ROSETTA STONE INC
Form 10-Q
August 03, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2016
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 29, 2016, there were 21,982,235 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, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$29,705	$ 47,782
Restricted cash	415	80
Accounts receivable (net of allowance for doubtful accounts of $1,209 and $1,196, at June 30, 2016 and December 31, 2015, respectively)	35,104	47,327
Inventory	7,952	7,333
Deferred sales commissions	12,333	13,526
Prepaid expenses and other current assets	5,360	3,612
Income tax receivable	1,082	—
Total current assets	91,951	119,660
Deferred sales commissions	4,855	5,614
Property and equipment, net	24,693	22,532
Goodwill	48,839	50,280
Intangible assets, net	24,797	28,244
Other assets	1,784	2,213
Total assets	$196,919	$ 228,543
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$9,159	$ 10,778
Accrued compensation	9,846	8,201
Income tax payable	—	121
Obligations under capital lease	542	521
Other current liabilities	29,923	35,318
Deferred revenue	99,219	106,868
Total current liabilities	148,689	161,807
Deferred revenue	33,145	35,880
Deferred income taxes	5,517	4,998
Obligations under capital lease	2,332	2,622
Other long-term liabilities	664	826
Total liabilities	190,347	206,133
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, 2016 and December 31, 2015, respectively	—	—
Non-designated common stock, $0.00005 par value, 190,000 and 190,000 shares authorized, 23,452 and 23,150 shares issued and 22,452 and 22,150 shares outstanding at June 30, 2016 and December 31, 2015, respectively	2	2
Additional paid-in capital	187,719	185,863
Accumulated loss	(166,279)	(149,794)

Accumulated other comprehensive loss	(3,435)	(2,226)
Treasury stock, at cost, 1,000 and 1,000 shares at June 30, 2016 and December 31, 2015, respectively	(11,435)	(11,435)
Total stockholders' equity	6,572	22,410
Total liabilities and stockholders' equity	$196,919	$ 228,543

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,	
	2016	2015	2016	2015
Revenue:				
Product	$7,959	$14,209	$17,990	$34,183
Subscription and service	37,757	37,202	75,728	75,670
Total revenue	45,716	51,411	93,718	109,853
Cost of revenue:				
Cost of product revenue	2,389	3,719	5,034	9,356
Cost of subscription and service revenue	5,575	5,301	10,978	10,966
Total cost of revenue	7,964	9,020	16,012	20,322
Gross profit	37,752	42,391	77,706	89,531
Operating expenses:				
Sales and marketing	28,740	30,555	59,533	70,705
Research and development	6,748	6,953	13,319	15,925
General and administrative	10,118	11,920	20,895	27,674
Impairment	2,902	160	2,902	451
Lease abandonment and termination	30	—	30	—
Total operating expenses	48,538	49,588	96,679	114,755
Loss from operations	(10,786)	(7,197)	(18,973)	(25,224)
Other income and (expense):				
Interest income	10	7	23	11
Interest expense	(121)	(93)	(233)	(181)
Other income and (expense)	927	(503)	2,155	(2,084)
Total other income and (expense)	816	(589)	1,945	(2,254)
Loss before income taxes	(9,970)	(7,786)	(17,028)	(27,478)
Income tax (benefit) expense	(992)	389	(543)	581
Net loss	$(8,978)	$(8,175)	$(16,485)	$(28,059)
Loss per share:				
Basic	$(0.41)	$(0.38)	$(0.75)	$(1.31)
Diluted	$(0.41)	$(0.38)	$(0.75)	$(1.31)
Common shares and equivalents outstanding:				
Basic weighted average shares	21,948	21,689	21,908	21,355
Diluted weighted average shares	21,948	21,689	21,908	21,355

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,	
	2016	2015	2016	2015
Net loss	$(8,978)	$(8,175)	$(16,485)	$(28,059)
Other comprehensive (loss) gain, net of tax:				
Foreign currency translation (loss) gain	(732)	754	(1,209)	(393)
Other comprehensive (loss) gain	(732)	754	(1,209)	(393)
Comprehensive loss	$(9,710)	$(7,421)	$(17,694)	$(28,452)

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, 2016	Six Months Ended June 30, 2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$(16,485)	$(28,059)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense	1,818	3,395
(Gain) loss on foreign currency transactions	(2,343)	1,695
Bad debt expense	280	952
Depreciation and amortization	6,586	6,683
Deferred income tax expense	508	379
Loss (gain) on disposal of equipment	36	(2)
Amortization of deferred financing fees	132	68
Loss on impairment	2,902	451
Loss (gain) from equity method investments	40	(9)
Net change in:		
Restricted cash	(360)	24
Accounts receivable	12,089	31,665
Inventory	(622)	(1,167)
Deferred sales commissions	1,981	(1,447)
Prepaid expenses and other current assets	(1,703)	(1,499)
Income tax receivable or payable	(1,190)	(633)
Other assets	326	(159)
Accounts payable	(1,630)	(10,738)
Accrued compensation	1,661	(4,090)
Other current liabilities	(5,921)	(19,875)
Other long-term liabilities	(163)	(321)
Deferred revenue	(10,367)	(3,919)
Net cash used in operating activities	(12,425)	(26,606)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(5,934)	(5,153)
Proceeds from sale of fixed assets	38	—
Acquisitions, net of cash acquired	—	(1,688)
Other investing activities	—	(280)
Net cash used in investing activities	(5,896)	(7,121)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from the exercise of stock options	37	37
Payment of deferred financing costs	(100)	(34)
Payments under capital lease obligations	(338)	(375)
Net cash used in financing activities	(401)	(372)
Decrease in cash and cash equivalents	(18,722)	(34,099)
Effect of exchange rate changes in cash and cash equivalents	645	(755)
Net decrease in cash and cash equivalents	(18,077)	(34,854)
Cash and cash equivalents—beginning of period	47,782	64,657
Cash and cash equivalents—end of period	$29,705	$29,803

SUPPLEMENTAL CASH FLOW DISCLOSURE:		
Cash paid during the periods for:		
Interest	$100	$113
Income taxes, net of refunds	$153	$1,040
Noncash financing and investing activities:		
Accrued liability for purchase of property and equipment	$579	$262
Equipment acquired under capital lease	$27	$—

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 select third party retailers and distributors. 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 14, 2016, the Company announced the withdrawal of direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings (the "2016 Restructuring Plan"). Where appropriate, the Company seeks to operate through partners in the geographies being exited. The Company has also initiated processes to close the software development operations in France and China. These actions are additive to the plan announced on March 11, 2015 (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. 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.

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 investee's governing body, 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 14, 2016. The June 30, 2016 consolidated balance sheet included herein includes account balances as of December 31, 2015 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, 2016 and December 31, 2015, the Company’s results of operations for the three and six months ended June 30, 2016 and 2015 and its cash flows for the six months ended June 30, 2016 and 2015 have been made. The results for the three and six months ended June 30, 2016 are not necessarily indicative of the results to be expected for the year ending December 31, 2016. All references to June 30, 2016 or to the three and six months ended June 30, 2016 and 2015 in the notes to the consolidated financial statements are unaudited.

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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 management to make certain estimates and assumptions. The amounts reported in the consolidated financial statements include significant estimates and assumptions that have been made, including, but not limited to, those related to revenue recognition, allowance for doubtful accounts, estimated sales returns and reserves, stock-based compensation, restructuring costs, fair value of intangibles and goodwill, disclosure of contingent assets and liabilities, disclosure of contingent litigation, and allowance for valuation of deferred tax assets. The Company bases its estimates and assumptions on historical experience and on various other judgments that are believed to be reasonable under the circumstances. The Company continuously evaluates its estimates and assumptions. Actual results may differ from these estimates and assumptions.
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 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 online services, the Company allocates the total arrangement consideration to its deliverables based on the existence of 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 online service, which is considered an undelivered software-related element. The online service includes access to conversational coaching services. Because the Company only sells the 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 the perpetual product. Where VSOE of the undelivered online services can be established, arrangement consideration is allocated using the residual method. The Company determines VSOE by reference to the range of comparable stand-alone renewal sales of the 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. Where VSOE of the undelivered online services cannot be established, revenue is deferred and recognized commensurate with the delivery of the online services.
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 Language and Literacy 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 Language and Literacy 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 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 an online service where customers are allowed to begin their short-term online services at any point during a registration window, which is typically up to six months from the date of purchase from us or an authorized reseller. The 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 ratably 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

As part of the 2016 Restructuring Plan and 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 these plans, the Company incurred restructuring related costs, including employee severance and related benefit costs, contract termination costs, and other related costs. These costs are included 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

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

costs are generally considered “one-time” benefits and recognized at fair value in the period in which a detailed plan has been approved by management and communicated to the terminated employees. Severance costs pursuant to ongoing benefit arrangements, including termination benefits provided for in existing employment contracts, are recognized when probable and reasonably estimable.

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

Other related costs generally include external consulting and legal costs associated with the strategic shift in business focus 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, 2016. 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.

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

Divestitures
The Company deconsolidates divested subsidiaries when there is a loss of control or when appropriate when evaluated under the variable interest entity model. The Company recognizes a gain or loss at divestiture equal to the difference between the fair value of any consideration received and the carrying amount of the former subsidiary's assets and liabilities. Any resulting gain or loss is reported in "Other income and (expense)" on the consolidated statement of operations.
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. For options granted with service and/or performance conditions, the fair value of each grant is estimated on the date of grant using the Black-Scholes option pricing model. For options granted with market-based conditions, the fair value of each grant is estimated on the date of grant using the Monte-Carlo simulation.
The Company estimates the expected term of options using a combination of historical information and the simplified method for estimating the expected term. The Company uses its own historical stock price data to estimate its forfeiture rate and expected volatility over the most recent period commensurate with the estimated expected term of the awards. For the risk-free interest rate, the Company uses a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.
The Company's restricted stock and restricted stock unit grants are accounted for as equity awards. Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent. For equity awards granted with market-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.
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,	
	2016	2015	2016	2015
Net loss	$(8,978)	$(8,175)	$(16,485)	$(28,059)
Foreign currency translation (loss) gain	(732)	754	(1,209)	(393)
Comprehensive loss	$(9,710)	$(7,421)	$(17,694)	$(28,452)

Comprehensive Loss
Comprehensive loss consists of net loss and other comprehensive loss or gain. Other comprehensive loss or gain refers to revenues, expenses, gains, and losses that are not included in net loss, but rather are recorded directly in stockholders' equity. For the three and six months ended June 30, 2016 and 2015, the Company's comprehensive loss

consisted of net loss and foreign currency translation losses and gains. The other comprehensive loss or gain presented in the consolidated financial statements and the notes are presented net of tax. There has been no tax expense or benefit associated with the components of other comprehensive loss or gain due to the presence of a full valuation allowance for each of the three and six months ended June 30, 2016 and 2015.

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

Advertising Costs
Costs for advertising are expensed as incurred. Advertising expense for the three and six months ended June 30, 2016 was $8.9 million and $18.5 million, respectively, and for the three and six months ended June 30, 2015 was $8.8 million and $22.2 million, respectively.
Recently Issued Accounting Standards Updates ("ASU") Not Yet Adopted
In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (“ASU 2016-13”). ASU 2016-13 changes the methodology for measuring credit losses on financial instruments and the timing of when such losses are recorded. ASU 2016-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those years, beginning after December 15, 2018. The Company is in the process of evaluating the adoption date and impact of the new guidance on the Company's consolidated financial statements and disclosures.

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"). Under ASU 2016-09, accounting for share-based payment award transactions was simplified related to the accounting for (a) income tax effects; (b) minimum statutory tax withholding requirements; (c) and forfeitures. ASU 2016-09 is effective for public entities in annual periods beginning after December 15, 2016, including interim periods within those annual periods. Early adoption is permitted. The Company is in the process of evaluating the adoption date and impact of the new guidance on the Company's consolidated financial statements and disclosures.
In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) ("ASU 2016-02"). Under ASU 2016-02, entities will be required to recognize a lease liability and a right-of-use asset for all leases. Lessor accounting is largely unchanged. ASU 2016-02 is effective for public entities in fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is in the process of evaluating the impact of the new guidance on the Company's consolidated financial statements and disclosures.
In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 changes how entities measure certain equity investments and present changes in the fair value of financial liabilities measured under the fair value option that are attributable to their own credit. Under the new guidance, entities will be required to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value and recognize any changes in fair value in net income unless the investments qualify for the new practicability exception. The accounting for other financial instruments, such as loans and investments in debt securities is largely unchanged. ASU 2016-01 is effective for public entities in fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not believe that the adoption of this guidance will have a material impact on the Company's consolidated 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 annual periods ending after December 15, 2016, and interim periods thereafter. 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), which replaces the current revenue accounting guidance. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date which defers the effective date of the updated

guidance on revenue recognition by one year. In March 2016, the FASB issued ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which clarifies and improves the operability and understandability of the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, which clarifies and improves the operability and understandability of the implementation guidance on identifying performance obligations and licensing. Collectively these ASUs comprise the new revenue standard ("New Revenue Standard"). The core principle of the New Revenue Standard is that an entity should recognize revenue to depict the

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

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. The New Revenue Standard is effective for annual periods beginning after December 31, 2017. Entities may choose from two adoption methods, with certain practical expedients. The Company expects that it will adopt the New Revenue Standard beginning in the first quarter of 2018 and is currently evaluating the appropriate transition method and any impact of the New Revenue Standard on the Company's consolidated financial statements and disclosures.

