ROSETTA STONE INC
Form 10-K
March 10, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2009

Commission file number: 1-34283

Rosetta Stone Inc.

(Exact name of registrant as specified in its charter)

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

Registrant's telephone number, including area code:
800-788-0822

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $0.00005 per share	New York Stock Exchange

Securities Registered Pursuant to Section 12(g) of the Act:
None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes o No ý

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 Web site, 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 o No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

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. (Check one):

Large Accelerated filer o	Accelerated filer o	Non-accelerated filer ý (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 Act). Yes o No ý

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately $300 million as of June 30, 2009 (based on the last sale price of such stock as quoted on the New York Stock Exchange).

As of March 2, 2010, there were 20,251,027 shares of common stock outstanding.

Documents incorporated by reference: Portions of the definitive Proxy Statement to be delivered to stockholders in connection with the 2010 Annual Meeting of Stockholders to be held on May 26, 2010 are incorporated by reference into Part III.

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PART I

Item 1. *Business*

Overview

We are a leading provider of technology-based language learning solutions. We develop, market and sell language learning solutions consisting of software, online services and audio practice tools primarily under our *Rosetta Stone* brand. Our teaching method, which we call *Dynamic Immersion*, is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our courses are based on our proprietary interactive technologies and pedagogical content, and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. We believe our award-winning solutions provide an effective, convenient and fun way to learn languages. We currently offer our self-study language learning solutions in 31 languages. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

People throughout the world seek to learn foreign languages for a variety of reasons, including to learn about other cultures, to communicate with friends and family, to enhance their career prospects, to travel internationally and to obtain personal enjoyment and enrichment. According to a December 2007 industry analysis we commissioned from The Nielsen Company, a market research firm, which we refer to as the Nielsen survey, the language learning industry worldwide represented over $83 billion in consumer spending in 2007, of which more than $32 billion was for self-study. According to the Nielsen survey, the language learning industry in the United States, where we generated 92% of our revenue in 2009, represented over $5 billion in consumer spending in 2007, of which over $2 billion was for self-study.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages. This has enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 82% of our revenue in 2009 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Apple, Barnes & Noble, Office Depot and Borders. According to an August 2008 survey we commissioned from Global Market Insite Inc., or GMI, a market research services firm, which we refer to as the GMI survey, *Rosetta Stone* is the most recognized language learning brand in the United States. Additionally, of those surveyed who had an opinion of our brand, over 80% associated it with high quality and effective products and services for teaching foreign languages. January and February 2009 internal studies showed aided brand awareness for Rosetta Stone in the US was approximately 74-79%, based on general population surveys and confirmed that *Rosetta Stone* is the most recognized language learning brand in the United States.

We grew our revenue from $25.4 million in 2004 to $252.3 million in 2009, representing a 58% compound annual growth rate.

Our Industry

Market Size. According to the Nielsen survey, the worldwide language learning industry represented more than $83 billion in consumer spending in 2007, of which more than $32 billion was for self-study. The Nielsen survey also estimated that the language learning industry in the United States, where we generated 92% of our revenue in 2009, represented more than $5 billion in consumer spending in 2007, of which more than $2 billion was for self-study. In a more recent study in 2009 we

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estimated the language learning industry represented more than $4.5 billion in consumer spending, of which $2.4 billion was for self-study.

The language learning market is highly fragmented and consists of the following primary models: classroom instruction utilizing the traditional approach of memorization, grammar and translation; immersion-based classroom instruction; self-study books, audio tapes and software that rely on grammar and translation; and free online offerings that provide basic content and opportunities to practice writing and speaking.

Key Drivers of Demand in Language Learning Market. We believe that language learning is becoming more important and valued by individuals and institutions in the United States and throughout the world. The demand for language learning is driven in part by:

- individuals seeking the enjoyment and enrichment brought by learning a language;
- professionals conducting business in a global economy;
- schools seeking to educate their students in local and foreign languages;
- companies training their employees;
- leisure travelers seeking language proficiency for independent international travel;
- armed forces training soldiers to communicate in foreign languages;
- immigrants and expatriates seeking to successfully function in their new environments;
- individuals connecting with their ethnic and family roots; and
- parents supplementing their children's education.

Limitations of Traditional Methods for Language Learning. The human brain has a natural capacity to learn languages. Children learn their native language without using rote memorization or adult analytical abilities for grammatical understanding. They learn at their own pace through their immersion in the language spoken around them and using trial and error. They do not rely on translation. By contrast, foreign languages have traditionally been taught by focusing on memorization, grammar translation and word translation, typically in an academic classroom setting. This traditional method involves learning complex grammar rules, conjugating verbs and memorizing vocabulary lists. Students have little practice speaking or listening in the classroom, and practice outside the classroom typically involves rote listening to audio recordings and pronunciation exercises, with little or no feedback on pronunciation accuracy. Many students who were taught languages using the traditional method regard it as ineffective and boring.

Emergence of Immersion Language Learning. To address some of the shortcomings of traditional language learning methods, language learning specialists have developed an alternative method for teaching language known as immersion learning, in which only the target language is spoken. We believe that immersion learning is more effective than the traditional translation and grammar method in helping learners move towards conversational fluency. Immersion learning provides a more natural, direct learning environment, where the learner deduces meaning and develops an intuition of language structure. This is similar to the manner in which children learn their native language, without an awareness of formal grammar rules or the necessity to translate. Most immersion learning programs, however, require either one-on-one teaching, a small group course or travel to a foreign country. These programs can cost several thousand dollars and are less convenient than self-study alternatives.

Use of Interactive Technologies. There has been a rapid adoption of interactive technologies and software tools to help learning in both consumer and institutional markets, supported by the rapid increase in computing technologies and internet use. According to a 2008 report by

Euromonitor

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International, Inc., a market research firm, there will be more than one billion personal computers in use, and 1.7 billion internet users, by 2009. Given busy lifestyles, adult language learners seek solutions that work flexibly and do not require physical classroom attendance. Educators are interested in deploying learning tools that are relevant to their students, who have had extensive exposure to computer software and interactive games. Corporations are recognizing the value and effectiveness of using their technology investment to help increase the skills of their workforce. According to a July 2007 report by Global Industry Analysts, Inc., a market research firm, the global demand for the delivery of instructional content through the use of electronic technology, or eLearning, will grow an average of 21% annually between 2007 and 2010, reaching a total estimated value of $53 billion by 2010.

The Need for a High-Quality, Trusted Solution. Consumers and institutions face a confusing array of alternatives when choosing a language course due to the fragmented nature of the language learning market. Most providers of language learning offer little information to potential customers about their teaching methods and do not have well known brands. The few major internationally known language learning providers generally offer only classroom instruction, which is not convenient for all prospective language learners. In addition, there are numerous self-study courses in the market available at a variety of price points, most of which are offered as audio and books and do not provide an interactive, immersion learning experience. There are also many community websites that provide free opportunities to practice.

We believe that language learners seek a trusted name-brand solution that is more convenient and affordable than classroom alternatives, and more effective, interactive and engaging than other self-study options. We believe the combination of these elements is not offered by traditional providers of language instruction.

The Rosetta Stone Solution

Our mission is to change the way people learn languages. We believe our solutions provide an effective way to learn languages in a convenient and engaging manner. Our approach, called *Dynamic Immersion*, eliminates translation and grammar explanation and is designed to leverage the innate, natural language learning ability that children use to learn their native language. We consider traditional translation and grammar methods as obstacles that delay and impede the successful acquisition of language proficiency, and our solutions avoid those elements. Our computer-based self-study courses allow our customers to learn using the immersion method on their own schedule and for a price that is significantly lower than most classroom-based or one-on-one alternatives. Although other audio and software publishers claim to teach with immersion methods, we believe that we are the only self-study solution that teaches strictly without any translation or explicit grammar explanations. Our proprietary solutions have been developed over the past 16 years by professionals with extensive linguistic, educational and instructional technology expertise. We estimate that our content library consists of more than 25,000 individual photographic images and more than 400,000 professionally recorded sound files. We design the sequencing of our content to optimize learning. The result is a rigorous and complete language learning curriculum that is also designed to be flexible, fun and convenient.

Our language learning solutions are built upon a flexible software platform that supports multiple languages and is deployable on personal computers, on local networks and online. The platform incorporates a number of proprietary technologies that are key to enabling language learning, including:

- speech recognition that is focused on the unique challenges of language learners;
- *Adaptive Recall* algorithms that repeat content at scheduled intervals to promote long-term retention;

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- reporting features and curriculum options designed to enhance the effectiveness and administration of classroom, enterprise and home school learning; and
- an intuitive user interface that assists the learner's transition from listening comprehension to speaking.

Rosetta Stone offers a broad product suite, with courses currently available in 31 languages. Our courses are available in up to five levels of proficiency per language, with each level providing approximately 40 hours of instruction and containing multiple units, lessons and activities.

In July 2009, we introduced *Rosetta Stone TOTALe,* an online language learning solution that integrates our online courses with coach-led practice sessions, fun and engaging language games, interaction with native speakers and live support from customer service agents.

We also provide an online peer-to-peer practice environment called *SharedTalk*, at *www.sharedtalk.com*, where registered language learners meet for language exchange to practice their foreign language skills. During 2009, we had more than 125,000 active *SharedTalk* users.

Our innovative solutions have received numerous awards and recognitions, including our placing #14 on the 2009 Inc. 5000 list for the education industry, the 2009 National Parenting Publications Awards (NAPPA) Honors Award for Rosetta Stone Version 3 Personal Edition, four classroom specific awards in 2009 for Classroom Version 3, two enterprise specific awards in 2009, the 2008 CODiE awards for best corporate learning solution and best instructional solution in other curriculum areas sponsored by the Software & Information Industry Association, the 2008 education product of the year awarded by MacWorld, the 2008 BESSIE multilevel foreign language award for Spanish Levels 1, 2, and 3 awarded by *ComputED Gazette* in 2008, the 2008 EDDIE Award for our classroom edition as the best foreign language website awarded by *ComputED Gazette*, the 2007 EDDIE multilevel foreign language award for Chinese levels 1 and 2 and a 2007 multilevel English-as-a-second-language, or ESL, award for English levels 1, 2, and 3 awarded by *ComputED Gazette*.

Competitive Strengths

We consider the foundations of our success to be the quality and breadth of our solutions, the strength of our brand and our direct distribution model. Together, we believe these elements represent a business model with attractive economics that differentiates us from other language learning providers. The quality of our solutions supports our price point, which in turn allows us to deploy a multi-channel marketing effort and a broad-based direct distribution network. We focus on educating consumers about the benefits of our solutions by leveraging our advertising and our kiosk network to drive customers to our call centers and websites, where they can learn about our solutions, try product demonstrations and then transact directly with us.

We believe our competitive strengths include:

Advanced Technology-Enabled Language Learning System. Our proprietary solutions combine effective immersion learning with the benefits of flexibility and interactivity to provide for an efficient and engaging language learning experience. We intend to remain at the forefront of technological and pedagogical advances in language learning.

Scalable and Adaptable Platform and Content. Our solutions are designed to be efficiently delivered across multiple languages, systems and geographic markets. For example, we deploy many of the same images and image combinations across multiple languages, which accelerates our ability to add new languages. Because our solutions do not rely upon translation from the target language into the learner's native language, they require only modest localization to be used by learners from other native language backgrounds. This facilitates our ability to sell our existing language courses in new international markets. In addition, our software platform is engineered to work in the same way both

online and locally installed, allowing for multiple delivery methods. We also use the same platform for all editions of our solutions: personal, enterprise, classroom and home school.

Effective Multi-Channel Marketing and Distribution Model. We believe that our multi-channel marketing and distribution strategy is a competitive strength because it enables us to market and serve our diverse customer base more broadly and make marketing impressions with a high frequency and at a relatively low cost per impression. As compared to competitors that rely primarily on retailers or online vendors to sell their products, our direct marketing and distribution strategy enables us to exert more control over our own growth and the customer experience. Our marketing, sales and distribution efforts are highly integrated and focused on direct interaction with consumers. As a result, we are able to present a tightly controlled and unified message to the marketplace. Our television, online, print and radio advertising includes a "call to action" that drives customers directly to our websites and call centers, where we seek to convert them to sales. Our marketing tools and techniques allow us to attribute sales results to specific marketing initiatives. We utilize this data to continuously improve the efficiency of our websites, call centers, advertising and media planning and buying. We also operated 242 kiosks as of December 31, 2009, which extend our direct interaction with customers and allow them to experience our solutions with the guidance of one of our product specialists. Our kiosks are located in airports, malls and other strategic, high-traffic locations. In our institutional markets, sales efforts are led by our direct sales force. We conduct our institutional marketing primarily through tradeshows and customer visits. Our marketing campaigns also support this channel. We augment our direct distribution network with select retailers, including Amazon.com, Apple, Barnes & Noble and Borders. We also offer our products in a limited number of ZoomShop unmanned automated kiosks. During the year ended December 31, 2009, approximately 82% of our revenue came from our direct channels, including our websites, call centers, kiosks and institutional sales force, and the remainder was attributable to sales through retailers.

Leading and Trusted Brand, with a Differentiated, High-Quality Positioning. According to the GMI survey, *Rosetta Stone* is the most recognized brand of language learning solutions in the United States. Additionally, of those surveyed who had an opinion of our brand, over 80% associated the brand with high-quality and effective products and services for teaching foreign languages. We believe we have positioned *Rosetta Stone* as a premium brand and a trusted choice for learning languages. Our marketing message centers on key points of differentiation from our competitors' traditional language offerings by focusing on our learners' own intrinsic competence. We believe that continued marketing and brand building will drive broader demand for our products and help us pursue our goal of making *Rosetta Stone* the preeminent language learning brand.

Enthusiastic and Loyal Customer Base. Our customers exhibit loyalty and enthusiasm for our products and many promote sales of our products through word-of-mouth referrals. Our latest survey of our individual customers in the United States, completed in August 2009, revealed that 90% of respondents expressed satisfaction with our solutions, with a satisfaction rating of 6 or higher on a 10-point scale, and 88% would recommend our solutions to friends or colleagues. Our latest survey of our institutional customers in the United States, completed in February 2010, revealed that 85% of respondents expressed satisfaction with our solutions, with a satisfaction rating of 6 or higher on a 10-point scale, and 83% said that they would recommend our solution to other organizations.

Effective Products. We believe our solutions are effective. According to a January 2009 study we commissioned from Roumen Vesselinov, Ph.D, visiting assistant professor, Queens College, City University of New York, after 55 hours of study using our Spanish program the average WebCAPE score will be at a level sufficient to fulfill the requirements for one semester of study in a college that offers six semesters of Spanish. Statistically, the study concluded that such an outcome would occur with 95% confidence. WebCAPE, which stands for Web-based Computer Adaptive Placement Exam, is a standardized test which, according to their website, is used by over 500 colleges and universities for

placement. In addition, approximately 64% of the students participating in the study increased their oral proficiency by at least one level on a seven-level scale based on the American Council on the Teaching of Foreign Languages (ACTFL) OPIc test, which is used worldwide by academic institutions, government agencies, and private corporations for evaluating oral language proficiency.

In May 2009, we commissioned Rockman et al, an independent evaluation research and consulting firm, to conduct a quantitative study to measure the effectiveness of the Rosetta Stone solution including new *Rosetta Stone TOTALe*, and product features such as *Rosetta Studio*, our live online language learning practice sessions with dedicated conversation coaches. According to the study, after 64 hours of study with Rosetta Stone Spanish (Latin American) and six hours of *Rosetta Studio* sessions, 78% of the students participating in the study increased their oral proficiency by at least one level on the seven-level scaled developed by ACTFL. Based on the overall results from the research study, the researchers from Rockman et al concluded that the Rosetta Stone solution is both an effective and efficient means of learning foreign languages.

