000	205,000	240,000	263,000

5. INVENTORY
Inventory consisted of the following (in thousands):

	June 30, 2015	December 31, 2014
Raw materials	$4,140	$3,163
Finished goods	3,496	3,337
Total inventory	$7,636	$6,500

6. GOODWILL
The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisitions of Livemocha, 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.

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

The following table shows the balance and changes in goodwill for the Company's operating segments for the six months ended June 30, 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	(511)	(1,181)	(1,692)
Balance as of June 30, 2015	$8,027	$48,865	$56,892

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.
7. INTANGIBLE ASSETS
Intangible assets consisted of the following items as of the dates indicated (in thousands):

	June 30, 2015			December 31, 2014		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Tradename/trademark *	$12,469	$(1,164)	$11,305	$12,526	$(1,062)	$11,464
Core technology	15,435	(6,750)	8,685	15,890	(5,661)	10,229
Customer relationships	26,497	(15,525)	10,972	26,889	(14,344)	12,545
Website	12	(12)	—	12	(12)	—
Patents	300	(181)	119	300	(161)	139
Total	$54,713	$(23,632)	$31,081	$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 June 30, 2015, the carrying value of the tradename asset was $10.6 million.
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 June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Included in cost of revenue:				
Cost of product revenue	$62	$89	141	$183
Cost of subscription and service revenue	84	57	151	110
Total included in cost of revenue	146	146	292	293
Included in operating expenses:				
Sales and marketing	697	931	1,422	1,876
Research and development	454	531	910	1,015
General and administrative	—	—	—	—
Total included in operating expenses	1,151	1,462	2,332	2,891
Total	$1,297	$1,608	2,624	3,184

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

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

	As of June 30, 2015
2015 - remaining	$2,595
2016	4,734
2017	4,258
2018	3,644
2019	1,532
Thereafter	3,711
Total	$20,474

Impairment Reviews of Intangible Assets
The Company also routinely reviews indefinite-lived intangible assets and long-lived assets for potential impairment as part of the Company's internal control framework. As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of June 30, 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.
8. OTHER CURRENT LIABILITIES
The following table summarizes other current liabilities (in thousands):

	June 30, 2015	December 31, 2014
Accrued marketing expenses	$13,882	$31,985
Accrued professional and consulting fees	1,929	2,804
Sales return reserve	2,412	3,570
Sales, withholding and property taxes payable	4,675	5,875
Accrued purchase price of business acquisition	—	1,688
Other	10,888	10,235
Total other current liabilities	$33,786	$56,157

9. 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 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 June 30, 2015, there were no borrowings outstanding and the Company was eligible to borrow $25.0 million of available credit. A quarterly commitment fee accrues on any unused portion of the credit facility at a nominal annual rate.

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 six months ended June 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 June 30, 2015
2015-remaining	$255
2016	504
2017	504
2018	497
2019	497
Thereafter	1,366
Total minimum lease payments	$3,623
Less amount representing interest	555
Present value of net minimum lease payments	$3,068
Less current portion	372
Obligations under capital lease, long-term	$2,696

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

10. INCOME TAXES

In accordance with ASC topic 740, Income Taxes (“ASC 740”), and ASC subtopic 740-270, Income Taxes: Interim Reporting, the income tax provision for the six months ended June 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.

As of June 30, 2015, the Company is under audit in the United States for the income tax years 2009 to 2012. Currently the Company expects the IRS audit to be completed in 2015 and will provide additional information at that time. While the ultimate results cannot be predicted with certainty, the Company believes that the resulting adjustments, if any, will not have a material adverse effect on its consolidated financial condition or results of operations.

As of June 30, 2015 and December 31, 2014, the Company had $446,000 and $446,000, respectively, of unrecognized tax benefits, which if recognized, $51,000 would affect income tax expense. These liabilities for unrecognized tax benefits are presented as a reduction to the related deferred tax asset where appropriate and the remaining amount is included in “Income Taxes Payable.” Interest and penalties related to uncertain tax positions are recorded as part of the income tax provision. As of June 30, 2015, the Company had accrued approximately $30,000 in "Income Taxes Payable", compared to $26,000 as of December 31, 2014.

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of June 30, 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 June 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 June 30, 2015, a valuation allowance was provided for the U.S., Korea, 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 June 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

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

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 June 30, 2015, and December 31, 2014, the Company’s U.S. deferred tax liability was $4.1 million and $3.5 million, respectively, related to its goodwill and indefinite lived intangibles. As of June 30, 2015 the Company had foreign net deferred tax liabilities of $0.4 million compared to net deferred tax liabilities of $0.8 million at December 31, 2014.

For the six months ended June 30, 2015 the Company recorded an income tax expense of $0.6 million. The expense in the current period is made up of tax expense related to current year profits of operations in Germany, and foreign withholding taxes recorded during the period. 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.

11. STOCK-BASED COMPENSATION

2006 Stock Incentive Plan

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

2009 Omnibus Incentive Plan

On February 27, 2009, the Company's Board of Directors approved the 2009 Omnibus Incentive Plan (the "2009 Plan") that provides for the ability of the Company to grant up to 2,437,744 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 June 30, 2015 there were 3,233,564 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.

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

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

	Six Months Ended June 30, 2015	Six Months Ended June 30, 2014
Expected stock price volatility	49.1%-63.1%	64.1%-64.6%
Expected term of options	6 years	6 years
Expected dividend yield	—	—
Risk-free interest rate	1.19%-1.75%	1.53%-1.71%

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

	Three Months Ended June 30, 2015	Three Months Ended June 30, 2014	Six Months Ended June 30, 2015	Six Months Ended June 30, 2014
Included in cost of revenue:				
Cost of product revenue	$16	$20	$38	$61
Cost of subscription and service revenue	(14)	(3)	(3)	(44)
Total included in cost of revenue	2	17	35	17
Included in operating expenses:				
Sales and marketing	227	513	588	941
Research and development	171	305	311	432
General and administrative	1,708	1,118	2,461	1,969
Total included in operating expenses	2,106	1,936	3,360	3,342
Total	$2,108	$1,953	$3,395	$3,359

Stock Options

The following table summarizes the Company's stock option activity from January 1, 2015 to June 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	(4,924)	7.44		
Options canceled	(1,102,982)	13.33		
Options Outstanding, June 30, 2015	2,093,807	10.77	7.58	316,960
Vested and expected to vest June 30, 2015	1,922,820	10.82	7.51	316,426
Exercisable at June 30, 2015	815,799	$11.96	6.09	$304,847

As of June 30, 2015, there was approximately $7.9 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 1.98 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)

11. STOCK-BASED COMPENSATION (Continued)

Restricted Stock Awards

The following table summarizes the Company's restricted stock award activity from January 1, 2015 to June 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	(399,690)	10.56	
Awards canceled	(116,542)	12.16	
Nonvested Awards, June 30, 2015	379,326	$11.34	$4,300,457

As of June 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 $4.8 million and is expected to be recognized over a period of 2.44 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 six months ended June 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 $0.9 million and $0.2 million, respectively, for the six months ended June 30, 2014. During the first quarter of 2015, the Company issued 160,860 performance share awards related to the conclusion of the 2013 LTIP.

12. STOCKHOLDERS' EQUITY

At June 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 June 30, 2015, the Company had shares of common stock issued of 23,156,437 and shares of common stock outstanding of 22,156,437.

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 were repurchased during 2014 or the six months ended June 30, 2015. Shares repurchased under the program were recorded as

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
12. STOCKHOLDERS' EQUITY (Continued)

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

13. 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 June 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 six months ended June 30, 2015 (in thousands):

	Balance at January 1, 2015	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at June 30, 2015
Severance costs	$—	$7,159	$(5,388)	$(1,048)	$723
Contract termination costs	—	1,135	—	—	1,135
Other costs	—	410	(32)	—	378
Total	$—	$8,704	$(5,420)	$(1,048)	$2,236

(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 six months ended June 30, 2015 and 2014, and total costs incurred through June 30, 2015 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,		Incurred through
	2015	2014	2015	2014	June 30, 2015
Severance costs	$1,146	$—	$7,159	$—	$7,159
Contract termination costs	1,135	—	1,135	—	1,135
Other costs	164	—	410	—	410
Total	$2,445	$—	$8,704	$—	$8,704

As of June 30, 2015, the entire restructuring liability of $2.2 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)
13. RESTRUCTURING (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Cost of revenue	$60	$—	$97	$—
Sales and marketing	1,290	—	4,414	—
Research and development	97	—	701	—
General and administrative	998	—	3,492	—
Total	$2,445	$—	$8,704	$—

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

In connection with the 2015 Restructuring Plan, the Company may incur additional costs and is working to finalize these costs. As of the filing of these financial statements, the restructuring expense associated with these additional costs cannot be reasonably estimated. As a result, as of June 30, 2015, the Company cannot estimate its total restructuring expense.

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.