3. DIVESTITURES

As part of the shift in strategy initiated in early 2015, the Company determined that its ownership of the consumer-oriented Rosetta Stone Korea Ltd. ("RSK") entity no longer agreed with the Company’s overall strategy to focus on the Enterprise & Education Language and Literacy businesses. In September 2015, the Company completed the divestiture of 100% of the Company's capital stock of RSK to the then-current President of RSK for consideration equal to the assumption of RSK's net liabilities at the date of sale.

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

4. NET LOSS PER SHARE

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Numerator:				
Net loss	$(8,978)	$(8,175)	$(16,485)	$(28,059)
Denominator:				
Weighted average number of common shares:				
Basic	21,948	21,689	21,908	21,355
Diluted	21,948	21,689	21,908	21,355
Loss per common share:				
Basic	$(0.41)	$(0.38)	$(0.75)	$(1.31)
Diluted	$(0.41)	$(0.38)	$(0.75)	$(1.31)

For the three and six months ended June 30, 2016 and 2015, no common stock equivalent shares were included in the calculation of the Company’s diluted net income per share.

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ROSETTA STONE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
4. NET LOSS PER SHARE (Continued)

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 (in thousands).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Stock options	17	39	22	40
Restricted stock units	169	108	165	114
Restricted stocks	70	37	83	86
Total common stock equivalent shares	256	184	270	240

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

	June 30, 2016	December 31, 2015
Raw materials	$ 4,086	$ 3,375
Finished goods	3,866	3,958
Total inventory	$ 7,952	$ 7,333

6. GOODWILL
The value of goodwill is primarily derived from the acquisition of Rosetta Stone Ltd. (formerly known as Fairfield & Sons, Ltd.) in January 2006, the acquisition of certain assets of SGLC International Co. Ltd ("SGLC") in November 2009, the acquisition of Livemocha, Inc. ("Livemocha") in April 2013, the acquisition of Lexia Learning Systems, Inc. ("Lexia") in August 2013, and the acquisitions of Vivity Labs, Inc. ("Vivity") and Tell Me More S.A. ("Tell Me More") in January 2014.
The Company tests goodwill for impairment annually on June 30 of each year at the reporting unit level using a fair value approach, in accordance with the provisions of ASC topic 350, Intangibles - Goodwill and other ("ASC 350"), or more frequently, if impairment indicators arise.
The following table shows the balance and changes in goodwill for the Company's operating segments for the six months ended June 30, 2016 (in thousands):

			Consumer		
	Enterprise & Education Language Segment	Literacy Segment	Consumer Language Reporting Unit	Consumer Fit Brains Reporting Unit	Total
Balance as of December 31, 2015	$ 38,700	$ 9,962	$ —	$ 1,618	$ 50,280
Impairment of Consumer Fit Brains	—	—	—	(1,740)	(1,740)
Effect of change in foreign currency rate	177	—	—	122	299
Balance as of June 30, 2016	$ 38,877	$ 9,962	$ —	$ —	$ 48,839

Annual Impairment Testing of Goodwill
In connection with the annual goodwill impairment analysis performed as of June 30, 2016, the Company performed Step 1 of the goodwill impairment test for the Enterprise & Education Language and Literacy reporting units, which both resulted in fair values that substantially exceeded the carrying values, and therefore no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

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

The Consumer Fit Brains reporting unit was also evaluated, which resulted in a fair value that was significantly below the carrying value. The decrease in fair value was due to the second quarter 2016 strategy update for the Consumer Fit Brains business. The Consumer Fit Brains reporting unit is no longer considered central to the core strategy for the Company's focus on language and literacy learning. Due to the continued declines in operations since the $5.6 million partial impairment in the fourth quarter of 2015, management revised the Consumer Fit Brains financial projections in the second quarter of 2016 assuming reduced media spend and reduced revenue in 2016 and beyond. The change in operating plans and the lack of cushion since the fourth quarter 2015 impairment resulted in an implied fair value of goodwill that was significantly below its carrying value. As a result, the Company recorded an impairment loss of $1.7 million, which represents a full impairment of the remaining Consumer Fit Brains reporting unit's goodwill. The impairment charge is recorded in the "Impairment" line on the statement of operations.

7. INTANGIBLE ASSETS

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

	June 30, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Tradename/trademark *	$12,460	$ (1,434)	$11,026	$12,442	$ (1,271)	$11,171
Core technology	15,324	(10,058)	5,266	15,149	(7,817)	7,332
Customer relationships	26,344	(17,918)	8,426	26,245	(16,603)	9,642
Website	12	(12)	—	12	(12)	—
Patents	300	(221)	79	300	(201)	99
Total	$54,440	$ (29,643)	$24,797	$54,148	$ (25,904)	$28,244

* 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, 2016, 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,	
	2016	2015	2016	2015
Included in cost of revenue:				
Cost of product revenue	$44	$62	$92	$141
Cost of subscription and service revenue	103	84	201	151
Total included in cost of revenue	147	146	293	292
Included in operating expenses:				
Sales and marketing	542	697	1,257	1,422
Research and development	452	454	894	910
General and administrative	—	—	—	—
Total included in operating expenses	994	1,151	2,151	2,332
Total	$1,141	$1,297	$2,444	$2,624

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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 2016 and years thereafter (in thousands):

	As of June 30, 2016
2016 - remaining	$1,913
2017	3,814
2018	3,221
2019	1,532
2020	1,282
Thereafter	2,428
Total	$14,190

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.
During the second quarter of 2016, the Company revised the business outlook and financial projections for the Consumer Fit Brains reporting unit, which prompted a long-lived intangible asset impairment analysis of the Consumer Fit Brains tradename, developed technology, and customer relationships. The carrying values of the intangible assets exceeded the estimated fair values. As a result, the Company recorded an impairment loss of $1.2 million associated with the impairment of the remaining carrying value of the Consumer Fit Brains long-lived intangible assets as of June 30, 2016. The impairment charge is recorded in the "Impairment" line on the statement of operations.
As an indefinite-lived intangible asset, the Rosetta Stone tradename was evaluated as of June 30, 2016 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, 2016	December 31, 2015
Accrued marketing expenses	$17,075	$ 20,022
Accrued professional and consulting fees	1,459	1,746
Sales return reserve	2,649	3,728
Sales, withholding and property taxes payable	3,832	3,879
Other	4,908	5,943
Total other current liabilities	$29,923	$ 35,318

9. FINANCING ARRANGEMENTS
Revolving Line of Credit
On October 28, 2014, Rosetta Stone Ltd. (“RSL”), a wholly owned subsidiary of parent company Rosetta Stone Inc., executed a Loan and Security Agreement with Silicon Valley Bank (“Bank”) to obtain a $25.0 million revolving credit facility (the “credit facility”). The Company executed the First Amendment to the credit facility with the Bank effective March 31, 2015, the Second Amendment effective May 1, 2015, the Third Amendment effective June 29, 2015, and the Fourth Amendment effective December 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

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dispositions of assets, certain of which covenants were amended in the First, Second, Third, and Fourth Amendments, which were primarily amended to reflect updates to the Company's financial outlook. The Third Amendment also changed the definition of "change of control" to eliminate a clause referring to a change in a portion of the Board of Directors within a twelve-month period.

On March 14, 2016, the Company executed the Fifth Amendment to the credit facility. Under the amended agreement, the Company may borrow up to $25.0 million, including a sub-facility, which reduces available borrowings, for letters of credit in an aggregate availability amount of $4.0 million. Borrowings by RSL under the credit facility are guaranteed by the Company as the ultimate parent. The credit facility has a term that expires on January 1, 2018, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

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

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

The credit facility contains customary affirmative and negative covenants, including covenants that limit or restrict 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 amount and minimum financial performance requirements, as defined in the credit facility. As of June 30, 2016, the Company was in compliance with all covenants.

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

As of June 30, 2016, there were no borrowings outstanding and the Company was eligible to borrow $21.7 million of available credit, less $4.0 million in letters of credit that have been issued by the Bank on the Company's behalf, resulting in a net borrowing availability of $17.7 million. 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, the Company holds a capital lease for a building near Versailles, France.

During the six months ended June 30, 2016 and 2015, the Company acquired $27,000, and zero, respectively, of equipment or software through the issuance of capital leases.

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

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

	As of June 30, 2016
2016-remaining	$258
2017	659
2018	507
2019	503
2020	499
Thereafter	868
Total minimum lease payments	$3,294
Less amount representing interest	420
Present value of net minimum lease payments	$2,874
Less current portion	542
Obligations under capital lease, long-term	$2,332

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, 2016 is based on the estimated annual effective tax rate for fiscal year 2016. The estimated effective tax rate may be subject to adjustment in subsequent quarterly periods as the estimates of pretax income for the year, along with other items that may affect the rate, may change and may create a different relationship between domestic and foreign income and loss.

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

Valuation Allowance Recorded for Deferred Tax Assets

The Company evaluates the recoverability of its deferred tax assets at each reporting period for each tax jurisdiction and establishes a valuation allowance, if necessary, to reduce the deferred tax asset to an amount that is more likely than not to be recovered. As of June 30, 2016, 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, 2016 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

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

- 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, 2016, a valuation allowance was provided for the U.S., Japan, China, Hong Kong, Mexico, Spain, France and Brazil where the Company has determined the deferred tax assets will not more likely than not be realized. Evaluation of the remaining jurisdictions as of June 30, 2016 resulted in the determination that no additional valuation allowances were necessary at this time. However, the Company will continue to assess the need for a valuation allowance against its deferred tax assets in the future and the valuation will be adjusted accordingly, which could materially affect the Company’s financial position and results of operations.

As of June 30, 2016, and December 31, 2015, the Company’s U.S. deferred tax liability was $5.4 million and $4.8 million, respectively, related to its goodwill and indefinite lived intangibles. As of June 30, 2016 the Company had foreign net deferred tax liabilities of $0.1 million compared to foreign net deferred tax liabilities of $0.2 million at December 31, 2015. As of June 30, 2016, and December 31, 2015, the Company had no unrecognized tax benefits.

For the six months ended June 30, 2016 the Company recorded an income tax benefit of $0.5 million. The benefit in the current period is the result of tax benefits related to current year losses in Canada. The loss in Canada includes a $1.7 million goodwill impairment charge that was non-deductible for tax purposes. The goodwill impairment charge had a significant impact on our effective tax rate for the second quarter and six months ended June 30, 2016. The tax benefit was partially offset by tax expense related to current year profits of operations in Germany and the U.K. 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.

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

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

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, 2016 there were 1,218,085 shares available for future grant under the 2009 Plan.

Valuation Assumptions

The determination of fair value of our stock-based awards is affected by assumptions regarding subjective and complex variables. Generally, our assumptions are based on historical information and judgment is required to determine if historical trends may be indicators of future outcomes. In accordance with ASC 718, the fair value of stock-based awards to employees is calculated as of the date of grant. Compensation expense is then recognized over the requisite service period of the award. Stock-based compensation expense recognized is based on the estimated portion of the awards that are expected to vest. Estimated forfeiture rates are applied in the expense calculation. The Company calculates the pool of additional paid-in capital associated with excess tax benefits in accordance with ASC 718. The Company determines the fair values of stock-based awards as follows:

- Service-Based Restricted Stock Awards, Restricted Stock Units, and Performance-Based Restricted Stock Awards: Fair value is determined based on the quoted market price of our common stock on the date of grant.
- Service-Based Stock Options and Performance-Based Stock Options: Fair value is determined using the Black-Scholes pricing model, which requires the use of estimates, including the risk-free interest rate, expected volatility, expected dividends, and expected term.
- Market-Based Restricted Stock Awards and Market-Based Stock Options: The fair value of the market-based awards is determined using a Monte-Carlo simulation model. The Monte Carlo valuation also estimates the number of market-based awards that would be awarded which is reflected in the fair value on the grant date.

For the six months ended June 30, 2016 and 2015, the fair value of service-based stock options and performance-based stock options granted was calculated using the following assumptions in the Black-Scholes model:

	Six Months Ended June 30,	
	2016	2015
Expected stock price volatility	46.1%-47.0%	49.1%-63.1%
Expected term of options	5.5 - 6.5 years	6 years
Expected dividend yield	—	—
Risk-free interest rate	1.24%-1.50%	1.19%-1.75%

For the six months ended June 30, 2016 and 2015, the fair value of market-based stock options and market-based restricted stock awards granted was calculated using the following assumptions in the Monte-Carlo simulation model:

	Six Months Ended June 30,	
	2016	2015
Expected stock price volatility	44.9%-49.1%	none
Expected term of options	1.7 years-7 years	none
Expected dividend yield	—	none
Risk-free interest rate	.71%-1.53%	none

Stock-Based Compensation Expense

Stock compensation expense associated with service-based equity awards is recognized in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period. For equity awards granted with performance-based conditions, stock compensation expense is recognized in the statement of operations ratably for each vesting tranche based on the probability that operating performance conditions will be met and to what extent.

For equity awards granted with market-based conditions, stock compensation is recognized in the statement of operations ratably for each vesting tranche regardless of meeting or not meeting the market conditions.