Our Strategy

Our goal is to strengthen our position as a leading provider of language learning solutions through the following strategies:

Extend Our Technological and Product Leadership. We intend to apply new technologies to maintain our product leadership. We currently are working on a variety of product development initiatives. For example, in July 2009, we introduced *Rosetta Stone TOTALe,* a new web-based service that extends our existing language courses by offering opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization, offering online learning games and interaction with native speakers and offering live support from customer service agents. We provide *Rosetta Stone TOTALe* primarily as a bundle with our software and audio offerings. At the same time, we expect to provide augmented free peer-to-peer language practice, building on our existing success with *www.sharedtalk.com*. In addition, we are evaluating opportunities to extend our learning solutions to hand-held devices, and we intend to continue to advance our proprietary software platform and our speech recognition technology.

Expand Our Core Product Portfolio. We plan to expand our product portfolio by adding more advanced course levels for our existing languages. We give learners the option to purchase our solutions at a single level of difficulty, or as a bundle of all available levels. Currently, six of our languages are offered in all five levels of proficiency and another 19 of our languages are offered in the first three levels of proficiency. Our other six languages are available in only one level of proficiency. We also plan to add new languages and new skill development and remediation courses for advanced language learners. We believe that there is an opportunity to increase our revenue as we introduce additional levels of proficiency to our existing languages. In addition, we believe that there may be opportunities for us to introduce additional language learning solutions containing industry-specific content.

Increase U.S. Market Share. To increase our penetration of the U.S. market and expand our brand awareness, we intend to increase our marketing campaigns through the purchase of additional television, print, radio and online advertising, and to explore new media channels. We believe that our multi-channel marketing model helps to build greater brand awareness, which over time will further increase our marketing efficiency. We also intend to continue to add select retail relationships and kiosks. For example, a selection of our solutions has become available in Office Depot, Books-A-Million and London Drugs retail outlets. For our institutional business, we expect to expand our direct sales force along with our institutional marketing activities. During the third quarter of 2010 we plan to introduce a new version of our core offering called Rosetta Stone Version 4 TOTALe, which integrates our current Version 3 language learning software solution with our *Rosetta Stone TOTALe*

web-based service offering that includes socialization features and dedicated language conversation coaches.

Increase Our Focus on Sizeable Non-U.S. Markets. We generated approximately 8% of our revenue in 2009 from sales outside the United States. According to the Nielsen survey, over 90% of the $83 billion spent in 2007 on consumer language learning products and services was spent outside the United States. We therefore believe that there is a significant opportunity for us to expand our business internationally utilizing many of the successful marketing and distribution strategies we have used in the United States. We have established subsidiaries in the United Kingdom, Japan and Germany as well as a branch office in South Korea to develop our international business. In addition, we are exploring opportunities to expand our presence in Asia, Europe and South America. Because our solutions do not rely upon translation from the target language into the learner's native language, they require only modest localization to be used by learners from other native language backgrounds, and thus we believe that we can efficiently scale our business internationally.

Products and Services

We offer language learning solutions in 31 languages under the *Rosetta Stone* brand. Each language currently has up to five levels, with each consecutive level representing a higher level of proficiency. We sell each level as a standalone unit, although we offer a price incentive to customers to purchase all available levels of a language as a bundle, where that option is available. In August 2007, we released our Version 3 solution for ten of our best selling languages. We released an additional four languages in Version 3 in March 2008 and we released an additional seven languages in Version 3 in September 2008. In May 2009, we released Levels 4 and 5 in English (US) and Spanish (Latin America) as well as an additional four languages in Version 3. In July 2009, we released *Rosetta Stone TOTALe*, our new web-based service offering that includes a component of dedicated language conversation coaching. In November 2009, we released Levels 4 and 5 in 4 additional languages in Version 3. As of December 31, 2009, all Version 3 languages are sold with Audio Companion and all Version 3 languages, except for Latin, are available with *Rosetta Stone TOTALe* web-based services.

We have four different editions: personal, enterprise, classroom and home school. Each edition utilizes the same core software product, but includes different ancillary features as follows:

Personal Edition This edition is targeted to individual consumers and contains the core software product we use for all editions.

Enterprise Edition This edition is targeted to businesses, armed forces, government organizations and not-for-profit entities and can accommodate organizations of any size, from individual learners to entire global organizations. This edition includes management tools that provide easy-to-use administrative and reporting functionality. These tools deliver easy-to-read reports and graphs that track learner activity, progress and scores, thereby providing organizations with key information they need to measure return on their language learning investment.

Classroom Edition This edition is targeted to language programs in primary, secondary and higher education settings and is scalable to accommodate a variety of implementations, from individual schools to district-wide programs and universities. The classroom edition is designed to be incorporated into a teacher's overall language-learning curriculum, complementing in-class teaching and enabling individualized self-paced learning outside the classroom. The classroom edition includes a learner management tool, the *Rosetta Stone Manager*, which provides easy-to-use administrative and reporting functionality. This tool enables teachers to plan lessons and generate reports and graphs that track student and classroom activity, progress and scores.

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Home School Edition This edition is targeted to families with home school students and is designed to provide parents the tools and resources they need to manage student progress without extensive planning or supervision. The home school edition includes administrative tools that permit parents to follow student progress and access specific information about student performance, such as completed exercises, test scores, and time spent learning, and to generate printable progress reports. In addition, parents have the ability to enroll their students in predefined curriculum paths designed to assist in lesson planning and in achieving learning objectives.

With our personal edition, we offer a compact disc audio practice tool, the *Audio Companion*, in all 25 Version 3 languages. *Audio Companion* is a series of digital audio files that contain lessons directly aligned to the Rosetta Stone curriculum, allowing users to practice and carry on their immersive experience when they are away from a computer. The lessons on the *Audio Companion* can be transferred to MP3 players. The *Audio Companion* provides a convenient opportunity for practicing material that was previously learned through the software program. Unlike other common audio products, Rosetta Stone does not rely solely on an audio environment to teach, so we can create an immersive audio environment, using only the target language, which reinforces material learned from our software program.

Our solutions are available both pre-packaged and by subscription online through our language learning portal. For the year ended December 31, 2009, approximately 87% of our revenue was from CD-ROM sales to both consumers and institutions, while approximately 13% was from online subscriptions.

We currently offer the following languages:

	Level 1	Level 2	Level 3	Level 4	Level 5	Audio Companion	TOTALe	Version 2	Version 3
Arabic									
Chinese (Mandarin)									
Danish									
Dutch									
English (U.K.)									
English (U.S.)									
Farsi (Persian)									
French									
German									
Greek									
Hebrew									
Hindi									
Indonesian									
Irish									
Italian									
Japanese									
Korean									
Latin									
Pashto									
Polish									
Portuguese (Brazil)									
Russian									
Spanish (Latin America)									
Spanish (Spain)									
Swahili									
Swedish									
Tagalog									
Thai									
Turkish									
Vietnamese									
Welsh									

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We also provide an online peer-to-peer practice environment called *SharedTalk*, at *www.sharedtalk.com*, where registered language learners meet for language exchange and to practice their foreign language skills. During 2009, we had more than 125,000 active *SharedTalk* users.

In July 2009, we introduced *Rosetta Stone TOTALe*, an online language learning solution that integrates our online courses with coach-led practice sessions, fun and engaging language games, interaction with native speakers and live support from customer service agents.

In addition, we have developed Rosetta Stone products for the exclusive use of Native American communities to help to save their endangered languages, including Mohawk, Chitimacha, Innutitut and Iñupiaq.

Technology

We develop most of our own technology, including our proprietary unified language learning software platform. Our newest application, Version 3, currently supports up to five levels of proficiency and is available in 25 languages. Version 2, our legacy application, is available for our other 6 languages. We intend to offer additional languages on Version 3. The technology underlying both Version 2 and Version 3 is designed to handle the complexities of a wide variety of languages, including languages written from right-to-left such as Arabic and Hebrew and languages with characters such as Chinese and Japanese.

Our Version 3 platform is flexible and capable of meeting a wide range of market requirements, including:

- enabling reporting features and additional curriculum options for our home school edition;
- providing our solutions in a local networked environment to enable a class management tool in the classroom edition;
- offering our solutions online through a commercial learning management system for our enterprise customers; and
- providing localized interfaces and help files in the user's native language, which are currently available in eight languages.

In each of these cases, the learner receives the same engaging language learning experience and content.

We have developed a speech recognition technology focused on the unique challenges of language learners, stressing non-native speech understanding and pronunciation feedback. This technology, which is included in Version 3, is available for 25 of our languages and runs on all widely available operating systems and on local and online applications. Our speech recognition models include languages traditionally not supported by general-purpose speech recognition software, such as Irish.

We have developed proprietary algorithms we call *Adaptive Recall,* which are designed to enhance the learner's experience by reintroducing content at longer and longer intervals in order to improve long-term retention. *Adaptive Recall,* available in Version 3, is designed to be efficient with a learner's time, bringing material back in the program less and less frequently as the learner remembers over extended periods of time.

We have developed a proprietary student management system, which is designed to allow teachers and administrators to configure their own lesson plans using our content and exercises and to review reports for evaluation of student progress.

We have developed an intuitive user interface that assists in the learner's transition from listening comprehension to speaking, making language skill development an integrated experience.

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We have also created proprietary content development tools that allow our curriculum specialists to write, edit, manage and publish our course materials. These tools allow authors, translators, voicers, photographers and editors to work efficiently and cooperatively across multiple locations.

Content and Curriculum

The foundation of *Dynamic Immersion* is our proprietary content, consisting of a total of more than 25,000 individual photographic images and more than 400,000 professionally recorded sound files. Each Version 3 language contains approximately 10,000 individual photographic images and 15,000 professionally recorded sound files. We believe these photographic images and recorded sound files are a competitive strength, as we have created many of the pictures and all of the sound files ourselves. We believe that our images and their juxtaposition convey a universal meaning, which makes it possible for us to broadly deploy the same images across multiple languages. In addition, we have developed a sophisticated method for sequencing the images, which is designed to build a rich curriculum that incrementally teaches the user the most important and relevant language skills necessary to achieve fluency. We believe that our sequence of images is as effective for someone learning Arabic or Mandarin Chinese as it is for someone learning Spanish or English. To supplement our core content, we incorporate specific nuances for each language, such as dual forms for parts of speech in Arabic. Our ability to tailor our content also enables us to develop customized versions of our language learning solutions to address the specific needs of various industries. For example, we created a customized version of our Arabic learning solution for the U.S. Army, which includes military-specific content, such as vocabulary, images and curriculum sequencing. In the future, we may develop customized versions for other industries, such as healthcare, business, real estate and retail.

In addition to visual learning experiences, our Version 3 solutions incorporate an integrated speech program utilizing our voice recognition application, which works in languages that are traditionally not supported by general-purpose speech recognition software. As an integral component of the program, this voice recognition feature works with our learners to promote the appropriate pronunciation of the words and concepts included in the lesson.

Throughout the curriculum sequence, our program combines the introduction of new concepts, practice of recent material and production of key phrases. As learners progress along our curriculum, they transition from seeing and recognizing to speaking as our program prompts them to pronounce the words they are being taught. Our solution covers all aspects necessary for fluency within a completely immersive environment without requiring translation or explanation, including alphabet, vocabulary, intuitive grammar, reading, writing, listening, pronunciation and conversation. While rigorous and complete, the curriculum is designed to remain flexible, allowing learners to alter their individual pace and focus of instruction to meet their particular goals and abilities. The language content for our respective courses is organized into up to five levels of proficiency, with each level providing approximately 40 hours of instruction and containing multiple units, lessons and activities.

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Customers

Our customers include individuals, home school parents, educational institutions, armed forces, government agencies, corporations and not-for-profit institutions. We sell to our customers through a direct-to-consumer and institutional marketing and distribution strategy.

Channel	Customer Type	Representative Customers
Consumer	Individual	Based on our internal studies, 60% annually earn more than $75,000 and 44% earn more than $100,000
	Retailers	Amazon.com, Apple, Barnes & Noble, Borders, Office Depot, Books-A-Million, London Drugs
Institutional	Educational Institutions	Primary and Secondary Schools: New York City Department of Education (NY), DeKalb County Schools (GA), Cherokee County Board of Education (GA), Yonkers Public Schools (NY), Oakland Unified School District (CA), Manatee County Schools (FL)
		Universities: James Madison University, University of Wisconsin, West Chester University, Virginia Commonwealth University, Clark Atlanta University, Jackson State University
	Government, Armed Forces and Not-for-Profit Organizations	U.S. Department of Homeland Security, U.S. Immigration and Customs Enforcement, Foreign Service Institute, Defense Intelligence Agency, U.S. Department of the Air Force, U.S. Army, U.S. Marines, The Church of Jesus Christ of Latter-Day Saints, Council for Adult and Experiential Learning, Pacific Training Institute Clinic, AARP, Neighborhood House of St. Paul, Seattle Goodwill
	Corporations	Reuters Group Plc, General Motors Corp., Pride International Inc., Res-Care, Inc., Cerner Corp., Tyco Electronics Corp., Molex Inc., Experian Information Solutions, Inc., Marriott International, Inc., Whole Foods Market Inc.

Marketing and Distribution Channels

Our multi-channel marketing and distribution model consists of print, online, television and radio direct-response advertising, kiosks, our institutional sales force and retail resellers. We believe that this marketing and distribution model, through which each channel complements and supports the others, provides:

- greater brand awareness across channels;
- cost-effective consumer acquisition and education;
- premium brand building; and
- improved convenience for consumers.

Consumer

Consumer sales accounted for approximately 79% of our revenue for the year ended December 31, 2009. Our consumer distribution model comprises a mix of our call centers, websites, network of kiosks and select retail resellers, such as Amazon.com, Apple, Barnes & Noble and Borders. We also offer our products in a limited number of ZoomShop unmanned automated kiosks. We believe these channels complement each other, as consumers that have seen our direct-to-consumer advertising may purchase

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at our kiosks or retailers, and those who have seen our solutions demonstrated at our kiosks may purchase solutions through our retailers, websites or call centers.

Direct to Consumer. Our direct-to-consumer channel, which we define as sales generated through either our websites or call centers, accounted for approximately 57% of our consumer revenue for the year ended December 31, 2009. We utilize several forms of advertising to drive our direct-to-consumer sales, including print, online, television and radio. We advertise in a variety of national publications, such as *Time, The Economist, The New Yorker* and *National Geographic*. Our online media strategy encompasses banner and paid search advertising, as well as affiliate relationships. We work with various online agencies to buy both impression-based and performance-based traffic. All our advertisements include a "call to action," which encourages potential customers to visit our websites or contact a call center to order a product or a CD-ROM demo. Our advertisements include promotional codes that encourage customers to indicate which television or radio spot or publication they are responding to in order for us to track performance of each discrete media buy. By using different codes for different advertising media and campaigns, we can track the link between our media buying and the demand it generates. This gives us insight into the effectiveness of each form of advertising we purchase, which enables us to more closely tie our advertising spending to the results achieved. We receive our orders in the direct-to-consumer channel through our websites and call centers. Our marketing to this channel also supports the kiosk and retail channels.

Rosetta Stone Kiosks. As of December 31, 2009, we operated 242 retail kiosks, including 3 full service retail outlets, in airports, malls and other strategic high-traffic locations in 39 states and the District of Columbia. This does not include the ZoomShop unmanned automated kiosks in which we offer our products. As of December 31, 2009, we also operated 9 kiosks in the United Kingdom, 12 in Japan and 20 in South Korea. Some of our international kiosks are inside the stores of other retailers. These company-operated kiosks accounted for approximately 20% of our consumer revenue for the year ended December 31, 2009. With bright and colorful displays, efficient use of retail space and limited capital investment, we believe that our company-operated kiosks are an effective outlet for selling our solutions and reinforcing our brand image. We believe that our kiosks enhance our ability to build strong consumer relationships and promote additional customer interest through the provision of personal demonstrations by our sales associates.

Most of our kiosk site licenses range between three to six months with renewal options. Our policy is to close under-performing kiosks expeditiously.

We also offer our products in a limited number of unmanned ZoomShop automated kiosks. Although these devices do not offer the one-on-one experience that the kiosks provide, there are interactive demonstrations on their touch screens with audio that helps illustrate our teaching techniques. These devices allow us to quickly establish a presence in retail locations for a very low capital commitment.