14. LEASE ABANDONMENT AND TERMINATION

As part of the Company’s effort to reduce general and administrative expenses through a planned space consolidation at its Arlington, Virginia headquarters location, the Company incurred lease abandonment charges of zero and $3.2 million during the six months ended June 30, 2015 and 2014, respectively. Prior to January 31, 2014, the Company occupied the 6^{th} and 7^{th} floors at its Arlington, Virginia headquarters. The Company estimated the liability under operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, Exit or Disposal Cost Obligation ("ASC 420"), as the Company has no future economic benefit from the abandoned space and the lease does not terminate until December 31, 2018. All leased space related to the 6^{th} 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 six months ended June 30, 2015 and 2014 is as follows (in thousands):

	As of June 30,	
	2015	2014
Accrued lease abandonment costs, beginning of period	$1,679	$413
Costs incurred and charged to expense	—	3,688
Principal reductions	(259)	(1,993)
Accrued lease abandonment costs, end of period	$1,420	$2,108
Accrued lease abandonment costs liability:		
Short-term	$428	$743

Long-term	992	1,365
Total	$1,420	$2,108

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

15. COMMITMENTS AND CONTINGENCIES
Operating Leases
The Company leases copiers, parking spaces, buildings, a warehouse and office space under operating lease and site license arrangements, some of which contain renewal options. Building, warehouse and office space leases range from 12 months to 75 months. Certain leases also include lease renewal options.
The following table summarizes future minimum operating lease payments for the remaining six months of 2015 and the years thereafter (in thousands):

	As of June 30, 2015
Periods Ending December 31,	
2015-remaining	$2,699
2016	5,634
2017	4,254
2018	3,673
2019	1,089
Thereafter	1,506
Total	$18,855

Total expenses under operating leases are $1.3 million and $1.4 million for the three months ended June 30, 2015 and 2014, respectively. Total expenses under operating leases are $2.7 million and $2.9 million for the six months ended June 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 June 30, 2015 and December 31, 2014, respectively. The deferred rent asset is $31,000 and $20,000 at June 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 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.

Rosetta Stone GmbH expects that damages will be awarded to Langenscheidt based on the finding of trademark infringement. However, at this point, the Company cannot predict the amount of damages which Langenscheidt will be awarded nor when any damages will be required to be paid. Langenscheidt has filed a Motion for Attorneys' Fees to which Rosetta Stone GmbH has objected. The Company has concluded that it will be required to pay court costs and opposing counsel fees and has recorded a liability of $0.3 million as of June 30, 2015. The Company will continue to incur legal fees and other costs in connection with the resolution of this case.

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

16. SEGMENT INFORMATION

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)
16. SEGMENT INFORMATION (Continued)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Revenue:				
Enterprise & Education	$23,291	$19,414	$46,459	$37,295
Consumer	28,120	37,901	63,394	80,785
Total revenue	$51,411	$57,315	$109,853	$118,080
Segment contribution:				
Enterprise & Education	6,528	3,324	12,802	7,526
Consumer	10,796	9,470	19,902	21,524
Total segment contribution	$17,324	$12,794	$32,704	$29,050
Unallocated expenses, net:				
Unallocated cost of sales	2,142	2,264	4,692	4,776
Unallocated sales and marketing	3,890	4,159	10,129	9,384
Unallocated research and development	6,953	8,368	15,925	17,141
Unallocated general and administrative	11,376	13,437	26,731	28,513
Unallocated non-operating expense/(income)	589	(293)	2,254	(468)
Unallocated impairment	160	—	451	2,199
Unallocated lease abandonment expense	—	118	—	3,688
Total unallocated expenses, net	$25,110	$28,053	$60,182	$65,233
Loss before income taxes	$(7,786)	$(15,259)	$(27,478)	$(36,183)

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 six months ended June 30, 2015 and 2014 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
United States	$41,539	$46,637	$87,728	$96,047
International	9,872	10,678	22,125	22,033
Total	$51,411	$57,315	$109,853	$118,080

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

	June 30, 2015	December 31, 2014
United States	$21,043	$20,451
International	4,188	4,826
Total	$25,231	$25,277

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
16. 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 six months ended June 30, 2015 and 2014 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Language learning	$45,713	$54,852	$98,878	$113,964
Literacy	4,733	1,923	8,903	3,334
Brain fitness	965	540	2,072	782
Total	$51,411	$57,315	$109,853	$118,080

17. SUBSEQUENT EVENTS
Effective August 1, 2015, the Company entered into a definitive agreement to transfer 100% of the Company's capital stock of Rosetta Stone Korea Ltd. ("RSK") to the current President of RSK. Upon the closing, the Company will have no responsibility with respect to any of RSK's assets or liabilities. 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 will loan RSK $0.5 million which will be repaid in five equal installments due every six months beginning December 31, 2016. The closing date of this transaction is expected to be September 30, 2015.

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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. In the second quarter of 2015, an additional $12 million in annualized cost savings initiatives were identified. 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 13 "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 June 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 $6.5 million for the three months ended June 30, 2015 as compared to $3.3 million for the three months ended June 30, 2014, primarily due to the increase in Enterprise & Education revenue driven by an increase in literacy revenue of $2.8 million and an increase of $1.4 million in our education language-learning channel. Consumer segment contribution increased from $9.5 million for the three months ended June 30, 2014 to $10.8 million for the three months ended June 30, 2015. Despite the decrease in Consumer revenue, our Consumer segment contribution increased, primarily due to a decrease in media spend and other cost reduction initiatives to align Consumer segment spending with our strategic focus on the Enterprise & Education segment.

For the six months ended June 30, 2015, Enterprise & Education segment contribution increased to $12.8 million compared to $7.5 million for the six months ended June 30, 2014, primarily due to the increase in literacy revenue of $5.6 million and increases of $2.7 million and $0.5 million in our education and corporate language-learning channels, respectively. Consumer segment contribution decreased from $21.5 million for the six months ended June 30, 2014 to $19.9 million for the six months ended June 30, 2015. The decrease in Consumer segment contribution is primarily due to a decrease in Consumer revenue, which was only partially offset by 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.

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

Our Enterprise & Education revenue is seasonally stronger in the second and third quarters of the calendar year due to education and government purchasing cycles. The corporate channel of our Enterprise & Education segment is seasonally stronger in the fourth quarter. 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.

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

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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 six months ended June 30, 2015, we incurred an income tax expense of $0.4 million and $0.6 million, respectively, despite incurring losses before taxes of $7.8 million and $27.5 million, respectively, resulting in worldwide effective tax rates of (5.0)% and (2.1)%, respectively. These tax rates resulted from tax expense related to current year income of operations in Germany, foreign withholding taxes, and the tax impact of amortization of indefinite lived intangibles. This was offset by tax benefits related to current year losses in the U.K. and Canada.

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.

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:

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•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. For our annual goodwill test performed at June 30, we exercised our option to bypass Step 0 and began our annual test with Step 1.

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.

In connection with the annual goodwill impairment analysis performed at June 30, 2015, 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 in 2015 as a result of the annual test.

For additional risk factors which could affect the assumptions used in our valuation of our reporting units, see the section titled "Risk Factors" in Part II, Item 1A of this Report. Accordingly, we cannot provide assurance that the 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 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 June 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

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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 June 30, 2015 and the three months ended June 30, 2014

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

	Three Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
Revenue:				
Product	$14,209	$28,125	$(13,916)	(49.5)%
Subscription and service	37,202	29,190	8,012	27.4%
Total revenue	51,411	57,315	(5,904)	(10.3)%
Cost of revenue:				
Cost of product revenue	3,719	7,269	(3,550)	(48.8)%
Cost of subscription and service revenue	5,301	4,691	610	13.0%
Total cost of revenue	9,020	11,960	(2,940)	(24.6)%
Gross profit	42,391	45,355	(2,964)	(6.5)%
Operating expenses:				
Sales and marketing	30,555	37,833	(7,278)	(19.2)%
Research and development	6,953	8,368	(1,415)	(16.9)%
General and administrative	11,920	14,002	(2,082)	(14.9)%
Impairment	160	—	160	100.0%
Lease abandonment and termination	—	118	(118)	(100.0)%
Total operating expenses	49,588	60,321	(10,733)	(17.8)%
Loss from operations	(7,197)	(14,966)	7,769	(51.9)%
Other income and (expense):				
Interest income	7	5	2	40.0%
Interest expense	(93)	(50)	(43)	86.0%
Other income and (expense)	(503)	(248)	(255)	102.8%
Total other income and (expense)	(589)	(293)	(296)	101.0%
Loss before income taxes	(7,786)	(15,259)	7,473	(49.0)%
Income tax expense (benefit)	389	491	(102)	(20.8)%
Net loss	$(8,175)	$(15,750)	$7,575	(48.1)%

Total revenue decreased to $51.4 million for the three months ended June 30, 2015 from $57.3 million for the three months ended June 30, 2014. The change in revenue is due to an increase in Enterprise & Education revenue of $3.9 million, which was more than offset by a decrease in Consumer revenue of $9.8 million.

The operating loss for the three months ended June 30, 2015 totaled $7.2 million, compared to an operating loss of $15.0 million for the three months ended June 30, 2014. Operating expenses decreased $10.7 million, primarily comprised of decreases of $7.3 million in sales and marketing expenses, $1.4 million in research and development expenses, and $2.1 million in general and administrative expenses. The decrease in operating expenses reflects the actions from our 2015 Restructuring Plan. The overall decrease in operating expenses was partially offset by a decrease in gross profit of $3.0 million, driven by a $5.9 million decrease in revenue only partially offset by a $2.9 million decrease in cost of revenue.