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Included in cost of revenue:				
Cost of product revenue	$6	$16	$7	$38
Cost of subscription and service revenue	15	(14)	(2)	(3)
Total included in cost of revenue	21	2	5	35
Included in operating expenses:				
Sales and marketing	240	227	319	588
Research and development	289	171	170	311
General and administrative	847	1,708	1,324	2,461
Total included in operating expenses	1,376	2,106	1,813	3,360
Total	$1,397	$2,108	$1,818	$3,395

Service-Based Stock Options

The following table summarizes the Company's service-based stock option activity from January 1, 2016 to June 30, 2016:

	Service-based Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life (years)	Aggregate Intrinsic Value
Service-based Options Outstanding, January 1, 2016	1,837,165	$ 10.58	7.70	$ 130,262
Service-based options granted	464,194	7.50		
Service-based options exercised	(9,268)	4.04		
Service-based options canceled	(238,157)	10.88		
Service-based Options Outstanding, June 30, 2016	2,053,934	9.88	7.89	165,607
Vested and expected to vest June 30, 2016	1,884,674	10.03	7.77	130,981
Exercisable at June 30, 2016	1,208,912	$ 10.43	7.15	$ 43,452

As of June 30, 2016, future compensation cost related to the non-vested portion of the service-based stock option awards not yet recognized in the consolidated statement of operations was $4.4 million and is expected to be recognized over a weighted average period of 2.69 years.

Service-based stock options are granted at the discretion of the Board of Directors or the Compensation Committee (or its authorized member(s)) and expire 10 years from the date of the grant. Service-based stock options generally vest over a four-year period based upon required service conditions and do not have performance or market conditions.

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

Service-Based Restricted Stock Awards
The following table summarizes the Company's service-based restricted stock award activity from January 1, 2016 to June 30, 2016:

	Nonvested Service-Based Awards Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested Service-based Awards, January 1, 2016	341,579	$ 10.61	$3,624,153
Service-based awards granted	261,208	7.43	
Service-based awards vested	(101,138)	10.72	
Service-based awards canceled	(26,486)	10.47	
Nonvested Service-Based Awards, June 30, 2016	475,163	$ 8.86	$4,209,136

As of June 30, 2016, future compensation cost related to the nonvested portion of the service-based restricted stock awards not yet recognized in the consolidated statement of operations was $3.8 million and is expected to be recognized over a weighted average period of 2.16 years.
Service-based restricted stock awards are granted at the discretion of the Board of Directors or Compensation Committee (or its authorized member(s)). Restricted stock awards generally vest over a four-year period based upon required service conditions.
Restricted Stock Units
The following table summarizes the Company's restricted stock unit activity from January 1, 2016 to June 30, 2016:

	Units Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Units Outstanding, January 1, 2016	187,942	$ 11.16	$1,257,332
Units granted	67,663	7.70	521,005
Units released	(58,719)	11.51	
Units cancelled	(8,829)	8.50	
Units Outstanding, June 30, 2016	188,057	9.93	1,457,442
Vested and expected to vest at June 30, 2016	144,253	7.70	481,241
Vested and deferred at June 30, 2016	82,157	$ 12.44	$636,717

For the six months ended June 30, 2016, 67,663 restricted stock units were granted to members of the Board of Directors as part of their compensation packages. Restricted stock units convert to common stock following the separation of service with the Company. Beginning June 2015, all restricted stock unit awards vest quarterly over a one year period from the date of grant, with expense recognized straight-line over the vesting period. Prior to June 2015, all restricted stock unit awards were immediately vested with expense recognized in full on the grant date. The Company's restricted stock units are accounted for as equity awards. The grant date fair value is based on the market price of the Company's common stock at the date of grant. The Company did not grant any restricted stock units prior to April 2009.
Performance and Market Conditioned Restricted Stock Awards and Stock Options
On April 4, 2016, the Company named Mr. John Hass as President, CEO and Chairman of the Board. In conjunction with his appointment, the Compensation Committee approved a stock-based compensation package for Mr. Hass

aimed to provide significant reward potential for achieving outstanding Company operating performance results and building shareholder value. The package was comprised of performance-based restricted stock awards (PRSAs), performance-based stock options (PSOs), market-based restricted stock awards (MRSAs), and market-based stock options (MSOs). Awards also vest if a majority change in control of the Company occurs during the performance or vesting period.

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

Performance Conditioned:
In addition to the performance condition, the PRSAs and PSOs also have a service condition. Vesting of PRSAs and PSOs are dependent upon whether the Company achieves certain operating performance targets which are based on the Company's defined measures of revenue, bookings, adjusted free cash flow, and adjusted EBITDA, measured against the full-year 2016 operating results. Following the end of the performance measurement period on December 31, 2016, PRSAs and PSOs issued based on the operating performance metrics will vest 50%, 25%, and 25% on April 4, 2017, 2018 and 2019, respectively.
The Company records compensation expense ratably for each vesting tranche of the PRSAs and PSOs based on the probability that operating performance conditions will be met and to what extent. Changes in the probability estimates will be accounted for in the period of change using a cumulative catch-up adjustment to retroactively apply the new probability estimates. In any period in which the Company determines that achievement of the performance metrics is not probable, the Company ceases recording compensation expense and all previously recognized compensation expense for the award is reversed.
The PRSAs were granted at "target" (at 100% of target). Based upon actual attainment of the operating performance results through December 31, 2016 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of PRSAs originally granted. As of June 30, 2016, future compensation cost related to the nonvested portion of the PRSAs not yet recognized in the consolidated statement of operations was $0.3 million and is expected to be recognized over a weighted average period of 1.97 years.
The following table summarizes the Company's PRSA activity from January 1, 2016 to June 30, 2016:

	Nonvested PRSAs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested PRSAs, January 1, 2016	—	$ —	$ —
PRSAs granted	70,423	7.10	500,003
PRSAs vested	—	—	
PRSAs canceled	—	—	
Performance adjustments	(23,392)		
Nonvested PRSAs, June 30, 2016	47,031	$ 7.10	$ 333,920

The PSOs were granted at "maximum" (at 200% of target). Based on actual attainment of the operating performance results through December 31, 2016 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of PSOs originally granted. As of June 30, 2016, future compensation cost related to the nonvested portion of the PSOs not yet recognized in the consolidated statement of operations was $0.3 million and is expected to be recognized over a weighted average period of 1.97 years.
The following table summarizes the Company's PSO activity from January 1, 2016 to June 30, 2016:

	PSOs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
PSOs Outstanding, January 1, 2016	—	$ —	$ —
PSOs granted	314,465	3.24	1,000,242
PSOs released	—	—	

PSOs cancelled	—		—	
Performance adjustments	(209,460	)	3.24	
PSOs Outstanding, June 30, 2016	105,005		3.24	333,997
Vested and expected to vest at June 30, 2016	—		—	—
Exercisable at June 30, 2016	—		$ —	$ —

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

Market Conditioned:
In addition to the market condition, the MRSAs and MSOs also have a service condition. Vesting of these MRSAs and MSOs are dependent upon whether the Company achieves predetermined growth rates of total shareholder return for the two-year measurement period beginning on January 4, 2016 and ending on December 29, 2017. Following the end of the market performance measurement period on December 29, 2017, MRSAs issued based on total shareholder return will vest annually on a pro-rata basis over three years beginning April 4, 2018. The Company records compensation expense ratably for each vesting tranche of the MRSAs and MSOs based on the Monte Carlo fair value estimated on the grant date, regardless of meeting or not meeting the market conditions.
The MRSAs were granted at "target" (at 100% of target). Based upon actual attainment of total shareholder return growth rate results through December 29, 2017 relative to target, actual issuance of RSAs can fall anywhere between a maximum of 200% and 0% of the target number of MRSAs originally granted. As of June 30, 2016, future compensation cost related to the nonvested portion of the MRSAs not yet recognized in the consolidated statement of operations was $0.4 million and is expected to be recognized over a weighted average period of 3.01 years.
The following table summarizes the Company's MRSA activity from January 1, 2016 to June 30, 2016:

	Nonvested MRSAs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Nonvested MRSAs, January 1, 2016	—	$ —	$—
MRSAs granted	70,423	6.17	434,510
MRSAs vested	—	—	
MRSAs canceled	—	—	
Nonvested MRSAs, June 30, 2016	70,423	$ 6.17	$434,510

The MSOs were granted at "maximum" (at 200% of target). Based on actual attainment of total shareholder return growth rate results through December 29, 2017 relative to maximum, actual issuance of stock options can fall anywhere between 100% and 0% of the maximum number of MSOs originally granted. As of June 30, 2016, future compensation cost related to the nonvested portion of the MSOs not yet recognized in the consolidated statement of operations was $0.3 million and is expected to be recognized over a weighted average period of 3.01 years.
The following table summarizes the Company's MSO activity from January 1, 2016 to June 30, 2016:

	MSOs Outstanding	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
MSOs Outstanding, January 1, 2016	—	$ —	$ —
MSOs granted	314,465	0.94	294,550
MSOs released	—	—	
MSOs cancelled	—	—	
MSO Outstanding, June 30, 2016	314,465	0.94	294,550
Vested and expected to vest at June 30, 2016	—	—	—
Exercisable at June 30, 2016	—	$ —	$ —

12. STOCKHOLDERS' EQUITY

At June 30, 2016, 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, 2016, the Company had shares of common stock issued of 23,452,343 and shares of common stock outstanding of 22,452,343.

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

On May 8, 2013, the Company filed a universal shelf registration statement to offer equity or issue debt in the amount of $150.0 million, 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 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, 2015, or the six months ended June 30, 2016. Shares repurchased under the program were recorded as treasury stock on the Company’s consolidated balance sheet. The shares repurchased under this program during the year ended December 31, 2013 were not the result of an accelerated share repurchase agreement. Management has not made a decision on whether shares purchased under this program will be retired or reissued.

13. RESTRUCTURING

2016 Restructuring Plan

In the first quarter of 2016, the Company announced and initiated actions to withdraw the direct sales presence in almost all of its non-U.S. and non-northern European geographies related to the distribution of Enterprise & Education Language offerings. The Company has also initiated processes to close its software development operations in France and China.

Restructuring charges included in the Company’s unaudited consolidated statement of operations related to the 2016 Restructuring Plan include the following:

- Employee severance and related benefits costs incurred in connection with headcount reductions involving employees primarily in France, China, Brazil, Canada, Spain, Mexico, U.S. and the U.K.;
- Contract termination costs associated with operating lease terminations from office closures; and
- Other related costs.

The following table summarizes activity with respect to the restructuring charges for the 2016 Restructuring Plan during the six months ended June 30, 2016 (in thousands):

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at June 30, 2016
Severance costs	$ —	$ 4,401	$ (2,015)	$ —	$ 2,386
Contract termination costs	—	94	—	(69)	25
Other costs	—	441	(95)	(74)	272
Total	$ —	$ 4,936	$ (2,110)	$ (143)	$ 2,683

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

2015 Restructuring Plan

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, 2016. The Company does not expect to incur any additional restructuring costs in connection with the 2015 Restructuring Plan.

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

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, 2016 (in thousands):

	Balance at January 1, 2016	Cost Incurred	Cash Payments	Other Adjustments (1)	Balance at June 30, 2016
Severance costs	$ 252	$ 85	$ (240)	$ —	$ 97
Contract termination costs	—	—	—	—	—
Other costs	—	—	—	—	—
Total	$ 252	$ 85	$ (240)	$ —	$ 97

(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.

Restructuring Cost

The following table summarizes the major types of costs associated with the 2016 and 2015 Restructuring Plans for the three and six months ended June 30, 2016 and 2015, and total costs incurred through June 30, 2016 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,		Incurred through
	2016	2015	2016	2015	June 30, 2016
Severance costs	$2,233	$1,146	$4,486	$7,159	$11,726
Contract termination costs	94	1,135	94	1,135	1,228
Other costs	185	164	441	410	858
Total	$2,512	$2,445	$5,021	$8,704	$13,812

As of June 30, 2016, the entire restructuring liability of $2.8 million was classified as a current liability within accrued compensation and other current liabilities on the consolidated balance sheets.

The following table presents total restructuring costs associated with the 2016 and 2015 Restructuring Plans included in the related line items of our Statement of Operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Cost of revenue	$477	$60	$572	$97
Sales and marketing	734	1,290	2,219	4,414
Research and development	579	97	928	701
General and administrative	722	998	1,302	3,492
Total	$2,512	$2,445	$5,021	$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."

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

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 $3.2 million in the first quarter of 2014. Prior to January 31, 2014, the Company occupied the 6th and 7th floors at its Arlington, Virginia headquarters. The Company estimated the liability under operating lease agreements and accrued lease abandonment costs in accordance with ASC 420, Exit or Disposal Cost Obligation ("ASC 420"), as the Company has no future economic benefit from the abandoned space and the lease does not terminate until December 31, 2018. All leased space related to the 6th floor was abandoned and ceased to be used by the Company on January 31, 2014.

A summary of the Company's lease abandonment activity for the six months ended June 30, 2016 and 2015 is as follows (in thousands):

	As of June 30,	
	2016	2015
Accrued lease abandonment costs, beginning of period	$1,281	$1,679
Costs incurred and charged to expense	30	—
Principal reductions	(217)	(259)
Accrued lease abandonment costs, end of period	$1,094	$1,420
Accrued lease abandonment costs liability:		
Short-term	$434	$428
Long-term	660	992
Total	$1,094	$1,420

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 74 months. Certain leases also include lease renewal options.