Retailers. Sales to retailers accounted for approximately 23% of our consumer revenue for the year ended December 31, 2009. Our retailers enable us to provide additional points of contact to educate consumers about our solutions, expand our presence beyond our own kiosks and websites, and further strengthen and enhance our brand image. Our retail relationships include Amazon.com, Apple, Barnes & Noble, Books-A-Million, Borders, Office Depot and London Drugs. Sales in the retail channel are highly correlated with our media expenditures in the direct-to-consumer channel.

Institutional

Institutional sales accounted for approximately 21% of our revenue for the year ended December 31, 2009. Our institutional distribution model is focused on targeted sales activity primarily through a direct sales force in four markets: schools, colleges and universities; the U.S. armed forces

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and federal government agencies; corporations; and not-for-profit organizations. Regional sales managers are responsible for sales of our solutions in their territories and supervise account managers who are responsible for maintaining our customer base.

Educational Institutions. These customers include primary and secondary schools and represented approximately 44% of our institutional sales for the year ended December 31, 2009. In our experience, colleges, universities and schools frequently rely on references from peer institutions and an official request-for-proposal, or RFP, process when selecting a vendor. We generate sales leads from sources such as visiting potential customer sites to provide briefings on our solutions and the industry, interacting with attendees at trade shows and conferences, responding to inbound calls based on recommendations from existing customers and monitoring and responding to RFPs.

Federal Government Agencies and Armed Forces, Not-for-Profit. These customers include governmental agencies and armed forces and organizations developing workforces to serve non-native speaking populations, offering literacy programs and preparing members for overseas missions and accounted for approximately 25% of our institutional sales for the year ended December 31, 2009. Many customers in this market license our products through online subscriptions. We have recently been adding sales representatives to this group to allow greater focus by senior sales executives on expanding some of our key relationships.

Corporations. We promote interest in this market with onsite visits, trade show and seminar attendance, speaking engagements and direct mailings. Many of our customers in the market prefer online subscription delivery. Corporations represented 12% of our institutional revenue for the year ended December 31, 2009.

Home Schools. We promote interest in this market through advertising in publications focused on home schooling, attending local trade shows and seminars and direct mailings. Home school sales accounted for approximately 19% of our institutional revenue for the year ended December 31, 2009.

International

International sales accounted for approximately 8% of our revenue for the year ended December 31, 2009. In the near term, our international activity is primarily focused on successfully growing our business in the United Kingdom, Germany, South Korea and Japan, where we are utilizing many of the same direct-to-consumer and channel strategies that we developed in the domestic market. We opened our United Kingdom office in 2005, our Japan office in 2007, and our Korean office in 2009. Over time, we believe that we will be able to develop a similar business model in other markets in Europe, Asia and Latin America.

Product Development

Our product portfolio is a result of significant investment in product development over 16 years. Our product development focuses on both software and content development. Our development efforts include both creating new solutions and adding new languages to existing solutions. Our development team has specific expertise in speech recognition, interface design, immersion learning and instructional design.

In 2006, we licensed speech recognition technology for language learning from the Regents of the University of Colorado. We subsequently hired several of the original developers of this technology to begin building our expertise in speech recognition. Since 2006, we have made significant improvements to the original technology. We believe that this technology and expertise distinguishes us from other companies in our industry.

In August 2007, we launched a new product platform, Version 3, in ten languages in our consumer channels. This product launch was the culmination of over three years of research and development. Version 3 provides a significant set of new features and benefits, including our proprietary speech recognition technology. We subsequently introduced four additional Version 3 languages in March 2008 and seven more Version 3 languages in September 2008. We also introduced the *Audio Companion* compact disc practice tool in all 14 of our then-available Version 3 languages in June 2008 and introduced the *Audio Companion* in the seven new Version 3 languages in September 2008. In May 2009, we released Levels 4 and 5 in English (US) and Spanish (Latin America) as well as an additional four languages in Version 3. In July 2009, we released *Rosetta Stone TOTALe*, our new web-based service offering that includes a component of dedicated language conversation coaching. In November 2009, we released Levels 4 and 5 in 4 additional languages in Version 3. As of December 31, 2009, all Version 3 languages are sold with Audio Companion and all Version 3 languages, except for Latin, are available with *Rosetta Stone TOTALe* web-based services.

Our research and development expenses were $26.2 million in the year ended December 31, 2009.

Sourcing and Fulfillment

Our strategy is to maintain a flexible, diversified and low-cost manufacturing base. We use third-party contract manufacturers and suppliers to obtain substantially all our product and packaging components and to manufacture finished products. We believe that we have good relationships with our manufacturers and suppliers and that there are alternative sources in the event that one or more of these manufacturers or suppliers is not available. We continually review our manufacturing and supply needs against the capacity of our contract manufacturers and suppliers with a view to ensuring that we are able to meet our production goals, reduce costs and operate more efficiently.

We package and distribute our products primarily from our fulfillment facility in Harrisonburg, Virginia. We also contract with third-party fulfillment vendors in Munich, Netherlands and Tokyo, Japan. From Tokyo, we distribute products for consumer orders in Japan. From Munich, we distribute products for consumer orders in Europe. We distribute products for the remainder of our orders from Harrisonburg, Virginia.

Competition

The language learning industry is highly fragmented and subject to rapidly changing consumer preferences and industry trends. We expect competition in the markets that we serve to persist and intensify. We face varying degrees of competition from a wide variety of companies providing language learning solutions including:

- language learning center operators;
- audio CD and MP3 download providers;
- pre-packaged software producers;
- textbook publishers;
- online tutoring service providers; and
- online peer-to-peer practice providers.

Our competitors include Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), Random House Ventures LLC (Living Language), Disney Publishing Worldwide and McGraw-Hill Education.

We believe that the principal competitive factors in our industry include:

- product differentiation, including:

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- teaching method,
- effectiveness,
- accessibility and convenience,
- availability and quality of speech recognition, and
- fun and likelihood of continued engagement,
- brand recognition and reputation;
- price; and
- effective advertising.

We believe that we compete favorably on the basis of these factors.

Intellectual Property

Our ability to protect our core technology and intellectual property is critical to our success. We rely on a combination of measures to protect our intellectual property, including patents, trade secrets, trademarks, trade dress, copyrights and non-disclosure and other contractual arrangements.

We have one U.S. patent that has been granted and several international and U.S. patents pending. Many of these pending patents relate to our language teaching methods.

We hold a perpetual, irrevocable and worldwide license from the University of Colorado allowing us to use speech recognition technology for language learning solutions. We entered into the license agreement in December 2006, and paid the University of Colorado an up-front license fee.

We have registered a variety of trademarks, including *Rosetta Stone*, *Rosetta World*, *Rosetta Stone Language Learning Success* & global design, *Audio Companion*, *Dynamic Immersion*, *The Fastest Way to Learn a Language. Guaranteed.*, *Adaptive Recall*, *Contextual Formation*, the Rosetta Stone blue stone logo and design, the Rosetta Stone blue stone logo and design/*Language Learning Success*, *Rosettastone.com,* and *SharedTalk*. We have applied to register our *TOTALe*, *rWorld*, *Rosetta Studio, Rosetta Course, Rosetta Stone Totale and Simbio* trademarks. All these trademarks are the subject of either registrations or pending applications in the United States, as well as numerous countries worldwide where we do business. We intend to continue to strategically register, both domestically and internationally, trademarks we utilize today and those we develop in the future.

We own the copyright on our Version 2 English editions. We are registering or have registered in the United States our Version 2 non-English editions and all editions of our Version 3 languages.

We believe that the distinctive marks that we use in connection with our solutions are important in building our brand image and distinguishing our solutions from those of our competitors. These marks are among our most valuable assets. In addition to our distinctive marks, we own several copyrights and trade dress rights to our solutions, product packaging and user manuals. We also place significant value on our trade dress, which is the overall image and appearance of our solutions, and we believe that our trade dress helps to distinguish our solutions in the marketplace.

Furthermore, our employees, contractors and other parties with access to our confidential information sign agreements that prohibit the unauthorized disclosure of our proprietary rights, information and technology.

Employees

As of December 31, 2009, we had 1,738 total employees, consisting of 922 full-time and 816 part-time employees. Our personnel consisted of 266 employees in sales and marketing, 333 employees

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in research and development, 190 in general and administrative and 894 kiosk sales employees. None of our employees is represented by a collective bargaining agreement. We believe our employee relations are good.

Other Information

Our Internet address is *www.rosettastone.com*. We make available free of charge through our Internet website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to the Securities Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the United States Securities and Exchange Commission (SEC).

Item 1A. *Risk Factors*

In addition to the other information set forth in this annual report on Form 10-K, you should carefully consider the risk factors discussed below and in other documents we file with the Securities and Exchange Commission, which could materially affect our business, financial condition or future results. These are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Our actual operating results may differ significantly from our guidance.

From time to time, we may release guidance in our quarterly earnings releases, quarterly earnings conference call, or otherwise, regarding our future performance that represent our management's estimates as of the date of release. This guidance, which includes forward-looking statements, is based on projections prepared by our 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 compiles or examines the projections and, accordingly, no such person expresses any opinion or any other form of assurance with respect thereto.

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

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions of 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 will vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon, or otherwise consider, our guidance in making an investment decision in respect of our common stock.

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

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Risks Related to Our Business

Because we generate all of our revenue from language learning solutions, a decline in demand for our language learning solutions or for language learning solutions in general could cause our revenue to decline.

We generate substantially all of our revenue from our language learning solutions, and we expect that we will continue to depend upon language learning solutions for substantially all of our revenue in the foreseeable future. Because we are dependent on our language learning solutions, factors such as changes in consumer preferences for these products may have a disproportionately greater impact on us than if we offered multiple product categories. If consumer interest in our language learning software products declines, or if consumer interest in learning foreign languages in general declines, we would likely experience a significant loss of sales. Some of the potential developments that could negatively affect interest in and demand for language learning software products include:

- a decline in international travel;
- changes in U.S. laws or policies making it more difficult for foreign persons to visit or take up residence in the United States; and
- a reduction in the roles of the U.S. armed forces or other governmental agencies in foreign countries.

Because a substantial portion of our revenue is generated from our consumer business, if we fail to accurately forecast consumer demand and trends in consumer preferences, our Rosetta Stone brand, sales and customer relationships may be harmed.

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

- identify, anticipate, understand and respond to these trends in a timely manner;
- introduce appealing new products and performance features on a timely basis;
- anticipate and meet consumer demand for additional languages and learning levels;
- 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, kiosk locations 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.

A decline in consumer demand for our solutions, or any failure on our part to satisfy changing consumer preferences, could harm our business and profitability.

We depend on discretionary consumer spending in the consumer segment of our business. Adverse trends in general economic conditions, including retail shopping patterns, airport traffic or consumer confidence, 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. We depend on the continued popularity of malls as shopping destinations and the ability of mall anchor tenants and other attractions to generate customer traffic for our retail mall-based kiosks. We also depend on continued airline travel to generate traffic for our retail kiosks located in airports. Decreases in mall or airport traffic adversely affect the sales from our kiosks and our profitability and financial condition. In addition, an increase in the taxation of online sales could result in reduced online purchases or reduced margins on such sales. Furthermore, consumers may defer purchases of our solutions in anticipation of new products or new versions from us or our competitors.

Intense competition in our industry may hinder our ability to generate revenue and may diminish our margins.

The market for foreign language learning solutions is rapidly evolving, highly fragmented and intensely competitive, and we expect both product and pricing competition to persist and intensify. Increased competition could cause reduced revenue, price reductions, reduced gross margins and loss of market share. Our competitors include Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), a subsidiary of CBS Corporation, Random House Ventures LLC (Living Language), Disney Publishing Worldwide, a subsidiary of Walt Disney Company, and McGraw-Hill Education, a subsidiary of The McGraw-Hill Companies. Many of our current and potential competitors have longer operating histories and substantially greater financial, technical, sales, marketing and other resources than we do, as well as greater name recognition worldwide. The resources of these competitors also may enable them to respond more rapidly to new or emerging technologies and changes in customer requirements, reduce prices to win new customers and offer free language learning software or online services. We may not be able to compete successfully against current or future competitors.

As the market for foreign language solutions continues to develop, a number of other companies with greater resources than ours could attempt to enter the market or increase their presence by acquiring or forming strategic alliances with our competitors or our distributors or by introducing their own competing products. These companies and their products may be superior to any of our current competition. We may not have the financial resources, technical expertise, marketing, distribution or support capabilities to compete effectively with any of these new entrants to the market.

As we continue to expand into foreign markets, we expect that we will experience competition from local foreign language learning companies that have strong brand recognition and more experience in selling to local consumers and a better understanding of local marketing, sales channels and consumer preferences.

Our success will depend on our ability to adapt to these competitive forces, to adapt to technological advances, to develop more advanced products more rapidly and less expensively than our competitors, to continue to develop an international sales network, to adapt to changing consumer preferences and to educate potential customers about the benefits of using our solutions rather than our competitors' products and services. Existing or new competitors could introduce new products and services with superior features and functionality at lower prices. This could impair our ability to sell our products and services.

Demand for paid language learning solutions such as ours could decline if effective language learning solutions become available for free.

Presently there are a number of free online language websites offering limited vocabulary lists and grammar explanations and tips. In addition, there are some online services offering limited free lessons and learning tools, including one sponsored by the U.S. Department of Education to help immigrants learn English. Many of these websites offer free language practice opportunities with other language learners. If these free products become more sophisticated and competitive or gain widespread acceptance by the public, demand for our solutions could decline.

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

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

- create greater awareness of our brands and our language learning solutions;
- select the right market, media and specific media vehicle in which to advertise;
- identify the most effective and efficient level of spending in each market, 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;
- drive traffic to our websites, call centers, kiosks and distribution channels; and
- convert customer inquiries into actual orders.

Our planned marketing expenditures 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.

Much of our radio, television and print 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 we cannot assure you 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.

Our business depends on our Rosetta Stone brand, and if we are not able to maintain and enhance our brand, our business and operating results may be harmed.

We believe that market awareness of our *Rosetta Stone* brand in the United States has contributed significantly to the success of our business. We also believe that maintaining and enhancing the *Rosetta Stone* brand is critical to maintaining our competitive advantage. As we continue to grow in size, expand our products and services and extend our geographic reach, maintaining the quality and consistency of our language learning solutions, and thus the quality of our brand, may be more difficult. In addition, software piracy and trademark infringement may harm our *Rosetta Stone* brand by undermining our reputation for quality software programs.

We depend on search engines and other online sources to attract visitors to our websites, and if we are unable to attract these visitors and convert them into customers in a cost-effective manner, our business and financial results may be harmed.

Our success depends on our ability to attract online consumers to our websites and convert them into customers in a cost-effective manner. We depend, in part, on search engines and other online sources for our website traffic. We are included in search results as a result of both paid search listings, where we purchase specific search terms that will result in the inclusion of our listing, and algorithmic searches that depend upon the searchable content on our sites. Search engines and other online sources revise their algorithms from time to time in an attempt to optimize their search results.

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If one or more of the search engines or other online sources on which we rely for website traffic were to modify its general methodology for how it displays 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.

Our expansion into international markets may not succeed and imposes special risks.

Our business strategy contemplates continued expansion into international markets. We are currently expanding our direct sales channels in Europe and Asia. In addition, we are expanding our indirect sales channels in Europe, Asia and Latin America through retailer and distributor arrangements with third parties. If we are unable to expand our international operations successfully and in a timely manner, our ability to pursue our growth strategy will be impaired. Such expansion 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.

Our international operations and our efforts to increase sales in international markets are subject to a number of risks that are in addition to or different than those affecting our U.S. operations, including:

- difficulty in staffing and managing geographically dispersed operations and culturally diverse work forces and increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- difficulty in establishing and maintaining financial and other internal controls over geographically dispersed operations;
- competition from local foreign language software providers and preferences for local products in some regions;
- expenses associated with customizing products, support services and websites for foreign countries;
- inability to identify an effective and efficient level of advertising, marketing and promotional expenditures in order to maintain acceptable customer acquisition costs;
- difficulties with providing appropriate and appealing products to suit consumer preferences and capabilities in these markets, such as the potential need to customize English language software solutions for local markets;
- difficulties with establishing successful kiosk sales channels;
- inability to successfully develop relationships with significant retailers and distributors;
- potential political and economic instability in some regions;
- potential unpredictable changes in foreign government regulations;
- legal and cultural differences in the conduct of business;
- import and export license requirements, tariffs, taxes and other trade barriers;

inflation and fluctuations in currency exchange rates;

potentially adverse tax consequences;

difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;

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- the burden and difficulties of complying with a wide variety of U.S. and foreign laws, regulations, trade standards, treaties and technical standards, including the Foreign Corrupt Practices Act;
- difficulty in protecting our intellectual property and the high incidence of software piracy in some regions;
- costs and delays in downsizing foreign work forces as a result of differing employment and other laws;
- protectionist laws and business practices that favor local competitors; and
- uncertainty regarding liability for information retrieved and replicated in foreign countries.