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The following table sets forth revenue for our two operating segments for the three months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Three Months Ended June 30,						2015 Versus 2014			
	2015			2014			Change		% Change	
Enterprise & Education	$23,291	45.3	%	$19,414	33.9	%	$3,877		20.0	%
Consumer	28,120	54.7	%	37,901	66.1	%	(9,781	)	(25.8	)%
Total Revenue	$51,411	100.0	%	$57,315	100.0	%	$(5,904	)	(10.3	)%

Enterprise & Education Segment

Total Enterprise & Education revenue increased $3.9 million, or 20%, from the three months ended June 30, 2014 to the three months ended June 30, 2015. Enterprise & Education literacy revenue increased $2.8 million. Enterprise & Education language revenue increased $1.1 million, comprised primarily of an increase of $1.4 million in our education channel, partially offset by a decrease in revenue of $0.4 million in our corporate channel. The Enterprise & Education revenue increased, in part, due to the revenue recognition of subscription service contracts recorded as deferred revenue in prior periods. Due to purchase accounting, deferred revenue associated with Lexia and Tell Me More was recorded at fair value, which is lower than the book value, and resulted in lower second quarter 2014 revenue. As a result, we expect year over year revenues to become more comparable as we lap the purchase accounting impact, which will result in lower revenue growth rates than what we experienced in the second quarter of 2015.

Consumer Segment

Consumer revenue decreased $9.8 million, or 26%, from the three months ended June 30, 2014 to the three months ended June 30, 2015. This decrease was due to reductions in revenue from our direct-to-consumer, retail, and homeschool sales channels of $7.5 million, $2.5 million, and $0.3 million, respectively, partially offset by an increase of $0.4 million related to Fit Brains. These declines reflect the decision to significantly curtail promotional pricing under our strategic transformation. In recent quarters, we focused on driving customers to purchase through our direct-to-consumer channel, particularly through our website, by implementing more aggressive discounting and promotional activity to combat the introduction of lower priced competitor products. In connection with our shift in strategy to focus on the passionate learner, we have been and expect to be more disciplined with pricing, relying much less on discounting, which may continue to negatively impact our Consumer revenue. Our Consumer business is seasonal and typically peaks in the fourth quarter during the holiday shopping season.

Revenue by Product Revenue and Subscription and Service Revenue

We categorize and report our revenue in two categories—product revenue and subscription and service revenue. Product revenue includes revenue allocated to our perpetual language-learning product software, revenue from the sale of audio practice products, and sales of certain mobile applications. Subscription and service revenue includes web-based software subscriptions, online services for our conversational coaching and language-learning community access, as well as revenue from professional services. Subscription and service revenue are typically deferred at the time of sale and then recognized ratably over the subscription or service period. We bundle our perpetual product software with short-term online services. As a result, we typically defer 10%-35% of the revenue of each of these bundled sales. We recognize the deferred revenue over the term of the service period.

The following table sets forth revenue for products and subscription and services for the three months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Three Months Ended June 30,						2015 Versus 2014			
	2015			2014			Change		% Change	
Product	$14,209	27.6	%	$28,125	49.1	%	$(13,916	)	(49.5	)%
Subscription and service	37,202	72.4	%	29,190	50.9	%	8,012		27.4	%
Total revenue	$51,411	100.0	%	$57,315	100.0	%	$(5,904	)	(10.3	)%

Product Revenue

Product revenue decreased $13.9 million, or 49%, to $14.2 million during the three months ended June 30, 2015 from $28.1 million during the three months ended June 30, 2014. The primary drivers of the decrease in product revenue were decreases of $10.7 million and $2.6 million in the direct-to-consumer and retail sales channels, respectively.

Product revenue also decreased primarily due to the year-over-year decline in product unit sales volume, the decrease in the average sale price of

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our bundled language-learning software products, and the increase in the revenue amount allocated and deferred to online service revenue due to the change in VSOE associated with this bundled service from $25 to $39 in late 2014. We expect a shift away from product revenue as we carry out our strategy to accelerate the migration of our Consumer business to our subscription-based products. However, it is important to note that these subscribers generally only stay for the duration of the subscription period, which could negatively impact our revenue in the future.

Subscription and Service Revenue

Subscription and service revenue increased $8.0 million, or 27%, to $37.2 million for the three months ended June 30, 2015 from $29.2 million for the three months ended June 30, 2014. The increase in subscription and service revenue was primarily due to increases of $2.8 million and $1.1 million in the literacy and language-learning education service sales channels, respectively, within the Enterprise & Education segment. Within the Consumer segment, we realized increases of $3.3 million and $0.4 million in direct-to-consumer and Fit Brains service sales, respectively. Subscription and service revenue also increased due to the increase in the amount allocated to online service revenue due to the change in VSOE associated with the bundled service from $25 to $39 in late 2014. Our Q2 2014 subscription and service revenue was lower due to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with Lexia and Tell Me More. As a result, we expect the growth rates from our Enterprise & Education segment to mitigate over time.

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

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the three months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Three Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
Revenue:				
Product	$14,209	$28,125	$(13,916)	(49.5)%
Subscription and service	37,202	29,190	8,012	27.4%
Total revenue	51,411	57,315	(5,904)	(10.3)%
Cost of revenue:				
Cost of product revenue	3,719	7,269	(3,550)	(48.8)%
Cost of subscription and service revenue	5,301	4,691	610	13.0%
Total cost of revenue	9,020	11,960	(2,940)	(24.6)%
Gross profit	$42,391	$45,355	$(2,964)	(6.5)%
Gross margin percentages	82.5%	79.1%	3.4%	

Total cost of revenue decreased $2.9 million for the three months ended June 30, 2015 from $12.0 million for the three months ended June 30, 2014. The change in total cost of revenue was primarily due to a $1.0 million decrease in physical inventory costs due to the reduction in sales, a $1.1 million decrease in payroll and benefits expense driven by the reduced headcount from the 2015 Restructuring Plan, and a $0.5 million decrease in freight and payment processing fees due to the reduction in sales.

Cost of Product Revenue

Cost of product revenue for the three months ended June 30, 2015 was $3.7 million, a decrease of $3.6 million, or 49%, from the three months ended June 30, 2014. As a percentage of product revenue, cost of product revenue remained flat at 26% for the three months ended June 30, 2015 and 2014. The dollar decrease in cost of product revenue is primarily due to decreases of $1.2 million, $0.9 million, and $0.3 million in payroll and benefits, inventory costs, and freight costs, respectively, due to the shift away from hard product sales to online subscription sales.

Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the three months ended June 30, 2015 was $5.3 million, an increase of $0.6 million, or 13%, from the three months ended June 30, 2014. As a percentage of subscription and service revenue, cost of subscription and service revenue decreased to 14% for the three months ended June 30, 2014 compared to 16% for the same prior year period. The dollar increase was primarily due to increases in hosting due to the shift in sales mix to subscription service sales and amortization of intangibles. We expect the cost of subscription and service revenue will increase as we focus

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our business around the Enterprise & Education business and accelerate the migration of our Consumer business to our subscription-based products.

Gross Profit

Gross profit decreased $3.0 million to $42.4 million for the three months ended June 30, 2015 compared to $45.4 million for the three months ended June 30, 2014. Gross profit percentage increased to 82% from 79% for the three months ended June 30, 2015 compared to the three months ended June 30, 2014. The dollar decrease in gross profit was primarily due to the decrease in revenue. The percentage increase in gross profit percentage was primarily due to the decrease in inventory and freight costs associated with hard product sales as we continue to shift to online subscription sales.

Operating Expenses

	Three Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Sales and marketing	$30,555	$37,833	$(7,278)	(19.2)%
Research and development	6,953	8,368	(1,415)	(16.9)%
General and administrative	11,920	14,002	(2,082)	(14.9)%
Impairment	160	—	160	100.0%
Lease abandonment and termination	—	118	(118)	(100.0)%
Total operating expenses	$49,588	$60,321	$(10,733)	(17.8)%

Sales and Marketing Expenses

Sales and marketing expenses for the three months ended June 30, 2015 were $30.6 million, a decrease of $7.3 million, or 19%, from the three months ended June 30, 2014. As a percentage of total revenue, sales and marketing expenses decreased to 59% from 66% for the three months ended June 30, 2015 compared to the three months ended June 30, 2014. The decrease in sales and marketing expenses was primarily due to a reduction in media and marketing expense and a decrease in payroll and benefits expense. Media expense decreased $4.6 million across TV, radio, print, Internet, social media and online display as a result of the strategic shift in focus. Marketing expenses related to creative development also decreased by $1.2 million year-over-year due to the shift in focus on the Consumer market in 2015. Payroll and benefit expense decreased $1.8 million due to the salary savings from the reduced headcount as a result of the 2015 Restructuring Plan, lower variable incentive compensation expenses based on reduced funding expectations, and the absence of vacation expenses due to an early 2015 change in the paid time off policy. As we implement our strategic plan, we expect to continue to optimize our Consumer media and marketing costs.