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

The following table summarizes future minimum operating lease payments for the remaining six months of 2016 and the years thereafter (in thousands):

	As of June 30, 2016
Periods Ending December 31,	
2016-remaining	$2,456
2017	4,019
2018	3,770
2019	1,253
2020	962
Thereafter	590
Total	$13,050

Total expenses under operating leases are $1.0 million and $1.3 million for the three months ended June 30, 2016 and 2015, respectively. Total expenses under operating leases are $2.1 million and $2.7 million for the six months ended June 30, 2016 and 2015, respectively.
The Company accounts for its leases under the provisions of ASC topic 840, Accounting for Leases ("ASC 840"), and subsequent amendments, which require that leases be evaluated and classified as operating leases or capital leases for financial reporting purposes. Certain operating leases contain rent escalation clauses, which are recorded on a straight-line basis over the initial term of the lease with the difference between the rent paid and the straight-line rent recorded as either a deferred rent asset or liability depending on the calculation. Lease incentives received from landlords are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction to rent expense.
Litigation
From time to time, the Company has been subject to various claims and legal actions in the ordinary course of its business. The Company is not currently involved in any legal proceeding the ultimate outcome of which, in its judgment based on information currently available, would have a material impact on its business, financial condition or results of operations.
16. SEGMENT INFORMATION
In March 2016, the Company announced its strategy to position the organization for success. The Company has prioritized the growth of literacy sales and is taking actions to align resources to drive this growth. As a result of this shift, the Company reevaluated its segment structure. Prior to the strategy shift, the Company was managed in two operating segments - "Enterprise & Education" and "Consumer". Following the shift, the Company is managed in three operating segments - "Enterprise & Education Language", "Literacy", and "Consumer". The new Literacy segment was previously a component of the "Enterprise & Education" segment and is comprised solely of the Lexia business. The Literacy segment focuses on delivering subscription-based English literacy-learning and assessment solutions to grades pre-K through 12. 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. Segment contribution excludes depreciation, amortization, stock compensation, research and development, restructuring related and other non-recurring expenses. The Company

does not allocate expenses beneficial to all segments, which includes certain general and administrative expenses such as legal fees, payroll processing fees, and accounting related 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. Prior periods have been reclassified to reflect our current segment presentation and definition of segment contribution.

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

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

Operating results by segment for the three and six months ended June 30, 2016 and 2015 were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Revenue:				
Enterprise & Education Language	$17,490	$18,558	$35,821	$37,556
Literacy	7,950	4,733	15,527	8,903
Consumer	20,276	28,120	42,370	63,394
Total revenue	$45,716	$51,411	$93,718	$109,853
Segment contribution:				
Enterprise & Education Language	$6,752	$4,601	$12,852	$8,796
Literacy	1,236	(193)	2,274	(317)
Consumer	3,862	9,454	8,811	16,775
Total segment contribution	$11,850	$13,862	$23,937	$25,254
Unallocated expenses, net:				
Unallocated cost of sales	$1,515	$656	$2,536	$1,318
Unallocated sales and marketing	1,825	2,290	4,372	6,790
Unallocated research and development	6,748	6,953	13,319	15,925
Unallocated general and administrative	9,616	11,000	19,751	25,994
Unallocated non-operating expense/(income)	(816)	589	(1,945)	2,254
Unallocated impairment	2,902	160	2,902	451
Unallocated lease abandonment expense	30	—	30	—
Total unallocated expenses, net	$21,820	$21,648	$40,965	$52,732
Loss before income taxes	$(9,970)	$(7,786)	$(17,028)	$(27,478)
Segment contribution margin:				
Enterprise & Education Language	38.6 %	24.8 %	35.9 %	23.4 %
Literacy	15.5 %	(4.1)%	14.6 %	(3.6)%
Consumer	19.0 %	33.6 %	20.8 %	26.5 %

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, 2016 and 2015 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
United States	$37,626	$41,539	$77,421	$87,728
International	8,090	9,872	16,297	22,125
Total	$45,716	$51,411	$93,718	$109,853

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

The information below summarizes long-lived assets by geographic area classified as held and used as of June 30, 2016 and December 31, 2015 (in thousands):

	June 30, 2016	December 31, 2015
United States	$21,142	$ 18,704
International	3,551	3,828
Total	$24,693	$ 22,532

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, 2016 and 2015 (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Language learning	$36,612	$45,713	$75,839	$98,878
Literacy	7,950	4,733	15,527	8,903
Brain fitness	1,154	965	2,352	2,072
Total	$45,716	$51,411	$93,718	$109,853

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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 14, 2016.

Overview

Rosetta Stone Inc. ("Rosetta Stone," the "Company," "we" or "us") is dedicated to changing people's lives through the power of language and literacy education. Our innovative, personalized language and reading programs drive positive learning outcomes in thousands of schools, businesses, government organizations and for millions of individuals around the world. Our cloud-based programs allow users to learn online or on-the-go via tablet or smartphone, whether in a classroom, corporate setting, or personal learning environment. Rosetta Stone is also a leader in the literacy education space, helping millions of students build fundamental reading skills. Additionally, our Fit Brains business offers personalized brain training programs that are both exciting and challenging.
Rosetta Stone Inc. was incorporated in Delaware in 2005. Founded in 1992, Rosetta Stone pioneered the use of interactive software to accelerate language learning and is widely recognized today as the industry leader in providing effective language programs. 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.
As our Company has evolved, we believe that our Enterprise & Education Language and Literacy segments are 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 demand is growing for e-learning based literacy solutions in the U.S. and English language-learning around the globe.
As a result, we are emphasizing the development of products and solutions for Corporate and K-12 learners who need to speak and read English. This focus extends to the Consumer segment, where we continue to make product investments serving the needs of passionate language learners who are motivated, results focused and willing to pay for a quality language-learning experience.
To position the organization for success, we have begun and will continue to focus on the following four priorities:

1. Grow literacy sales by providing fully aligned digital instruction and assessment tools for K-12, building a direct distribution sales force to replace our historical reseller model, and continuing to develop our implementation services business;
2. Position our Enterprise & Education Language segment for profitable growth by focusing on our best geographies and customer segments and successfully delivering a new language-learning suite for Corporate customers that offers a

simple, more modern, metrics-driven suite of tools that are results-oriented and easily integrated with leading corporate language-learning systems;

3. Maximize the profitability of our Consumer language business by providing an attractive value proposition and a streamlined, mobile-oriented product portfolio focused on consumers' demand, while optimizing our marketing spend appropriately; and
4. Right-size the entire cost base of the Company, including
   - optimizing our media spend and other marketing costs in Consumer sales and marketing;
   - right-sizing our Enterprise & Education Language segment to target those geographies and customer segments where we have the greatest opportunity; and
   - reducing our general and administrative costs.

In pursuing these priorities, we will (i) allocate capital to the areas of our business that we believe have the greatest growth potential, including our literacy-learning business, (ii) focus our businesses on their best customers, including K-12 learners primarily in North America, Corporate learners primarily in North America and Northern Europe in our Enterprise & Education Language segment, and passionate learners in the United States and select non-U.S. geographies in our Consumer language business, and (iii) optimize the sales and marketing costs for these businesses and the costs of our business overall.

On March 14, 2016, we announced the 2016 Restructuring Plan, outlining our withdrawal of the direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of the Enterprise & Education Language offerings. These operations were adding sales, but at too high a cost and without the near-term ability to capture scale efficiencies. Where appropriate, we seek to operate through partners in the geographies being exited. We have also initiated processes to close the software development operations in France and China. These actions are additive to the 2015 Restructuring Plan to accelerate and prioritize our focus on satisfying the needs of more passionate Corporate and K-12 learners, and emphasizing those who need to speak and read English. If our intentions are realized, the 2016 Restructuring Plan will reduce headcount by approximately 17% of our year-end 2015 full-time workforce and is expected to result in annual cost savings of approximately $19.0 million. As it will take time to exit certain geographies, the full benefit of these changes will not be realized until the second half of 2016 or early 2017. 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 conjunction with the 2016 and 2015 Restructuring Plans, 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, 2016, we currently have three operating segments, Enterprise & Education Language, Literacy, and Consumer, rather than the two operating segments (Enterprise & Education and Consumer) we had as of December 31, 2015. The Enterprise & Education Language segment derives language learning revenue from sales to educational institutions, government agencies and corporations worldwide. The Literacy segment derives revenue from the sales of literacy solutions to educational institutions serving grades K through 12. The Consumer segment derives revenue from sales to individuals and retail partners. 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 Language segment contribution increased to $6.8 million with segment contribution margin of 39% for the three months ended June 30, 2016 as compared to segment contribution of $4.6 million and segment contribution margin of 25% for the three months ended June 30, 2015. The dollar and margin increases were primarily due to lower sales and marketing expenses due to a reduced headcount and other cost saving measures. Literacy segment contribution increased to $1.2 million with segment contribution margin of 16% for the three months ended June 30, 2016 as compared to a segment contribution loss of $0.2 million and segment contribution margin of negative 4% for the three months ended June 30, 2015. The dollar and margin increases were primarily due to the larger revenue base on which segment contribution is calculated, offset by an increase in sales and marketing expense due to the transition to a direct sales team and investments made to improve the Literacy product portfolio and infrastructure. The margin improvement related to the effect of purchase accounting will diminish over time. Consumer segment contribution decreased from $9.5 million with a segment contribution margin of 34% for the three months ended June 30, 2015 to $3.9 million with a segment contribution margin of 19% for the three months ended June 30, 2016. The dollar and margin decrease in Consumer segment contribution reflects the $7.8 million decrease in Consumer revenue, largely driven by the one-time impact of $3.6 million from a reduction in the suggested retail value as a result of the price protection granted to retail partners.

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For the six months ended June 30, 2016, Enterprise & Education Language segment contribution increased to $12.9 million with a segment contribution margin of 36% compared to $8.8 million for the six months ended June 30, 2015 with a segment contribution margin of 23%. The dollar and margin increases are primarily due to the cost reduction initiatives in early 2016 as compared to the prior year. Literacy segment contribution increased to $2.3 million with segment contribution margin of 15% for the six months ended June 30, 2016 as compared to a segment contribution loss of $0.3 million and segment contribution margin of negative 4% for the six months ended June 30, 2015. The dollar and margin increases were primarily due to the larger revenue base on which segment contribution is calculated, offset by an increase in sales and marketing expense due to the transition to a direct sales team and support infrastructure. The margin improvement related to the effect of purchase accounting will diminish over time. Consumer segment contribution decreased from $16.8 million with a contribution margin of 26% for the six months ended June 30, 2015 to $8.8 million with a contribution margin of 21% for the six months ended June 30, 2016. The dollar and margin decrease in Consumer segment contribution is primarily due to a decrease in Consumer revenue of $21.0 million, which includes the one-time impact of $3.6 million from a reduction in the suggested retail value as a result of the price protection granted to retail partners.

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. We expect the trend in Consumer subscription sales to accelerate in 2016 as customer preferences continue to move towards mobile experiences. Over the approximate next 18 months, we intend to move all of our Consumer business to subscription sales.

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 segment presentation and definition of segment contribution.

Components of Our Statement of Operations

Revenue

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

In the Consumer market, our perpetual product software is often bundled with our short-term online conversational coaching and online community services and sold as a package. Approximately $25 to $39 in revenue per unit is derived from these short-term online services. As a result, we typically defer 10% to 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 sales force as well as through our network of resellers and organizations who typically gain access to our solutions under a web-based subscription service. We distribute our Consumer products predominantly through our direct sales channels, primarily our website and call centers, which we refer to as our direct-to-consumer channel. We also distribute our Consumer products through select third-party retailers and distributors. For purposes of explaining variances in our revenue, we separately discuss changes in our Enterprise & Education Language, Literacy, and our Consumer sales channels because the customers and revenue drivers of these channels are different.

Within our Enterprise & Education Language segment, revenue in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Our Literacy segment revenue is seasonally stronger in the second quarter of the calendar year corresponding to school district budget years.

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Our Consumer revenue is affected by seasonal trends associated with the holiday shopping season. 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, and general and administrative. When certain events occur, we also recognize operating expenses related to asset impairment and operating lease terminations.

Our operating expenses primarily consist of personnel costs, direct advertising and marketing expenses and professional fees associated with contract product development, legal, accounting and consulting. Personnel costs for each category of operating expenses include salaries, bonuses, stock-based compensation and employee benefit costs. Included within our operating expenses are restructuring costs that consist primarily of employee severance and related benefit costs, contract termination costs, and other related costs associated with our restructuring activities.

Sales and Marketing. Our sales and marketing expenses consist primarily of direct advertising expenses related to television, print, radio, online and other direct marketing activities, personnel costs for our sales and marketing staff, and commissions earned by our sales personnel. Sales commissions are generally paid 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.