The effects of any of the risks described above could reduce our future revenue from our international operations and could harm our overall business, revenue and financial results.

Our introduction of Rosetta Stone Version 4 TOTALe will increase our costs as a percentage of revenue, may not succeed and may harm our business, financial results and reputation.

We have publicly announced plans to introduce Rosetta Stone Version 4 TOTALe in the third quarter of 2010. Rosetta Stone Version 4 TOTALe integrates our existing language learning software solutions with web-based services, which will provide opportunities for practice with dedicated language conversation coaches and other language learners to increase language socialization. These web-based services will have a much higher cost as a percentage of revenue than our software solutions. We expect to offer Rosetta Stone Version 4 TOTALe primarily by bundling the web-based services of TOTALe with our software and audio offerings. At the same time, we expect to provide augmented, free peer-to-peer language practice. We will devote significant capital, personnel and management attention to develop and launch Rosetta Stone Version 4 TOTALe, including replacing our existing product packaging with Version 4 TOTALe packaging, expanding our staff of conversational coaches and customer support employees, incurring related research and development expenses, and incurring significant marketing expenses relating to the launch of the new offering. The services associated with Rosetta Stone Version 4 TOTALe will decrease our margins. Rosetta Stone Version 4 TOTALe will also present new management and marketing challenges that differ from the challenges we face in our existing business. In addition, we will be required to defer recognition of a portion of each sale of Version 4 TOTALe in connection with the subscription terms of our on-line socialization services. We cannot assure you that Rosetta Stone Version 4 TOTALe will be introduced on the timetable publicly announced or that it will be successful or profitable, or if it is profitable, that it will provide an adequate return on capital expended. If we are not successful in our launch of Rosetta Stone Version 4 TOTALe, our business, financial results and reputation may be harmed.

Our introduction of the "Rosetta Stone Mini" and/or an introductory language learning software offering may not succeed and may harm our business, financial results and reputation.

We have publicly announced plans to introduce an iPhone/iPod Touch/Mobile application, with the project name of Rosetta Stone Mini" to be released in the second half of 2010 that will provide a sub-2 hour learning experience in a new language. In addition, we have publicly announced plans to release an introductory offering at a sub-$200 price point, which we refer to as the introductory offering, with our launch of the full Rosetta Stone Version 4 TOTALe language learning solution. Both the Rosetta Stone Mini and the introductory offering will carry lower price points than our full Rosetta Stone Version 4 TOTALe language learning solution and may cannibalize sales of our more expensive solutions. We will devote significant capital, personnel and management attention to develop and launch the Rosetta Stone Mini and the introductory offering, including related research and development expenses, and incurring significant marketing expenses relating to the launch. These new products will present new management and marketing challenges that differ from the challenges we

face in our existing business. We cannot assure you that the Rosetta Stone Mini or the introductory offering will be successful or that either offering will be profitable, or if it is profitable, that it will provide an adequate return on capital expended. If we are not successful in our launch of the Rosetta Stone Mini or the introductory offering, our business, financial results and reputation may be harmed.

Product returns could exceed our estimates, which would diminish our reported revenue.

We offer consumers who purchase our packaged software and audio practice products directly from us an unconditional full money-back six-month guarantee. We also permit some of our retailers and distributors to return packaged products, subject to limitations. We establish revenue reserves for packaged product returns based on historical experience, estimated channel inventory levels and 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.

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

Our success depends in part upon the continued adoption by institutions 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 can result from offering courses online. If the acceptance of technology-based education does not grow our ability to continue to grow our institutional business could be impaired.

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

Many of our institutional customers are colleges, universities, primary and secondary schools, other education providers, armed forces and government agencies who 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, or other education providers or for armed forces 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 institutional business faces a lengthy and unpredictable sales cycle for our solutions, which could delay new sales.

We face a lengthy sales cycle between our initial contact with some potential institutional 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 institutional 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 institutional 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 both their administrators and faculties; and
- the length and timing of customers' approval processes.

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If we are unable to continually enhance our products and services and adapt them to technological changes and customer needs, including the emergence of new computing devices and more sophisticated online services, we may lose market share and revenue and our 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. For example, the number of individuals who access the internet through devices other than a personal computer, such as personal digital assistants, mobile telephones, televisions and set-top box devices, has increased dramatically, and this trend is likely to continue. Our products and services were designed for high resolution, graphical environments such as those available on desktop and laptop computers. The lower resolution, functionality and memory associated with alternative devices currently available may make the use of our products and services through such devices difficult. Because each manufacturer or distributor may establish unique technical standards for its devices, our products and services may not work or be viewable on these devices. We have no experience to date in operating versions of our products and services developed or optimized for users of alternative devices, and new devices and new platforms are continually being released. Accordingly, it is difficult to predict the problems we may encounter in developing versions of our products and services for use on these alternative devices, and 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 that respond to these or other technological developments and changing customer needs cost effectively, we may lose market share and revenue and our business could suffer.

If we fail to manage our growth effectively, we may experience difficulty in filling purchase orders, declines in product and service quality and customer satisfaction, increased costs or disruption in our operations.

We have experienced rapid growth in our business in recent periods, which has strained our managerial, operational, financial and other resources.

We anticipate that continued growth of our operations will be required to satisfy increasing consumer and institutional demand and to avail ourselves of new market opportunities. The expanding scope of our business and growth in the number of our employees, customers and sales locations will continue to place a significant strain on our management team, information technology systems and other resources. To properly manage our growth, we need to hire and retain personnel, upgrade our existing operational, management and financial and reporting systems, including warehouse management and inventory control, improve our business processes and controls and identify and develop relationships with additional retailers and distributors. We may also be required to expand our distribution facilities and our operational facilities or add new facilities, which could require significant capital expenditures. Failure to effectively manage our growth in a cost-effective manner could result in difficulty in filling purchase orders, declines in product and service quality and customer satisfaction, increased costs or disruption of our operations.

Our rapid growth also makes it difficult for us to adequately predict the expenditures we will need to make in the future. If we do not make the necessary overhead expenditures to accommodate our future growth, we may not be successful in executing our growth strategy.

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 and net income. These variations are primarily related to increased sales of our products and services to consumers in the fourth quarter during the holiday selling season as well as higher sales to governmental and educational institutions in the second and third quarters. We sell to a significant number of our retailers, distributors and institutional 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 institutional 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. As our business grows, these seasonal fluctuations may become more pronounced. Any seasonal or quarterly fluctuations that we report in the future may differ from the expectations of market analysts and investors. This could cause the price of our common stock to fluctuate significantly.

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

We rely on retailers and distributors, together with our direct sales force, to sell our products. Our sales to retailers are highly concentrated on a small group, including Amazon.com, Apple, Barnes & Noble, Borders and Office Depot. We expect that our arrangements with these retailers and distributors will continue to generate significant revenue for us. Sales to or through our retailers and distributors accounted for approximately 18% of our revenue for the year ended December 31, 2009.

We have no control over the amount of products that these retailers 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 will not promote competitors' products over our products or enter into exclusive relationships with competitors. Any material adverse change in the principal commercial terms, material decrease in the volume of sales generated by our larger retailers or distributors or major disruption or termination of a relationship with these retailers and distributors could result in a potentially 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. In addition, if one or more of such retailers or distributors were unable to meet their obligations with respect to accounts payable to us, we could be forced to write off such accounts. In addition, 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.

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.

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The loss of key personnel or the failure to attract and retain highly qualified personnel could compromise our ability to effectively manage our business and pursue our growth strategy.

Our future performance depends on the continued service of our key technical, development, sales, services and management personnel. We rely on our executive officers and senior management to execute our existing business plans and to identify and pursue new opportunities. We rely on our technical and development personnel for product innovation. We generally do not have employment agreements with our personnel and, therefore, they could terminate their employment with us at any time. The loss of key employees could result in significant disruptions to our business, and the integration of replacement personnel could be costly and time consuming, could cause additional disruptions to our business, and could be unsuccessful. We do not carry key person life insurance covering any of our employees.

Our future success also depends on our continued ability to attract and retain highly qualified technical, development, sales, services and management personnel. Competition for such personnel is intense, and we may fail to retain our key employees or attract or retain other highly qualified personnel in the future. Many of our employees are located in Harrisonburg, Virginia, a city that does not have a large pool of qualified replacement personnel. The lack of qualified local replacement personnel may make it more difficult to quickly find replacement personnel and may increase the costs of identifying and relocating replacement personnel to Harrisonburg, Virginia.

In addition, wage inflation and the cost of retaining our key personnel in the face of competition for such personnel may increase our costs faster than we can offset these costs with increased prices or increased sales volume.

If we are unable to hire, train, motivate and retain sales personnel to staff our kiosks, or to identify suitable locations and negotiate site licenses on acceptable terms, we could lose revenue, our costs could increase and our profitability could decline.

In order to successfully grow our kiosk sales channel we must be able to hire, train, motivate and retain sales personnel to staff these kiosks. Our kiosks are small and widely dispersed, and, as such, are operated without substantial hands-on management or oversight by us. As a result, we depend on our kiosk sales personnel to effectively manage sales, customer issues and reporting of financial transactions from these kiosks. The opening and success of new kiosks will depend upon various additional factors, including our ability to identify suitable locations and our ability to negotiate site licenses on acceptable terms and labor costs. Specifically, we must identify and negotiate cost-effective site licenses for kiosk locations that will generate sufficient consumer demand. Many of these site licenses contain terms and conditions that are highly favorable to licensors including allowing licensors to cancel them on short notice, sometimes as little as thirty days, and broad indemnification terms in favor of licensors. If competition for kiosk space increases, license rates may increase and other terms may become even less favorable to us, resulting in lower profitability. Our failure to properly manage the expansion of this sales channel could cause us to lose revenue and increase our expenses.

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 systems 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 language learning solutions, including our online language courses and *Rosetta Stone TOTALe*, and our *SharedTalk* online peer-to-peer collaborative and interactive community. 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

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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. We do not maintain real-time back-up of all of our data, and in the event of system disruptions, we could experience 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. 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 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, defamation, promotions, billing, consumer protection, accessibility, content regulation, quality of services, and intellectual property ownership and infringement in many instances is unclear or unsettled. 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.

We may be subject to legal liability for new web-based online services.

Rosetta Stone TOTALe enables individuals to exchange information and engage in various online activities on a domestic and an international basis. The law relating to the liability of providers of online services for activities of their users is currently unsettled both within the U.S. and internationally. Claims may be brought against us for defamation, negligence, copyright or trademark infringement, unlawful activity, tort, including personal injury, fraud, or other theories based on the nature and content of information that may be posted online or generated by our users. Defense of any such actions could be costly and involve significant time and attention of our management and other resources and may require us to change our business in an adverse manner.

In addition, the amount of data we store for our users on our servers (including personal information) will increase as we increase our web based services. Any systems failure or compromise of our security that results in the release of our users' data could seriously limit the adoption of our products and services as well as harm our reputation and brand and, therefore, our business. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand the number of web based products and services we offer as well as increase the number of countries where we operate.

Further, failure or perceived failure by us to comply with our policies, applicable requirements, or industry self-regulatory principles related to the collection, use, sharing or security of personal information, or other privacy, data-retention or data-protection matters could result in a loss of user confidence in us, damage to our brands, and ultimately in a loss of users, advertising partners, or affiliates which could adversely affect our business.

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

Maintaining our network security is of critical importance because our online e-commerce systems and our online administration tools for our institutional business store proprietary and confidential customer, employee and other sensitive data, such as names, addresses, other personal information and credit card numbers. We and our vendors use commercially available encryption technology to transmit personal information when taking orders. We use security and business controls to limit access and use of personal information. However, third parties may be able to circumvent these security and business measures by developing and deploying viruses, worms and other malicious software programs that are designed to attack or attempt to infiltrate our systems and networks. In addition, employee error, malfeasance or other errors in the storage, use or transmission of personal information could result in a breach of customer or employee privacy. We employ contractors and temporary and part-time employees who may have access to the personal information of customers and employees. It is possible such individuals could circumvent our controls, which could result in a breach of customer or employee privacy.

Possession and use of personal information in conducting our business subjects us to legislative and regulatory burdens that could require notification of data breach, restrict our use of personal information and hinder our ability to acquire new customers or market to existing customers. We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols imposed by law, regulation, industry standards or contractual obligations.

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

We are exposed to risks associated with credit card and payment fraud and with credit card processing, which could cause us to lose revenue.

Many of our customers use credit cards or automated payment systems to pay for our products and services. We have suffered losses, and may continue to suffer losses, as a result of orders placed with fraudulent credit cards or other fraudulent payment data. For example, under current credit card practices, we may be liable for fraudulent credit card transactions if we do not obtain a cardholder's signature, a frequent practice in internet sales. We employ technology solutions to help us detect fraudulent transactions. However, the failure to detect or control payment fraud could cause us to lose sales and revenue.

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

We rely on both an in-house call center and third-party call centers to sell our solutions, respond to customer service and technical support requests and process orders. Any significant interruption in the operation of these facilities, including an interruption caused by our failure to successfully expand or upgrade our systems or to manage these expansions or upgrades, could reduce our ability to receive and process orders and provide products and services, which could result in lost and cancelled sales and damage to our brand and reputation.

As we grow, we will need more capacity from those existing call centers or we will need to identify and contract with new call centers. We may not be able to continue to locate and contract for call

center capacity on favorable terms, or at all. Additionally, the rates those call centers charge us may increase or those call centers may not continue to provide service at the current levels.

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

Our call center employs a large number of personnel and historically has been subject to a high turnover rate among employees. We may have to terminate employees from time to time as our business changes and labor demands shift among our facilities. Any significant increase in labor costs, deterioration of employee relations, slowdowns or work stoppages at any of our locations, employee turnover or otherwise, could harm our business and profitability. In addition, high employee turnover could increase our exposure to employee-related litigation. Likewise, the third-party call centers we utilize face similar issues.

If any of our products 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 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 will 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 market acceptance of our products and services;
- diversion of our resources;
- a lower rate of license renewals or upgrades for consumer and institutional customers;
- injury to our reputation; or
- increased service expenses or payment of damages.

In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products and services. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms, or at all, we could face significant financial losses.

Our sales to U.S. government agencies and armed forces subject us to special risks that could adversely affect our business.

Government sales entail a variety of risks including:

- government contracts are subject to the approval of appropriations by the United States Congress to fund the expenditures by the agencies under these contracts. Congress often appropriates funds for government agencies on a yearly basis, even though their contracts may call for performance over a number of years;
- our products and services are included on a General Services Administration, or GSA, schedule. The loss of the GSA schedule covering our software products and related services could cause us to lose our ability to sell our products and

services to U.S. government customers;

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- we must comply with complex federal procurement laws and regulations in connection with government contracts, which may impose added costs on our business; and

- federal government contracts contain provisions and are subject to laws and regulations that provide government customers with rights and remedies not typically found in commercial contracts. These rights and remedies allow government clients, among other things, to terminate existing contracts, with short notice, for convenience without cause, reduce or modify contracts or subcontracts, and claim rights in products, systems, and technology produced by us.

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 we grow and 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.

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 student learning management systems of our institutional customers. As a result, we must continually ensure that our products interoperate properly with these systems. Changes in operating systems, the technologies we incorporate into our products or the computer systems our customers use may damage our business. For example, our online Version 2 software subscriptions, which we offer in six languages, does not currently operate properly with the newly released Microsoft Windows 7 and Mac OS X operating systems.

As our product and service offerings become more complex, our reported revenue may become less predictable.