Research and Development Expenses

Research and development expenses were $7.0 million for the three months ended June 30, 2015, a decrease of $1.4 million, or 17%, from the three months ended June 30, 2014. As a percentage of total revenue, research and development expenses decreased slightly from 15% to 14% for the three months ended June 30, 2015 compared to the three months ended June 30, 2014. The decrease was primarily due to a decrease in payroll and benefits expense due to the reduction in force associated with the 2015 Restructuring Plan. The main drivers of this decrease were a $0.6 million decrease in variable incentive compensation expenses based on reduced funding expectations, a $0.2 million salary savings from the reduced headcount as a result of the 2015 Restructuring Plan, and a reduction of $0.2 million due to the absence of vacation expenses due to an early 2015 change in the paid time off policy. In accordance with our shift in strategy, we plan to focus our product investment on integrating our foundations, advantage and advanced English for business products into a single platform, enhancing our reporting and administrator tools, extending our assessment capabilities, and bringing other new and innovative features to the market for all of our customers. We expect our research and development expenses to increase as we fund these initiatives.

General and Administrative Expenses

General and administrative expenses decreased $2.1 million to $11.9 million for the three months ended June 30, 2015 compared to $14.0 million for the three months ended June 30, 2014. As a percentage of revenue, general and administrative expenses decreased to 23% from 24% for the three months ended June 30, 2015 compared to the three months ended June 30, 2014. The decrease in general and administrative expenses was due to a decrease in payroll and benefits expense and a decrease in third party service expenses. Payroll and benefits expense decreased by $1.0 million due to a reduction in variable

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incentive compensation expense based on reduced funding expectations and reduced headcount as a result of the 2015 Restructuring Plan. As a result of our restructuring actions, we expect our general and administrative expenses to decrease in the near term.

Impairment

Impairment expenses were $0.2 million for the three months ended June 30, 2015, an increase of $0.2 million, or 100%, from the three months ended June 30, 2014. The increase was due to a current period impairment charge of $0.2 million related to the abandonment of a previously capitalized internal-use software project.

Lease Abandonment and Termination

Lease abandonment and termination expenses were zero for the three months ended June 30, 2015, compared to $0.1 million during the three months ended June 30, 2014. The decrease is attributable to the second quarter 2014 lease abandonment of a Tell Me More office space in Phoenix, Arizona due to the physical location closure to streamline operations.

Interest and Other Income (Expense)

	Three Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Interest income	$7	$5	$2	40.0 %
Interest expense	(93)	(50)	(43)	86.0 %
Other income and (expense)	(503)	(248)	(255)	102.8 %
Total other income and (expense)	$(589)	$(293)	$(296)	101.0 %

Interest income for the three months ended June 30, 2015 was $7,000, an increase of $2,000, or 40%, from the three months ended June 30, 2014. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the three months ended June 30, 2015 was $93,000, an increase of $43,000 from the three months ended June 30, 2014, attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other expense for the three months ended June 30, 2015 was $0.5 million, an increase of $0.3 million, from $0.2 million for the three months ended June 30, 2014. The fluctuation is primarily attributable to foreign exchange losses.

Income Tax Expense

	Three Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Income tax expense	$389	$491	$(102)	(20.8)%

Our income tax expense for the three months ended June 30, 2015 was $0.4 million, compared to $0.5 million for the three months ended June 30, 2014. The decrease primarily resulted from lower pretax income from certain foreign operations.

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Comparison of the six months ended June 30, 2015 and the six months ended June 30, 2014
The following table sets forth our consolidated statement of operations for the periods indicated (in thousands, except percentages):

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
Revenue:				
Product	$34,183	$60,497	$(26,314)	(43.5)%
Subscription and service	75,670	57,583	18,087	31.4%
Total revenue	109,853	118,080	(8,227)	(7.0)%
Cost of revenue:				
Cost of product revenue	9,356	15,093	(5,737)	(38.0)%
Cost of subscription and service revenue	10,966	9,038	1,928	21.3%
Total cost of revenue	20,322	24,131	(3,809)	(15.8)%
Gross profit	89,531	93,949	(4,418)	(4.7)%
Operating expenses:				
Sales and marketing	70,705	76,930	(6,225)	(8.1)%
Research and development	15,925	17,142	(1,217)	(7.1)%
General and administrative	27,674	30,055	(2,381)	(7.9)%
Impairment	451	2,199	(1,748)	(79.5)%
Lease abandonment and termination	—	3,688	(3,688)	(100.0)%
Total operating expenses	114,755	130,014	(15,259)	(11.7)%
Loss from operations	(25,224)	(36,065)	10,841	(30.1)%
Other income and (expense):				
Interest income	11	10	1	10.0%
Interest expense	(181)	(106)	(75)	70.8%
Other income and (expense)	(2,084)	(22)	(2,062)	9,372.7%
Total other income and (expense)	(2,254)	(118)	(2,136)	1,810.2%
Loss before income taxes	(27,478)	(36,183)	8,705	(24.1)%
Income tax expense (benefit)	581	(191)	772	(404.2)%
Net loss	$(28,059)	$(35,992)	$7,933	(22.0)%

Total revenue decreased to $109.9 million for the six months ended June 30, 2015 from $118.1 million for the six months ended June 30, 2014. The change in revenue was due to an increase in Enterprise & Education revenue of $9.2 million, which was more than offset by a decrease in Consumer revenue of $17.4 million.

The operating loss for the six months ended June 30, 2015 totaled $25.2 million, compared to an operating loss of $36.1 million for the six months ended June 30, 2014. Operating expenses decreased $15.3 million, which included a $1.7 million reduction in goodwill and other impairment charges and a $3.7 million reduction in lease abandonment and termination expenses. Excluding the impairment and lease-related costs, operating expenses decreased $9.8 million, comprised of decreases of $6.2 million in sales and marketing expenses, $1.2 million in research and development expenses, and $2.4 million in general and administrative expenses. The decrease in operating expenses, excluding the impairment and lease-related costs, reflects the up-front restructuring costs incurred at the beginning of the implementation of our shift in strategy. Gross profit decreased $4.4 million, driven by an $8.2 million decrease in revenue and a $3.8 million decrease in cost of revenue.

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The following table sets forth revenue for our two operating segments for the six months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Six Months Ended June 30,				2015 Versus 2014	
	2015		2014		Change	% Change
Enterprise & Education	$46,459	42.3 %	$37,295	31.6 %	$9,164	24.6 %
Consumer	63,394	57.7 %	80,785	68.4 %	(17,391)	(21.5)%
Total Revenue	$109,853	100.0 %	$118,080	100.0 %	$(8,227)	(7.0)%

Enterprise & Education Segment

Total Enterprise & Education revenue increased $9.2 million, or 25%, from the six months ended June 30, 2014 to the six months ended June 30, 2015. Enterprise & Education literacy revenue increased $5.6 million. Enterprise & Education language revenue increased $3.6 million, comprised primarily of increases of $2.7 million and $0.5 million in our education and corporate sales channels, respectively. Enterprise & Education revenue increased, in part, due to the revenue recognition of subscription service contracts recorded as deferred revenue in prior periods. Due to purchase accounting, deferred revenue associated with Lexia and Tell Me More was recorded at fair value, which is lower than the book value, and resulted in lower 2014 revenue. As a result, we expect year over year revenues to become more comparable as we lap the purchase accounting impact, which will result in lower revenue growth rates than what we experienced in the first half of 2015.

Consumer Segment

Consumer revenue decreased $17.4 million, or 22%, from the six months ended June 30, 2014 to the six months ended June 30, 2015. This decrease was largely due to reductions in revenue from our direct-to-consumer, retail, and homeschool sales channels of $14.3 million, $4.2 million, and $0.4 million, respectively, slightly offset by an increase of $1.3 million in revenue of our Fit Brains offerings. These declines reflect the decision to significantly curtail promotional pricing under our strategic transformation.

Revenue by Product Revenue and Subscription and Service Revenue

The following table sets forth revenue for products and subscription and services for the six months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Six Months Ended June 30,				2015 Versus 2014	
	2015		2014		Change	% Change
Product	$34,183	31.1 %	$60,497	51.2 %	$(26,314)	(43.5)%
Subscription and service	75,670	68.9 %	57,583	48.8 %	18,087	31.4 %
Total revenue	$109,853	100.0 %	$118,080	100.0 %	$(8,227)	(7.0)%

Product Revenue

Product revenue decreased $26.3 million, or 43%, to $34.2 million during the six months ended June 30, 2015 from $60.5 million during the six months ended June 30, 2014. Product revenue decreased $21.3 million, $3.9 million, and $0.7 million in the direct-to-consumer, retail, and homeschool sales channels, respectively. Product revenue also decreased primarily due to the decrease in the average sale price of our bundled language-learning software products from promotional pricing, a decline in product unit sales volume, and the increase in the revenue amount allocated and deferred to online service revenue due to the change in VSOE associated with this bundled service from $25 to $39 in late 2014.We expect a shift away from product revenue as we carry out our strategy to accelerate the migration of our Consumer business to our subscription-based products. However, it is important to note that these subscribers generally only stay for the duration of the subscription period, which could negatively impact our revenue in the future.