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

Impairment. Impairment expenses consist primarily of goodwill impairment, impairment of long-lived assets, 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 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 income represents interest received on our cash and cash equivalents. Interest expense is primarily related to interest on our capital leases and amortization of deferred financing fees associated with our revolving credit facility. Fluctuations in foreign currency exchange rates in our foreign subsidiaries cause foreign exchange gains and losses. 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 Benefit and Expense

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

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

For the three and six months ended June 30, 2016, we incurred an income tax benefit of $1.0 million and $0.5 million, respectively, despite incurring losses before taxes of $10.0 million and $17.0 million, respectively, resulting in worldwide effective tax rates of 9.9% and 3.2%, respectively. These tax rates resulted from current year losses in Canada including a $1.7 million goodwill impairment charge that was non-deductible for tax purposes. The tax benefit was partially offset by tax expense related to current year income of operations in Germany and the U.K., as well as the tax impact of amortization of indefinite lived intangibles.

For the year ended December 31, 2015, we recorded an income tax expense of $1.2 million primarily attributable to losses before tax of $45.6 million resulting in worldwide effective tax rate of (2.5)%. 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. In addition, we believe that a discussion of these policies is necessary for readers to understand and evaluate our consolidated financial statements contained in this annual report on Form 10-Q:

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

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 14, 2016. 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, except as described below:

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 as of June 30, 2016, we performed Step 1 of the goodwill impairment test for the Enterprise & Education Language and Literacy reporting units, which both resulted in fair values that substantially exceeded the carrying values, and therefore no goodwill impairment charges were recorded in connection with the annual analysis for these reporting units.

The Consumer Fit Brains reporting unit was also evaluated which resulted in a fair value that was significantly below the carrying value. The decrease in fair value was due to the second quarter 2016 strategy update for the Consumer Fit Brains business. The Consumer Fit Brains reporting unit is no longer considered central to the core strategy for our focus on language and literacy learning. Due to the continued declines in the operations since the $5.6 million partial impairment in the fourth quarter of 2015, we revised the Consumer Fit Brains financial projections in the second quarter of 2016 assuming reduced media spend and reduced revenue in 2016 and beyond. The change in operating plans and the lack of cushion since the fourth quarter 2015 impairment resulted in an implied fair value of goodwill that was significantly below its carrying value. As a result, we recorded an impairment loss of $1.7 million, which represents a full impairment of the remaining Consumer Fit Brains reporting unit's goodwill.

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.

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Results of Operations

Comparison of the three months ended June 30, 2016 and the three months ended June 30, 2015

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

	Three Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
Revenue:				
Product	$7,959	$14,209	$(6,250)	(44.0)%
Subscription and service	37,757	37,202	555	1.5 %
Total revenue	45,716	51,411	(5,695)	(11.1)%
Cost of revenue:				
Cost of product revenue	2,389	3,719	(1,330)	(35.8)%
Cost of subscription and service revenue	5,575	5,301	274	5.2 %
Total cost of revenue	7,964	9,020	(1,056)	(11.7)%
Gross profit	37,752	42,391	(4,639)	(10.9)%
Operating expenses:				
Sales and marketing	28,740	30,555	(1,815)	(5.9)%
Research and development	6,748	6,953	(205)	(2.9)%
General and administrative	10,118	11,920	(1,802)	(15.1)%
Impairment	2,902	160	2,742	1,713.8 %
Lease abandonment and termination	30	—	30	100.0 %
Total operating expenses	48,538	49,588	(1,050)	(2.1)%
Loss from operations	(10,786)	(7,197)	(3,589)	49.9 %
Other income and (expense):				
Interest income	10	7	3	42.9 %
Interest expense	(121)	(93)	(28)	30.1 %
Other income and (expense)	927	(503)	1,430	(284.3)%
Total other income and (expense)	816	(589)	1,405	(238.5)%
Loss before income taxes	(9,970)	(7,786)	(2,184)	28.1 %
Income tax (benefit) expense	(992)	389	(1,381)	(355.0)%
Net loss	$(8,978)	$(8,175)	$(803)	9.8 %

Total revenue decreased to $45.7 million for the three months ended June 30, 2016 from $51.4 million for the three months ended June 30, 2015. The decline in revenue was due to a decrease in Consumer revenue of $7.8 million, a decrease in Enterprise & Education revenue of $1.1 million, partially offset by an increase in Literacy revenue of $3.2 million.

The operating loss for the three months ended June 30, 2016 totaled $10.8 million, compared to an operating loss of $7.2 million for the three months ended June 30, 2015. Operating expenses decreased $1.1 million, primarily comprised of decreases of $1.8 million in sales and marketing expenses, $1.8 million in general and administrative expenses, and $0.2 million in research and development expenses, which were partially offset by a $2.7 million increase in impairment charges. The decrease in general and administrative expenses and sales and marketing expenses reflects the continued savings as a result of the ongoing expense reduction actions. The $1.1 million reduction in operating expenses partially offset a decrease in gross profit of $4.6 million, driven by a $5.7 million decrease in revenue only partially offset by a $1.1 million decrease in cost of revenue, which lead to an overall $3.6 million increase in the loss from operations.

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The following table sets forth revenue for our three operating segments for the three months ended June 30, 2016 and 2015 (in thousands, except percentages):

	Three Months Ended June 30,				2016 Versus 2015	
	2016		2015		Change	% Change
Enterprise & Education Language	$17,490	38.2 %	$18,558	36.1 %	$(1,068)	(5.8)%
Literacy	7,950	17.4 %	4,733	9.2 %	3,217	68.0 %
Consumer	20,276	44.4 %	28,120	54.7 %	(7,844)	(27.9)%
Total Revenue	$45,716	100.0%	$51,411	100.0%	$(5,695)	(11.1)%

Enterprise & Education Language Segment

Enterprise & Education Language revenue decreased $1.1 million, or 6%, from the three months ended June 30, 2015 to the three months ended June 30, 2016. The decrease in Enterprise & Education Language revenue reflects a decrease of $1.3 million in the corporate channel, which was partially offset by an increase of $0.2 million in our education channel. We expect revenue associated with the Enterprise & Education Language business will decline as we execute our strategy to exit our direct presence in unprofitable geographies and manage this business for profitable growth. Where appropriate, we will seek to operate in the geographies we exit through partners.

Literacy Segment

Literacy revenue increased $3.2 million, or 68%, from the three months ended June 30, 2015 to $7.9 million for the three months ended June 30, 2016, reflecting the impact of purchase accounting. Adjusting for the impact of purchase accounting on Literacy revenue, revenue would have been $9.2 million in the second quarter of 2016 compared to $6.9 million in the second quarter of 2015, and the Literacy pro-forma growth would have been 33% year-over-year. We continue to experience these purchase accounting impacts for the Literacy segment due to the typical subscription length. As a result, we expect year over year revenues to become more comparable as we move beyond the purchase accounting impact, which we expect to result in lower revenue growth rates than what we experienced in the second quarter of 2016.

Consumer Segment

Consumer revenue decreased $7.8 million, or 28%, from the three months ended June 30, 2015 to the three months ended June 30, 2016. This decrease was primarily due to reductions in revenue from our retail and direct-to-consumer sales channels of $5.6 million and $2.0 million, respectively. A significant contributor to the decrease in the retail sales channel was the planned one-time reduction in the suggested retail value in the U.S. of $3.6 million in order to price protect our resellers. In connection with our recent shift in strategy, we continue to manage the Consumer business for a targeted bottom-line result. 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% to 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, 2016 and 2015 (in thousands, except percentages):

	Three Months Ended June 30,				2016 Versus 2015	
	2016		2015		Change	% Change
Product	$7,959	17.4 %	$14,209	27.6 %	$(6,250)	(44.0)%

Subscription and service	37,757	82.6 %	37,202	72.4 %	555	1.5 %
Total revenue	$45,716	100.0%	$51,411	100.0%	$(5,695)	(11.1)%

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Product Revenue
Product revenue decreased $6.3 million, or 44%, to $8.0 million during the three months ended June 30, 2016 from $14.2 million during the three months ended June 30, 2015. The primary drivers of the decrease in product revenue were decreases of $4.9 million and $0.9 million in the retail and direct-to-consumer sales channels, respectively, within our Consumer segment which reflect the decision to reduce the suggested retail value in the U.S. by $3.6 million. The majority of the remaining decrease in product revenue was due to a year-over-year decrease in the averages sales price of our bundled language-learning software products and secondarily due to a decline in product unit sales volume. Additionally, product revenue declined due to the ongoing transition of our sales model toward subscription sales rather than box product sales, which we expect to be 100% subscription-based by the end of 2017. 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 $0.6 million, or 1%, to $37.8 million for the three months ended June 30, 2016 from $37.2 million for the three months ended June 30, 2015. The increase in subscription and service revenue was due to an increase in the Literacy segment of $3.2 million, which was partially offset by decreases of $2.1 million in the Consumer segment and $0.6 million in the Enterprise & Education Language segment. As earlier noted, the 68% increase in Literacy revenue is due, in part, to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with the Lexia acquisition, which had the effect of lowering prior year revenue. The decline in Consumer revenue was comprised of decreases in the direct-to-consumer, global retail and homeschool sales channels of $1.1 million, $0.7 million, and $0.5 million, respectively. The Enterprise & Education Language business realized a net decrease of $0.6 million comprised of a $1.0 million decline in the corporate sales channel, partially offset by an increase of $0.4 million in the education sales channels.
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, 2016 and 2015 (in thousands, except percentages):

	Three Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
Revenue:				
Product	$7,959	$14,209	$(6,250)	(44.0)%
Subscription and service	37,757	37,202	555	1.5 %
Total revenue	45,716	51,411	(5,695)	(11.1)%
Cost of revenue:				
Cost of product revenue	2,389	3,719	(1,330)	(35.8)%
Cost of subscription and service revenue	5,575	5,301	274	5.2 %
Total cost of revenue	7,964	9,020	(1,056)	(11.7)%
Gross profit	$37,752	$42,391	$(4,639)	(10.9)%
Gross margin percentages	82.6 %	82.5 %	0.1 %	

Total cost of revenue decreased $1.1 million for the three months ended June 30, 2016 from $9.0 million for the three months ended June 30, 2015. The change in total cost of revenue was primarily due to a $0.7 million decrease in physical inventory costs due to the reduction in sales of physical product, and a corresponding decrease in freight and payment processing fees of $0.3 million and $0.2 million, respectively, also due to the reduction in sales.
Cost of Product Revenue
Cost of product revenue for the three months ended June 30, 2016 was $2.4 million, a decrease of $1.3 million, or 36%, from the three months ended June 30, 2015. As a percentage of product revenue, cost of product revenue increased to 30% for the three months ended June 30, 2016 compared to 26% for the three months ended June 30, 2015. The dollar decrease in cost of product revenue was primarily due to decreases of $0.4 million, $0.3 million, $0.2 million, $0.1 million, and $0.1 million in inventory costs, payroll and benefits, freight, commission and processing fee

costs, respectively, due to the shift away from hard product sales to online subscription sales.

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Cost of Subscription and Service Revenue

Cost of subscription and service revenue for the three months ended June 30, 2016 was $5.6 million, an increase of $0.3 million, or 5%, from the three months ended June 30, 2015. As a percentage of subscription and service revenue, cost of subscription and service revenue increased slightly to 15% for the three months ended June 30, 2016 compared to 14% for the same prior year period. The dollar and percentage increase was primarily due to increases in allocated costs from a higher allocation rate associated with the increase in subscription and service revenue. We expect the cost of subscription and service revenue will increase as we focus 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 $4.6 million to $37.8 million for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. Gross profit percentage remained flat at 83% for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The dollar decrease in gross profit was primarily due to the decrease in revenue.

Operating Expenses

	Three Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Sales and marketing	$28,740	$30,555	$(1,815)	(5.9)%
Research and development	6,748	6,953	(205)	(2.9)%
General and administrative	10,118	11,920	(1,802)	(15.1)%
Impairment	2,902	160	2,742	1,713.8 %
Lease abandonment and termination	30	—	30	100.0 %
Total operating expenses	$48,538	$49,588	$(1,050)	(2.1)%

In the first quarter of 2015, we announced and initiated actions to reduce headcount and other costs in order to support our 2015 strategic shift in business focus. In the first quarter of 2016, we announced and initiated actions to exit the direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of our Enterprise & Education Language offerings and close our software development operations in France and China.

Included within our operating expenses are restructuring charges related to the 2016 and 2015 Restructuring Plans which relate to employee severance and related benefits costs incurred in connection with headcount reductions, contract termination costs, and other related costs. As a result of these actions, we realized reductions in our operating expenses, primarily associated with reduced payroll and benefits costs.

The following table presents restructuring costs associated with the 2016 and 2015 Restructuring Plans included in the related line items of our results from operations:

	Three Months Ended June 30,	
	2016	2015
	(in thousands)	
Cost of revenue	$477	$60
Sales and marketing	734	1,290
Research and development	579	97
General and administrative	722	998
Total	$2,512	$2,445

Sales and Marketing Expenses

Sales and marketing expenses for the three months ended June 30, 2016 were $28.7 million, a decrease of $1.8 million, or 6%, from the three months ended June 30, 2015. As a percentage of total revenue, sales and marketing expenses increased to 63% from 59% for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The decrease in

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sales and marketing expense was primarily due to a $1.2 million decrease in contract termination fees associated with the 2015 Restructuring Plan and the initial cost savings associated with the 2016 Restructuring Plan. In connection with our 2016 strategy, we intend to continue to optimize our Consumer media and marketing costs and manage the Consumer business for profitability and plan to manage the sales and marketing expenses to drive these results.