Our planned expansion of products and services will generate more varied sources of revenue than our existing business. 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.

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Many of our expenses are fixed and many are based, in significant part, on our expectations of our future revenue and are incurred prior to the sale of our products and services. Therefore, any significant decline in revenue for any period could have an immediate negative impact on our margins, net income and financial results for the period.

Our expense levels are based, in significant part, on our estimates of future revenue and many of these expenses are fixed in the short term. As a result, we may be unable to adjust our spending in a timely manner if our revenue falls short of our expectations. Accordingly, any significant shortfall of revenue in relation to our estimates could have an immediate negative effect on our profitability. In addition, as our business grows, we anticipate increasing our operating expenses to expand our product development, technical support, sales and marketing and administrative organizations. Any such expansion could cause material losses to the extent we do not generate additional revenue sufficient to cover the additional expenses.

We may need to raise additional funds to pursue our growth strategy or continue our operations, and we may be unable to raise capital when needed.

From time to time, we may seek additional equity or debt financing to provide for the capital expenditures required to finance working capital requirements, continue our expansion, develop new products and services or make acquisitions or other investments. In addition, if our business plans change, general economic, financial or political conditions in our markets change, or other circumstances arise that have a material effect on our cash flow, the anticipated cash needs of our business as well as our conclusions as to the adequacy of our available sources of capital could change significantly. Any of these events or circumstances could result in significant additional funding needs, requiring us to raise additional capital. We cannot predict the timing or amount of any such capital requirements at this time. If financing is not available on satisfactory terms, or at all, we may be unable to expand our business or to develop new business at the rate desired and our results of operations may suffer.

Risks Related to Intellectual Property Rights

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, pending patents, 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 copyrights, trademarks, trade secret laws, confidentiality procedures, contractual provisions and technical measures.

We have several patent applications on file. 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 is not certain, they may be contested, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies now or in the future. In addition, we have not emphasized patents as a source of significant competitive advantage and have instead sought to primarily protect our proprietary rights under laws affording protection for trade secrets, copyright and trademark protection of our products, brands, trademarks and other intellectual property where available and appropriate. However, all of 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 assure you 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, may be unenforceable under the laws of several jurisdictions.

Protection of trade secret and other intellectual property rights in the markets 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 lose significant revenue due to illegal use of our software. If piracy activities increase, it may further harm our business.

We also expect that the more successful we are, the more likely that competitors will 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 future trade secret protection for our source code if any unauthorized disclosure of such code occurs. The loss of future 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 purchase our trademarks and confusingly similar terms as keywords in internet search engine advertising programs and in the header and text of the resulting sponsored link advertisements in order to divert potential customers to their websites. Preventing such unauthorized use is inherently difficult. If we are unable to protect our trademarks and confusingly similar terms from such unauthorized use, competitors and other third parties may continue to drive potential online customers away from our websites to competing websites, which could harm our reputation and cause us to lose sales.

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

We own several federal trademark registrations, including the *Rosetta Stone* mark, hold common law trademark rights and have federal trademark applications pending in the United States and abroad for additional trademarks. Even if federal registrations 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 United States and overseas. 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 have not registered copyrights for all our products, which may limit our ability to enforce them.

We have not registered our copyrights in all of our software, written materials, website information, designs or other copyrightable works. The United States Copyright Act automatically protects all of our copyrightable works, but without a registration we cannot enforce those copyrights against infringers or seek certain statutory remedies for any such infringement. Preventing others from copying our products, written materials and other copyrightable works is important to our overall success in the marketplace. In the event we decide to enforce any of our copyrights against infringers, we will first be required to register the relevant copyrights, and we cannot be sure that all of the material for which we seek copyright registration would be registrable in whole or in part, or that once registered, we would be successful in bringing a copyright claim against any such infringers.

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 that include the terms Rosetta Stone and Rosetta World. Third parties may acquire substantially similar domain names that decrease the value of our domain names and trademarks and other proprietary rights which may hurt our business. Moreover, the regulation of domain names in the United States and foreign countries is subject to change. Governing bodies could appoint additional domain name registrars or modify the requirements for holding domain names. Governing bodies could also establish additional "top-level" domains, which are the portion of the Web address that appears to the right of the "dot," such as "com," "gov" or "org." As a result, we may not maintain exclusive rights to all potentially relevant domain names in the United States or in other countries in which we conduct business, which could harm our business or reputation.

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

We may become subject to material claims of infringement by competitors and other third parties with respect to current or future products, e-commerce and other web-related technologies, online business methods, trademarks or other proprietary rights. Our competitors, some of which may have substantially greater resources than us and have made significant investments in competing products and technologies, 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

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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 sales of the affected products or impose significant penalties 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.

Some of our products and services include intellectual property owned by third parties, including software that is integrated with internally developed software and a portion of our voice recognition software, which we license from the University of Colorado. From time to time we may be required to renegotiate with these third parties or negotiate with new third parties to include their technology or content in our existing products, in new versions of our existing products or in wholly new products. We may not be able to negotiate or renegotiate licenses on commercially reasonable terms, or at all, and the third-party software may not be appropriately supported, maintained or enhanced by the licensors. If we are unable to obtain the rights necessary to use or continue to use third-party technology or content in our products and services, the inability to support, maintain and enhance any software could result 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. In such event, 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.

Risks Related to Owning Our Common Stock

Some of our stockholders could together exert significant influence over our company.

As of December 31, 2009, funds affiliated with ABS Capital Partners beneficially owned in the aggregate shares representing approximately 25% of our outstanding voting power. Two managing members of the general partner of ABS Capital Partners currently serve on our board of directors. Additionally, as of December 31, 2009, Norwest Equity Partners VIII, LP, or Norwest, beneficially owned in the aggregate shares representing approximately 16% of our outstanding voting power. One managing member of the general partner of Norwest currently serves on our board of directors. As a result, these stockholders could together potentially have significant influence over all matters presented to our stockholders for approval, including election and removal of our directors and change of control transactions. The interests of these stockholders may not always coincide with the interests of the other holders of our common stock.

As a public company we incur additional cost and face increased demands on our management and key employees.

We have operated as a public company only since April 15, 2009. As a public company, we incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, as well as rules implemented by the Securities and Exchange Commission, or SEC, and the New York Stock Exchange, impose various requirements on public companies. Our management and other personnel devote substantial amounts of time to these requirements. Moreover, these requirements have significantly increased our legal and financial compliance costs and have made some activities more time-consuming and costly. In addition, we incur additional costs associated with our public company reporting requirements. These rules and regulations also make it more difficult and more expensive for us to obtain director and officer liability insurance. We estimate that the incremental annual public company costs will be between $1.5 million and $2.0 million in fiscal 2010, which will primarily be reflected in general and administrative costs. However, these estimates may prove to be inaccurate as many of these costs are beyond our control, and the actual incremental costs associated with our public company status could materially exceed our estimates. If our profitability is harmed by these additional costs, it could have a negative effect on the trading price of our common stock.

In prior periods, we identified material weaknesses in our internal controls that could result in material misstatements in our financial statements. Although we have remediated the weaknesses, if we do not maintain adequate internal controls over financial reporting, it could impair our ability to comply with the accounting and reporting requirements applicable to public companies.

In relation to our consolidated financial statements for the year ended December 31, 2007, we identified material weaknesses in our internal controls over financial reporting in accounting for inventory, income taxes and stock-based compensation, our general computer controls and controls within our enterprise resources planning system. In addition, we identified a significant deficiency in our financial closing process. No material weaknesses or significant deficiencies in our internal controls were identified in relation to our consolidated financial statements for the years ended December 31, 2008 and 2009. A material weakness is defined as a significant deficiency or combination of significant deficiencies that result in a reasonable possibility that a material misstatement of our financial statements will not be prevented by our internal control over financial reporting. A significant deficiency means a control deficiency, or combination of control deficiencies, that adversely affects our ability to initiate, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of our financial statements that is more than inconsequential will not be prevented or detected by our internal control over financial reporting.

Our independent registered public accounting firm's audit for the years ended December 31, 2008 and 2009 included consideration of internal control over financial reporting as a basis for designing their audit procedures, but not for the purpose of expressing an opinion on the effectiveness of our internal controls over financial reporting. If such an evaluation had been performed or when we are required to have them perform such an evaluation, additional material weaknesses, significant deficiencies and other control deficiencies may have been or may be identified. Ensuring that we have adequate internal financial and accounting controls and procedures in place to help produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be evaluated frequently. We incur increased costs and demands upon management as a result of complying with the laws and regulations affecting public companies relating to internal controls, which could materially adversely affect our results of operations.

Because of these material weaknesses, there is heightened risk that a material misstatement of our annual or quarterly financial statements relating to the periods that these material weaknesses existed

was not prevented or detected. We have taken steps to remediate our material weaknesses, including hiring additional accounting and finance personnel and engaging consultants. Although we believe we have remediated these material weaknesses and significant deficiencies and did not identify any new material weaknesses or significant deficiencies in relation to our consolidated financial statements for the years ended December 31, 2008 or 2009, we cannot be certain that our efforts to remediate these internal control weaknesses were successful or that similar material weaknesses will not recur.

Our internal growth plans will also put additional strains on our internal controls if we do not augment our resources and adapt our procedures in response to this growth. As a public company, we are required to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 regarding internal controls beginning with our fiscal year ending December 31, 2010. In the event that we have not adequately remedied these material weaknesses, and if we fail to maintain proper and effective internal controls in future periods, we could become subject to potential review by the New York Stock Exchange, the SEC or other regulatory authorities, which could require additional financial and management resources, could result in our delisting by the New York Stock Exchange, could compromise our ability to run our business effectively and could cause investors to lose confidence in our financial reporting.

If securities analysts do not publish research or reports about our business or if they publish negative evaluations of our stock, the price of our stock could decline.

The trading market for our common stock depends in part on the research and reports that industry or financial analysts publish about us or our business. If one or more of the analysts covering our business downgrade their evaluations of or recommendations regarding our stock, or if one or more of the analysts cease providing research coverage on our stock, the price of our stock could decline. If one or more of these analysts cease providing research coverage on our stock, we could lose visibility in the market for our stock, which in turn could cause our stock price to decline.

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

Provisions in our second amended and restated certificate of incorporation and second amended and restated bylaws, and in the Delaware General Corporation Law, may make it difficult and expensive for a third-party to pursue a takeover attempt we oppose even if a change in control of our company would be beneficial to the interests of our stockholders. Any provision of our second amended and restated certificate of incorporation or second amended and restated bylaws or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock. Our board of directors has the authority to issue up to 10,000,000 shares of preferred stock in one or more series and to fix the powers, preferences and rights of each series without stockholder approval. The ability to issue preferred stock could discourage unsolicited acquisition proposals or make it more difficult for a third party to gain control of our company, or otherwise could adversely affect the market price of our common stock. Further, as a Delaware corporation, we are subject to Section 203 of the Delaware General Corporation Law. This section generally prohibits us from engaging in mergers and other business combinations with stockholders that beneficially own 15% or more of our voting stock, or with their affiliates, unless our directors or stockholders approve the business combination in the prescribed manner. However, because funds affiliated with ABS Capital Partners and Norwest acquired their shares prior to our initial public offering, Section 203 is currently inapplicable to any business combination or transaction with them or their affiliates. In addition, our second amended and restated certificate of incorporation includes a classified board of directors and requires that any action to be taken by stockholders must be taken at a duly called meeting of stockholders and may not be taken by

written consent. Our second amended and restated bylaws require that any stockholder proposals or nominations for election to our board of directors must meet specific advance notice requirements and procedures, which make it more difficult for our stockholders to make proposals or director nominations.

Item 2. *Properties*

Our corporate headquarters are located in Arlington, Virginia, where we sublease approximately 31,281 square feet of space. The term of this sublease runs through December 31, 2013 and we have the right to extend that lease for an additional three years. We believe that our headquarters space will be adequate for the foreseeable future.

We continue to lease approximately 14,541 square feet of space in Arlington, Virginia, which was the site of our corporate headquarters until late 2008. This space consists of multiple leased spaces with lease obligations with terms ending between December 31, 2009 and August 31, 2013. We intend to continue to attempt to sublease a portion of this space, but we cannot assure you that we will be able to sublease any of this space or that, if we do, it will be on terms that will cover our rent expense related to the space.

We currently own a facility with approximately 62,000 square feet of usable space in Harrisonburg, Virginia, that serves as our operations office, where we perform most of our product development. In addition, we lease a facility with approximately 40,000 square feet in Harrisonburg, Virginia for use as a packing and distribution center for all of our U.S. and some of our international fulfillment. We are seeking additional space in Harrisonburg to support our future growth.

We also lease space for our three full service retail outlets in Missouri, New Jersey, and New York and for small offices in Boulder, Colorado, Tokyo, Japan, Seoul, South Korea, Munich, Germany and London, United Kingdom. Our Boulder office serves as a research and development location while our Tokyo, Seoul and London offices serve as our regional sales offices.

As of December 31, 2009, we also had site licenses for 242 kiosks. Most of our kiosk site licenses have terms of three to six months and provide for a minimum rent plus a percentage rent based upon sales after certain minimum thresholds have been achieved. These site licenses generally require that we pay insurance, utilities, real estate taxes and repair and maintenance expenses. Some of the site licenses also contain early termination options, which can be exercised by us or the licensor under certain conditions.

Item 3. *Legal Proceedings*

In July 2009, we filed a lawsuit in the United States District Court for the Eastern District of Virginia against Google Inc., seeking, among other things, to prevent Google from infringing upon our trademarks. In this lawsuit, we assert, among other things, that Google allows third parties, including individuals involved in software piracy operations, to purchase the right to use our trademarks or other terms confusingly similar in Google's Adwords advertising program. This lawsuit seeks, among other things, injunctive relief to prevent Google from selling our trademarks or other terms confusingly similar for use in Google's Adwords advertising program. To date, Google has not made any counterclaims for damages against us, however, we expect to incur material legal fees and other costs and expenses in pursuit of our claims against Google.

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

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PART II

Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market for Common Stock

Our common stock is listed on the New York Stock Exchange under the symbol "RST." The following table sets forth, for each of the periods indicated, the high and low reported sales price of our common stock on the NYSE.

	High	Low
Year ended December 31, 2009		
Fourth Quarter	$ 23.72	$ 16.55
Third Quarter	30.69	20.35
Second Quarter (Beginning April 16)	31.67	22.10
First Quarter		
Year ended December 31, 2008		
Fourth Quarter		
Third Quarter		
Second Quarter		
First Quarter		

On March 2, 2010, the last reported sales price of our common stock on the NYSE was $23.64 per share. As of that date, there were approximately 667 holders of record of our common stock.

Dividends

We have not paid any cash dividends on our common stock and do not intend to do so in the foreseeable future. We currently intend to retain all available funds and any future earnings to support the operation of and to finance the growth and development of our business. We do not anticipate paying any cash dividends in the foreseeable future.

Securities Authorized For Issuance Under Equity Compensation Plans

For information regarding securities authorized for issuance under equity compensation plans, see Part III "Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters."

Stockholder Return Performance Presentation

The following graph compares the change in the cumulative total stockholder return on our common stock during the period from April 16, 2009 (the first day our stock began trading on the NYSE) through December 31, 2009, with the cumulative total return on the NYSE Composite Index and the SIC Code Index that includes all U.S. public companies in the Standard Industrial Classification (SIC) Code 7372-Prepackaged Software. The comparison assumes that $100 was invested on April 16, 2009 in our common stock and in each of the foregoing indices and assumes reinvestment of dividends, if any.

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COMPARISON OF 8 MONTH CUMULATIVE TOTAL RETURN*

Among Rosetta Stone Inc., The NYSE Composite Index
And SIC code 7372 index

*$100 invested on 4/16/09 in stock or index, including reinvestment of dividends.
Fiscal year ending December 31.