Subscription and Service Revenue

Subscription and service revenue increased $18.1 million, or 31%, to $75.7 million for the six months ended June 30, 2015 from $57.6 million for the six months ended June 30, 2014. Within the Enterprise & Education segment, the increase in subscription and service revenue was primarily due to an increase of $5.6 million in literacy revenue combined with language revenue increases of $2.5 million and $0.9 million in the education and corporate service sales channels, respectively. The Consumer segment realized increases of $7.0 million and $1.3 million in direct-to-consumer and Fit Brains service sales, respectively. Subscription and service revenue also increased due to the increase in the amount allocated to online service

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revenue due to the change in VSOE associated with the bundled service from $25 to $39 in late 2014. Our 2014 subscription and service revenue was lower due to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with Lexia and Tell Me More. As a result, we expect the growth rates from our Enterprise & Education segment to mitigate over time.

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

The following table sets forth cost of product revenue and subscription and service revenue, as well as gross profit for the six months ended June 30, 2015 and 2014 (in thousands, except percentages):

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
Revenue:				
Product	$34,183	$60,497	$(26,314)	(43.5)%
Subscription and service	75,670	57,583	18,087	31.4%
Total revenue	109,853	118,080	(8,227)	(7.0)%
Cost of revenue:				
Cost of product revenue	9,356	15,093	(5,737)	(38.0)%
Cost of subscription and service revenue	10,966	9,038	1,928	21.3%
Total cost of revenue	20,322	24,131	(3,809)	(15.8)%
Gross profit	$89,531	$93,949	$(4,418)	(4.7)%
Gross margin percentages	81.5%	79.6%	1.9%	

Total cost of revenue decreased $3.8 million for the six months ended June 30, 2015 from $24.1 million for the six months ended June 30, 2014. The decrease in total cost of revenue was primarily due to decreases in payroll and benefits expense, inventory expense, and freight and payment processing fees. Payroll and benefit expenses declined $1.8 million driven by reduced headcount predominantly in the online experience Consumer group. Inventory expense declined $1.6 million due to the first quarter 2014 charges to inventory obsolescence in our Asian operations and a higher standard cost revaluation recorded in early 2014. Freight and processing fees decreased $0.6 million due to the decrease in sales.

Cost of Product Revenue

Cost of product revenue for the six months ended June 30, 2015 was $9.4 million, a decrease of $5.7 million, or 38%, from the six months ended June 30, 2014. As a percentage of product revenue, cost of product revenue increased to 27% from 25% for the six months ended June 30, 2015 compared to the same prior year period. The increase in cost as a percentage of revenue was primarily attributable to a decline in product revenue. The dollar decrease in cost of product revenue is primarily due to decreases of $2.0 million, $1.6 million, and $0.5 million in payroll and benefits, inventory costs, and freight costs, respectively, due to the shift away from hard product sales to online subscription sales.

Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the six months ended June 30, 2015 was $11.0 million, an increase of $1.9 million, or 21%, from the six months ended June 30, 2014. As a percentage of subscription and service revenue, cost of subscription and service revenue decreased to 14% for the six months ended June 30, 2015 from 16% compared to the same prior year period. The dollar increase was primarily due to increases in hosting and amortization of intangibles due to the shift in sales mix to subscription service sales.

Gross Profit

Gross profit decreased $4.4 million to $89.5 million for the six months ended June 30, 2015 compared to $93.9 million for the six months ended June 30, 2014. Gross profit percentage increased to 82% from 80% for the six months ended June 30, 2015 compared to the six months ended June 30, 2014. The dollar decrease in gross profit was primarily due to the decrease in revenue. The increase in gross profit percentage was primarily due to the decrease in inventory and freight costs associated with hard product sales as we continue to shift to online subscription sales.

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Operating Expenses

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Sales and marketing	$70,705	$76,930	$(6,225)	(8.1)%
Research and development	15,925	17,142	(1,217)	(7.1)%
General and administrative	27,674	30,055	(2,381)	(7.9)%
Impairment	451	2,199	(1,748)	(79.5)%
Lease abandonment and termination	—	3,688	(3,688)	(100.0)%
Total operating expenses	$114,755	$130,014	$(15,259)	(11.7)%

Sales and Marketing Expenses

Sales and marketing expenses for the six months ended June 30, 2015 were $70.7 million, a decrease of $6.2 million, or 8%, from the six months ended June 30, 2014. As a percentage of total revenue, sales and marketing expenses decreased slightly to 64% from 65% for the six months ended June 30, 2015 compared to the six months ended June 30, 2014. The decrease in sales and marketing expenses was due to decreases in media and marketing expenses, payroll and benefit expenses, and amortization expense, which were partially offset by increases in commission expense and professional services expenses. Media spend decreased $6.5 million due to a shift in spend from TV, radio and print to Internet marketing and online displays. Marketing expenses also decreased by $1.6 million due to decreased spend in creative development and advertising expenses as a result of the strategic shift in focus. Despite an increase of $1.0 million in severance expense as a result of the 2015 reduction in force, payroll and benefit expense decreased $0.9 million due to salary savings from the reduced headcount as a result of the 2015 Restructuring Plan, lower variable incentive compensation expenses based on reduced funding expectations, and the absence of vacation expenses due to an early 2015 change in the paid time off policy. Amortization expense decreased $0.5 million due to the fully depreciated Tell Me More trade name at the end of 2014. Commission expense increased $2.6 million primarily driven by an increase in Enterprise & Education literacy revenue. Professional services increased $0.7 million due to contract termination expense as a result of the 2015 Restructuring Plan partially offset by reduced call center spending.

Research and Development Expenses

Research and development expenses were $15.9 million for the six months ended June 30, 2015, a decrease of $1.2 million, or 7%, from the six months ended June 30, 2014. As a percentage of total revenue, research and development expenses decreased slightly from 15% to 14% for the six months ended June 30, 2015 compared to the six months ended June 30, 2014. The dollar decrease was due to a reduction in payroll and benefits expense of $1.4 million due to a decrease in variable incentive compensation expenses based on reduced funding expectations and decreased vacation expense due to the change in our paid time off policy in early 2015, slightly offset by an increase in severance expense related to the 2015 Restructuring Plan.

General and Administrative Expenses

General and administrative expenses decreased $2.4 million to $27.7 million for the six months ended June 30, 2015 compared to $30.1 million for the six months ended June 30, 2014. As a percentage of revenue, general and administrative expenses remained flat at 25% for the six months ended June 30, 2015 and 2014. The decrease in general and administrative expenses was due to reductions in third party services, bad debt, travel, and rent expenses, which were partially offset by an increase in professional services expense. Third party services expense decreased $1.2 million mainly driven by decreased software and hardware maintenance expenses in 2015. Bad debt expense decreased by $0.5 million due to improvements in accounts receivable aging as compared to 2014. Travel expenses decreased $0.3 million as a result of the international trips in support of acquisition related activities in the first quarter of 2014. Rent expense decreased $0.2 million due to the Arlington 6th floor rent expense incurred in January 2014 prior to the lease termination. Professional services expense increased $0.3 million due to increased consulting expenses related to the strategic business and growth review and higher audit fees primarily associated with our 2014 goodwill impairment charges, partially offset by a decrease in legal expenses in 2015.

Impairment

Impairment expenses were $0.5 million for the six months ended June 30, 2015, a decrease of $1.7 million, or 79%, from the six months ended June 30, 2014. The decrease was primarily attributable to a $2.2 million goodwill impairment charge related to our former Rest of World Consumer Language reporting unit taken in 2014, partially offset by 2015 impairment charges totaling $0.5 million related to the abandonment of a previously capitalized internal-use software project.

Lease Abandonment and Termination

Lease abandonment and termination expenses were zero for the six months ended June 30, 2015, compared to $3.7 million during the six months ended June 30, 2014. The decrease is attributable to the 2014 lease abandonment of the sixth floor space in the Arlington, VA office of $3.1 million as well as the closure of the Japan office resulting in lease abandonment costs of $0.4 million.

Interest and Other Income (Expense)

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Interest income	$11	$10	$1	10.0%
Interest expense	(181)	(106)	(75)	70.8%
Other income and (expense)	(2,084)	(22)	(2,062)	9,372.7%
Total other income and (expense)	$(2,254)	$(118)	$(2,136)	1,810.2%

Interest income for the six months ended June 30, 2015 was $11,000, an increase of $1,000, or 10%, from the six months ended June 30, 2014. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the six months ended June 30, 2015 was $0.2 million, an increase of $0.1 million from the six months ended June 30, 2014, attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other expense for the six months ended June 30, 2015 was $2.1 million, an increase of $2.1 million, from the six months ended June 30, 2014. The fluctuation is primarily attributable to foreign exchange losses.

Income Tax Expense (Benefit)

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Income tax expense (benefit)	$581	$(191)	$772	(404.2)%

Our income tax expense for the six months ended June 30, 2015 was $0.6 million, compared to an income tax benefit of $0.2 million for the six months ended June 30, 2014. The change primarily resulted from the tax benefits related to the goodwill impairment charge taken during the first quarter of 2014 related to the former Rest of World Consumer Language reporting unit. The goodwill that was written off related to acquisitions from prior years, a portion of which resulted in a tax benefit as a result of writing off of a deferred tax liability previously recorded (i.e., goodwill had tax basis and was amortized for tax).