Research and Development Expenses

Research and development expenses were $6.7 million for the three months ended June 30, 2016, a slight decrease of $0.2 million, or 3%, from the three months ended June 30, 2015. As a percentage of total revenue, research and development expenses increased slightly from 14% to 15% for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The dollar decrease was primarily due to the decrease in professional services expense due to the capitalization of consulting work to develop the Language Learning Suite for Enterprise and other new products. In accordance with our shift in strategy, we continue to focus our product investment on the development of the Language Learning Suite for Enterprise, a single solution that will integrate our foundations, advantage and advanced English for business products, enhance our reporting and administrator tools and extend our assessment capabilities. We expect to maintain our current level of investment in our research and development expenses as we address these initiatives.

General and Administrative Expenses

General and administrative expenses decreased $1.8 million to $10.1 million for the three months ended June 30, 2016 compared to $11.9 million for the three months ended June 30, 2015. As a percentage of revenue, general and administrative expenses decreased slightly to 22% from 23% for the three months ended June 30, 2016 compared to the three months ended June 30, 2015. The primary factors driving the decrease in general and administrative expenses were a reduction in payroll and benefits expense and a reduction in bad debt expense. Payroll and benefits expense decreased $0.5 million due to the higher stock compensation expense in the prior year associated with the 2015 Restructuring Plan. Bad debt expense decreased $0.5 million due to better collection efforts. We expect our general and administrative expenses to continue to decline as we take steps to reduce costs. However, as a result of shareholder engagement and execution of our accelerated strategy, our general and administrative expenses may increase in the near term.

Impairment

Impairment expenses were $2.9 million for the three months ended June 30, 2016, an increase of $2.7 million compared to the three months ended June 30, 2015. The increase was due to the 2016 second quarter Fit Brains impairment of goodwill of $1.7 million and intangible assets of $1.2 million, which was partially offset by a prior year impairment charge related to the abandonment of a previously capitalized internal-use software project.

Interest and Other Income (Expense)

	Three Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Interest income	$10	$7	$3	42.9 %
Interest expense	(121)	(93)	(28)	30.1 %
Other income and (expense)	927	(503)	1,430	(284.3)%
Total other income and (expense)	$816	$(589)	$1,405	(238.5)%

Interest income for the three months ended June 30, 2016 was $10,000, an increase of $3,000, or 43%, from the three months ended June 30, 2015. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the three months ended June 30, 2016 was $0.1 million, an increase of $28,000 from the three months ended June 30, 2015, attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other income and expense for the three months ended June 30, 2016 was income of $0.9 million, a change of $1.4 million, from an expense of $0.5 million for the three months ended June 30, 2015. The change is driven by favorable foreign exchange impacts in the current period.

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Income Tax Benefit and Expense

	Three Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Income tax (benefit) expense	$(992)	$389	$(1,381)	(355.0)%

Our income tax benefit for the three months ended June 30, 2016 was $1.0 million, compared to income tax expense of $0.4 million for the three months ended June 30, 2015. The change primarily resulted from increased pretax losses in Canada including a $1.7 million goodwill impairment charge related to Fit Brains.

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Comparison of the six months ended June 30, 2016 and the six months ended June 30, 2015

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

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
Revenue:				
Product	$17,990	$34,183	$(16,193)	(47.4)%
Subscription and service	75,728	75,670	58	0.1 %
Total revenue	93,718	109,853	(16,135)	(14.7)%
Cost of revenue:				
Cost of product revenue	5,034	9,356	(4,322)	(46.2)%
Cost of subscription and service revenue	10,978	10,966	12	0.1 %
Total cost of revenue	16,012	20,322	(4,310)	(21.2)%
Gross profit	77,706	89,531	(11,825)	(13.2)%
Operating expenses:				
Sales and marketing	59,533	70,705	(11,172)	(15.8)%
Research and development	13,319	15,925	(2,606)	(16.4)%
General and administrative	20,895	27,674	(6,779)	(24.5)%
Impairment	2,902	451	2,451	543.5 %
Lease abandonment and termination	30	—	30	100.0 %
Total operating expenses	96,679	114,755	(18,076)	(15.8)%
Loss from operations	(18,973)	(25,224)	6,251	(24.8)%
Other income and (expense):				
Interest income	23	11	12	109.1 %
Interest expense	(233)	(181)	(52)	28.7 %
Other expense	2,155	(2,084)	4,239	(203.4)%
Total other income and (expense)	1,945	(2,254)	4,199	(186.3)%
Loss before income taxes	(17,028)	(27,478)	10,450	(38.0)%
Income tax (benefit) expense	(543)	581	(1,124)	(193.5)%
Net loss	$(16,485)	$(28,059)	$11,574	(41.2)%

Total revenue decreased to $93.7 million for the six months ended June 30, 2016 from $109.9 million for the six months ended June 30, 2015. The decline in revenue was due to a decrease in Consumer revenue of $21.0 million, a decrease in Enterprise & Education revenue of $1.7 million, which was partially offset by an increase in Literacy revenue of $6.6 million.

The operating loss for the six months ended June 30, 2016 totaled $19.0 million, compared to an operating loss of $25.2 million for the six months ended June 30, 2015. Operating expenses decreased $18.1 million, which was comprised of decreases of $11.2 million in sales and marketing expenses, $6.8 million in general and administrative expenses, and $2.6 million in research and development expenses, which were partially offset by a $2.5 million increase in impairment charges. The decrease in sales and marketing, research and development, and general and administrative operating expenses reflects the continued cost savings initiatives. Gross profit decreased $11.8 million, driven by a $16.1 million decrease in revenue only partially offset by a $4.3 million decrease in cost of revenue.

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The following table sets forth revenue for our three operating segments for the six months ended June 30, 2016 and 2015 (in thousands, except percentages):

	Six Months Ended June 30,				2016 Versus 2015	
	2016		2015		Change	% Change
Enterprise & Education Language	$35,821	38.2 %	$37,556	34.2 %	$(1,735)	(4.6)%
Literacy	15,527	16.6 %	8,903	8.1 %	6,624	74.4 %
Consumer	42,370	45.2 %	63,394	57.7 %	(21,024)	(33.2)%
Total Revenue	$93,718	100.0%	$109,853	100.0%	$(16,135)	(14.7)%

Enterprise & Education Language Segment

Enterprise & Education Language revenue decreased $1.7 million, or 5%, from the six months ended June 30, 2015 to the six months ended June 30, 2016. The decrease in Enterprise & Education Language revenue reflects a decrease of $2.5 million in the corporate channel, which was partially offset by increases of $0.5 million and $0.4 million in our education and non-profit sales channels, respectively. We expect revenue associated with the Enterprise & Education Language business will decline as we execute our strategy to exit our direct presence in unprofitable geographies and manage this business for profitable growth. Where appropriate, we will seek to operate in the geographies we exit through partners.

Literacy Segment

Literacy revenue increased $6.6 million, or 74%, from the six months ended June 30, 2015 to the six months ended June 30, 2016, reflecting the impact of purchase accounting. Adjusting for the impact of purchase accounting on Literacy revenue, revenue would have been $18.1 million for the six month period ending June 30, 2016 compared to $13.4 million in the six month period ending June 30, 2015, and the Literacy pro-forma growth would have been 36% year-over-year. We continue to experience these purchase accounting impacts for the Literacy segment due to the typical subscription length. As a result, we expect year over year revenues to become more comparable as we move beyond the purchase accounting impact, which we expect to result in lower revenue growth rates than what we experienced in the first half of 2016.

Consumer Segment

Consumer revenue decreased $21.0 million, or 33%, from the six months ended June 30, 2015 to the six months ended June 30, 2016. This decrease was largely due to reductions in revenue from our direct-to-consumer, retail and homeschool sales channels of $11.6 million, $8.6 million, and $1.2 million, respectively. These declines reflect the decision to significantly curtail promotional pricing under our shift in strategy. The reduction in the retail channel was due in part to the planned reduction in the suggested retail value in the U.S. which impacted Consumer revenues by $3.6 million. In connection with our recent 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

The following table sets forth revenue for products and subscription and services for the six months ended June 30, 2016 and 2015 (in thousands, except percentages):

	Six Months Ended June 30,				2016 Versus 2015	
	2016		2015		Change	% Change
Product	$17,990	19.2 %	$34,183	31.1 %	$(16,193)	(47.4)%
Subscription and service	75,728	80.8 %	75,670	68.9 %	58	0.1 %
Total revenue	$93,718	100.0%	$109,853	100.0%	$(16,135)	(14.7)%

Product Revenue

Product revenue decreased $16.2 million, or 47%, to $18.0 million during the six months ended June 30, 2016 from $34.2 million during the six months ended June 30, 2015. Product revenue decreased $8.0 million and $7.4 million in the retail and direct-to-consumer sales channels, respectively, within the Consumer segment. The decrease in retail sales is due in part to the reduction in suggested retail value in the U.S. which negatively impacted product revenue by $3.6 million. The majority of the remaining decrease in product revenue was due to a year-over-year decline in product unit sales volume and secondarily due to a decrease in the averages sales price of our bundled language-learning software products. Product revenue also decreased due

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to the continued 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 was flat at $75.7 million for the six months ended June 30, 2016 and the six months ended June 30, 2015. Literacy segment revenue increased by $6.6 million due, in part, to the write-down effects of purchase accounting on the pre-acquisition deferred revenue balances associated with the Lexia acquisition, which had the effect of lowering prior year revenue. Within the Enterprise & Education Language segment, the corporate sales channel decreased $2.0 million, which was partially offset by increases in the education and non-profit sales channels of $0.5 million and $0.4 million, respectively. Consumer segment subscription and service revenue declined by $5.4 million, driven by declines in the direct-to-consumer, homeschool, and retail channels of $4.1 million, $1.0 million, and $0.6 million, respectively.

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, 2016 and 2015 (in thousands, except percentages):

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
Revenue:				
Product	$17,990	$34,183	$(16,193)	(47.4)%
Subscription and service	75,728	75,670	58	0.1 %
Total revenue	93,718	109,853	(16,135)	(14.7)%
Cost of revenue:				
Cost of product revenue	5,034	9,356	(4,322)	(46.2)%
Cost of subscription and service revenue	10,978	10,966	12	0.1 %
Total cost of revenue	16,012	20,322	(4,310)	(21.2)%
Gross profit	$77,706	$89,531	$(11,825)	(13.2)%
Gross margin percentages	82.9 %	81.5 %	1.4 %	

Total cost of revenue decreased $4.3 million for the six months ended June 30, 2016 from $20.3 million for the six months ended June 30, 2015. The decrease in total cost of revenue was primarily due to decreases in inventory expense, freight and payment processing fees, and professional services. Inventory expense declined $2.0 million due to the decrease in box product sales. Freight and processing fees decreased $1.3 million due to the decrease in sales. Professional service cost decreased $0.4 million due to reduced spending on outside services for consumer product support.

Cost of Product Revenue

Cost of product revenue for the six months ended June 30, 2016 was $5.0 million, a decrease of $4.3 million, or 46%, from the six months ended June 30, 2015. As a percentage of product revenue, cost of product revenue increased slightly to 28% from 27% for the six months ended June 30, 2016 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 was primarily due to decreases of $1.2 million, $1.0 million, $0.9 million, and $0.4 million in inventory costs, payroll and benefits, freight and payment processing costs, and commissions, 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, 2016 was $11.0 million, which was flat as compared to the six months ended June 30, 2015. As a percentage of subscription and service revenue, cost of subscription and service revenue remained flat at 14% for the six months ended June 30, 2016 compared to the same prior year period.

Gross Profit

Gross profit decreased $11.8 million to $77.7 million for the six months ended June 30, 2016 compared to $89.5 million for the six months ended June 30, 2015. Gross profit percentage increased slightly to 83% from 82% for the six months ended

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June 30, 2016 compared to the six months ended June 30, 2015. 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.

Operating Expenses

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Sales and marketing	$59,533	$70,705	$(11,172)	(15.8)%
Research and development	13,319	15,925	(2,606)	(16.4)%
General and administrative	20,895	27,674	(6,779)	(24.5)%
Impairment	2,902	451	2,451	543.5 %
Lease abandonment and termination	30	—	30	100.0 %
Total operating expenses	$96,679	$114,755	$(18,076)	(15.8)%

In the first quarter of 2015, we announced and initiated actions to reduce headcount and other costs in order to support our 2015 strategic shift in business focus. In the first quarter of 2016, we announced and initiated actions to exit the direct sales presence in almost all of our non-U.S. and non-northern European geographies related to the distribution of our Enterprise & Education Language offerings and to close our software development operations in France and China.

Included within our operating expenses are restructuring charges related to the 2016 and 2015 Restructuring Plans which relate to employee severance and related benefits costs incurred in connection with headcount reductions, contract termination costs, and other related costs. As a result of these actions, we realized reductions in our operating expenses, primarily associated with reduced payroll and benefits costs.

The following table presents restructuring costs associated with the 2016 and 2015 Restructuring Plans included in the related line items of our results from operations:

	Six Months Ended June 30,	
	2016	2015
	(in thousands)	
Cost of revenue	$572	$97
Sales and marketing	2,219	4,414
Research and development	928	701
General and administrative	1,302	3,492
Total	$5,021	$8,704

While there were restructuring plans initiated in each of the six-month periods ended June 30, 2016 and 2015, the severance expenses in the first half of 2015 were greater than the severance expenses in the first half of 2016, primarily due to the number of headcount reductions in senior management in 2015.