Use of Proceeds from Public Offering of Common Stock

On April 15, 2009, our registration statement (File No. 333-153632) was declared effective for our initial public offering, pursuant to which we registered the offering and sale of 3,125,000 shares of common stock by Rosetta Stone Inc. and the associated sale of 3,125,000 shares of common stock by funds associated with ABS Capital Partners and Norwest Equity Partners VIII, LP (collectively, the "Private Equity Funds") and the additional sale pursuant to the underwriters' over-allotment option for an additional 937,500 shares of common stock by the Private Equity Funds, at a public offering price of $18.00 per share. The offering closed on April 21, 2009. The managing underwriters were Morgan Stanley & Co. Incorporated and William Blair & Company, LLC.

As a result of the offering, we received net proceeds of approximately $49.0 million, after deducting underwriting discounts and commissions of $3.9 million and additional offering-related expenses of approximately $3.3 million. In April 2009, we used $7.9 million to satisfy the federal, state and local withholding tax obligations associated with the "net issuance" of stock grants we made to 10 of our key employees, including executive officers, on April 15, 2009. In April 2009, we used $9.9 million of the net proceeds to repay the outstanding balances under our revolving line of credit with Wells Fargo. We anticipate that we will use the remaining net proceeds from our initial public offering for working capital and other general corporate purposes, which may include the acquisition of other businesses, products or technologies. We do not, however, have agreements or commitments for any specific acquisitions at this time. Pending such uses, we plan to invest the net proceeds in short-term, interest-bearing, investment grade securities.

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Item 6. ***Selected Consolidated Financial Data***

The following table sets forth our selected consolidated statement of operations, balance sheet and other data for the periods indicated. The selected consolidated statement of operations data for the years ended December 31, 2009, 2008 and 2007, and the period from January 4, 2006 through December 31, 2006, and the consolidated balance sheet data as of December 31, 2009, 2008, 2007 and 2006 have been derived from Rosetta Stone Inc., or the Successor, audited consolidated financial statements. The selected consolidated statement of operations data for the period from January 1, 2006 through January 4, 2006 and the year ended December 31, 2005, represents the operations of Fairfield & Sons, Ltd., or the Predecessor, which was acquired by Rosetta Stone Inc. on January 4, 2006 and have been derived from Predecessor audited consolidated financial statements. The selected consolidated financial data as of December 31, 2005 has been derived from Predecessor audited financial statements. This information should be read in conjunction "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements contained elsewhere in this Annual Report on Form 10-K. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

The Predecessor incurred transaction-related expenses during the period from January 1, 2006 through January 4, 2006 relating to the acquisition by Rosetta Stone Inc. on January 4, 2006. Included in the expenses were $5.9 million related to restricted common stock, $3.1 million in cash bonuses and $1.2 million in acquisition-related bank fees.

	Successor				Predecessor	
	Year Ended December 31,			Period from January 4, through December 31,	Period from January 1, through January 4,	Year Ended December 31,
	2009	2008	2007	2006	2006	2005
	(in thousands, except per share data)					
Statements of Operations Data:						
Revenue	$ 252,271	$ 209,380	$ 137,321	$ 91,298	$ 272	$ 48,402
Cost of revenue	33,427	28,676	20,687	12,541	203	8,242
Gross profit	218,844	180,704	116,634	78,757	69	40,160
Operating expenses:						
Sales and marketing	114,899	93,384	65,437	45,854	695	22,432
Research and development	26,239	18,387	12,893	8,117	41	2,819
Acquired in-process research and development				12,597		
General and administrative	57,174	39,577	29,786	16,590	142	8,157
Lease abandonment		1,831				
Transaction-related expenses					10,315	
Total operating expenses	198,312	153,179	108,116	83,158	11,193	33,408
Income (loss) from operations	20,532	27,525	8,518	(4,401)	(11,124)	6,752
Other income and expense:						
Interest income	159	454	673	613		38
Interest expense	(356)	(891)	(1,331)	(1,560)		
Other (expense) income	112	239	154	60	3	134
Interest and other income (expense), net	(85)	(198)	(504)	(887)	3	172
Income (loss) before income taxes	20,447	27,327	8,014	(5,288)	(11,121)	6,924

Income tax expense (benefit)	7,084	13,435	5,435	(1,240)		143
Net income (loss)	13,363	13,892	2,579	(4,048)	(11,121)	6,781
Preferred stock accretion			(80)	(159)		
Income (loss) attributable to common stockholders	$ 13,363	$ 13,892	$ 2,499	$ (4,207)	$ (11,121)	$ 6,781
Income (loss) per share attributable to common stockholders:						
Basic	$ 0.89	$ 7.29	$ 1.47	$ (2.63)	$ (37,194)	$ 24,658
Diluted	$ 0.67	$ 0.82	$ 0.15	$ (2.63)	$ (37,194)	$ 24,658
Common shares and equivalents outstanding:						
Basic weighted average shares	14,990	1,905	1,702	1,598	0.299	0.275
Diluted weighted average shares	19,930	16,924	16,533	1,598	0.299	0.275

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	Successor				Predecessor	
	Year Ended December 31,			Period from January 4, through December 31,	Period from January 1, through January 4,	Year Ended December 31,
	2009	2008	2007	2006	2006	2005
	(in thousands, except per share data)					
Other Data:						
Stock-based compensation included in:						
Cost of sales	$ 34	$ 2	$ 2	$ 1	$	$
Sales and marketing	999	153	189	59		
Research and development	5,959	482	360	128		
General and administrative	15,158	953	776	373		
Transaction-related expenses					5,930	
Total stock-based compensation expense	$ 22,150	$ 1,590	$ 1,327	$ 561	$ 5,930	$
Intangible amortization included in:						
Cost of sales	$	$ 13	$ 1,227	$ 1,213	$	$
Sales and marketing	42	3,003	3,596	4,113		
Total intangible amortization expense	$ 42	$ 3,016	$ 4,823	$ 5,326	$	$

	Sucessor Year Ended December 31,				Predecessor Year Ended December 31,
	2009	2008	2007	2006	2005
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 95,188	$ 30,626	$ 21,691	$ 16,917	$ 11,738
Total assets	225,442	138,818	110,376	96,754	25,620
Deferred revenue	26,106	15,744	12,939	8,105	6,231
Notes payable and capital lease obligation		9,910	13,324	15,917	63
Redeemable convertible preferred stock			5,000	4,920	
Total stockholders' equity	$ 156,435	$ 79,071	$ 58,125	$ 53,548	$ 8,985

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Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with our consolidated financial statements and notes thereto which appear elsewhere in this Annual Report on Form 10-K. Our actual results may differ materially from those currently anticipated and expressed in such forward-looking statements as a result of a number of factors, including those discussed under "Risk Factors" and elsewhere in this Annual Report on Form 10-K.

Overview

We are a leading provider of technology-based language learning solutions. We develop, market and sell language learning solutions consisting of software, online services and audio practice tools primarily under our *Rosetta Stone* brand. Our teaching method, which we call *Dynamic Immersion*, is designed to leverage the innate, natural language learning ability that children use to learn their native language. Our courses are based on our proprietary interactive technologies and pedagogical content and utilize a sophisticated sequencing of images, text and sounds to teach a new language without translation or grammar explanation. We believe our award-winning solutions provide an effective, convenient and fun way to learn languages. We currently offer our self-study language learning solutions in 31 languages. Our customers include individuals, educational institutions, armed forces, government agencies and corporations.

The strength and breadth of our solutions have allowed us to develop a business model that we believe distinguishes us from other language learning companies. Our scalable technology platform and our proprietary content can be deployed across many languages, which have enabled us to cost-effectively develop a broad product portfolio. We have a multi-channel marketing and distribution strategy that directly targets customers, utilizing print, online, television and radio advertising, public relations initiatives and our branded kiosks. Approximately 82% of our revenue for the year ended December 31, 2009 was generated through our direct sales channels, which include our call centers, websites, institutional sales force and kiosks. We also distribute our solutions through select retailers such as Amazon.com, Apple, Barnes & Noble, Borders and Office Depot.

We generate revenue primarily from sales of packaged software and audio practice products and online software subscriptions. Our continued growth depends, in part, on our ability to maintain strong brand recognition in order to generate sales from new customers. We continuously balance our need to achieve short-term financial goals with the equally critical need to invest in our products, our brand and our infrastructure to ensure our future success. In making decisions about spending levels in our various functional organizations, we consider many factors, including:

- our ability to expand our presence and penetration of existing markets;
- the extent to which we can sell new products and services to existing customers;
- our success in expanding our brand;
- the evolution of our product and service offerings; and
- our ability to expand our presence and reach geographically.

We believe the primary factors that affect our financial performance include the following:

- customer acceptance of our product and service offerings;
- continued product and service innovation;
- average revenue per customer;

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- direct marketing variables, including:
  - print, television and radio media discounts and rates;
  - the relevance of our advertising;
  - online pay-per-click and other online advertising rates;
  - internal and external call center conversion rates; and
  - website traffic and conversion rates;
- customer brand loyalty;
- the number and quality of our kiosk locations;
- our presence in international markets; and
- cross-channel management of consumer and institutional markets.

We believe that our multi-channel marketing and distribution models are fundamental to our success. Specifically, we focus on educating customers about the many benefits of our products and services by leveraging our advertising and kiosk network in order to drive website and call center traffic.

Components of Our Statement of Operations

Revenue

We derive revenue from sales of language learning solutions consisting of packaged software and audio practice products and online software subscriptions. Revenue is presented as product revenue or subscription and service revenue in our consolidated financial statements. Our audio practice products are normally combined with our packaged software products and sold as a solution.

Product revenue consists of revenue from sales of our packaged software and audio products. Subscription and service revenue consists primarily of revenue from our online software subscriptions. The content of our packaged software and subscription offerings are the same. We simply offer our customers the ability to choose which format they prefer without differentiating the learning experience. We intend to begin bundling time-based subscription licenses of our web-based TOTALe services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market during the third quarter of 2010 as part of our Rosetta Stone Version 4 TOTALe launch. As a result, we anticipate that we will be deferring approximately 20%-25% of each of these bundled sales. The deferred revenue will be recognized over the subscription term in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition.*

We sell our solutions directly to individuals, educational institutions, armed forces, government agencies and corporations. We distribute our consumer products predominantly through our direct sales channels, primarily our websites and call centers, which we refer to as our direct-to-consumer channel. We also distribute our consumer products through our kiosks, which we own, as well as through select retailers. The majority of our consumer customers purchase our packaged software and audio practice products. We sell to institutions primarily through our direct institutional sales force. Many institutions elect to license our products on a subscription basis. For purposes of explaining variances in our revenue, we separately discuss changes in our consumer and institutional sales channels because the customers and revenue drivers of these

channels are different. We anticipate that revenue growth in future periods will be less significant than we have experienced historically.

Our consumer revenue is affected by seasonal trends associated with the holiday shopping season. As a result, our fourth quarter ended December 31, 2009 accounted for 31% of our annual revenue in

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2009. Our institutional revenue is seasonally stronger in the second and third quarters of the calendar year due to education, home school and government purchasing cycles. We expect these trends to continue.

Cost of 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. Cost of subscription and service revenue primarily represents costs associated with supporting our online language learning service, which includes 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. We expect our cost of revenue to increase in absolute dollars in future periods as our unit sales continue to grow. We also expect cost of revenue will increase as a percentage of revenue in future periods with the planned launch of Rosetta Stone Version 4 TOTALe which includes services that have higher direct costs to deliver to customers than our existing software solutions.

Operating Expenses

We classify our operating expenses into three categories: sales and marketing, research and development and general and administrative.

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.

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, rental payments for our kiosks and commissions paid to our sales personnel. Sales and marketing expenses also include amortization expense of intangible assets related to customer relationships associated with the 2006 acquisition of Fairfield & Sons, Ltd. These intangible assets were fully amortized by January 2009. In 2007, we began to make significant investments to expand our sales and marketing operations in Europe and Japan. In 2009, we began to make significant investments to expand our sales and marketing operations in South Korea. In each case we established local sales offices and call centers, added employees and launched marketing and public relations campaigns within the region. We intend to continue to expand our sales activities within these regions as well as to expand our presence into new countries, including Germany, in addition to expanding our media and advertising campaigns in the United States. As a result, we expect sales and marketing expenses to increase in future periods.

Research and Development. Research and development expenses consist primarily of personnel costs and contract development fees associated with the development of our solutions. Our development efforts are primarily based in the United States and are devoted to expanding our product portfolio through the addition of new content and new complimentary products and services to our language learning solutions. We expect our investment in research and development expenses to increase in future years but provide us with significant benefits in the future.

General and Administrative. General and administrative expenses consist primarily of personnel costs of our executive, finance, legal, human resources and other administrative personnel, as well as accounting and legal professional services fees and other corporate expenses. We expect general and administrative expenses to increase in future periods as we expect to continue to invest in corporate

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infrastructure and incur additional expenses associated with being a public company, including increased legal and accounting costs, investor relations costs, independent director compensation, exchange listing fees and stockholder related fees, higher insurance premiums and compliance costs in connection with Section 404 of the Sarbanes-Oxley Act of 2002. We also intend to increase administrative expenses as a result of our planned international expansion.

Stock Compensation Charge. Included in the respective operating expense lines is an aggregate $18.8 million expense, consisting of $18.5 million in stock-based compensation expense and $0.3 million in payroll tax expense, related to common stock grants awarded to key employees equal to a total of 591,491 shares in April 2009. This grant was net of the number of shares required to be withheld to satisfy the federal, state and local tax withholding obligations. The aggregate grant date fair value of the awards was $18.5 million, which we recognized as stock-based compensation expense on the grant date, as the awards were immediately vested. We allocated this $18.8 million aggregate expense among the operating expense line items in accordance with the functions performed by the respective employees who received the grants.

Other Income (Expense)

Other income (expense) primarily consists of interest income and interest expense. Interest expense is related to our long-term debt, the outstanding balance of which was zero as of December 31, 2009. Interest income represents interest received on our cash and cash equivalents.

Income Tax Expense

Income tax expense consists of federal and state income taxes in the United States. For the year ended December 31, 2009, our worldwide effective tax rate was approximately 35%-38%. We expect our worldwide rate to be approximately 35% in 2010 and beyond assuming no general increase in U.S. federal or state income tax rates applicable to companies such as ours. However, we expect our income tax expense to increase in absolute dollars as our income continues to grow.

Critical Accounting Policies and Estimates

In presenting our financial statements in conformity with accounting principles generally accepted in the United States, or 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 critical accounting policies listed below 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 to understand and evaluate the consolidated financial statements contained in this annual report on Form 10-K.

Revenue Recognition

Revenue is primarily derived from the sale of packaged software and audio practice products, online software subscriptions and professional services. Our professional services include training, implementation services and dedicated conversational coaching associated with Rosetta Stone *TOTALe*,

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which was released in July 2009. Revenue is recognized for software products and related services in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition* ("ASC 985-605").

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 and determinable; and collectability is probable. Revenues from packaged software and audio practice products and online software subscriptions are recorded net of discounts.

Revenue is recognized from the sale of packaged software and audio practice products when the product has been delivered, assuming the remaining revenue recognition criteria have been met. Software products include sales to end user customers and resellers. In most cases, revenue from sales to resellers is not contingent upon resale of the software to the end user and is recorded in the same manner as all other product sales. Revenue from sales of packaged software products are recognized as the products are shipped and title passes. A limited amount of packaged software products are sold to resellers on a consignment basis. Revenue is recognized for these consignment transactions once the end-user sale has occurred, assuming the remaining revenue recognition criteria have been met. In accordance with Accounting Standards Codification subtopic 985-605-50, *Software: Revenue Recognition: Customer Payments and Incentives* ("ASC 985-605-50"), price protection for changes in the manufacturer suggested retail value granted to resellers for the inventory that they have on hand at the date the price protection is offered is recorded as a reduction to revenue. We offer 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 twelve months and a successful collection history has been established, revenue is recognized at the time of sale, assuming the remaining revenue recognition criteria have been met. For the years ended December 31, 2009, 2008 and 2007, installment sales represented 8%, 4% and 3% respectively. Packaged software is provided to customers who purchase directly from us with a six-month right of return. We also allow our retailers to return unsold products, subject to some limitations. In accordance with Accounting Standards Codification subtopic 985-605-15, *Software: Revenue Recognition: Products* ("ASC 985-605-15"), product revenue is reduced for estimated returns, which are based on historical return rates.