Liquidity and Capital Resources

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

As part of our strategic shift, we have begun and will continue to reorganize our business around our Enterprise & Education segment while we optimize our media and marketing spend to focus on the passionate learners of our Consumer segment. Beginning in the second quarter of 2015, we saw reductions in the overall top line from our Consumer business due to the effects of reduced media and marketing spend, coupled with less promotional pricing and a focus on the passionate learner. As we grow and center our business on the Enterprise & Education segment and continue to realign and right-size our business, we expect our cash flows from our Consumer business to stabilize. In addition, our Enterprise & Education business and our Consumer business are affected by variations in different sales-to-cash patterns. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash. We expect these

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historical trends to continue but the magnitude of the second-half cash generation could be impacted by the changing mix of our sales, shifting away from Consumer sales that typically turn to cash quickly to Enterprise & Education sales that have longer collection cycles. Our Consumer revenue is affected by seasonal trends associated with the holiday shopping season. In addition, we extend payments to certain vendors in order to minimize the amount of working capital deployed in the business. We expect these trends to continue.

We believe our current cash and cash equivalents, short-term investments and funds generated from our operations will be sufficient to meet our working capital and capital expenditure requirements through the foreseeable future, including at least the next 12 months. In order to maximize our cash position, we will continue to manage our existing inventory, receivable, and payable balances. In addition, borrowings under our revolving credit facility can be utilized to meet working capital requirements, anticipated capital expenditures, and other obligations.

We expect that our future growth may continue to require additional working capital. Our future capital requirements will depend on many factors, including development of new products, market acceptance of our products, the levels of advertising and promotion required to launch additional products and improve our competitive position in the marketplace, the expansion of our sales, support and marketing organizations, the optimization of office space in the U.S. and worldwide and building the infrastructure necessary to support our growth, the response of competitors to our products and services, and our relationships with suppliers and clients.

On October 28, 2014, we entered into a $25.0 million revolving credit Loan and Security Agreement with Silicon Valley Bank, which was amended effective March 31, 2015, May 1, 2015, and further amended effective June 29, 2015. The revolving credit facility has a term of 3 years during which we may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions. As of the date of this filing, no borrowings have been made under the revolving credit agreement.

We are subject to certain financial and restrictive covenants under the credit facility, which have been amended to reflect the revised outlook in connection with our 2015 Restructuring Plan. We are required to maintain compliance with a minimum liquidity ratio and maintain a minimum Adjusted EBITDA. As of June 30, 2015, we were in compliance with all of the covenants under the revolving credit agreement.

The total amount of cash that was held by foreign subsidiaries as of June 30, 2015 was $13.8 million. If we were to repatriate the cash from our foreign subsidiaries, a significant tax liability could result.

Cash Flow Analysis

	Six Months Ended June 30,		2015 Versus 2014	
	2015	2014	Change	% Change
	(in thousands, except percentages)			
Net cash used in operating activities	$(26,606)	$(18,104)	$(8,502)	47.0%
Net cash used in investing activities	$(7,121)	$(33,917)	$26,796	(79.0)%
Net cash (used in) provided by financing activities	$(372)	$276	$(648)	(234.8)%

Net Cash Used in Operating Activities

Net cash used in operating activities was $26.6 million for the six months ended June 30, 2015 compared to $18.1 million for the six months ended June 30, 2014, a change of 47%. Despite a decrease in net loss of $7.9 million, net cash used in operating activities increased primarily due to a decrease of $16.5 million from changes in operating assets and liabilities and a decrease of $1.7 million from changes in non-cash items. Non-cash items primarily consist of stock-based compensation expense, bad debt expense, depreciation and amortization, loss on foreign currency transactions, deferred income taxes, amortization of debt issuance costs, gain or loss from disposal of equipment, impairment loss, and earnings from equity method investments. Included in the net cash used in operating activities are non-recurring cash payments of $5.4 million related to our 2015 Restructuring Plan.

Net Cash Used in Investing Activities

Net cash used in investing activities was $7.1 million for the six months ended June 30, 2015, compared to $33.9 million for the six months ended June 30, 2014, a change of $26.8 million. Net cash used in investing activities decreased primarily due to the 2014 acquisition related cash outflows of $29.4 million pertaining to the acquisitions of Tell Me More and Vivity during the first quarter of 2014. In the first quarter of 2015, we paid the remaining holdback of $1.7 million related to the 2013

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acquisition of Lexia. This was partially offset by an increase of $0.6 million in cash used for the purchase of property and equipment.

Net Cash Used In (Provided By) Financing Activities

Net cash used in financing activities was $0.4 million for the six months ended June 30, 2015 compared to cash provided by financing activities of $0.3 million for the six months ended June 30, 2014. The decrease in net cash related to financing activities was primarily due to the decrease in proceeds from the exercise of stock options of $0.6 million due to the decrease in our stock price.

During the last three years, inflation has not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Off-Balance Sheet Arrangements

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

Contractual Obligations

We lease buildings, parking spaces, equipment, and office space under operating lease agreements. We also lease certain equipment, software and a building near Versailles, France under capital lease agreements. The following table summarizes our future minimum rent payments under non-cancellable operating and capital lease agreements as of June 30, 2015 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
	(in thousands)				
Capitalized leases and other financing arrangements	3,623	507	1,005	994	1,117
Operating leases	18,855	5,608	8,883	3,355	1,009
Total	22,478	6,115	9,888	4,349	2,126

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

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

Interest Rate Sensitivity

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

Credit Risk

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

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Interim President and Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2015. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2015, our Interim President and Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or 15d-15(d) of the Exchange Act that occurred during the quarter ended June 30, 2015 that had materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with our business previously disclosed in our Annual Report on Form 10-K filed on March 16, 2015 with the U.S. Securities and Exchange Commission for the period ended December 31, 2014. An investment in our common stock involves a substantial risk of loss. Investors should carefully consider these risk factors, together with all of the other information included herewith, before deciding to purchase shares of our common stock. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our common stock could decline and all or part of an investment may be lost. The risks described below are not the only ones facing us. Our business is also subject to the risks that affect many other companies, such as general economic conditions and geopolitical events. Further, additional risks not currently known to us or that we currently believe are immaterial could have a material adverse effect on our business, financial condition, cash flows and results of operations.

We might not be successful in executing our strategy of focusing on the Enterprise & Education segment and on more passionate learners, and our company reorganization and realignment might not produce the desired results.

We are continuing to undertake 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 on those who wish to speak and read English. If we do not successfully execute our accelerated strategy, our revenue and profitability could decline. In connection with the implementation of our revised strategy, in the first quarter of 2015, the Company announced and initiated actions to reduce headcount and other costs. We are also evaluating and implementing opportunities for further cost savings and efficiencies. These cost reduction efforts could harm our business and results of operations by distracting management and employees, causing difficulty in hiring, motivating and retaining talented and skilled personnel, and creating uncertainty among our customers and vendors that could lead to delays or unexpected costs. Also, our ability to achieve anticipated cost savings and other benefits from these efforts is subject to many estimates and assumptions, which are subject to significant economic, competitive and other uncertainties, some of which are beyond our control. If these estimates and assumptions are incorrect, or if other unforeseen events occur, our business and financial results could be adversely affected.

Our actual operating results may differ significantly from our guidance.

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

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We generally state possible outcomes as high and low ranges, which are intended to provide a sensitivity analysis as variables are changed but actual results could fall outside of the expected ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such persons. Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions in the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon, or

otherwise consider, our guidance in making an investment decision in respect of our common stock.
Any failure to successfully implement our strategy or the occurrence of any of the events or circumstances set forth in these "Risk Factors" and elsewhere in this report could result in the actual operating results being different from our guidance, and such differences may be adverse and material.

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

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

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

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

Because a substantial portion of our revenue is currently generated from our Consumer business, if we fail to accurately anticipate consumer demand and trends in consumer preferences, our brands, sales and customer relationships may be harmed.

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

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

We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers might not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably

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impacting revenue. We might not achieve significant revenue from new product and service investments for a number of years, if at all. We also might not be able to develop new solutions or enhancements in time to capture business opportunities or achieve sustainable acceptance in new or existing places. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors. A decline in consumer demand for our solutions, or any failure on our part to satisfy such changing consumer preferences, could harm our business and profitability.

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

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

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

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

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

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers and distributors are concentrated on a group of key retailers that comprises a mix of websites, such as Amazon.com, Digital River and the Apple iTunes App Store, and select retail resellers such as Barnes & Noble, Best Buy, Target, Books-a-Million, Staples, Office Depot and Sam's Club, home shopping networks such as HSN and evineLive (ShopHQ) in the U.S., and North American consignment distributors such as Wynit Distribution and Software Packaging Associates (SPA).

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

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

Price reductions and other concessions could reduce our revenue.

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

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

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

Our future growth and profitability will depend in large part upon the effectiveness and efficiency of our marketing.