Sales and Marketing Expenses

Sales and marketing expenses for the six months ended June 30, 2016 were $59.5 million, a decrease of $11.2 million, or 16%, from the six months ended June 30, 2015. As a percentage of total revenue, sales and marketing expenses was flat at 64% for the six months ended June 30, 2016 and for the six months ended June 30, 2015. The decrease in sales and marketing expense was primarily due to decreases in payroll and benefits, professional services, media and marketing expenses, and amortization expense, which were partially offset by an increase in commission expense. Payroll and benefit expense decreased $4.0 million due primarily to salary savings from the reduced headcount. Professional services expenses decreased $3.4 million related to a $1.2 million contract termination fee associated with the 2015 Restructuring Plan and other reductions in the consumer market. Media expenses decreased $2.4 million, comprised of a reduction of $1.8 million in offline media and a decrease of $0.6 million in online media.

Marketing expenses decreased $1.3 million due to overall decreased spend in advertising and retail visual displays due to the change in focus in the general consumer market.

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Research and Development Expenses

Research and development expenses were $13.3 million for the six months ended June 30, 2016, a decrease of $2.6 million, or 16%, from the six months ended June 30, 2015. As a percentage of total revenue, research and development expenses remained flat at 14% for the six months ended June 30, 2016 and the six months ended June 30, 2015. The dollar decrease was primarily due to a reduction in payroll and benefits expense of $1.7 million driven by increased capitalized labor projects associated with the Language Learning Suite for Enterprise and other new products and the reduced headcount.

General and Administrative Expenses

General and administrative expenses decreased $6.8 million to $20.9 million for the six months ended June 30, 2016 compared to $27.7 million for the six months ended June 30, 2015. As a percentage of revenue, general and administrative expenses decreased to 22% for the six months ended June 30, 2016 from 25% for the six months ended June 30, 2015. The decrease in general and administrative expenses was due to reductions in payroll and benefits, communications, and bad debt. Payroll and benefits decreased $4.3 million driven by the reduction in headcount, heavier executive restructuring accruals in the prior year related to the 2015 Restructuring Plan, and reductions in stock compensation expense related to the change in CEO in the second quarter of 2015. Communications expense decreased $0.7 million due to cost savings identified related to hosting fees. Bad debt expense decreased by $0.7 million due to improvements in accounts receivable collections.

Impairment

Impairment expenses were $2.9 million for the six months ended June 30, 2016, a increase of $2.5 million, or 543%, from the six months ended June 30, 2015. The increase was due to the 2016 second quarter Fit Brains impairment of goodwill of $1.7 million and intangible assets of $1.2 million, which was partially offset by a prior year impairment charge related to the abandonment of a previously capitalized internal-use software project.

Interest and Other Income (Expense)

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Interest income	$23	$11	$12	109.1 %
Interest expense	(233)	(181)	(52)	28.7 %
Other income and (expense)	2,155	(2,084)	4,239	(203.4)%
Total other income and (expense)	$1,945	$(2,254)	$4,199	(186.3)%

Interest income for the six months ended June 30, 2016 was $23,000, an increase of $12,000, or 109%, from the six months ended June 30, 2015. Interest income represents interest earned on our cash and cash equivalents.

Interest expense for the six months ended June 30, 2016 was $0.2 million, an increase of $0.1 million from the six months ended June 30, 2015, attributable to interest on our capital leases and the recognition of our financing fees associated with our undrawn revolving credit facility.

Other income and expense for the six months ended June 30, 2016 was income of $2.2 million, a favorable change of $4.2 million, from an expense of $2.1 million for the six months ended June 30, 2015. The change is primarily attributable to foreign exchange fluctuations.

Income Tax Benefit and Expense

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Income tax (benefit) expense	$(543)	$581	$(1,124)	(193.5)%

Our income tax benefit for the six months ended June 30, 2016 was $0.5 million, compared to income tax expense of $0.6 million for the six months ended June 30, 2015. The change primarily resulted from the increased losses in Canada year-over-year including a $1.7 million goodwill impairment charge related to Fit Brains and the impact of the 2015 Restructuring Plan in certain foreign jurisdictions.

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Liquidity and Capital Resources

Our principal source of liquidity at June 30, 2016 consisted of $29.7 million in cash and cash equivalent and short-term investments, a decrease of $18.1 million compared to December 31, 2015. Our primary operating cash requirements include the payment of salaries, employee benefits and other personnel related costs, as well as direct advertising expenses, costs of office facilities, and costs of information technology systems. Historically, we have primarily funded these requirements through cash flows from our operating activities. For the six months ended June 30, 2016, we generated negative cash flows from operating activities as reflected in our consolidated statements of cash flows.

As part of our strategic shift, we have begun and continue to reorganize our business around our Enterprise & Education Language and Literacy segments while we optimize our Consumer segment for profitability and cash generation. Our operating segments are affected by different sales-to-cash patterns. Within our Enterprise & Education Language and Literacy segments, revenue in our education, government, and corporate sales channels are seasonally stronger in the second half of the calendar year due to purchasing and budgeting cycles. Our Consumer revenue is affected by seasonal trends associated with the holiday shopping season. Consumer sales typically turn to cash more quickly than Enterprise & Education Language and Literacy sales, which tend to have longer collection cycles. Historically, in the first half of the year we have been a net user of cash and in the second half of the year we have been a net generator of cash. We expect this trend to continue. In 2016, we expect our cash balance to decline, in part, as we execute the restructuring actions in accordance with our revised strategy and other initiatives, as well as anticipated near-term lower operating results.

We believe our current cash and cash equivalents, short-term investments and funds generated from our sales will be sufficient to meet our cash needs for at least the next twelve months. We have generated significant operating losses as reflected in our accumulated deficit and we may continue to incur operating losses in the future that may continue to require additional working capital to execute strategic initiatives to grow our business. Our future capital requirements will depend on many factors, including development of new products, market acceptance of our products, the levels of advertising and promotion required to launch additional products and improve our competitive position in the marketplace, the expansion of our sales, support and marketing organizations, the optimization of office space in the U.S. and worldwide, building the infrastructure necessary to support our growth, the response of competitors to our products and services, and our relationships with suppliers. We extend payments to certain vendors in order to minimize the amount of working capital deployed in the business. In order to maximize our cash position, we will continue to manage our existing inventory, 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.

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, June 29, 2015, December 29, 2015, and further amended effective March 14, 2016. Under the amended agreement, we may borrow up to $25.0 million, including a sub-facility, which reduces available borrowings, for letters of credit in the aggregate availability amount of $4.0 million (the "credit facility"). Borrowings by RSL under the credit facility are guaranteed by us as the ultimate parent. The credit facility has a term that expires on January 1, 2018, during which time RSL may borrow and re-pay loan amounts and re-borrow the loan amounts subject to customary borrowing conditions.

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

As of the date of this filing, no borrowings have been made under the revolving credit agreement and we were eligible to borrow $21.7 million of available credit less $4.0 million in letters of credit have been issued by Silicon Valley

Bank on our behalf, resulting in a net borrowing availability of $17.7 million. 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 2016 Restructuring Plan. We are required to maintain compliance with a minimum liquidity ratio and maintain a minimum Adjusted EBITDA. As of June 30, 2016, 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, 2016 was $5.3 million. As of June 30, 2016, we do not intend to repatriate the cash from our foreign subsidiaries, however, if we were to repatriate this foreign cash, no tax liability would result due to the current period and carryforward net operating losses.

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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.

Cash Flow Analysis

	Six Months Ended June 30,		2016 Versus 2015	
	2016	2015	Change	% Change
	(in thousands, except percentages)			
Net cash used in operating activities	$(12,425)	$(26,606)	$14,181	(53.3)%
Net cash used in investing activities	$(5,896)	$(7,121)	$1,225	(17.2)%
Net cash used in financing activities	$(401)	$(372)	$(29)	7.8 %

Net Cash Used in Operating Activities

Net cash used in operating activities for the six months ended June 30, 2016 was $12.4 million. The primary factors affecting our operating cash flows during the period were our net loss of $16.5 million, adjusted for non-cash charges totaling $10.0 million, and an unfavorable overall change in operating assets and liabilities of $5.9 million. Non-cash items primarily consisted of $6.6 million in depreciation and amortization expense, $2.9 million in impairment charges, and $1.8 million in stock-based compensation expense, which were partially offset by a $2.3 million gain on foreign currency transactions.

Net cash used in operating activities for the six months ended June 30, 2015 was $26.6 million. The primary factors affecting our operating cash flows during the period were our net loss of $28.1 million, adjusted for non-cash charges totaling $13.6 million, and an unfavorable overall change in operating assets and liabilities of $12.2 million. Non-cash items primarily consisted of $6.7 million in depreciation and amortization expense, $3.4 million in stock-based compensation expense, $1.7 million in foreign currency exchange losses, $1.0 million in bad debt expense, and $0.5 million in impairment loss. The change in the gain/loss on foreign currency translations is the result of volatile exchange rates compared to the prior year rates and volume of foreign currency transactions. The decrease in stock compensation expense was due to the higher stock compensation expense in the prior year associated with the 2015 Restructuring Plan. Bad debt expense also decreased due to improved collection efforts.

For the six months ended June 30, 2016, the primary drivers of the change in operating assets and liabilities were a decrease in accounts receivable of $12.1 million, which were more than offset by decreases of $10.4 million in deferred revenue and $5.9 million in other current liabilities of $5.9 million. The decrease in accounts receivable was primarily related to the timing of sales compared to when payments are made along with the increase in sales during the fourth quarter 2015 holiday season. The decrease in deferred revenue was primarily due to the seasonality of our offerings, specifically due to the higher renewals in the corporate sales channel in the fourth quarter. The decrease in other current liabilities is related to having fewer obligations due for marketing, advertising, and rebates as a result of our shift in strategy and ongoing cost reduction efforts.

For the six months ended June 30, 2015, the primary drivers of the change in operating assets and liabilities were a decrease in other current liabilities of $19.9 million, a decrease of $10.7 million in accounts payable, a decrease of $4.1 million in accrued compensation, a decrease of $3.9 million in deferred revenue, an increase of $1.5 million in prepaid and other current assets, an increase of $1.4 million in deferred sales commissions, an increase of $1.2 million in inventory, that were partially offset by a decrease in accounts receivable of $31.7 million. These changes primarily reflect the impacts from our initial shift in strategy and cost reduction efforts.

Net Cash Used in Investing Activities

Net cash used in investing activities was $5.9 million for the six months ended June 30, 2016, compared to $7.1 million for the six months ended June 30, 2015, a change of $1.2 million. Purchases of property and equipment, which primarily relates to capitalized labor on product and corporate IT projects increased $0.8 million related to the development of the Language Learning Suite for Enterprise and other new products. Cash used in acquisition activities decreased by $1.7 million, reflecting the remaining holdback payment associated with the 2013 Lexia acquisition which was paid in the first quarter of 2015.

Net Cash Used In Financing Activities

Net cash used in financing activities remained flat at $0.4 million for the six-month periods ended June 30, 2016 and June 30, 2015. Deferred financing fees slightly increased due to the costs associated with the March 2016 amendment to our

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revolving credit facility. Capital lease payments totaled $0.3 million during the six-month period ended June 30, 2016, compared to $0.4 million during the six-month period ended June 30, 2015.

Off-Balance Sheet Arrangements

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

Contractual Obligations

As discussed in Notes 9 and 15 of Part 1 - Item 1, Financial Statements, we lease buildings, parking spaces, equipment, and office space under operating lease agreements. We also lease 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, 2016 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	$3,294	$660	$1,016	$999	$ 619
Operating leases	13,050	4,557	6,311	1,984	198
Total	$16,344	$5,217	$7,327	$2,983	$ 817

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

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

Interest Rate Sensitivity

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

Credit Risk

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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2016. 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

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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, 2016, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) or 15d-15(d) of the Exchange Act that occurred during the quarter ended June 30, 2016 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 14, 2016 with the SEC for the period ended December 31, 2015. An investment in our common stock involves a substantial risk of loss. Investors should carefully consider these risk factors, together with all of the other information included herewith, before deciding to purchase shares of our common stock. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such case, the market price of our common stock could decline and all or part of an investment may be lost.
The risks described below are not the only ones facing us. Our business is also subject to the risks that affect many other companies, such as general economic conditions and geopolitical events. Further, additional risks not currently known to us or that we currently believe are immaterial could have a material adverse effect on our business, financial condition, cash flows and results of operations. In addition to the other information set forth in this quarterly report on Form 10-Q, you should carefully consider the risk factors discussed below and in other documents we file with the SEC that could materially affect our business, financial condition, cash flows or future results.
Our business could be impacted as a result of actions by activist shareholders or others.
We may be subject, from time to time, to legal and business challenges in the operation of our company due to proxy contests, shareholder proposals, media campaigns and other such actions instituted by activist shareholders or others. Responding to such actions could be costly and time-consuming, disrupt our operations, may not align with our business strategies and could divert the attention of our Board of Directors and senior management from the pursuit of current business strategies. Perceived uncertainties as to our future direction as a result of shareholder activism or potential changes to the composition of the Board of Directors may lead to the perception of a change in the direction of the business or other instability that may make it more difficult to attract and retain qualified personnel and business partners, and could have a materially adverse effect on the Company's stock price.
We might not be successful in executing our strategy of focusing on the Enterprise & Education segment and on more passionate language learners in the Consumer segment, 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 maximize profitable growth in our Enterprise & Education Language segment by serving the needs of corporate and K-12 language learners, and prioritizing those who wish to speak and read English. In addition, we are now focusing on the needs of more passionate language learners in our Consumer segment, rather than addressing the needs of the mass marketplace. If we do not successfully execute our strategy, our revenue and profitability could decline. Our recent strategy changes include actions to reduce headcount, exit unprofitable geographies, and other cost savings initiatives. 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 business, economic and competitive uncertainties and contingencies, 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.