Revenue for software license agreements sold via online software subscriptions as hosting agreements are recognized in accordance with Accounting Standards Codification subtopic 985-605-05, *Software: Revenue Recognition: Background* ("ASC 985-605-05"). Revenue for online software subscriptions is recognized ratably over the term of the subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and twelve months. Some online licensing arrangements include a specified number of licenses that can be activated over a period of time, which typically ranges between twelve and twenty-four months. Revenue for these arrangements is recognized on a per license basis ratably over the term of the individual license subscription period, assuming all revenue recognition criteria have been met, which typically ranges between three and twelve months. Revenue for set-up fees related to online licensing arrangements is recognized ratably over the term of the online licensing arrangement, assuming all revenue recognition criteria have been met. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement and the subscription services are made available to the customer. In connection with packaged software product sales and online software subscriptions, technical support is provided to customers, including customers of resellers, at no additional charge. As the fee for technical support is included in the initial licensing fee, the technical support and services are generally provided within one year, the estimated cost of providing such support is deemed insignificant and no unspecified upgrades/enhancements are offered, technical support revenues are recognized together with the software product and license revenue. Costs associated with the technical support are accrued at the time of sale.

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Revenue from the sale of packaged software products with specific upgrade rights is recognized in accordance with ASC 985-605. Revenue recognition for these sales is deferred until the earlier of the point at which sufficient vendor-specific objective evidence ("VSOE") exist for the specific upgrade right or all elements of the arrangement have been delivered.

In accordance with ASC 985-605-50, cash sales incentives to resellers are accounted for as a reduction of revenue, unless a specific identified benefit is identified and the fair value is reasonably determinable.

We have been engaged to develop language learning software for certain endangered languages under fixed fee arrangements. These arrangements also include contractual periods of post-contract support ("PCS") and online hosting services ranging from one to ten years. Revenue for multi-element contracts will be recognized ratably once the PCS and online hosting periods begin, over the longer of the PCS or online hosting period. When the current estimates of total contract revenue and contract cost indicate a loss for a fixed fee arrangement, a provision for the entire loss on the contract is recorded.

Stock-Based Compensation

We account for stock-based compensation in accordance with Accounting Standards Codification topic 718, *Compensation Stock Compensation* ("ASC 718"), which was adopted by us effective January 1, 2006. Under ASC 718, all stock-based awards, including employee stock option grants, are recorded at fair value as of the grant date and recognized as expense in the statement of operations on a straight-line basis over the requisite service period, which is the vesting period.

As of December 31, 2009 and 2008, there were approximately $5.3 million and $4.4 million of unrecognized stock-based compensation expense related to non-vested stock option awards that is expected to be recognized over a weighted average period of 2.49 and 2.21 years, respectively.

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

	Years Ended December 31,		
	2009	**2008**	**2007**
Included in cost of revenue:			
Cost of product revenue	$ 34	$ 2	$ 2
Cost of subscription and service revenue			
Total included in cost of revenue	34	2	2
Included in operating expenses:			
Sales and marketing	999	153	189
Research and development	5,959	482	360
General and administrative	15,158	953	776
Total included in operating expenses	22,116	1,588	1,325
Total	$ 22,150	$ 1,590	$ 1,327

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

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The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model as follows:

	Year Ended December 31,		
	2009	2008	2007
Expected stock price volatility	61%	57%-62%	62%-70%
Expected term of options	6 years	6 years	6 years
Expected dividend yield			
Risk-free interest rate	1.71%-2.46%	2.08%-3.36%	3.50%-4.96%

Prior to the completion of our initial public offering in April 2009, our stock was not publicly quoted and we had a limited history of stock option activity, so we reviewed a group of comparable industry-related companies to estimate our expected volatility over the most recent period commensurate with the estimated expected term of the awards. In addition to analyzing data from the peer group, we also considered the contractual option term and vesting period when determining the expected option life and forfeiture rate. Subsequent to the initial public offering, we continue to review a group of comparable industry-related companies to estimate volatility, but also review the volatility of our own stock since the initial public offering. We consider the volatility of the comparable companies to be the best estimate of future volatility. For the risk-free interest rate, we use a U.S. Treasury Bond rate consistent with the estimated expected term of the option award.

The following table sets forth all stock option grants since the date of plan inception, through the date of this Annual Report on Form 10-K:

Grant Date	Number of Options Granted	Exercise Price	Common Stock Fair Value Per Share at Grant Date
May 22, 2006	1,366,456	$ 3.85	$ 4.57
August 16, 2006	29,861	3.85	5.10
August 21, 2006	149,500	3.85	5.14
September 5, 2006	130,000	3.85	5.25
December 8, 2006	29,133	3.85	5.92
February 2, 2007(1)	20,423	3.85	6.35
March 21, 2007	221,559	6.08	6.73
April 20, 2007(1)	31,330	6.08	6.98
June 5, 2007	59,800	7.31	7.31
August 3, 2007(1)	18,824	7.31	9.60
August 22, 2007	27,911	10.60	10.60
November 28, 2007	34,229	11.19	11.19
December 17, 2007(1)	22,178	10.60	11.30
February 8, 2008(1)	57,447	11.19	11.64
April 29, 2008(1)	99,346	11.64	10.36
May 28, 2008	110,916	10.36	10.36
August 19, 2008	36,075	14.22	14.22
November 19, 2008	99,021	17.49	17.49
April 15, 2009	441,911	18.00	18.00
May 28, 2009	15,000	22.30	22.30
August 19, 2009	1,974	20.35	20.35
November 18, 2009	12,445	16.74	16.74
December 7, 2009	1,259	18.05	18.05

(1) The exercise price for these stock options was established at the fair value of our common stock on the date of grant approval by the board of directors. However, in accordance with ASC 718, because all of the key terms of the stock option grants were not communicated to employees on a timely

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basis, we established the option grant date, the interpolated common stock fair value and stock option fair value as of the date on which all key option terms were communicated to the employees, which is the date reflected above.

Stock-based Compensation Expense in Connection with Executive Stock Grants and IPO Option and Restricted Stock Grants

We made stock grants, restricted stock grants and stock option grants to our employees on April 15, 2009. In connection with these grants, we recorded an aggregate expense of approximately $18.5 million in the second quarter of 2009, and an additional $6.3 million that will be recorded over the four-year vesting period of the stock options and restricted stock grants.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due to us from our normal business activities. We provide an allowance for doubtful accounts to reflect the expected non-collection of accounts receivable based on past collection history and specific risks identified.

Intangible Assets

Intangible assets consist of acquired technology, including developed and core technology, customer related assets, trade name and trademark and other intangible assets. Those intangible assets with finite lives are recorded at cost and amortized on a straight line basis over their expected lives in accordance with Accounting Standards Codification topic 350, *Goodwill and Other Intangible Assets* ("ASC 350"). On an annual basis, we review our indefinite lived intangible assets for impairment based on the fair value of indefinite lived intangible assets as compared to the carrying value in accordance with ASC 350. In the event the carrying value exceeds the fair value of the assets, the assets are written down to their fair value. There has been no impairment of intangible assets during any of the periods presented.

Goodwill

In accordance with ASC 350, goodwill is not amortized and is tested for impairment annually on June 30th and whenever events and circumstances occur indicating goodwill might be impaired. The first step is a screen for potential impairment by comparing the fair value of our one reporting unit with its carrying amount. The second step measures the amount of impairment loss, if any. As of June 30, 2009 and 2008, we reviewed the goodwill for impairment and determined that no impairment of goodwill was identified during any of the periods presented, nor is the reporting unit at risk of failing step one of the goodwill impairment test.

Valuation of Long-Lived Assets

In accordance with Accounting Standards Codification topic 360, *Accounting for the Impairment or Disposal of Long-lived Assets* ("ASC 360"), we evaluate the recoverability of our long-lived assets. ASC 360 requires recognition of impairment of long-lived assets in the event that the net book value of such assets exceeds the future undiscounted net cash flows attributable to such assets. Impairment, if any, is recognized in the period of identification to the extent the carrying amount of an asset exceeds the fair value of such asset. Based on our analysis, we believe that no impairment of our long-lived assets was indicated as of December 31, 2009 and 2008.

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Income Taxes

For the years ended December 31, 2009, 2008 and 2007, we accounted for income taxes in accordance with Accounting Standards Codification 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 bases of assets and liabilities. Under this method, deferred tax assets are recognized for deductible temporary differences, and operating loss and tax credit carryforwards. Deferred tax 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.

In June 2006, the Financial Accounting Standards Board ("FASB") issued certain provisions in the Accounting Standards Codification topic 740-10-25, *Income Taxes: Overall: Recognition,* ("ASC 740-10-25"), which clarify the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with ASC 740 and prescribe 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. These provisions also provide guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosures, and transition. We adopted these recognition provisions of ASC 740-10-25 effective January 1, 2007. The adoption of ASC 740-10-25 did not have a material impact on our financial condition, results of operations or cash flows.

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Results of Operations

The following table sets forth our consolidated statement of operations for the periods indicated.

	Year Ended December 31,		
	2009	2008	2007
	(in thousands, except per share data)		
Statements of Operations Data:			
Revenue	$ 252,271	$ 209,380	$ 137,321
Cost of revenue	33,427	28,676	20,687
Gross profit	218,844	180,704	116,634
Operating expenses:			
Sales and marketing	114,899	93,384	65,437
Research and development	26,239	18,387	12,893
General and administrative	57,174	39,577	29,786
Lease abandonment		1,831	
Total operating expenses	198,312	153,179	108,116
Income from operations	20,532	27,525	8,518
Other income and expense:			
Interest income	159	454	673
Interest expense	(356)	(891)	(1,331)
Other (expense) income	112	239	154
Interest and other income (expense), net	(85)	(198)	(504)
Income before income taxes	20,447	27,327	8,014
Income tax expense (benefit)	7,084	13,435	5,435
Net income	13,363	13,892	2,579
Preferred stock accretion			(80)
Income attributable to common stockholders	$ 13,363	$ 13,892	$ 2,499
Income per share attributable to common stockholders:			
Basic	$ 0.89	$ 7.29	$ 1.47
Diluted	$ 0.67	$ 0.82	$ 0.15
Common shares and equivalents outstanding:			
Basic weighted average shares	14,990	1,905	1,702
Diluted weighted average shares	19,930	16,924	16,533
Stock-based compensation included in:			
Cost of sales	$ 34	$ 2	$ 2
Sales and marketing	999	153	189

Research and development	5,959	482	360
General and administrative	15,158	953	776
Transaction-related expenses			
	$ 22,150	$ 1,590	$ 1,327
Intangible amortization included in:			
Cost of sales	$	$ 13	$ 1,227
Sales and marketing	42	3,003	3,596
	$ 42	$ 3,016	$ 4,823

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Comparison of the Year Ended December 31, 2009 and the Year Ended December 31, 2008

	Year Ended December 31,					
	2009		2008		Change	% Change
	(dollars in thousands)					
Product revenue	$ 218,549	86.6%	$ 184,182	88.0%	$ 34,367	18.7%
Subscription and service revenue	33,722	13.4%	25,198	12.0%	$ 8,524	33.8%
Total revenue	$ 252,271	100.0%	$ 209,380	100.0%	$ 42,891	20.5%
Revenue by sales channel:						
Direct-to-consumer	$ 114,002	45.2%	$ 96,702	46.2%	$ 17,300	17.9%
Kiosk	40,418	16.0%	36,314	17.3%	$ 4,104	11.3%
Retail	44,850	17.8%	34,638	16.5%	$ 10,212	29.5%
Total consumer	199,270	79.0%	167,654	80.1%	31,616	18.9%
Institutional	53,001	21.0%	41,726	19.9%	$ 11,275	27.0%
Total revenue	$ 252,271	100.0%	$ 209,380	100.0%	$ 42,891	20.5%

Revenue

Total revenue for the year ended December 31, 2009 was $252.3 million, an increase of $42.9 million, or 21%, from the year ended December 31, 2008.

Consumer

Consumer revenue was $199.3 million for the year ended December 31, 2009 an increase of $31.6 million, or 19%, from the year ended December 31, 2008. The increase in consumer revenue was attributable to a 14% increase in unit sales, which resulted in a $23.8 million increase in revenue, combined with a 4% increase in the average selling price of each unit, which accounted for a $7.8 million increase in revenue. Unit growth was driven by the planned expansion of our direct marketing programs, as well as growth in our retail distribution network. Direct advertising expenses increased 25% to $42.4 million during the year ended December 31, 2009, while the number of kiosks increased from 150 to 242 from December 31, 2008 to December 31, 2009. Our 2008 revenue includes a $2.6 million initial stocking order we received from Barnes & Noble in June 2008 to support their expansion of our product line to over 650 of their stores nationally. We did not have any such large initial stocking orders in 2009.

Product revenue represented 96% of total consumer revenue for the year ended December 31, 2009, with the balance attributable to subscription and service revenue. We intend to begin bundling time-based subscription licenses of our web-based TOTALe services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market during the third quarter of 2010 with the planned launch of Rosetta Stone Version 4 TOTALe. As a result, we will be deferring approximately 20% - 25% of each of these bundled sales. We will recognize the deferred revenue over the term of the subscription license in accordance with Accounting Standards Codification subtopic 985-605, *Software: Revenue Recognition.*

Institutional

Institutional revenue was $53.0 million for the year ended December 31, 2009, an increase of $11.3 million, or 27%, compared to the year ended December 31, 2008. The increase in institutional revenue was primarily due to the expansion of our direct sales force. As a result, we had a $4.8 million increase in education revenue, a $3.9 million increase in government revenue and a $2.0 million increase in corporate revenue.

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Product revenue represented 52% of total institutional revenue for the year ended December 31, 2009, and subscription and service revenue represented 48% for the same period.

Cost of Revenue and Gross Profit

	Year Ended December 31,			
	2009	2008	Change	% Change
	(dollars in thousands)			
Revenue:				
Product	$ 218,549	$ 184,182	$ 34,367	18.7%
Subscription and service	33,722	25,198	$ 8,524	33.8%
Total revenue	$ 252,271	$ 209,380	$ 42,891	20.5%
Cost of revenue:				
Cost of product revenue	$ 30,264	$ 26,539	$ 3,725	14.0%
Cost of subscription and service revenue	3,163	2,137	$ 1,026	48.0%
Total cost of revenue	33,427	28,676	4,751	16.6%
Gross profit	$ 218,844	$ 180,704	$ 38,140	
Gross margin percentages	86.7%	86.3%	0.4%	

Cost of revenue for the year ended December 31, 2009 was $33.4 million, an increase of $4.8 million, or 17%, from the year ended December 31, 2008. As a percentage of total revenue, cost of revenue decreased to 13% for the year ended December 31, 2009 compared to 14% for the year ended December 31, 2008. The dollar increase in cost of revenue was primarily attributable to expansion of our product offering combined with a change in our sales mix, offset in part by a reduction in affiliate commissions and the absence in the 2009 period of intangible amortization related to core technology associated with the acquisition of Fairfield & Sons, Ltd., which was fully amortized in 2008. Cost of subscription and service revenue increased by $1.0 million or 48% as we released *Rosetta Stone TOTALe*, our new web-based service offering that includes a component of dedicated language conversation coaching. We expect our cost of revenue will increase as a percent of revenue as we begin bundling time-based subscription licenses of our web-based TOTALe services with perpetual licenses of our Rosetta Stone Version 3 language learning solutions in the U.S. consumer market with the planned launch of Rosetta Stone Version 4 during the third quarter of 2010.