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

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

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

Some of our radio, television, print, and online advertising has been through the purchase of "remnant" advertising segments. These segments are random time slots and publication dates that have remained unsold and are offered at discounts to advertisers who are willing to be flexible with respect to time slots. There is a limited supply of this type of advertising and the availability of such advertising may decline or the cost of such advertising may increase. In addition, if we increase our marketing budget it cannot be assured that we can increase the amount of remnant advertising at the discounted prices we have obtained in the past. If any of these events occur, we may be forced to purchase time slots and publication dates at higher prices, which will increase our costs.

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

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

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

Our business strategy contemplates stabilizing the losses we have experienced internationally. We are currently augmenting and optimizing certain of our website direct sales channels in Europe, Asia and Latin America. In addition, we are continuing to selectively expand and optimize our indirect sales channels in Europe, Asia and Latin America through reseller and other arrangements with third parties. If we are unable to stabilize losses in our international operations successfully and in a timely manner, our business, revenue and financial results could be harmed. Such stabilization may be more difficult or take longer than we anticipate, and we may not be able to successfully market, sell, deliver and support our products and services internationally to the extent we expect.

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

We need to anticipate, develop and introduce new products, services and applications on a timely and cost-effective basis that keeps pace with technological developments and changing customer needs. The process of developing new high technology products, services and applications and enhancing existing products, services and applications is complex, costly and uncertain, and any failure by us to anticipate customers' changing needs and emerging technological trends accurately could significantly harm our ability to attract and retain customers and our results of operations. For example, the number of individuals who access the Internet through devices other than a personal computer, such as tablet computers, mobile devices, televisions and set-top box devices, has increased dramatically and this trend is likely to continue. Our products and services may not work or be viewable on these devices because each manufacturer or distributor may establish unique technical standards for such devices. Accordingly, we may need to devote significant resources to the creation, support and maintenance of such versions. If we fail to develop or sell products and services on a cost-effective basis that respond to these or other technological developments and changing customer needs, we may be harmed in our ability to attract and retain customers, and our revenue and business could suffer. Furthermore, our customers who view our advertising via mobile devices might not buy our products to the same extent that they do when viewing our advertising via personal computers or laptops. Accordingly, if we cannot convince customers to purchase our products via mobile devices, our business and results of operations could be harmed to the extent that the trend to mobile devices continues.

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

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

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

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

Many of our Enterprise & Education customers are colleges, universities, primary and secondary schools and school districts, other education providers, armed forces and government agencies that depend substantially on government funding. Accordingly, any general decrease, delay or change in federal, state or local funding for colleges, universities, primary and secondary schools and school districts, or other education providers or government agencies that use our products and services could cause our current and potential customers to reduce their purchases of our products and services, to exercise their right to terminate licenses, or to decide not to renew licenses, any of which could cause us to lose revenue. In addition, a specific reduction in governmental funding support for products such as ours would also cause us to lose revenue and could hurt our overall gross margins.

Some of our Enterprise & Education business faces a lengthy and unpredictable sales cycle, which could delay new sales.

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

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

As we move our Consumer business online and sell our solutions as a subscription, rather than for an upfront fee, our revenue, results of operations and cash flow could be negatively impacted.

Historically, we have predominantly sold our packaged software programs under a perpetual license for a single upfront fee and recorded 65-90% of the revenue at the time of sale. Certain of our online products are sold under different subscription terms, from short-term (less than one year) to 36-month subscriptions with a corresponding license term. Selling long-term subscriptions could result in substantially less cash and revenue from the initial sale to the customer and could have a substantially negative impact on our revenue, results of operations and cash flow in the short term. Furthermore, to the extent that customers use our products and services for only a short time after purchase, online subscription customers could be less likely to renew their subscriptions beyond the initial term with the effect that we could earn less revenue over time from each customer than historically.

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

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

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

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

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

The anticipated benefits of recent acquisitions could be impacted by a number of risks specific to our business, as well as by risks related to the integration process.

We made four acquisitions in 2013 and 2014. The significant risks and challenges that may limit our ability to achieve the anticipated benefits of acquisitions include:

- lack of employee retention stemming from the acquisitions;
- sales of the acquired products and services might not perform as we anticipated;

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- costs associated with operations in additional geographic locations and the incremental costs associated with doing business there;
- the risk of increased attrition of the acquired entities' customers;
- the risk that cross-selling Rosetta Stone products and services to customers of the acquired entities (and vice versa) might not be successful;
- the pipeline of the acquired entities' future products under development may take longer than predicted to launch or might fail to launch at all;
- the difficulty of integrating the acquired entities' technology into our current and future products and services; and
- the difficulty in managing a more complex technology environment which may reduce opportunities for economies of scale that otherwise could result from an acquisition.

If we are unsuccessful in addressing these risks and challenges, our business and prospects could be harmed.

We may incur significant costs related to data security breaches that could compromise our information technology network security, trade secrets and customer data.

Threats to our information technology network security can take a variety of forms. Individual hackers and groups of hackers, and sophisticated organizations or individuals may threaten our information technology network security. Cyber attackers may develop and deploy malicious software to attack our services and gain access to our networks, data centers, or act in a coordinated manner to launch distributed denial of service or other coordinated attacks. Cyber threats and attacks are constantly evolving, thereby increasing the difficulty of detecting and successfully defending against them. Cyber threats and attacks can have cascading impacts that unfold with increasing speed across internal networks and systems. Breaches of our network or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, resulting in product development delays, could compromise confidential or technical business information harming our competitive position, result in theft or misuse of our intellectual property or other assets, require us to allocate more resources to improved technologies, or otherwise adversely affect our business.

Our possession and use of personal information presents risks and expenses that could harm our business. Unauthorized disclosure or manipulation of such data, whether through breach of our network security or otherwise, could expose us to costly litigation and damage our reputation.

Possession and use of personal information in conducting our business subjects us to legislative and regulatory obligations that could require notification of data breaches, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. As our business and the regulatory environment evolve in the U.S. and internationally, we may become subject to additional and even more stringent legal obligations concerning our treatment of customer information. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

If third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to resolve these problems. A major breach of our network security and systems could have serious negative consequences for our businesses, including possible fines, penalties and damages, reduced customer demand for our products and services, harm to our reputation and brand, and loss of our ability to accept and process customer credit card orders.

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

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

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We are subject to rules, regulations and practices governing our accepted payment methods which could change or be reinterpreted to make it difficult or impossible for us to comply. A failure to comply with these rules or requirements could make us subject to fines and higher transaction fees and we could lose our ability to accept these payment methods. Our business and results of operations could be adversely affected if these changes were to occur.

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

We rely on our website, an in-house call center and third-party call centers to sell our solutions, respond to customer service and technical support requests and process orders. These activities are especially important during the holiday season and in particular Black Friday through Cyber Monday. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, could reduce our ability to receive and process orders and provide products and services, which could result in lost and cancelled sales and damage to our brand and reputation. These risks are more important during the Black Friday through Cyber Monday holiday season, when many sales of our products and services take place.

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

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

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

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

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

As part of our efforts to continue improving our internal control over financial reporting, we plan to continue to upgrade our existing financial information technology systems in order to automate several controls that are currently performed manually. We may experience difficulties in transitioning to these upgraded systems, including loss of data and decreases in productivity, as personnel become familiar with these new systems. In addition, our management information systems will require modification and refinement as our business needs change, which could prolong difficulties we experience with systems transitions, and we may not always employ the most effective systems for our purposes. If we experience difficulties in implementing new or upgraded information systems or experience significant system failures, or if we are unable to successfully modify our management information systems or respond to changes in our business needs, we may not be able to effectively manage our business and we may fail to meet our reporting obligations. In addition, as a result of the automation of these manual processes, the data produced may cause us to question the accuracy of previously reported financial results.

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

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

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

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

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

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

Our revolving credit facility contains financial covenants currently applicable to us, as well as a number of restrictive covenants, including restrictions on incurring additional debt, making investments and other restricted payments, selling assets, paying dividends and redeeming or repurchasing capital stock and debt, subject to certain exceptions. Our $25 million revolving credit facility requires us to maintain a minimum liquidity ratio and maintain a minimum Adjusted EBITDA during its term. Collectively, these covenants could constrain our ability to grow our business through acquisition or engage in other transactions. If we are not able to comply with all of these covenants, for any reason, we would not be able to borrow funds under the facility, and some or all of any outstanding debt could become immediately due and payable which could have a material adverse effect on our liquidity and ability to conduct our business.

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

Due to our historically seasonal cash flows, our business is a net user of cash during the first half of the year with the fourth quarter being a net generator of cash. As a result, we might need to further reduce costs or raise additional funds through public or private financings or borrowings in order to maintain our operations at their current level, develop or enhance products, fund expansion, respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing might not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of equity or convertible debt securities, the percentage ownership of our stockholders would be reduced and these securities might have rights, preferences and privileges senior to those of our current stockholders.

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

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

We may have exposure to greater than anticipated tax liabilities.