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

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions in the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. We expressly disclaim any obligation to update or revise any guidance, whether as a result of new information, future events or otherwise. 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 quarterly report on Form 10-Q could result in the actual operating results being different from our guidance, and such differences may be adverse and material.

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

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

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

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

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

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

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- provide appealing solutions that engage our customers;
- adapt and offer our products and services using rapidly evolving, widely varying and complex technologies;

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- anticipate and meet consumer demand for additional languages, learning levels and new platforms for delivery;
- effectively position and market our products and services;
- identify and secure cost-effective means of marketing our products to reach the appropriate consumers;
- identify cost-effective sales distribution channels and other sales outlets where interested consumers will buy our products;
- anticipate and respond to consumer price sensitivity and pricing changes of competitive products; and
- identify and successfully implement ways of building brand loyalty and reputation.

We anticipate having to make investments in new products in the future and we may incur significant expenses without achieving the anticipated benefits of our investment or preserving our brand and reputation. Investments in new products and technology are speculative, the development cycle for products may exceed planned estimates and commercial success depends on many factors, including innovativeness, developer support, and effective distribution and marketing. Customers might not perceive our latest offerings as providing significant new value and may reduce their purchases of our offerings, unfavorably impacting revenue. We might not achieve significant revenue from new product and service investments for a number of years, if at all. We also might not be able to develop new solutions or enhancements in time to capture business opportunities or achieve sustainable acceptance in new or existing marketplaces. Furthermore, consumers may defer purchases of our solutions 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 key group that is comprised of a mix of websites, such as Amazon.com and the Apple App Store, select retail resellers such as Barnes & Noble, Best Buy, Target, Books-a-Million, Staples, and Sam's Club, and consignment distributors such as Wynit Distribution and Software Packaging Associates.

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 our competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a significant decline in our revenue and profitability. Furthermore, product display locations and promotional activities that retailers undertake can affect the sales of our products. The fact that we also sell our products directly could cause retailers or distributors to reduce their efforts to promote our products or stop selling our products altogether.

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

Price changes and other concessions could reduce our revenue.

We continue to test and offer changes to the pricing of our products. If we reduce our prices in an effort to increase our sales, this could have an adverse impact on our revenue to the extent that unit sales do not increase in a sufficient amount to compensate for the lower pricing. Reducing our pricing to individual consumers could also cause us to have to lower pricing to our 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 lower prices to effectively compete and what other short-term or long-term impacts could be.

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

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 e-commerce website, call centers, distribution channels and retail partners; and
- convert customer inquiries into actual orders.

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

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.

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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 and reducing the losses we have experienced internationally. We continuously review and optimize certain of our website sales channels in Europe, Asia and Latin America. In addition, we continue to 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 and reduce losses in our international operations successfully and in a timely manner, our business, revenue and financial results could be harmed. Such stabilization and reduction 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.

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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 is characterized by a lengthy and unpredictable sales cycle, which could delay new sales.

We face a lengthy sales cycle between our initial contact with some potential 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 pursue our SaaS model and move our Consumer business online and increasingly sell our solutions as subscriptions, rather than packaged software 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 more long-term subscriptions could result in substantially higher discounts, resulting in 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 any quarterly reporting period. 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 Consumer products and services in the fourth quarter during the holiday selling season as well as higher sales to governmental, educational institutions, and corporations in the second half of the calendar year. We sell to a significant number of our retailers, distributors and 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.

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Acquisitions, joint ventures and strategic alliances may have an adverse effect on our business.
We have made and may continue to make acquisitions or enter into joint ventures and strategic alliances as part of our long-term business strategy. Such transactions may result in use of our cash resources, dilutive issuances of our equity securities, or incurrence of debt. Such transactions also involve significant challenges and risks including that the transaction does not advance our business strategy, that we do not realize a satisfactory return on our investment, that we experience difficulty integrating new technology, employees, and business systems, that we divert management's attention from our other businesses or that we acquire undiscovered liabilities such as patent infringement claims or violations of the U.S. Foreign Corrupt Practices Act and similar worldwide anti-bribery laws. It may take longer than expected to realize the full benefits, such as increased revenue, enhanced efficiencies, or more customers, or those benefits may ultimately be smaller than anticipated, or may not be realized. These events and circumstances could harm our operating results or financial condition.
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. We may be unable to anticipate these techniques or to implement adequate preventative measures in time. Cyber threats and attacks can have cascading impacts that unfold with increasing speed across internal networks and systems. Breaches of our network, credit card processing information, or data security could disrupt the security of our internal systems and business applications, impair our ability to provide services to our customers and protect the privacy of their data, 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. If we are unable to protect our information technology network against service interruption or failure, misappropriation or unauthorized disclosure or manipulation of data, whether through breach of our network security or otherwise, we could be subject to costly government enforcement actions and litigation and our reputation may be damaged.
Our business involves the collection, storage and transmission of personal, financial or other information that is entrusted to us by our customers and employees. Our information systems also contain the Company's proprietary and other confidential information related to our business. Our efforts to protect such information may be unsuccessful due to the actions of third parties, computer viruses, physical or electronic break-ins, catastrophic events, employee error or malfeasance or other attempts to harm our systems. Possession and use of personal information in conducting our business subjects us to legislative and regulatory obligations that could require notification of data breaches, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. Some of our commercial partners may receive or store information provided by us or our users through our websites. If these third parties fail to adopt or adhere to adequate information security practices, or fail to comply with our online policies, or in the event of a breach of their networks, our customers' data may be improperly accessed, used or disclosed. As our business and the regulatory environment evolve in the U.S. and internationally, we may become subject to additional and even more stringent legal obligations concerning our treatment of customer information. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.
If our systems are harmed or fail to function properly or if third parties improperly obtain and use the personal information of our customers or employees, we may be required to expend significant resources to repair or replace systems or to otherwise protect against security breaches or to address problems caused by the breaches. A major breach of our network security and systems could have serious negative consequences for our businesses, including possible fines, penalties and damages, reduced customer demand for our products and services, harm to our reputation

and brand, and loss of our ability to accept and process customer credit card orders. Any such events could have a material and adverse effect on our business, reputation or financial results. Our insurance policies carry coverage limits, which may not be adequate to reimburse us for losses caused by security breaches.

Changes in regulations or customer concerns regarding privacy and protection of customer data, or any failure to comply with such laws, could adversely affect our business.

Federal, state, and international laws and regulations govern the collection, use, retention, disclosure, sharing and security of data that we receive from and about our customers. The use of consumer data by online service providers and advertising

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networks is a topic of active interest among federal, state, and international regulatory bodies, and the regulatory environment is unsettled. Many states have passed laws requiring notification to customers where there is a security breach for personal data, such as California's Information Practices Act. We face similar risks in international markets where our products, services and apps are offered. Any failure, or perceived failure, by us to comply with or make effective modifications to our policies, or to comply with any federal, state, or international privacy, data-retention or data-protection-related laws, regulations, orders or industry self-regulatory principles could result in proceedings or actions against us by governmental entities or others, a loss of customer confidence, damage to the Rosetta Stone brands, and a loss of customers, which could potentially have an adverse effect on our business.

In addition, various federal, state and foreign legislative or regulatory bodies may enact new or additional laws and regulations concerning privacy, data-retention and data-protection issues, including laws or regulations mandating disclosure to domestic or international law enforcement bodies, which could adversely impact our business, our brand or our reputation with customers. For example, some countries are considering laws mandating that customer data regarding customers in their country be maintained in their country. Having to maintain local data centers in individual countries could increase our operating costs significantly. The interpretation and application of privacy, data protection and data retention laws and regulations are often uncertain and in flux in the U.S. and internationally. These laws may be interpreted and applied inconsistently from country to country and inconsistently with our current policies and practices, complicating long-range business planning decisions. If privacy, data protection or data retention laws are interpreted and applied in a manner that is inconsistent with our current policies and practices we may be fined or ordered to change our business practices in a manner that adversely impacts our operating results. Complying with these varying international requirements could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business and operating results.

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.

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

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

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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. We depend upon our credit card processors to carry out our sales transactions and remit the proceeds to us. At any time, credit card processors have the right to withhold funds otherwise payable to us to establish or increase a reserve based on their assessment of the inherent risks of credit card processing and their assessment of the risks of processing our customers' credit cards. If our credit card processors exercise their right to establish or increase a reserve, it may adversely impact our liquidity. Our business and results of operations could be adversely affected if these changes were to occur.

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

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

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

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

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

- delays in or loss of marketplace acceptance of our products and services;
- diversion of our resources;
- a lower rate of license renewals or upgrades for Consumer, Literacy 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.

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

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

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

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

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

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

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

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

To the extent the economic difficulties continue, or worldwide economic conditions materially deteriorate, our revenue, profitability and cash flows could be significantly reduced as customers would be unable to purchase products and services in the expected quantities and/or pay for them within normal agreed terms. A liquidity shortfall may delay certain development initiatives or may expose us to a need to negotiate further funding. While we anticipate that our existing cash and cash equivalents, together with availability under our existing revolving credit facility, cash balances and cash from operations, will be sufficient to fund our operations for at least the next 12 months, we may need to raise additional capital to fund operations in the future or to finance acquisitions. If we seek to raise additional capital in order to meet various objectives, including developing future technologies and services, increasing working capital, acquiring businesses and responding to competitive pressures, capital may not be available on favorable terms or may not be available at all. Lack of sufficient capital resources could significantly limit our ability to take advantage of business and strategic opportunities. Any additional capital raised through the sale of equity securities would dilute our stock ownership. If adequate additional funds are not available, we may be required to delay, reduce the scope of, or eliminate material parts of our business strategy, including potential additional acquisitions or development of new products, services and technologies.

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

We might need to further reduce costs or raise additional funds through public or private financings or borrowings in order to maintain our operations at their current level, develop or enhance products, fund expansion, respond to competitive pressures or to acquire complementary products, businesses or technologies. If required, additional financing might not be available on terms that are favorable to us, if at all. If we raise additional funds through the issuance of debt, equity or convertible debt securities, these securities might have rights, preferences and privileges senior to those of our current stockholders.

If our goodwill or indefinite-lived intangible assets become impaired, we may be required to record a significant 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 and accurate, the final determination of tax audits and any related litigation could be materially different from our historical tax provisions and accruals. The results of an audit or litigation could have a material adverse effect on our financial statements in the period or periods for which that determination is made. 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.

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

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

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

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

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

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

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

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

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

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

We own several U.S. trademark registrations, including registrations of the Rosetta Stone, Tell Me More, Livemocha, Lexia and FitBrains 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

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

We must monitor and protect our Internet domain names to preserve their value. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe on or otherwise decrease the value of our trademarks.

We own several domain names related to our business. Third parties may acquire substantially similar domain names or Top Level Domains ("TLDs") that decrease the value of our domain names and trademarks and other proprietary rights which may 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 U.S. and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars, modify the requirements for holding domain names or release additional TLDs. As a result, we may have to incur additional costs to maintain control over potentially relevant domain names or may not maintain exclusive rights to all potentially relevant domain names in the U.S. or in other countries in which we conduct business, which could harm our business or reputation. Moreover, attempts may be made to register our trademarks as new TLDs or as domain names within new TLDs and we will have to make efforts to enforce our rights against such registration attempts.

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

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

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

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

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

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

Some of our products and services contain intellectual property owned by third parties, including software that is integrated with internally developed software and voice recognition software, which we license from third parties. From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be

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

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

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

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. 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 introductions may not succeed and may harm our business, financial results and reputation.

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

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

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

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

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their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibits	
3.1	Second Amended and Restated Certificate of Incorporation of the Company (incorporated herein by reference to Exhibit 3.2 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
3.2	Second Amended and Restated Bylaws of the Company (incorporated herein by reference to Exhibit 3.4 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
4.1	Specimen certificate evidencing shares of Common Stock of the Company (incorporated herein by reference to Exhibit 4.1 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on February 23, 2009).
4.2	Registration Rights Agreement dated January 4, 2006 among the Company and the Investor Shareholders and other Shareholders listed on Exhibit A thereto (incorporated herein by reference to Exhibit 4.3 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (No. 333-153632) filed on November 5, 2008).
10.1*	Executive Employment Agreement between Rosetta Stone Ltd. and A. John Hass III effective as of April 1, 2016.
10.2*	Amended Executive Form of Restricted Stock Award Agreement under 2009 Plan effective for awards granted May 9, 2016.
10.3*	Amended Executive Form of Option Award Agreement under 2009 Plan effective for awards granted May 9, 2016.
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, 2016.
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, 2016.
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, 2016.
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

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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 3, 2016