Operating Expenses

	Year Ended December 31,			
	2009	2008	Change	% Change
	(dollars in thousands)			
Sales and marketing	$ 114,899	$ 93,384	$ 21,515	23.0%
Research and development	26,239	18,387	7,852	42.7%
General and administrative	57,174	39,577	17,597	44.5%
Lease abandonment		1,831	(1,831)	(100.0)%
Total operating expenses	$ 198,312	$ 153,179	$ 45,133	29.5%

Sales and Marketing Expenses

Sales and marketing expenses for the year ended December 31, 2009 were $114.9 million, an increase of $21.5 million, or 23%, from the year ended December 31, 2008. As a percentage of total

revenue, sales and marketing expenses were 46% for the year ended December 31, 2009, compared to 45% for the year ended December 31, 2008. The dollar and percentage increase in sales and marketing expenses were primarily attributable to the continued expansion of our direct marketing activities. Advertising expenses grew by $8.6 million and were primarily related to television and radio media and internet marketing. We also expanded the number of our kiosks from 150 as of December 31, 2008 to 242 as of December 31, 2009, which resulted in $6.2 million of additional kiosk operating expenses, including rent and sales compensation related expenses. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities also increased by $6.4 million. The stock compensation charge related to a common stock grant to key employees in connection with our initial public offering resulted in a $0.4 million increase in sales and marketing expense in 2009 compared to the prior year period. Completion in January 2009 of the amortization of the intangible assets associated with the 2006 acquisition of Fairfield & Sons, Ltd. resulted in a $3.0 million reduction in amortization expense in 2009 when compared to the prior year period.

Sales and marketing expenses without consideration of the stock compensation charge associated with the common stock grant to key employees in connection with our initial public offering would have been $114.5 million, an increase of $21.1 million or 23% from the prior year. As a percentage of revenue, sales and marketing expenses would have remained the same at 45% for the year ended December 31, 2009 compared to the prior year period.

Research and Development Expenses

Research and development expenses were $26.2 million for the year ended December 31 2009, an increase of $7.9 million, or 43%, from the year ended December 31, 2008. As a percentage of total revenue, research and development expenses increased to 10% for the year ended December 31, 2009 compared to 9% for the year ended December 31, 2008. The dollar and percentage increase were primarily attributable to a stock compensation charge related to common stock awarded to key employees which resulted in a $5.0 million increase in research and development expense in 2009 when compared to the prior year period. In addition, research and development expenses increased $3.0 million due to the addition of new product development personnel associated with the development of new products and services that are complementary to our existing solutions.

Research and development expenses without consideration of the stock compensation charge associated with the common stock grant to key employees in connection with our initial public offering would have been $21.2 million, an increase of $2.9 million or 16% from the prior year. As a percentage of revenue, research and development expenses would have decreased to 8% for the year ended December 31, 2009 from 9% for the prior year period.

General and Administrative Expenses

General and administrative expenses for the year ended December 31, 2009 were $57.2 million, an increase of $17.6 million, or 45%, from the year ended December 31, 2008. As a percentage of revenue, general and administrative expenses increased to 23% for the year ended December 31, 2009 compared to 19% for the year ended December 31, 2008. The dollar and percentage increase was primarily attributable to a stock compensation charge related to common stock awarded to key employees in connection with our initial public offering resulting in a $13.4 million increase in general and administrative expense. In addition, general and administrative expenses increased due to greater personnel related costs as we expanded our finance, legal, information technology and other administrative functions to support the overall growth in our business. Personnel-related costs increased $4.2 million with a corresponding increase in communications, training, recruitment, travel and other support costs of $0.6 million and new office space and equipment depreciation costs of $0.9 million. Legal fees also increased $0.4 million related to intellectual property protection matters, and liability insurances for directors and officers increased $0.3 million. This increase was partially offset by

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decreased professional service expenses of $1.5 million as we replaced contract staff with employees and a decrease in bad debt expense $0.7 million during the year ended December 31, 2009 as a result of improved collection efforts.

General and administrative expenses without consideration of the stock compensation charge associated with the common stock grant to key employees in connection with our initial public offering would have been $43.8 million, an increase of $4.2 million or 11% from the prior year. As a percentage of revenue, general and administrative expenses would have decreased to 17% for the year ended December 31, 2009 from 19% for the prior year period.

Stock-Based Compensation Charge

Included in each of the respective operating expense lines for the year ended December 31, 2009 is a portion of the $18.8 million charge related to the total of 591,491 shares of common stock awarded to 10 of our key employees in April 2009. The following table presents the stock-based compensation charge by operating expense line item:

	Year Ended December 31,			
	2009	2008	Change	% Change
	(dollars in thousands)			
Sales and marketing	$ 377	$	$ 377	100%
Research and development	5,033		$ 5,033	100%
General and administrative	13,393		13,393	100%
Total	$ 18,803	$	$ 18,803	100%

Lease Abandonment Expenses

We incurred no lease abandonment expense for the year ended December 31, 2009; however, with respect to the year ended December 31, 2008, we incurred lease abandonment expense associated with the relocation of our headquarters of $1.8 million consisting of accrued exit costs and liabilities under operating lease agreements.

Interest and Other Income (Expense)

	Year Ended December 31,			
	2009	2008	Change	% Change
	(dollars in thousands)			
Interest income	$ 159	$ 454	$ (295)	(65.0)%
Interest expense	(356)	(891)	$ 535	(60.0)%
Other income	112	239	$ (127)	(53.1)%
Total	$ (85)	$ (198)	$ 113	(57.1)%

Interest income represents interest earned on our cash and cash equivalents. Interest income for the year ended December 31, 2009 was $0.2 million, a decrease of $0.3 million, or 65%, from the year ended December 31, 2008. Interest expense is primarily related to our long-term debt, the outstanding balance of which was zero as of December 31, 2009. Interest expense for the year ended December 31, 2009 was $0.4 million, a decrease of $0.5 million, or 60% from the year ended December 31, 2008. The decrease was primarily due to the retirement of our previous Madison Capital term loan. Other Income for the year ended December 31, 2009 was $0.1 million, a decrease of $0.1 million, or 53% and is primarily due to foreign currency fluctuations.

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Income Tax Expense

	Year Ended December 31,			
	2009	2008	Change	% Change
	(dollars in thousands)			
Income tax expense	$ 7,084	$ 13,435	$ (6,351)	(47.3)%

Income tax expense for the year ended December 31, 2009 was $7.1 million, a decrease of $6.4 million, or 47%, compared to the year ended December 31, 2008. The decrease was the result of a decrease of $6.9 million in pre-tax income for the year ended December 31, 2009 and a lower effective tax rate, compared to the year ended December 31, 2008. Our effective tax rate decreased to 35% for the year ended December 31, 2009 compared to 49% for the year ended December 31, 2008. The reduction in our effective tax rate was a result of changes in the geographic distribution of our income and a change in our transfer pricing agreements.

We determine the pricing among our associated entities on the basis of detailed functional and economic analysis involving benchmarking against transactions among entities that are not under common control. Based on our analysis, we made changes to the transfer pricing agreements effective January 1, 2009. The resulting change in geographic distributions of income contributed to a lower effective tax rate as compared to the year ended December 31, 2008.

We do not currently record income tax on the results of our U.K., Japan or German subsidiaries. Despite enacting certain tax planning strategies during the year ended December 31, 2009, no subsidiary has produced sustainable pretax profits as of December 31, 2009 and each remains in a three-year cumulative loss position. Accordingly we continue to carry a full valuation allowance on net operating loss carryforwards and other deferred tax assets for these jurisdictions. As we continue operations in accordance with the revised transfer pricing agreements, we will monitor actual results and updated projections on a quarterly basis. When and if the subsidiaries realize or realistically anticipate sustainable profitability, we will assess the appropriateness of releasing the valuation allowance in whole or in part.

Comparison of the Year Ended December 31, 2008 and the Year Ended December 31, 2007

	Year Ended December 31,					
	2008		2007		Change	% Change
	(dollars in thousands)					
Product revenue	$ 184,182	88.0%	$ 119,897	87.3%	$ 64,285	53.6%
Subscription and service revenue	25,198	12.0%	17,424	12.7%	$ 7,774	44.6%
Total revenue	$ 209,380	100.0%	$ 137,321	100.0%	$ 72,059	52.5%
Revenue by sales channel:						
Direct-to-consumer	$ 96,702	46.2%	$ 61,950	45.1%	$ 34,752	56.1%
Kiosk	36,314	17.3%	23,947	17.4%	$ 12,367	51.6%
Retail	34,638	16.5%	21,206	15.4%	$ 13,432	63.3%
Total consumer	167,654	80.1%	107,103	78.0%	60,551	56.5%
Institutional	41,726	19.9%	30,218	22.0%	$ 11,508	38.1%
Total revenue	$ 209,380	100.0%	$ 137,321	100.0%	$ 72,059	52.5%

Revenue

Total revenue for the year ended December 31, 2008 was $209.4 million, an increase of $72.1 million, or 53%, from the year ended December 31, 2007.

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Consumer

Consumer revenue was $167.7 million for the year ended December 31, 2008, an increase of $60.6 million, or 57%, from the year ended December 31, 2007. The increase in consumer revenue was attributable to a 22% increase in unit sales, which resulted in a $23.7 million increase in revenue, combined with a 28% increase in the average selling price of each unit, which accounted for a $36.9 million increase in revenue. Unit growth was driven by the expansion of our direct advertising campaign as well as growth in our retail distribution network. Direct advertising expenses increased 38% to $33.9 million during the year ended December 31, 2008, while the number of kiosks increased from 86 to 150 from December 31, 2007 to December 31, 2008. We also received a $2.6 million initial stocking order from Barnes & Noble in June 2008 to support their expansion of our product line to over 650 of their stores nationally.

In August 2007, we released our Version 3 solution for ten of our best selling languages. All Version 3 solutions include three course levels, while our Version 2 solutions only include one or two course levels. Upon the release of a language in Version 3, we discontinue selling that language in Version 2 and, as a result, sales of Version 3 products replace sales of Version 2 products for that language. Our solutions are often purchased in sets including all available course levels for a language. The additional levels included in Version 3 enabled us to offer additional languages with three course levels, resulting in a greater number of available products at our highest price point for a complete set. In March 2008, we released Version 3 in four additional languages and, in June 2008, we released seven additional Version 3 languages. Also in June 2008, we released our *Audio Companion* practice tool product for all 14 then-available Version 3 languages. In September 2008, we released Version 3 and our *Audio Companion* in seven additional languages. This expansion of our product portfolio with higher price point options has resulted in the 28% increase in average selling price per unit for the year ended December 31, 2008.

Product revenue represented 94% of total consumer revenue for the year ended December 31, 2008, with the balance attributable to subscription and service revenue.

Institutional

Institutional revenue was $41.7 million for the year ended December 31, 2008, an increase of $11.5 million, or 38%, compared to the year ended December 31, 2007. The increase in institutional revenue was primarily due to the expansion of our direct sales force. As a result, we had a $9.4 million increase in education and home school revenue and a $1.6 million increase in corporate revenue.

Product revenue represented 65% of total institutional revenue for the year ended December 31, 2008, and subscription and service revenue represented 35% for the same period.

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Cost of Revenue and Gross Profit

	Year Ended December 31,			
	2008	2007	Change	% Change
	(dollars in thousands)			
Revenue:				
Product	$ 184,182	$ 119,897	$ 64,285	53.6%
Subscription and service	25,198	17,424	$ 7,774	44.6%
Total revenue	$ 209,380	$ 137,321	$ 72,059	52.5%
Cost of revenue:				
Cost of product revenue	$ 26,539	$ 19,055	$ 7,484	39.3%
Cost of subscription and service revenue	2,137	1,632	$ 505	30.9%
Total cost of revenue	28,676	20,687	7,989	38.6%
Gross profit	$ 180,704	$ 116,634	$ 64,070	
Gross margin percentages	86.3%	84.9%	1.4%	

Cost of revenue for the year ended December 31, 2008 was $28.7 million, an increase of $8.0 million, or 39%, from the year ended December 31, 2007. As a percentage of total revenue, cost of revenue was 14% for the year ended December 31, 2008 compared to 15% for the year ended December 31, 2007. The dollar increase in cost of revenue was attributable to growth in unit sales. The increase in gross margin percentage was due to a $0.9 million write down of inventory in the 2007 period associated with the transition from Version 2 to Version 3 product and packaging.

Operating Expenses

	Year Ended December 31,			
	2008	2007	Change	% Change
	(dollars in thousands)			
Sales and marketing	$ 93,384	$ 65,437	$ 27,947	42.7%
Research and development	18,387	12,893	$ 5,494	42.6%
General and administrative	39,577	29,786	$ 9,791	32.9%
Lease abandonment	1,831		$ 1,831	100.0%
Total operating expenses	$ 153,179	$ 108,116	$ 45,063	41.7%

Sales and Marketing Expenses

Sales and marketing expenses for the year ended December 31, 2008 were $93.4 million, an increase of $27.9 million, or 43%, from the year ended December 31, 2007. As a percentage of total revenue, sales and marketing expenses were 45% for the year ended December 31, 2008, compared to 48% for the year ended December 31, 2007. The dollar increase in sales and marketing expenses was primarily attributable to the continued expansion of our direct marketing activities. Advertising expenses grew by $9.3 million and were primarily related to the purchase of additional television media. We also expanded the number of our kiosks from 86 as of December 31, 2007 to 150 as of December 31, 2008, which resulted in $7.9 million of additional kiosk operating expenses, including sales compensation related expenses. Personnel costs related to growth in our institutional sales channel and marketing and sales support activities also increased by $7.7 million.

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Research and Development Expenses

Research and development expenses were $18.4 million for the year ended December 31, 2008, an increase of $5.5 million, or 43%, from the year ended December 31, 2007. As a percentage of total revenue, research and development expenses were 9% for the years ended December 31, 2008 and 2007. The dollar increase was primarily attributable to additional personnel and contract development costs associated with the transition of Version 2 languages to Version 3, as well as the development of new products and services that are complementary to our existing solutions.

General and Administrative Expenses

General and administrative expenses for the year ended December 31, 2008 were $39.6 million, an increase of $9.8 million, or 33%, from the year ended December 31, 2007. As a percentage of revenue, general and administrative expenses decreased to 19% for the year ended December 31, 2008 compared to 22% for the year ended December 31, 2007. The dollar increase was primarily attributable to a $4.3 million increase in personnel-related costs as we expanded our finance, information technology and other administrative functions to support the overall growth in our business, and a corresponding increase in communications, travel and other support costs of $4.4 million. Depreciation expense also increased $0.9 million and bad debt expense increased $0.8 million during the year ended December 31, 2008 as a result of greater capital expenditures and credit sales. We also incurred an additional $1.0 million in legal fees related to intellectual property protection matters. This increase was partially offset by decreased professional service expenses of $0.2 million as we replaced contract staff with employees.

Lease Abandonment Expenses

Lease abandonment expense associated with the relocation of our headquarters was $1.8 million for the year ended December 31, 2008, consisting of accrued exit costs and liabilities under operating lease agreements.

Interest and Other Income (Expense)

	Year Ended December 31,			
	2008	**2007**	**Change**	**% Change**
		(dollars in thousands)		
Interest income	$ 454	$ 673	$ (219)	(32.5)%
Interest expense	(891)	(1,331)	$ 440	(33.1)%
Other income	239	154	$ 85	55.2%
Total	$ (198)	$ (504)	$ 306	(60.7)%

Interest expense for the year ended December 31, 2008 was $0.9 million, a decrease of $0.4 million, or 33%, from the year ended December 31, 2007. The decrease was due to a reduction in the outstanding balance of our long-term debt as a result of $3.4 million in principal payments during the period

Income Tax Expense

	Year Ended December 31,			
	2008	**2007**	**Change**	**% Change**
		(dollars in thousands)		
Income tax expense	$ 13,435	$ 5,435	$ 8,000	147.2%

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Income tax expense for the year ended December 31, 2008 was $13.4 million, an increase of $8.0 million, or 147%, compared to the year ended December 31, 2007. The increase was the result of an increase of $19.3 million in pre-tax income for the year ended December 31, 2008, compared to the year ended December 31, 2007. Our effective tax rate decreased to 49.2% for the year ended December 31, 2008 compared to 67.8% for the year ended December 31, 2007 as a result of a decline in the percentage of foreign losses relative to total consolidated income before tax. We do not currently recognize income tax benefits on losses in our foreign subsidiaries.

Liquidity and Capital Resources

Our primary operating cash requirements include the payment of salaries, incentive compensation, employee benefits and other personnel-related costs, as well as direct advertising expenses, costs of office facilities and costs of information technology systems.

Since our inception, we have financed our operations solely through cash flow from operations with the exception of the acquisition of Fairfield & Sons, Ltd., which was funded in part through the sale of preferred and common stock