We are subject to income and indirect tax in the U.S. and many foreign jurisdictions. Significant judgment is required in determining our worldwide provision for income and indirect taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. The application of indirect taxes (such as sales and use tax, value-added tax, goods and services tax, business tax and gross receipt tax) to our businesses and to our users is complex, uncertain and evolving, in part because many of the fundamental statutes and regulations that impose indirect taxes were established before the adoption and growth of the Internet and e-commerce. We are subject to audit by multiple tax authorities throughout the world. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical tax provisions and accruals. The results of an audit or litigation could have a material effect on our financial statements in the period or periods for which that determination is made. Further, any changes to the U.S. or any foreign jurisdictions' tax laws, tax rates, or the interpretation of such tax laws, including the Base Erosion Profit Shifting project being conducted by the Organization for Economic Co-operation and Development could significantly impact how U.S. multinational corporations are taxed. Although we cannot predict whether or in what form any legislation changes may pass, if enacted it could have a material adverse impact on our tax expense, deferred tax assets and cash flows.

Our deferred tax assets may not be fully realizable.

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

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

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

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

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

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

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

In addition to issued patents, we have several patent applications on file in the U.S. and other countries. However, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. Even if patents are issued from our patent applications, which are not certain, they may be challenged, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, we have not emphasized patents as a source of significant competitive advantage and have instead sought to primarily protect our proprietary rights under laws affording protection for trade secrets, copyright and trademark protection of our products, brands, and other intellectual property where available and appropriate. These measures afford only limited protection and may be challenged, invalidated or circumvented by third parties. In addition, these protections may not be adequate to prevent our competitors or customers from copying or reverse-engineering our products. Third parties could copy all or portions of our products or otherwise obtain, use, distribute and sell our proprietary information without authorization. Third parties may also develop similar or superior technology independently by designing around our intellectual property, which would decrease demand for our products. In addition, our patents may not provide us with any competitive advantages and the patents of others may seriously impede our ability to conduct our business.

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

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

Protection of trade secret and other intellectual property rights in the places in which we operate and compete is highly uncertain and may involve complex legal questions. The laws of countries in which we operate may afford little or no protection to our trade secrets and other intellectual property rights. Although we defend our intellectual property rights and combat unlicensed copying and use of software and intellectual property rights through a variety of techniques, preventing unauthorized use or infringement of our intellectual property rights is inherently difficult. Despite our enforcement efforts against software piracy, we could lose significant revenue due to illegal use of our software and from counterfeit copies of our software. If piracy activities increase, it could further harm our business. We also suspect that competitors might try to illegally use our proprietary information and develop products that are similar to ours, which may infringe on our proprietary rights. In addition, we could potentially lose trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of trade secret protection could make it easier for third parties to compete with our products by copying functionality. In addition, any changes in, or unexpected interpretations of, the trade secret and other intellectual property laws in any country in which we operate may compromise our ability to enforce our trade secret and intellectual property rights. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our confidential information and trade secret protection. If we are unable to protect our proprietary rights or if third parties independently develop or gain access to our or similar technologies, our business, revenue, reputation and competitive position could be harmed.

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

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

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

We own several U.S. trademark registrations, including registrations of the Rosetta Stone, Tell Me More, Livemocha, and Lexia trademarks, as well as U.S. registrations of the color yellow as a trademark. In addition, we hold common law trademark rights and have trademark applications pending in the U.S. and abroad for additional trademarks. Even if federal registrations and registrations in other countries are granted to us, our trademark rights may be challenged. It is also possible that our competitors will adopt trademarks similar to ours, thus impeding our ability to build brand identity and possibly leading to customer confusion. In fact, various third parties have registered trademarks that are similar to ours in the U.S. and overseas. Furthermore, notwithstanding the fact that we may have secured trademark rights for our various trademarks in the United States and in some countries where we do business, in other countries we may not have secured similar rights and, in those countries there may be third parties who have prior use and prior or superior rights to our own. That prior use, prior or superior right could limit use of our trademarks and we could be challenged in our efforts to use our trademarks. We could incur substantial costs in prosecuting or defending trademark infringement suits. If we fail to effectively enforce our trademark rights, our competitive position and brand recognition may be diminished.

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

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

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

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

Some of our products and services contain intellectual property owned by third parties, including software that is integrated with internally developed software and voice recognition software, which we license from third parties. From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be appropriately supported, maintained or enhanced by the licensors. If we are unable to obtain the rights necessary to use or continue to use third-party technology or content in our products and services, this could harm our business, by resulting in increased costs, or in delays or reductions in product shipments until equivalent software could be developed, identified, licensed and integrated.

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

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

As our product and service offerings become more complex, our reported revenue may become less predictable.
We continue to transition our Consumer distribution more towards online. The accounting policies that apply to these sources of revenue may be more complex than those that apply to our traditional products and services. In addition, we may change the manner in which we sell our software licenses, and such change could cause delays in revenue recognition in accordance with accounting standards. Under these accounting standards, even if we deliver products and services to, and collect cash from, a customer in a given fiscal period, we may be required to defer recognizing revenue from the sale of such product or service until a future period when all the conditions necessary for revenue recognition have been satisfied. As we move more of our Consumer business online we will continue to collect less cash from our initial transactions with consumers which could substantially decrease our revenue in the short term. Conditions that can cause delays in revenue recognition include software arrangements that have undelivered elements for which we have not yet established vendor specific objective evidence of fair value, requirements that we deliver services for significant enhancements or modifications to customize our software for a particular customer or material customer acceptance criteria.
We offer consumer language-learning packages that include perpetual software and online services that have increased our costs as a percentage of revenue, and these and future product packages may not succeed and may harm our business, financial results and reputation.
Our Consumer language-learning packages integrate our language-learning software solutions with online services, which provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. The online services associated with this software package cause decreased margins. Customers may choose to not engage with conversation coaches or be willing to pay higher prices to do so. In addition, we are required to defer recognition of a portion of each sale of this packaged software in connection with the terms of our online service periods. We cannot assure you that our future software package offerings will be successful or profitable, or if they are profitable, that they will provide an adequate return on invested capital. If our software package offering is not successful, our business, financial results and reputation may be harmed.
Substantially all of our inventory is located in one warehouse facility. Any damage or disruption at this facility could cause significant financial loss, including loss of revenue and harm to our reputation.
Substantially all of our inventory is located in one warehouse facility. We could experience significant interruption in the operation of this facility or damage or destruction of our inventory due to natural disasters, accidents, failures of the inventory locator or automated packing and shipping systems or other events. If a material portion of our inventory were to be damaged or destroyed, we might be unable to meet our contractual obligations which could cause us significant financial loss, including loss of revenue and harm to our reputation. As our business continues to move online, we expect that this risk will diminish over time.
Provisions in our organizational documents and in the Delaware General Corporation Law may prevent takeover attempts that could be beneficial to our stockholders.
Provisions in our second amended and restated certificate of incorporation and second amended and restated bylaws, and in the Delaware General Corporation Law, may make it difficult and expensive for a third party to pursue a takeover attempt we oppose even if a change in control of our company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or second amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our board of directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

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Item 3. Defaults Upon Senior Securities
None.
Item 4. Mine Safety Disclosures
Not applicable.
Item 5. Other Information
During the quarter ended June 30, 2015, we identified errors related to the presentation of segment contribution for the year ended December 31, 2014 included in Note 17, "Segment Information" to the consolidated financial statements included in our Form 10-K filed on March 16, 2015. The as-reported segment contribution for Global Enterprise & Education was $16.1 million and should have been $22.9 million. The as-reported segment contribution for North America Consumer was $33.8 million and should have been $34.2 million. The as-reported unallocated sales and marketing expense was $9.0 million and should have been $16.2 million. These errors had no impact on the consolidated balance sheets, statements of operations, statements of cash flows, or statements of stockholders equity as of and for the year ended December 31, 2014.

We assessed the materiality of the errors in accordance with the SEC’s Staff Accounting Bulletin 99 and concluded that the previously issued consolidated financial statements were not materially misstated. In accordance with the SEC’s Staff Accounting Bulletin 108, we will correct these immaterial errors and present the revisions prospectively in future filings.

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Item 6. Exhibits

Exhibits

3.1(1)	Second Amended and Restated Certificate of Incorporation of the Company.
3.2(1)	Second Amended and Restated Bylaws of the Company.
4.1(1)	Specimen certificate evidencing shares of Common Stock of the Company.
4.2(1)	Registration Rights Agreement dated January 4, 2006 among the Company and the Investor Shareholders and other Shareholders listed on Exhibit A thereto.
10.1*	Third Amendment to Loan and Security Agreement dated as of June 29, 2015 between Silicon Valley Bank and Rosetta Stone Ltd.
10.2*	Director Form of Restricted Stock Unit Award Agreement under the Rosetta Stone Inc. Amended and Restated 2009 Omnibus Incentive Plan (for awards beginning June 2015).
31.1*	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2015.
31.2*	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2015.
32**	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, with respect to the Registrant’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2015.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema.
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase.
101.LAB*	XBRL Taxonomy Extension Label Linkbase.
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase.

* Filed herewith

** Furnished herewith

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

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SIGNATURES

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

ROSETTA STONE INC.
/s/ THOMAS M. PIERNO
Thomas M. Pierno
Chief Financial Officer

Date: August 5, 2015